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Work Incentives and Universal Credit: Reform of the Benefit System in the United Kingdom

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WORK INCENTIVES AND UNIVERSAL CREDIT - REFORM OF THE BENEFIT SYSTEM IN THE UNITED KINGDOM

ECONOMICS DEPARTMENT WORKING PAPERS No. 1033

by Jon Kristian Pareliussen

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ABSTRACT/RÉSUMÉ

Work incentives and Universal Credit – reform of the benefit system in the United Kingdom

Under the Universal Credit reform, the main means-tested benefits except the Council Tax Benefit will be pooled into one single benefit with one single taper rate. The reform will give people better incentives to work, reduce complexity and contribute to reducing poverty. The reform could reduce the number of workless households by between 45 000 and 240 000 and increase labour supply by the equivalent of 15 000-85 000 full-time employees. Increased take-up and increased entitlements for low income families will further reduce poverty and increase equality. However, the cost of childcare remains high even after taking childcare benefits into account. Despite significant improvements, childcare expenses will continue to be a hurdle to progress in work for second earners and lone parents, even after the Universal Credit reform.

JEL classification: D31; H31; H55; I38.

Key words: Welfare reform; Universal Credit; Work incentives; Childcare; Second earners; Lone parents; Poverty; Inequality; Benefit system; United Kingdom.

This working paper relates to the 2013 *OECD Economic Survey of the United Kingdom*. (www.oecd.org/eco/surveys/United Kingdom).

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Incitations à travailler et « Crédit Universel » - réforme du système de prestations sociales au Royaume-Uni

Dans le cadre de la réforme «Crédit Universel», les principales prestations sociales sous conditions de ressources, à l'exception de la prestation liée aux impôts locaux (Council Tax Benefit) seront regroupées en une prestation unique avec un taux de réduction unique. La réforme fournira de meilleures incitations à travailler, réduira la complexité et contribuera à réduire la pauvreté. La réforme pourrait réduire le nombre de ménages sans emploi de 45 000 à 240 000 et augmenter l'offre de travail de l'équivalent de 15 000 à 85 000 employés à temps plein. Une augmentation du recours aux prestations et l'augmentation des droits pour les familles à faible revenu va davantage réduire la pauvreté et accroître l'égalité. Cependant, le coût de la garde d'enfants reste élevé, même après prise en compte des prestations liées à la garde d'enfants. Malgré des améliorations notables, les frais de garde d'enfants resteront un obstacle à l'évolution professionnelle des seconds apporteurs de revenu et des parents isolés, même après la réforme « Crédit Universel ».

Classification JEL : D31; H31; H55; I38.

Mots clefs: Réforme de la protection sociale; Crédit Universel ; Prestation universelle; Incitations à travailler; Garde d'enfants; Seconds apporteurs de revenu; Parents isolés; Pauvreté; Inégalités; Système de prestations sociales; Royaume-Uni.

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WORK INCENTIVES AND UNIVERSAL CREDIT – REFORM OF THE BENEFIT SYSTEM IN THE UNITED KINGDOM

By Jon Kristian Pareliussen[1]

Summary and conclusions

The Welfare Reform Act of 2012 introduces a wide range of reforms to the benefits and tax credits system in the United Kingdom. Under the Universal Credit reform, the main means-tested benefits except the Council Tax Benefit will be pooled into one single benefit with one single taper rate. Stated goals of the Universal Credit reform include giving people incentives to work, diminishing complexity, reducing poverty and containing a trend of rising welfare costs.

The Universal Credit reform represents a radical overhaul of the incentive structure compared to the existing system, and is in many ways a big leap into uncharted territory. It is therefore impossible to say with certainty to which degree the Universal Credit will contribute to less welfare dependency and hence lower cost of the welfare system in the future. This depends on how the changes in incentives will be followed by behavioural change. The Department for Work and Pensions (DWP) assumes that the net effect on labour supply will reduce the number of workless households by 300 000 (DWP 2010). This paper shows that the effect could be a reduction of the number of workless households by between 45 000 and 240 000, with an increase in labour supply equivalent to 15 000-85 000 full-time employees. Although such analyses rest on a number of assumptions, the conclusion that more people will be working as a result of the reform seems robust. The combined impact of take-up and increased entitlements for low income families should have a further positive impact in reducing poverty and increasing equality. In its 2011 impact assessment, DWP estimates that these aspects of the reform will lift around 900 000 individuals out of poverty, including 350 000 children. This improvement will, however, most likely be more than offset by previous changes to the benefit system (IFS, 2012).

The benefits affected by the Universal Credit reform in the current system amount to approximately 6.2% of GDP. £2 billion (0.1% of GDP) has been set aside to cover the transition cost of the reform. The fiscal cost of increased entitlements and take-up is expected to be £4 billion, which will be partly offset by £2 billion in reduced costs of fraud and error (DWP, 2012). In the long run DWP also expects £0.5 billion a year in administrative savings. These estimates neither take into account the increased incentives to work nor the effects of increased simplicity and a reinforced conditionality regime. There is a strong case that the Universal Credit will give better incentives to work than the current system. Universal Credit also represents an indisputable simplification of the benefit system.

Primary earners in couples will see both better incentives and higher income after the reform. Many lone parents will face better work incentives and higher income. Second earners will have higher household incomes after the reform, while the effect on incentives is ambiguous. For single persons and lone parents, the effect of the reform is ambiguous. The removal of the current 16-hour threshold to

1. The author is a member of the Economics Department of the OECD. This paper was written as a technical background paper in preparation for the *OECD Economic Survey of the United Kingdom* 2013. The author would like to thank Brendan Price and Linda Richardson and their colleagues in the Directorate for Employment, Labour and Social Affairs for invaluable assistance with the OECD Taxben model as well as useful comments and suggestions. Further thanks go to Andrew Dean, Robert Ford, Piritta Sorsa, Christophe André and members of the UK administration for useful comments and suggestions, Clara Garcia for excellent technical assistance and Deirdre Claassen for excellent editorial support. The views expressed are those of the author, and not necessarily those of the OECD or its member countries.

become eligible for childcare support in combination with the increased earnings disregard will give significantly better incentives for lone parents to work a few hours a week compared to the current system. The removal of the threshold for childcare support is also positive for second earners. Still, high childcare costs can reduce the gain of the reform especially for low- to medium-wage second earners and lone parents earning more than their earnings disregard. These groups are, according to the literature, known to respond particularly well to improved incentives. In addition lone parents are overrepresented in poor households, so improving lone parent's incentives to work would also have the potential to reduce poverty and child poverty even further than the reform as it stands today.

Incentives to work – an international comparison

In this paper, changes to the UK welfare system implemented through the Universal Credit and some related reforms are analysed. Benefits for the elderly, disabled or sick are not addressed, as the focus of the paper is benefits for healthy working-age individuals. Benefits no longer available for new claimants are also ignored. The impact of other changes to the tax and benefit system, such as the introduction of caps and new up-rating rules are also not considered here.

The following benefits will be replaced by the Universal Credit: Income Support, income based Jobseekers Allowance (JSA), Housing Benefit, Child Tax Credit, Working Tax Credit (WTC) and the Childcare element of WTC. By design, the maximum benefit under Universal Credit will be of the same amount as the combined benefit entitlement under the current system for an individual out of work. In the current system, a working-age individual with low earnings and no disabilities may be entitled to receive payments from one or more of three main benefit groups; The first group consist of unemployment benefits and social assistance, which is administered by the Department for Work and Pensions (DWP) and tapered off with a rate of 100% after a earnings disregard of £20 to £80 a month. The second group includes the Housing Benefit and Council Tax Benefit, administered by local councils. The maximum amounts and earnings disregards of these benefits depend on individual circumstances as explained in Annex 1, and they are tapered off at rates of 65% and 20% of after tax earnings. The third group consists of the various Tax Credits, administered by HM Treasury, which are tapered off at a rate of 42% of gross earnings. Different benefits within each of these three groups are internally coordinated and roughly based on the same framework, while there is close to no coordination across the three benefit groups, leading to a rather erratic incentive structure. An extensive introduction to the UK tax- and benefit system before and after the Universal Credit reform is provided in Annex 1.

Two models have been used in this paper. To analyse the current and future steady state of UK welfare in isolation, a custom-made model, containing all major means-tested benefits in the UK except for Council Tax Credit, has been developed. Cross-country comparisons have been performed using a modified version of the OECD TaxBen model (OECD, 2007).

Assumptions

The analysis of the UK benefit system in this paper is based on its 2012/2013 rates and values. The rules and workings of the system are analysed both under current rules and under the rules which will apply under Universal Credit. The same goes for the income tax and national insurance. One exception is the average wage, which is calculated by updating the 2010 average wage by an expected wage growth of 2.3% (2012 Budget). The other exception is the rather large increase in personal allowance in the income tax which will be effective as from April 2013. This has been included by adjusting the 2013/14 figure of £9205 by expected inflation of 2.3% (2012 budget). The impact of welfare reform is assessed for a single person, a lone parent, primary and secondary earners in couples with and without children. All persons are assumed to be adults earning an hourly wage equal to approximately half the national average wage, or approximately £8.50 per hour. This number has been chosen since the bulk of benefit recipients are in the

four lowest income deciles. They all receive Housing Benefit based on the maximum Local Housing Allowance (LHA) in Maidstone, Kent, which is the standard value used in the OECD Taxben model. When running the model for two-earner couples, the primary earner is assumed to earn 67% of the average wage. The In-Work Credit, which is a payment of £40 a week available to lone parents who go from a period of 12 months or more on welfare to more than 16 hours of work a week after, is not included in the analyses. The New Deal for Lone Parents may offer additional support to lone parents *e.g.* regarding childcare below the 16 hour threshold in the current system. There is however some soft conditionality attached to this program, which is also excluded from the analyses.

The Housing Benefit is the means tested benefit with the most recipients, and it has a significant bearing on incentives both in the existing system and in Universal Credit, where people with higher housing support will have a lower earnings disregard. This is illustrated with an example in Annex 2. Council Tax Benefit (CTB) is not included in the calculations, but would result in local maximum METRs in the current system of approximately 96% in a situation where a person pays income tax and National Insurance Contributions (NIC) and receives Tax Credits, Housing Benefit and Council Tax Benefit at the same time. The impact under Universal Credit is uncertain, since the final design of Council Tax Benefit will be left to some extent to the discretion of Local Authorities. Assuming that CTB would be tapered off in a similar manner as in the current system, by tapering off by 20% of net earnings after loss of benefits, the resulting METR would be 81%. However, higher taper rates would give poorer work incentives, while a tapering against gross income could even result in METRs above 100%. Without counting Council Tax Benefit, the corresponding METRs are 90.6 in the current system and 76.2 in Universal Credit. An example on how CTB works in the current system and how it could potentially work in Universal Credit is analysed in Annex 3.

The international comparisons have been made by running OECD Taxben model. Unemployment insurance benefits have not been included, which is consistent with a situation where the individual has been out of work for a period of some months (rules differ from country to country). For the United Kingdom this does not affect the amount received by individuals, although it could have some implications on eligibility if the individual has a partner in work, or has savings over a certain threshold (see Annex 1 for detailed rules). Transitional benefits to improve the gain of taking up work have been included in the analyses, as this gives the most complete picture of the incentives at play when an individual makes a choice on whether or not to take up work. Again this does not affect the UK, but will have some effect on some of the other countries.

The Average Effective Tax Rate (AETR) is a common measure of incentives to go from inactivity to work. This is the measure of the payoff in per cent of a non-marginal increase in income going into work. For example, an AETR of 60% at 11 work hours means that if an individual goes from 0 to 11 work hours a week, he will keep 40% of the pay, while 60 pence in a pound will be lost in taxes and loss of benefits.

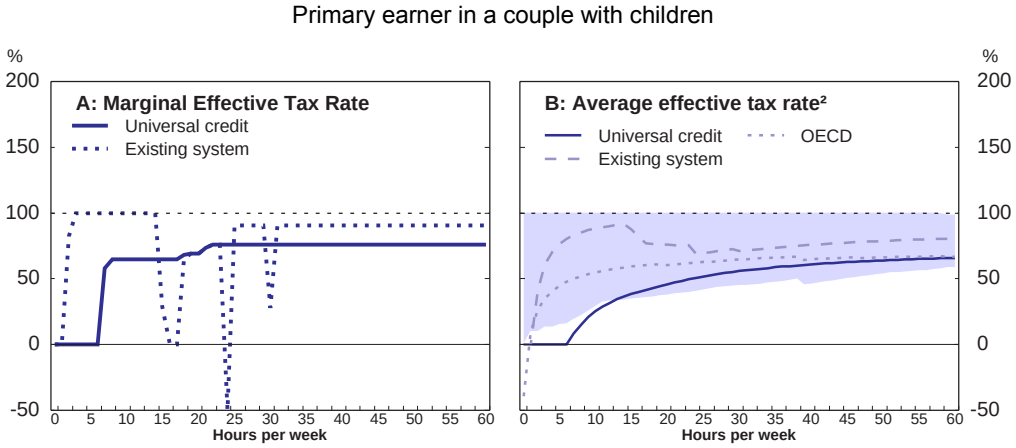
The Marginal Effective Tax Rate (METR) is a common measure of incentives to progress in work. This is the measure of the payoff in per cent of a marginal increase in labour income. For example, a METR of 80% at 11 hours of work means that if an individual increases the amount of hours from 10 to 11, he will keep 20% of the additional pay, or 20 pence in a pound. In the standard case the METR consists of taxes plus the withdrawal of benefits divided by the increase in gross income from one extra hour of work.

Results

Figure 1, Panel A shows how a primary earner with two children will be affected by the Universal Credit reform, and gives a typical example of how Universal Credit will transform incentives.

While the current system has 100% METR on low earnings and over 90% in extended intervals, Universal Credit starts out with a 0% METR and METRs are never above 76.2%. On the other hand, the current system can give strong incentives to reach certain thresholds in terms of hours worked per week, where METRs can be highly negative.

Figure 1. **Incentives to work before and after Universal Credit[1]**



1. Earning 50% of average hourly wage. Extreme negative marginal effective tax rates have been capped at -50%.
2. Data for the OECD refer to 2010. The shaded area denotes the range between the 25th and the 75th percentile in the OECD area.

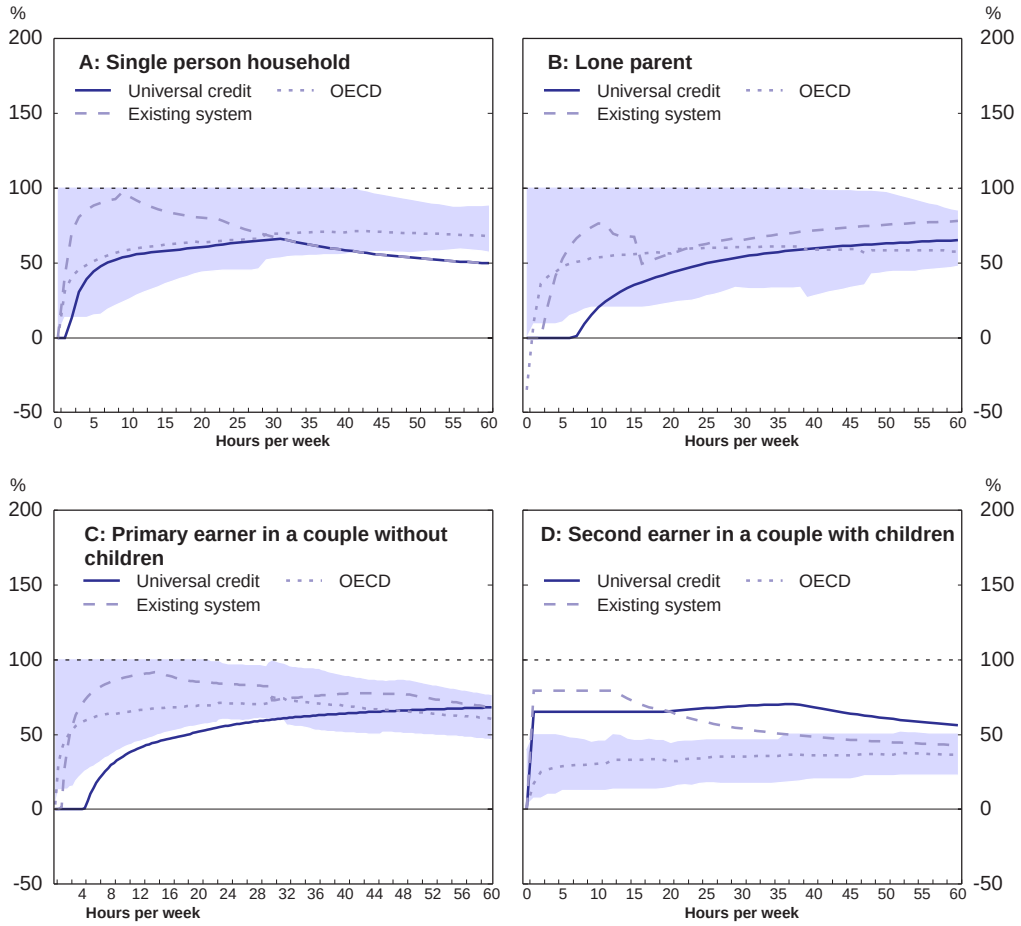
Source: OECD calculations and the OECD Taxben model.

The very generous disregard for primary earners in couples with children yields the result that on very low earnings the AETRs for the Universal Credit is below the 25th percentile of OECD countries. The current system gives poorer than average AETRs on low earnings compared to other OECD countries, while Universal Credit consistently provides better work incentives than both the current system and the OECD average, except for on very high numbers of hours worked (Figure 1, Panel B). Turning to Figure 2 we see that, except for second earners, Universal Credit generally provides better work incentives than both the current system and the OECD average. Work incentives under Universal Credit are much better than in most OECD countries on low hours. This is especially true for primary earners in couples, who enjoy an earnings disregard which is very high by OECD standards.

Second earners with children on the other hand, are outliers in terms of poor incentives compared to other OECD countries (Figure 2, Panel D). This partly reflects that other OECD countries have better incentives for second earners than for other individuals, as benefits have to a large extent been tapered off against the primary earner's income. It is however worth noting that the literature points to higher responsiveness to incentives for this group than for example for primary earners and singles, as discussed in more detail below.

Figure 2. **Work incentives in the United Kingdom compared to other OECD countries[1]**

Average effective tax rates



1. Earning 50% of average hourly wage. Extreme negative marginal effective tax rates have been capped at -50%. Data for the OECD refer to 2010. The shaded area denotes the range between the 25th and the 75th percentile in the OECD area.

Source: OECD calculations and the OECD Taxben model.

Childcare costs can worsen work incentives considerably

The system of childcare support affects the incentives for individuals to enter work, and incentives to increase or decrease their work hours, as measured by AETRs and METRs. The part of the childcare costs which parents themselves must cover, will give the same incentives as an additional tax on work. The groups who can be expected to be most affected by this added cost are lone parents and second earners in couples, assuming that in a couple, the partner who is not working will care for the children in the household.

Both in the existing benefit system and in Universal Credit, childcare support is based on a model where parents are refunded a percentage, currently 70%, of actual costs, subject to a ceiling. In the current system the childcare support is included in the Working Tax Credit. This means that lone parents will only receive this support if they are working 16 hours or more a week, while couples must work 24 hours or more between themselves and one partner must work 16 hours or more to be eligible. One major change

which has been signalled for the Universal Credit reform is that childcare support will be given also to parents who work less than the 16 and 24 hour thresholds that apply in the current system.

In the following analysis, incentives, including the cost of childcare, have been studied in more detail for lone parents and second earners. Individual circumstances will of course differ, and the analysis in this paper provides a few examples on how the inclusion of childcare costs can alter incentives to work for segments of the population. The reference families used in the examples are dependent on formal childcare, they have two children, one being a 3-4 year old receiving 15 hours free childcare per week, the other being 0-2 years and receiving none. Childcare costs are based on the 2012 Childcare cost survey performed by Daycare Trust, which found average childcare costs of £4 per hour and maximum childcare prices of £12 per hour for 25 hours a week (Daycare Trust, 2012).

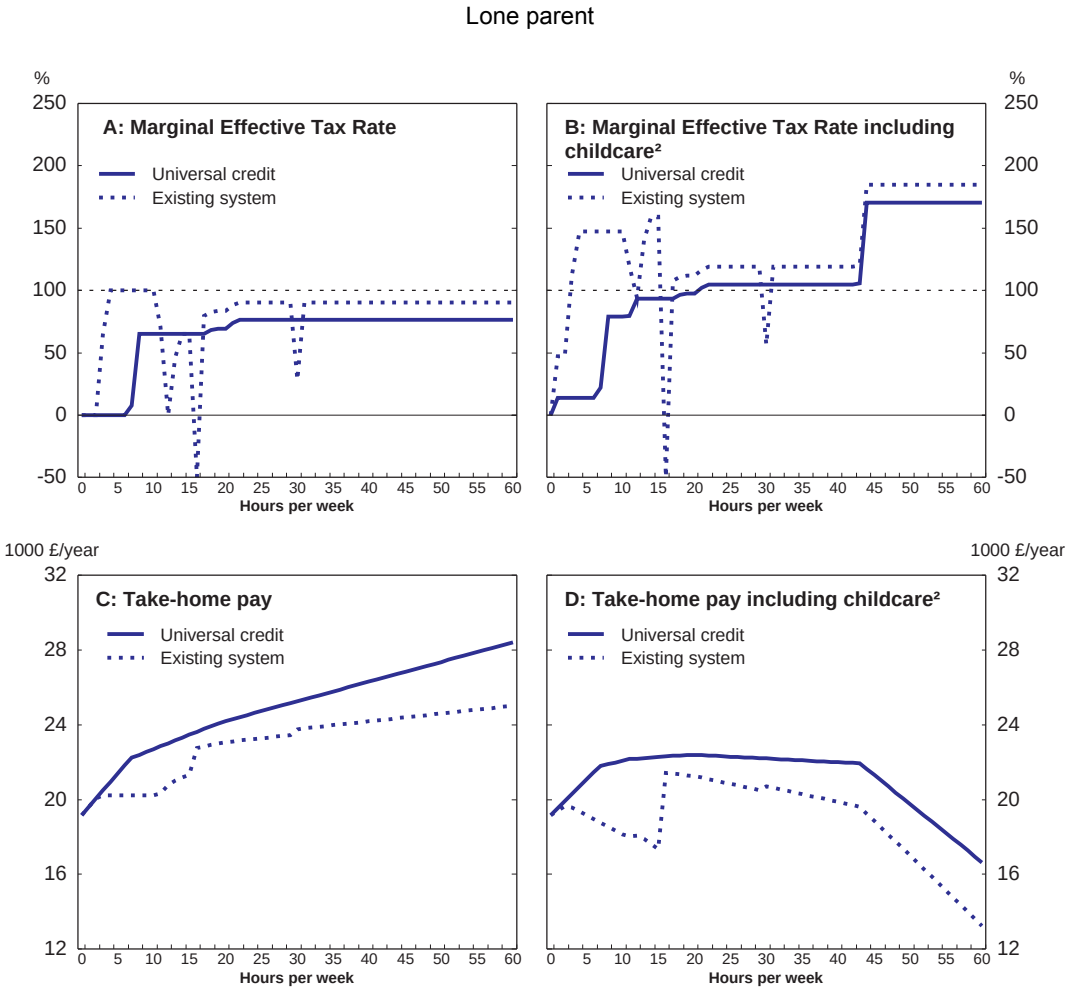
One can imagine a lot of combinations of children of different ages and circumstances which would result in lower childcare costs. This could be families with access to cheaper, informal childcare, families with schoolchildren or children entitled to special support. Some parents would also prefer to look after their own children, and would be less responsive to incentives. It is also plausible to imagine families which are not at all entitled to free childcare, or that childcare arrangements in combination with work travel and work hours may be cumbersome and reduce the effective amount of free childcare drastically, for example if buying childcare in "batches" is needed. The 15 hours free nursery education which is available to parents in the United Kingdom is not necessarily flexible, and could for example be given as 3-hour batches at fixed hours 5 days a week. This does not really suit parents moving into work without additional childcare arrangements. Steps are being taken by the Government to extend free childcare to 2-year olds from disadvantaged families and to increase the flexibility of free childcare provision.

Results including childcare

Even though the combination of the earnings disregard and the extension of childcare support below 16 hours a week in the Universal Credit will give good incentives for individuals working around 10 hours a week or less, the incentives to progress in work by working longer hours are weak for both second earners and lone parents.

Lone parents will face an additional hurdle to enter into work or progress in work if they are dependent on paid childcare (Figure 3). When this additional cost is added to the marginal effective tax rate (METR), it increases from a maximum of 76.2% to well above 100%. This is still an improvement compared to the current system, where METRs are consistently higher, except on the tax credit thresholds. The change of rules of childcare refunds on low hours has a pronounced effect below the 16 hour threshold. Childcare expenses are prohibitive for an individual wanting to work less than 16 hours a week in the current system. Highly negative METR in the 16th hour, when the Working Tax Credit kicks in, still make working slightly more profitable than inactivity. Under Universal Credit, METRs stay at approximately 20% for the first 9 hours of work, after which they climb to 93% in the 12th hour of work. This could give incentives to take on "mini-jobs", but lone parents facing childcare costs will have little incentive to work longer hours. Every hour worked over and above 21 hours a week would lead to a net loss.

Figure 3. **Childcare costs reduce incentives to work[1]**

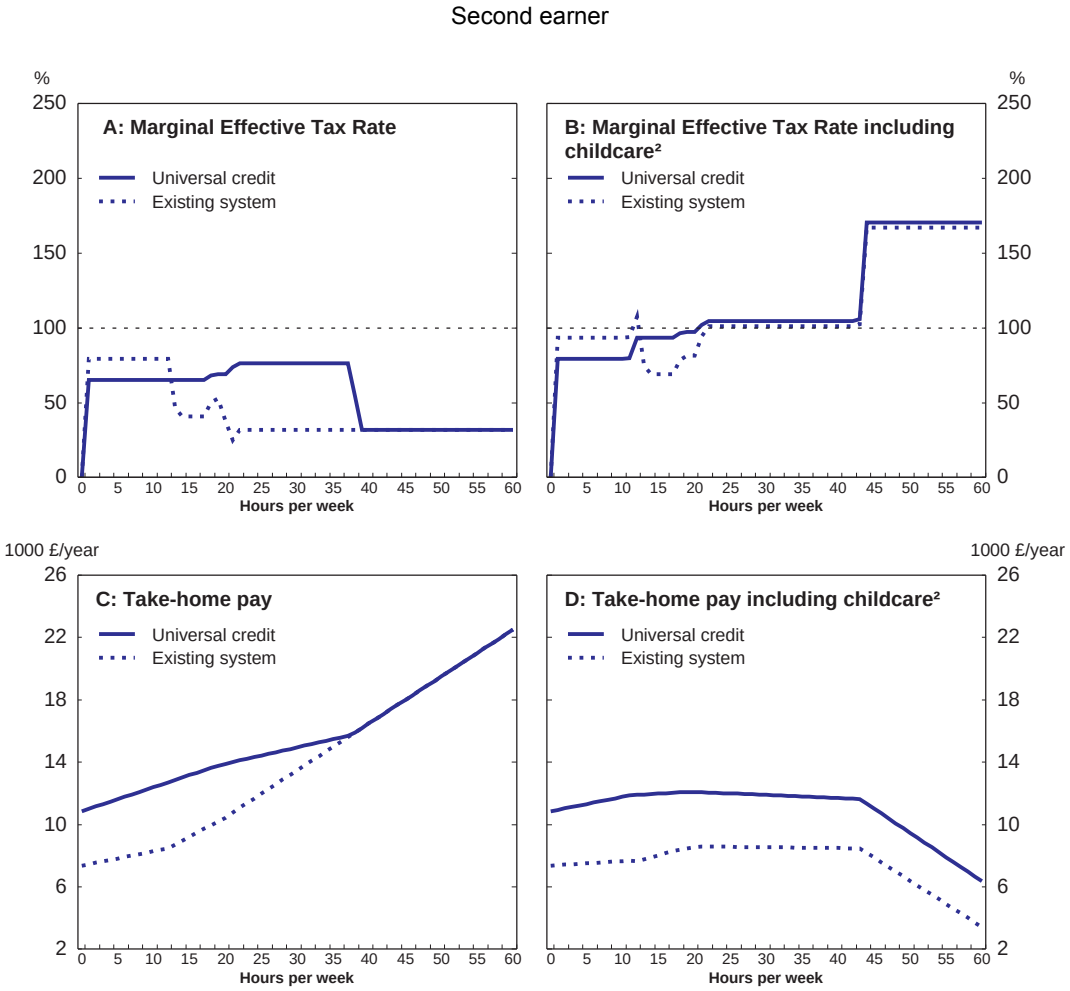


1. Earning 50% of average hourly wage. Extreme negative marginal effective tax rates have been capped at -50%.
2. Assuming childcare costs of £4 per child per hour worked.

Source: OECD calculations.

The removal of the 16 hour threshold has a positive effect on incentives also for second earners (Figure 4). This effect is very visible when comparing combined household earnings between the two systems, where a family will be left with significantly higher household earnings on low work hours in Universal Credit than in the existing system. There is however little to gain from entering work in either system for a second earner with two children in need of childcare. When adding out of pocket childcare expenses, METRs start at approximately 79% under Universal Credit, reaching 93% beyond 11 work hours and further rising to cross 100% in the 21st work hour. In the existing system, take-home pay is somewhat higher after the 16 hour WTC threshold, giving a slight incentive to go from inactivity to work.

Figure 4. **Childcare costs reduce incentives to work[1]**



1. Earning 50% of average hourly wage. Extreme negative marginal effective tax rates have been capped at -50%.
2. Assuming childcare costs of £4 per child per hour worked.

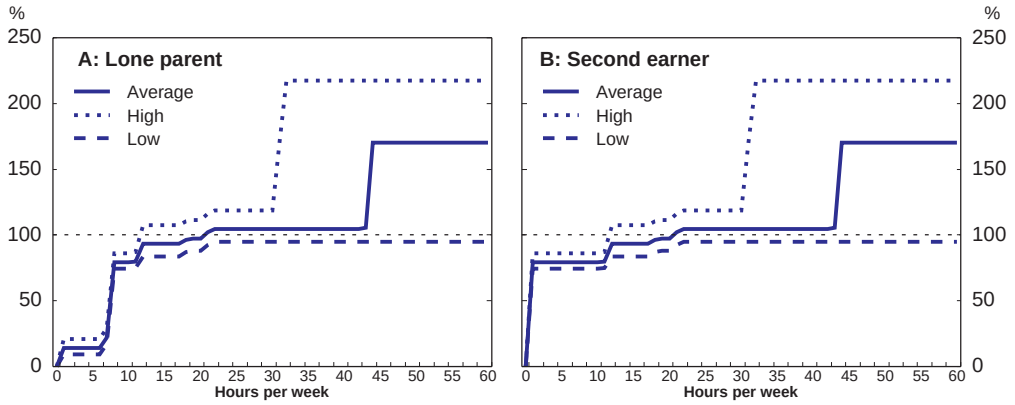
Source: OECD calculations and the OECD Taxben model.

Sensitivity analysis

Even relatively low childcare costs can have a high impact on work incentives under Universal Credit. An increase of the hourly childcare fee of 50% and a decrease of the same magnitude has been plotted in Figure 5. Although incentives are strong on low activity levels for lone parents, working more than 11 hours a week does not pay very well almost regardless of the actual childcare fee, since the 30% of the fee that parents themselves must cover is still enough to elevate METRs to levels above 90%. Second earners do not have the benefit of the earnings disregard. Even on low levels of childcare costs, the METR for the second earner starts at 70% and climbs to 85% in the 12th work hour.

Figure 5. **Even low childcare costs can have a high impact on work incentives[1]**

Sensitivity of METRs to different assumptions on childcare costs under Universal Credit



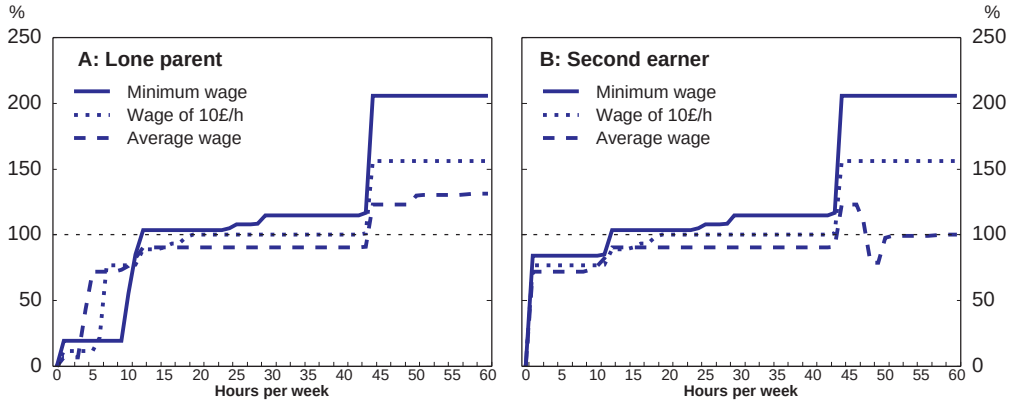
1. Earning 50% of average hourly wage. Extreme negative marginal effective tax rates have been capped at -50%.

Source: OECD calculations

The incentives to work for people who are dependent on paid childcare worsen with lower income, since the remaining 30% of childcare costs which are not reimbursed will make a larger share of the income on lower than on higher incomes. For lone parents, this effect is counterbalanced by the income disregard. METRs including childcare on average wage, £10 per hour and the statutory minimum wage have been plotted in Figure 6. Even though the levels of METRs will be the same for second earners as for lone parents, the disregard increases the amount of hours the lone parent can work before the higher levels of METRs are reached. Regardless of wage level, the lone parent reaches a high METR around 11 to 12 work hours a week. A second earner earning minimum wage (£6.19/hour) will experience a net marginal loss from working more than 12 hours a week, with METRs over 100%. With an income of £10 an hour, a marginal loss will occur from 19 work hours a week. Even on the national average wage, METRs are above 90% when the individual is working more than 11 hours a week.

Figure 6. **METRs including childcare are high even on the national average wage[1]**

Sensitivity of METRs to different assumptions on wage levels under Universal Credit



1. Assuming childcare costs of £4 per child per hour worked, and 70% reimbursement. Extreme negative marginal effective tax rates have been capped at -50%.

Source: OECD calculations

Box 1. **Early childhood education and care in the UK and selected OECD countries**

A growing body of research recognises that early childhood education and care (ECEC) brings a wide range of benefits: better child well-being and learning outcomes; more equity between children educational and working life outcomes and reduction of poverty; increased intergenerational social mobility; more female labour market participation; increased fertility rates; and better social and economic development for the society at large.

In the United Kingdom (England) childcare below the age of 3, in contrast with most European countries, is neither provided nor subsidised by the public sector. Low to middle income families can have some of their expenses covered through the benefit system. There is also a system where the Government offers a tax and National Insurance Contribution break to the employer and the employee if childcare is provided by the employer (Childcare Voucher, workplace nurseries and directly contracted childcare). Childcare is provided by for profit or non-profit daycare centres, childminders and sessional care by Crèches or playgroups. For the children aged 3 to 4, nursery schools are also available. These are run by the public or private sector. 15 hours a week are free of charge. 40% of 4 year olds receive 25 hours of care a week through full-time education in reception classes. Various other solutions are also available, such as nannies and au pair. These are generally not regulated, but can register voluntarily in the Ofsted Register.

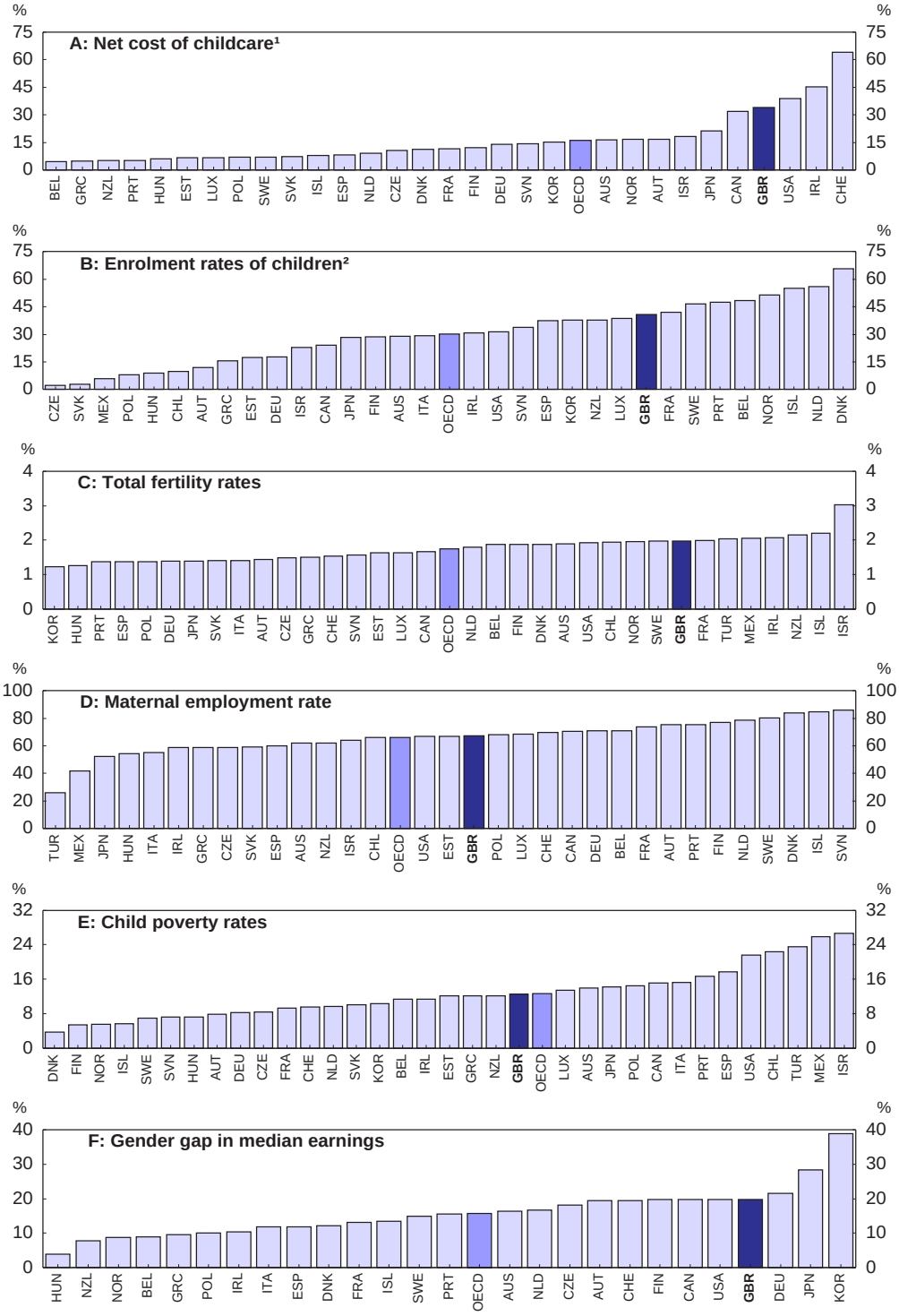
Estimates of average parental fees in the UK range from 45 to 75% of the cost of childcare, 2 to 4 times more than in Finland and 4 to 8 times more than in Sweden. Thus, it often does not pay for both parents to hold full-time jobs. The fact that nursery schools are often half-day raises the need for parents to resort to private day care and to take time off to transport children from one care source to another. As a result one parent working full-time and the other part-time is the norm in the UK (OECD, 2005). The current government is taking steps to increase the flexibility of the free 15 hours of nursery schools, so that children can be placed there for two full days instead of three or more half days, as is the case under current regulations. Opening hours will be extended with one hour in the morning and one in the afternoon. The new opening hours will be from 7am to 7pm. In addition, the 15 hours free nursery schooling is to be extended to two year-olds from deprived backgrounds, with a testing phase starting the fall of 2012. According to current plans, 40% of two year-olds will be covered by the free childcare entitlement by 2014-2015.

Child to adult ratios are in the range of 3 for children aged 0-2, 13 in preschool classes and 30 in reception classes. The fact that for the youngest children there are few children per adult compared to for example Nordic countries is likely to explain part of the high cost of childcare provision in the UK.

The launch of a commission on childcare was announced on 19 June 2012. The commission is looking at ways to encourage the provision of out of school hours and holiday childcare for children of school age, identifying regulations to childcare providers which are unnecessarily burdensome and examining how childcare supports families to move into sustained employment and out of poverty.

The UK fertility rate, the enrolment rate for the youngest children, and the maternal employment rate are all above the OECD average, despite high net costs of childcare. This is consistent with a high level of part-time work for second earners. The gender gap in median earnings in the UK is the fourth highest in the OECD; while the child poverty rate is also well above the best performing OECD countries.

Figure 7. **Children and family outcomes in the OECD**



1. As percentage of the average wage. The primary earner earns 100% of average wage, the secondary earner earns 50% of the average wage.
2. In formal care or early education services, children aged under 3 years.

Source: OECD (2011), OECD Family Database.

The provision of childcare services varies considerably across several dimensions in OECD countries, including the adult-child ratio, qualification requirements of the staff, the curriculum and general learning philosophy, the scale of provision, the organisation and the net cost to parents, which consists of fees (subsidised to varying degree) less tax reductions and various work- or childcare related benefits. The two main goals of ECEC are usually to support female employment and the learning and personal development of the child.

In many countries with separate systems for 0 – 3 and 4 – 6 year olds, there is a shortfall in capacity for the youngest children. Typically, the use of formal childcare arrangements rises with income, which both reflects the affordability of childcare arrangements and cultural factors among children with immigrant backgrounds.

In the Netherlands, childcare for the youngest children and early childhood education are separate systems, with daycare centres, family daycare and playgroups for children of age 0-4. The primary aim for childcare arrangements for the youngest children is to enable parents to combine raising children with having a job. Primary School Kindergarten is provided to children from 4 until the mandatory school age of 5. Early childhood education for children aged 2 to 6 is also available, particularly for children from disadvantaged backgrounds.

The central and local government, employers and parents all have their role to play in the provision and funding of childcare services. Central government is responsible for the national framework for quality, inspection and funding, while local government, through the municipal health authority, is responsible for maintaining quality requirements. Parents pay a fee for childcare services, but can get means-tested contributions from their employer (compulsory since 1997) and central government. Specific groups (*e.g.* students, job-seekers, newly arrived immigrants) can also get supplementary contributions from the municipality. The regulated number of children per adult (adult-child ratio) varies from 4 for the youngest children to 10 for children who are 4 years or older. Opening hours are normally from 8am to 6pm.

The net cost of childcare is low in the Netherlands, resulting in the second highest enrolment rates in the OECD and high maternal employment. Child poverty is below the OECD average, while the fertility rate and the gender wage gap are close to the OECD average.

In Finland, all families with young children are guaranteed access to subsidised childcare. Childcare for children below 6 is run by municipalities and the private sector, while pre-school classes for 6 year olds are public. As is also the case for the other Nordic countries and some other European countries, ECEC is provided under the same framework to all age groups until the mandatory school age. Another feature Finland shares with the other Nordic countries is a relatively high adult-child ratio, with a maximum 13 to 20 children per adult, depending on age. The fee-system for childcare is income-based, while pre-primary education for six-year olds is free, along with free transport and meals.

Local authorities are obliged by law to arrange an ECEC place for the child when the parents demand it, and the net cost of childcare in Finland is below the OECD average. On the other hand, Home Care payments provide financial support to those who do not make use of the childcare offer. Because childcare is relatively expensive to provide, most of the larger municipalities make additional Home Care payments to discourage use of municipal childcare. As a result, the financial incentives in the current system tilt the balance of work and care options towards mothers choosing to stay at home (OECD, 2005). The enrolment rate for the youngest children is below the OECD average, with only 44% of 2-year olds enrolled in formal childcare (compared to 85% in Sweden).

The Home Care payments and corresponding low enrolment rates are likely to be contributing to female employment outcomes which are significantly less equitable than in neighbouring Nordic countries. The total maternal employment rate is high compared to the OECD average, although it is the lowest among the Nordics. Only half of mothers with very young children are employed. This is about 20 percentage points lower than in Sweden. 20% of women in their early 40s who have completed the second stage of tertiary education are childless, compared with only 15% in Sweden. The gender wage gap of approximately 20% is also the highest among the Nordics, and 44% of female employees in their twenties have a temporary employment contract. Fertility rates are a bit above the OECD average and child poverty rates are the second lowest in the OECD.

Economy-wide effects of the reform

In the white paper "Universal Credit – Welfare that works", DWP has estimated that the net effect of the reform on labour supply is to reduce the number of workless households by 300 000 (DWP 2010). This estimate necessarily depends on a number of assumptions on the extent to which changes in

incentives will make individuals change their work patterns, their labour supply elasticities. There is great variation in the magnitude of elasticities found in the literature (Bargain *et al.*, 2011), but it is generally accepted that women, and in particular lone parents and women in couples with children, have higher labour supply elasticities than men. Brewer *et al*. (2005) estimate the lone parents' participation elasticity at 1.02, Bargain *et al*. (2011) find the corresponding elasticity to be 0.35. Using a crude model based on the analysis above and household data from the Family Resources Survey (FRS 2012), between 45 000 and 240 000 workless households would go from inactivity to work.

The benefits affected by the Universal Credit reform in the current system are approximately 6.2% of GDP. £2 billion (0.1% of GDP) has been set aside to cover the transition cost of the reform. The fiscal cost of increased entitlements and take-up is expected to be £4 billion, which will be partly offset by £2 billion in reduced costs of fraud and error (DWP, 2012). In the long run DWP also expects £0.5 billion a year in administrative savings. These estimates take into account neither the increased incentives to work nor the effects of increased simplicity and reinforced conditionality.

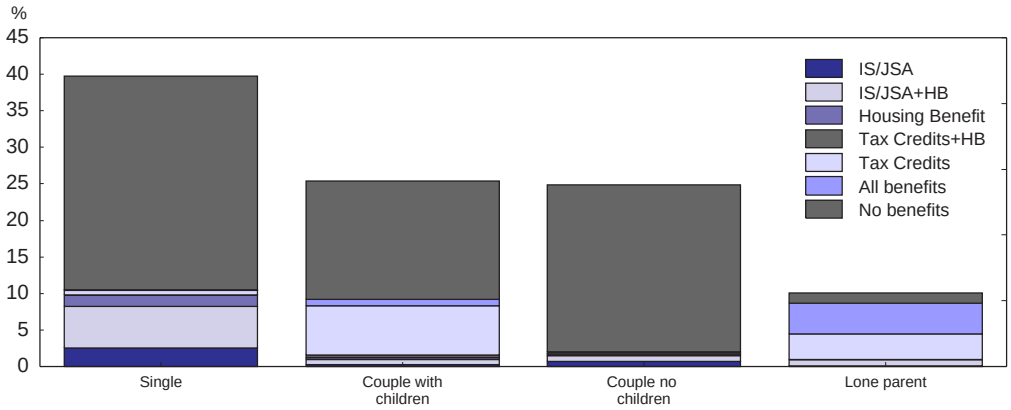
The Universal Credit is uncharted territory. This increases the uncertainty of the estimates cited above. Since elasticities by definition measure responsiveness to incentives at the margin, big changes in incentives could make the existing elasticity estimates of certain groups of people outdated. The examples above show that many people considering going from inactivity to a few hours of work a week will risk losing almost all their earnings under the current system, while under Universal Credit they will keep all of their earnings. Women with children would in the current system also have to take into account the full cost of any formal childcare, while a significant part of childcare expenses will be refunded under Universal Credit. At the other end of the scale, people who are working just above the WTC thresholds of 16 and 30 hours a week today have a very strong incentive to stay above these thresholds, while the Universal Credit by design will smooth the incentive structure and make it profitable also to work less.

Benefit recipients in the UK

Based on data from the Family Resources Survey (FRS 2012), excluding pensioners and students, some stylised facts on benefit recipients can be derived. Figure 8 shows the distribution of households in the UK, and which benefits they receive. Around 30% of UK households receive some form of means-tested benefits. Around 18% of households claim unemployment benefits or social assistance; around 18% claim Tax Credits, while around 16% claim housing benefit, alone or in combination with other benefits. Because of the Child Tax Credit, which is less tightly means tested than the Working Tax Credit, a higher share of lone parents and couples with children receive Tax Credits than childless households.

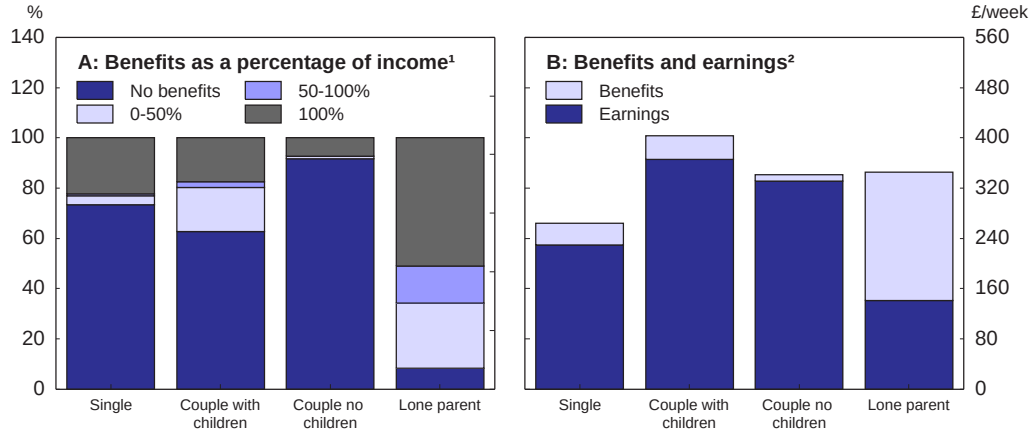
Lone parents make up 10% of all households. A large share of lone parents receives all three types of benefits. Just how dependent lone parents are on benefits can be seen in Figure 9. More than half of lone parents do not receive any earnings, and 2/3 of them receive more benefits than earnings. Less than 10% receive no benefits at all. On average, lone parents have lower combined income from earnings and benefits than individual adults in couples with children, and a higher share of their income consists of benefits. While benefits amount to an average of approximately 10% of couple earnings, for lone parents benefits amount to approximately 145% of earnings on average.

Figure 8. **Benefit claims by household type**
Percentage of households, 2010/2011



Source: Family Resources Survey and OECD calculations.

Figure 9. **Benefit dependency by household type**



1. Refers to gross disposable income.

2. Per adult in the household.

Source: Family Resources Survey and OECD calculations.

Change in incentives – the macro picture

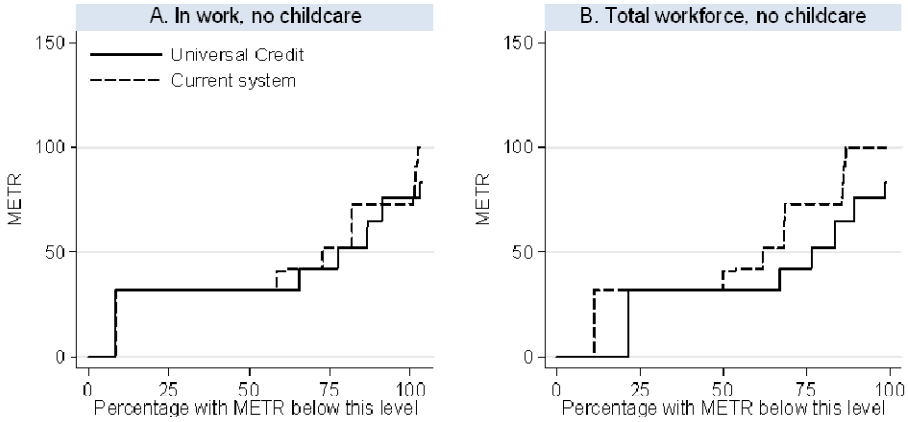
The simulations from the previous section give insights into the mechanisms at play both in the existing benefit system and under Universal Credit. Very high average effective tax rates (AETRs) and marginal effective tax rates (METRs) deter people from working, potentially causing social exclusion and a loss of productive capacity. At the same time, individuals with different characteristics react differently to similar work incentives. In most cases, labour supply responses are found to be substantial for low-skilled women or low-income families, for mothers of younger children and for lone parents. Full-time employment rates are more strongly affected by changes in childcare costs than part-time employment rates (OECD 2011).

An analysis of data from the Family Resources Survey (FRS 2010-2011) sheds light on how different individuals and households respond to work incentives. The METRs faced by individuals are assessed on the basis of the tax and benefit parameters of the model used in the previous section. A

simplification made is that in the current system disregards are ignored, as they are very low. The actual disregards range from less than an hour's pay on minimum wage for single persons to a bit above 3 hours pay on minimum wage for lone parents. An individual facing some costs related to working, such as travel, childcare or additional clothing costs would soon see the wages received from such a low number of hours worked eroded. This simplification should therefore be reasonable for the majority of individuals, and it makes it possible to give a more realistic picture of marginal incentives faced by the whole population, including those who are currently out of work.

Unsurprisingly, very few people work an amount of hours that would imply a very high METR (Figure 10, Panel A). The fact that a few people appear to do so could reflect either the above mentioned simplifications in the model, JSA conditionality, pleasure of working or investment in a future career. Figure 10 also indicates that the overall effect of the reform for people already in work is likely to be modest. There is however a large number of people who would reach a 100% METR if they went from inactivity to working a few hours a week (Figure 10, Panel B). This is a group the Universal Credit reform will affect through the higher earnings disregards and a lower taper rate.

Figure 10. **Incentives to increase work**[1]
Distribution of METRs; 2010/11



Source: Family Resources Survey and OECD calculations.

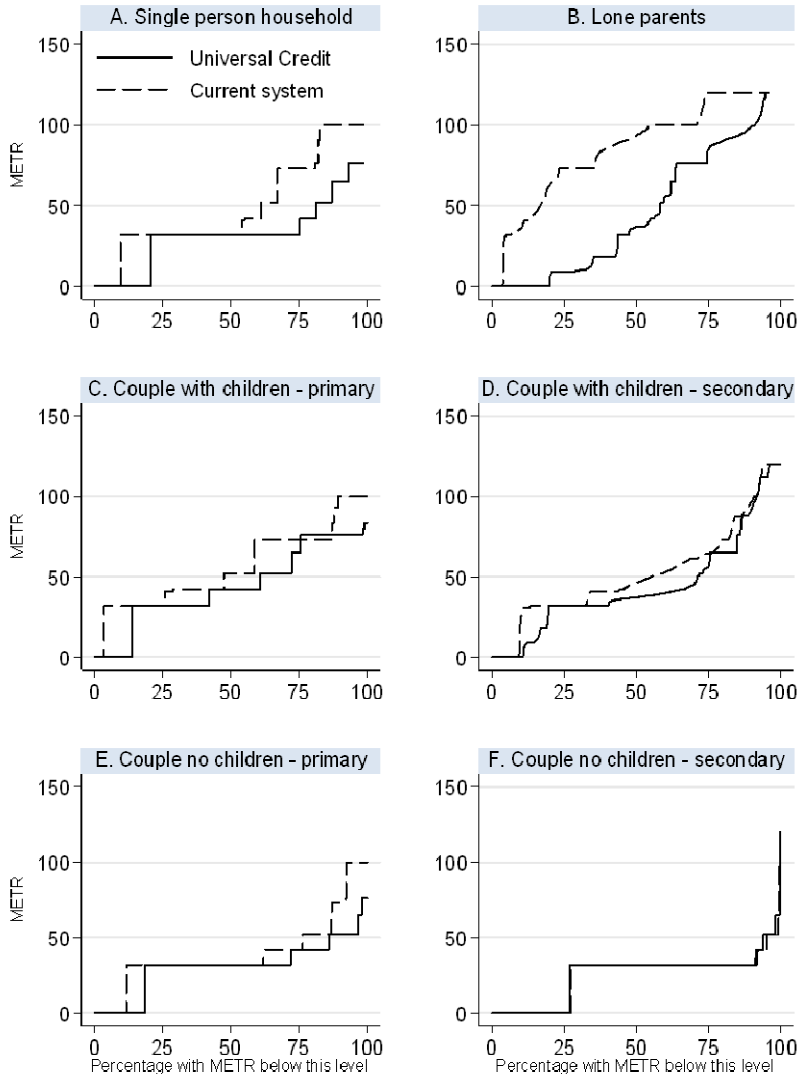
Figure 10, Panels A and B clearly show the disincentives inherent in the current system for people who are not working. Whether or not individuals who are currently not working will choose on a large scale to take up work when incentives are turned completely around from 100% to 0% METR is an open question. It is however reasonable to assume that at least some individuals will respond to this change by taking up some work. This could be a route to escape inactivity, maintain skills and even the first step to progress in working life in the future. The change in incentives to enter work is therefore a major improvement by the Universal Credit reform. Nevertheless, since the reform is unprecedented for the current population of benefit claimants, the magnitude of its effect on employment and hours worked is difficult to evaluate, especially since the cumulative effect on METRs shown in Figure 10 hides a lot of variation at the individual level. While 30% of the individuals in the sample will have their METRs reduced by more than 40 percentage points almost 20% will also see their METRs increase by more than 40%.

At the other end of the scale those with the highest METRs under Universal Credit will be persons who are fairly well advanced in working life, earning enough to pay both Income Tax and National Insurance Contributions, while at the same time facing tapering benefits. High METRs will also extend higher up the earnings distribution compared to the current system which provides erratic incentives and

highly negative METRs if certain thresholds are reached. Around the thresholds the effect of the reform is uncertain. For example, an individual could work 31 hours a week because he has a preference to work this much, but the removal of the "cliff edge" created by the working tax credit could also lead to a reduction in hours worked.

As shown in Figure 11, different household types are affected differently by the reform. The group which is most affected is lone parents. The reason is that lone parents are on average much more dependent on benefits than other households, and many of them are not working. Generally lone parents in the UK work much less than persons in the other household types. Hence the switch in the METR from close to 100% to 0 when working a few hours a week is affecting a large share of lone parents. This could encourage many of them to enter work, as lone parents is one of the groups known to respond to incentives, with a labour supply elasticity of 1.02 estimated for the UK (Brewer *et al.*, 2005).

Figure 11. **Incentives to increase work**[1]
Distribution of METRs for different categories of individuals; 2010/11



1. Including hypothetical childcare costs of £4 per child per hour worked.

Source: Family Resources Survey and OECD calculations.

Many single persons will also be going from 100 to 0% METRs, which could have an effect on their labour supply. Analyses on UK data gives lower labour supply (participation) elasticises for both single men (0.24) and men in couples (0.22) than for lone parents (Meghir, 2008). Corresponding numbers found by Bargain *et al*. (2011) are even lower. Single women without children have participation elasticities in line with single men, and women in couples without children have elasticities more or less in line with men in couples, and lower than what is the case for women in couples with children (Table 1). Still, when METRs change from 100% to 0, the effect of the reform for these groups will be quite unpredictable.

Table 1. **Own wage elasticities in the UK 2001**

	Single women		Single men		Woman in couple		Men in
	no children	children	no children	children	no children	children	couple
Hours	0.29	0.35	0.14	1.25	0.07	0.11	0.03
Participation	0.24		0.22		0.07		0.06

Source: Bargain *et al*. (2011)

The broad consensus among labour economists is that changes in participation are a more significant influence on overall labour supply than changes in the number of working hours, that labour supply is more elastic for women than for men, and that low-income groups and lone parents react more strongly to financial incentives than other groups (OECD 2007). Bargain *et al.* (2011) (Table 1) has derived elasticities for a number of European countries and the US. Their findings confirm the general view, although the actual elasticities derived are much lower than what was found by Brewer *et al*. in a UK specific study. Bargain *et al.* (2011) did not take into account the fixed costs of going into work, which could bias the elasticities downwards. Individuals who are currently in work will also respond differently according to their situation. Women in the UK with children of 4 years and younger are expected to have labour supply elasticities of 0.3 to 0.44 (Blundell *et al*., 1998).

Modelling the effects on labour supply

DWP assumes that the effect on labour supply of changed incentives to work will reduce the net number of workless households by 300 000, using their Policy Simulation Model as explained in the impact assessment accompanying their 2010 white paper (DWP 2010). This corresponds to slightly below 1% of the UK workforce. Combining the results from the custom made model used in the sections above with elasticities from the literature provides crude estimates of the effect of the reform in terms of labour supply. The model is constructed in two steps. First, the change in income from working additional hours implied by the move to Universal Credit is measured for all individuals covered by the Family Resources Survey who are in work. Second, the percentage changes in income are multiplied by the in-work labour supply elasticity for relevant groups of people (*e.g.* primary earner in childless couple or lone parent). For those who are currently not in work, a hypothetical amount of weekly hours is chosen. The default value is the average weekly work hours for people in the same group who are in work, but alternative assumptions are also used, such as lone parents working 10 hours a week, which could be a likely outcome for many in this group given the new incentive structure in Universal Credit. Using this hypothetical value, percentage differences in incomes from the current system to Universal Credit are calculated. This value is in turn multiplied by the participation elasticity for the relevant group, yielding an estimate of the total increase in hours worked per week. To assess the number of workless households going into work, the expected number of hours estimated previously is divided by the hypothetical amount of hours worked in the relevant group. This model is static and does not take into account labour demand effects. As outlined in the 2010 DWP impact assessment, this is a partial analysis, and there are a number of positive effects that are not captured by this type of model, such as increased transparency of work incentives, reduced

administrative complexity associated with a move into work, reduced risks of interruptions in benefit payments occurring and reinforcement of the conditionality regime.

The analyses show that the effect of the reform could be a reduction of the number of workless households by between 45 000 and 240 000, depending on the assumptions used in the model. At the lower end of the range, elasticities from Bargain *et al.* (2011) are used, while at the high end assumptions are based on Blundell *et al* (1998) and Meghir (2008). The increase in labour supply is estimated to be equivalent to 15 000-85 000 full-time employees working 40 hours a week. Such analyses are highly sensitive to the assumptions made. Nevertheless, the conclusion that more people will be working as a result of the reform does seem robust across different sets of assumptions. There are a number of reasons for the discrepancy between the result of this analysis and the DWP estimate. First, the result depends on assumptions of potential wages for those who are currently not working. Higher potential wages would give a higher return to enter into work. Second, the *ad hoc* model and the data used here are more crude than those used by DWP. For example, due to data issues all individuals on Employment and Support Allowance have been excluded from the analysis in this paper, while DWP has only excluded the support group. Since the ESA claimants have low participation rates, including this group will increase the estimates. Similarly, in couples where at least one individual is a pensioner, both individuals have been excluded from the analysis. This simplification will also bias the estimates in this paper downwards. Thirdly, the DWP estimates have been rounded to the closest one hundred thousand, which implies that the estimate of the "high response scenario" in this paper is not necessarily very far from DWPs own estimate.

The biggest potential to get people into work is among the groups currently under-represented in the workforce. The results from the simulation above are therefore depending very heavily on the labour supply response of lone parents and second earners with children. Depending on assumptions, 86 to 98% of the reduction in workless households is due to lone parents and women in couples with children moving into work.

Since it is not possible to say whether or not each individual will be dependent on formal childcare, childcare costs are not included in the analysis. Potential wage for those who are currently not working are based on the wages of individuals already in work. It does seem reasonable to believe that those individuals that are currently not working face higher barriers to work than comparable individuals who are already in work. Lower potential wages and a lack of affordable, quality childcare are likely to be among the more important of these barriers. A further possible critique to the results is that in a situation with significant slack in the economy, increasing the workforce without increasing job creation, would simply lead to increased unemployment.

Impacts on inequality and poverty

In its impact assessment of October 2011 (DWP 2011), DWP estimates that the combined impact of take-up and entitlements will lift around 900 000 individuals out of poverty, including more than 350 000 children and around 550 000 working-age adults, excluding the positive impacts of more people moving into work. In addition Take-home pay will generally be higher for people with low earnings (ignoring the savings rules). Both effects should contribute to reducing income inequalities in the UK. 2.8 million households will have increased entitlements under Universal Credit, while 2 million households will face a reduction. The winners are however overrepresented in the bottom 5 deciles of the income distribution.

In addition to better incentives and increased entitlements, Universal Credit will have an effect on the take-up of benefits, through different channels. The most direct channel is that since Universal Credit is integrated, households who are today taking up only part of the benefits they are eligible to will automatically receive their full entitlement under Universal Credit. It is also likely that some households

that do not take up their benefits today will do so in Universal Credit, mainly because of the simplicity of the system. While in the existing system people moving from one benefit to another lose their entitlement and have to make a new claim when going for example from JSA to WTC, there will be no new claims and no loss of entitlement, as the separation between out of work and in work benefits is removed. A proportion of households who are not entitled to benefits today, but will be under Universal Credit, could also be expected to take up Universal Credit.

According to the DWP impact assessment the bottom two deciles of the income distribution will see increases in entitlement of around £3 and £4 a week. For these deciles this equates to an increase of about two per cent of average weekly income. Those higher up the income distribution see smaller gains. When the analysis adjusts for improvements in take-up the gains to the bottom of the income distribution are bigger. The bottom two deciles gain around £11 and £10 a week respectively when accounting for imperfect take-up in the current system and improved take-up under Universal Credit. The most substantial reductions in entitlement are in the sixth and seventh decile, where households lose an average of around £1.30 a week. One of the reasons is that those in the sixth and seventh decile are most likely to be in receipt of Working Tax Credit and no other elements of the current system. No households will experience a reduction in benefit as a result of the introduction of Universal Credit, since at the point of transition to the new system, those households whose circumstances remain unchanged and who would otherwise experience a cash loss will receive cash protection (DWP, 2011). The effect of the cash protection will however fade away over time through inflation and changes in circumstances (IFS, 2012)

DWP's analyses on effects on inequality and poverty from increased entitlements and take-up of benefits depend to some extent on assumptions about benefit take-up behaviour. It is relatively safe to assume that those who would take up benefits in the current system would also do so in Universal Credit if they still are entitled. The integrated nature of Universal Credit is likely to lead to higher take-up. Judgment must be made on whether or not households who are not taking up their benefit today will do so in Universal Credit. The fact that people will not have to re-apply when going in and out of work, combined with reduced cost in terms of time of having to apply for just one benefit and the increased gain from higher entitlements should raise take-up rates. All in all DWP's analyses seems reasonable. Estimates by the Institute for Fiscal Studies (IFS, 2012) are even higher, although the IFS points out that this improvement will be more than offset by previous changes to the benefit system.

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ANNEX 1.

AN INTRODUCTION TO THE UK TAX-BENEFIT SYSTEM

The current UK welfare system

In the current system, a working-age individual with low earnings and no disabilities may be entitled to receive payments from one or more of three main benefit groups. The first group consist of unemployment benefits and social assistance. The second group includes the Housing Benefit and Council Tax Benefit.[1] The third group consist of the various Tax Credits. As explained below, different benefits within each of these groups are internally coordinated and roughly based on the same framework, while there is close to no coordination across the three benefit groups. Other benefits which can be accessed by working-age people, such as Child Benefit, Maternity Allowance, Discretionary Housing Payments, Winter Fuel Payments and Social Fund Payments are not included in the analysis in this paper, as they are of minor importance, except for Council Tax Benefit. This seems reasonable, since the benefits covered by this paper account for approximately 90% of benefit payments to working-age individuals with low earnings and no disabilities (IFS, 2010 and OECD calculations). The means-testing of Child Benefit announced in the 2012 budget applies on incomes of above £50 000 a year, and hence has limited importance in our analyses of families on average income or below, but is nonetheless included in the models for completeness. It should however be noted that entitlement to benefits like Income Support and Jobseekers Allowance also give automatic passporting to other, in many cases in-kind benefits, such as the Christmas Bonus, free school meals, 15 hours free childcare a week for 2-year olds, VAT reliefs and so on. While not treated in this paper, withdrawal of several of these benefits at the same time will reinforce adverse incentives in the current system. As the analyses later in the report show, Universal Credit removes the very obvious and large disincentives caused by the current three main benefits. The withdrawal of multiple of these smaller benefits may end up reducing incentives to work also under Universal Credit, depending on the final design of the new system.

Council Tax Benefit (CTB) is a scheme to exempt low income families in full or in part from the Council Tax. The Council Tax is a local tax, and hence it differs from location to location. The income test, capital threshold, applicable amounts and tapers of the Council Tax Benefit are the same as those of the Housing Benefit, so even though the effects of CTB on work incentives differs by location and cannot be included in a generalised model, in practice the CTB will reinforce the incentives caused by Housing Benefit, since the applicable amount is the same and tapering starts at the same threshold as for Housing Benefit. Changes to the CTB have been announced by the Coalition Government, in which a 10% cut in the CTB and more local level discretion has been signalled. It is yet not clear how much freedom municipalities will have in the design of localised CTB. CTB is a major benefit, counting for approximately 6% of all benefits paid to the eligible group. The final design of CTB can therefore have a significant impact on work incentives caused by the benefit reform, as shown in the example in Annex 3.

1. Council Tax Benefit is not included in the analyses.

Unemployment benefits and social assistance

Under the current system, people who are unemployed, underemployed or inactive can receive contribution or income based Jobseekers Allowance (JSA) or Income Support (IS). These benefits are administered by the Department for Work and Pensions (DWP). The contribution based JSA is only means tested against own income, not partners income or savings. It is available for individuals who have paid sufficient National Insurance Contribution in the two years before becoming unemployed, and it lasts for 182 days. Income Support is mainly available to lone parents, carers and those unable to work, while income based JSA is conditional on participation in activation policies. Income-based JSA and Income Support are means tested against household income, savings and unearned income. The rate ("Applicable Amount") is at the same level and depending on family type for all three benefits (Table A.1.1). JSA counts as taxable Income, while IS does not. All three benefits are tapered off penny for penny, subject to a disregard of £5 to £20 per week depending on household composition. Unearned income is tapered off penny for penny. Savings below £6 000 are ignored. Savings between £6 000 and £16 000 are assumed to generate an income of £1 a week for each £250 in savings. Persons with savings above £16 000 or persons working more than 16 hours a week lose their entitlement to these benefits in their entirety.[2]

Table A.1.1. **Income Support and Jobseekers Allowance**
Applicable Amounts

Household type	Rates £/year
Single aged 16 to 24	2933
Lone parent aged 16 to 17	2933
Couple one under 18 one under 24	2933
Single aged 25+	3702
Lone parent aged 18+	3702
Couple one under 18 one 25+	3702
Couple one under 18 one under 24 with child *	4430
Couple one under 18 one 25+ with child *	5811
Couple both 18+ *	5811
Disregard standard	261
Disregard couple	521

*Rate not available for contribution based Jobseekers Allowance

The Housing Benefit

The Housing Benefit (HB) is a means-tested allowance for rented accommodation. Almost all benefit costs are met by the central government. Together with Council Tax Benefit, it is administered by 380 local authorities. For tenants in the social housing sector (where rents are kept below market rates), the maximum housing benefit is usually equal to the actual rent. For private sector tenants the maximum housing benefit one can receive is the least of the actual rent, the Housing Benefit applicable amount (defined in Table A.1.2 below), the Local Housing Allowance (LHA) and the relevant maximum LHA cap. People on Income Support, or Income-based Jobseekers Allowance are automatically entitled to the maximum housing benefit. In this paper it is assumed that social sector rents are always at or below the LHA rates and caps. Rates and maximum LHA caps are shown in Table A.1.2 below. The LHA is based on local 30th percentile rent levels and household composition.

2. For income-based JSA and Income Support, persons with a partner working more than 24 hours a week also lose their entitlement.

The Housing Benefit is tapered off at a rate of 65% on after tax (and Tax Credits) income exceeding the Housing Benefit applicable amount. Savings and unearned income are treated as in Income Support and income based Jobseeker's Allowance.

One bedroom is allocated for:

- every adult couple
- every other adult aged 16 or over
- any two children of the same sex
- any two children regardless of sex under age 10
- any other child.

Table A.1.2. **Housing Benefit**

Housing Benefit = min (rent, applicable amount, LHA and HB cap)

	£/year
Applicable amount as in Basic Amount, with the following additions:	
Child or young person in household (per child)	3389
Family premium (one or more child)	907
Family premium lone parent	1158
Local Housing Allowance	Set locally
Housing Benefit Cap	
One bedroom (inc. shared accomodation)	13036
Two bedrooms	15121
Three bedrooms	17729
Four bedrooms	20857

Tax Credits

The tax credit system consists of three parts, the Working Tax Credit (WTC), The Childcare Element of WTC and the Child Tax Credit (CTC). Lone parents working more than 16 hours per week are entitled to Working Tax Credit, including the childcare element. For childless singles and couples, the threshold is 30 hours of work per week. In couples with children, one of the partners must work at least 16 hours per week, and together they must work at least 24 hours a week to be entitled to WTC, including the childcare element. The Child Tax Credit is available for all low-income households with children, regardless of hours worked per week. The sum of tax credits are tapered off at a rate of 41%, subject to an earnings disregard. Families who are entitled to the Child Tax Credit, but not entitled to the Working Tax Credit have a higher earnings disregard. Rates are shown in Table A.1.3 below. Tax credits are administered by Her Majesty's Revenues and Customs (HMRC). Tax credits are not simply a reduction of tax liabilities, they are paid out in cash if the tax liability is below the tax credit entitlement. For persons on Income Support or income based JSA, the tax credits are not tapered off.[3]

3. This rule has no bearing on the analyses in this paper, since an individual would need to earn more than £20 an hour, which is well over the national average wage, in order to earn anything on this feature.

A working-age individual with low earnings and no disability will be entitled to the Basic Element of WTC if he works more than 16, 24 (couples) or 30 hours a week. If the individual has children or is living in a couple, he will also be entitled to an addition. Individuals working more than 30 hours a week will be entitled to a 30 work hour premium. Individuals working more than the threshold will also be entitled to the Childcare Element, in which 70% of documented and approved childcare expenses are refunded, subject to a ceiling on total eligible expenses.

The Child Tax Credit consists of a family element, which is a single amount given to families with children, and a child element, which is an amount per child.

Table A.1.3. **Tax Credits**

Working Tax Credit (WTC)*	£/year
Basic element	1920
Addition to couples and lone parents	1950
Addition 30 work hours +	790
*Childcare element**	*£ / year*
Rate (per cent of eligible expenses)	70%
Cap one child	9125
Cap more than one child	15643
Child Tax Credit (CTC)	*£ / year*
Family element	545
Child element (x number of children)	2690
Tax Credit Taper and disregards	*£ / year*
Taper (per cent of earnings above disregard)	41%
Earnings disregard WTC	6420
Earnings disregard CTC**	15860

*Only available if working 16, 24 or 30 h/week

**Available for families not entitled to WTC

Independently of the Universal Credit reform a cap will also be introduced on the total amount of benefits a household can receive in any given month. Single person households without children will face a cap of £16 800 a year, while couples and lone parents will receive a maximum of £26 000 per year.

Universal Credit

Under the Universal Credit, the main means-tested benefits except for the Council Tax Benefit will be pooled. The following benefits will be replaced: Income Support, income based JSA, Housing Benefit, Child Tax Credit, Working Tax Credit and the Childcare element of WTC.

Under the Universal Credit, the maximum amount a household can receive is called the Basic Amount. By design, the Basic Amount will be the same amount as the combined benefit entitlement under the current system for an individual out of work. The Basic Amount consists of a Personal Amount, a Child Addition, a Childcare Addition and a Housing Addition. There is also a Disability Addition, which is not covered in this paper. The rates for the Personal Amount are equivalent to the current Income Support and Jobseekers Allowance rates. The rates for Child Addition are equivalent to the current Child Tax Credit and the Childcare Addition also has the same rates as the childcare element of the Working Tax

Credit. The Housing Addition is equivalent to the current Housing Benefit rates. The Working Tax Credit is abolished. The rates are shown in Table A.1.4 below.

Table A.1.4. **Basic Amount per household in Universal Credit**

Personal Amount	£ / year
Single aged 16 to 24	2933
Lone parent aged 16 to 17	2933
Couple one under 18 one under 24	2933
Single aged 25+	3702
Lone parent aged 18+	3702
Couple one under 18 one 25+	3702
Couple one under 18 one under 24 with child	4430
Couple one under 18 one 25+ with child	5811
Couple both 18+	5811
Child Addition	£ / *year*
Family Element	545
Child Element (per child)	2690
Childcare element	£ / *year*
Refund rate (per cent of eligible expenses)	70%
Cap one child	9125
Cap more than one child	15643
Housing Addition	£ / *year*
Appliccable amount as in Basic Amount, with the following additions:	
Child or young person in household (per child)	3389
Family premium (one or more child)	907
Family premium lone parent	1158
Local Housing Allowance	Set locally
Housing Addition Cap	
One bedroom	13036
Two bedrooms	15121
Three bedrooms	17729
Four bedrooms	20857

The Basic Amount will be withdrawn at a rate of 65%, based on the households combined earned income in the month before, and subject to an earnings disregard. The disregard varies according to family type and Housing Addition (Table A.1.5). The disregard is calculated as the Maximum disregard minus 1.5 times the Housing Addition, but never lower than the minimum disregard for the family type in question.

Table A.1.5. **Earnings Disregards in Universal Credit (£ / year)**

Family situation	Maximum	Minimum
Single adult	700	700
Couple without children	3000	1920
Couple with at least one child	7250	2440
Lone parent	9000	2780
Disabled (or disabled partner)	7000	2080
Addition in minimum disregard for 2nd and additional children		260
Unearned income		
Withdrawal rate unearned income	100%	
Withdrawal rate savings income	100%	
Savings disregard	6000	
Savings cap - no longer entitled to benefits	16000	
Benefits Cap		
Family Situation		
Single	1520.83	
Couple	2172.62	

The withdrawal rate for unearned income will reduce benefits by a rate of 100% from the first pound. Income from savings will count as weekly unearned income of £1 per £250 of savings in excess of £6 000. Savings above £16 000 will lead to a loss of the benefit entitlement in its entirety.

Income tax and national insurance

Taxes on income and National Insurance Contributions (NIC) are summarised in Table A.1.6 and A.1.7 below. In the income tax system, there is a tax free allowance which is deducted from gross earnings to give taxable income. Taxes start at the basic rate of 20% of taxable income, followed by two thresholds for taxable income, with progressively higher tax rates. In addition the tax free allowance is tapered off when gross earnings reaches £100 000 a year. For NIC, there is a tax free allowance and one threshold for gross earnings, with contribution rates being regressive.

Table A.1.6. **Income Tax in the UK (2012)**

Income thresholds and allowances	£ / year
Personal (Tax free) Allowance*	8998
Income limit Personal Allowance**	100000
First threshold (Higher rate)	34370
Second threshold (Additional rate)	150000
Income Tax rates	*Per cent*
Basic rate	20%
Higher rate	40%
Additional rate	50%

*8105 in 2012, but an increase to 9205 has been included in the model,

**Personal Allowance will taper off with a rate of 50 % above the limit *adjusted by inflation*

Table A.1.7. **National Insurance Contribution (2012)**

Income thresholds and allowances	£ / year
Primary Threshold	7592
Upper earnings limit	42484
National Insurance Contribution rates	*Per cent*
Primary rate below limit	12%
Primary rate above limit	2%

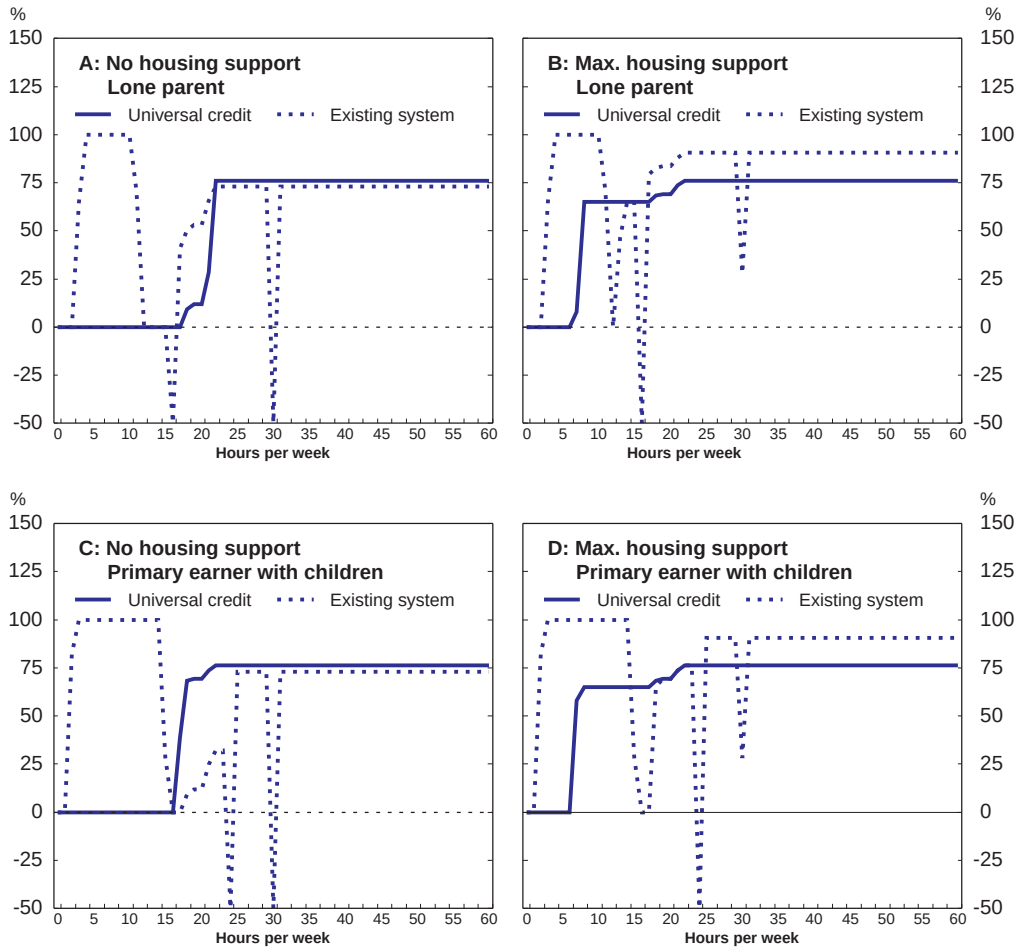
ANNEX 2.

THE SIGNIFICANCE OF THE HOUSING BENEFIT

This annex examines work incentives with zero and full housing benefit. This affects couples with children and lone parents the most, since the applicable amount is highly restrictive for the other groups. The impact of Housing Benefit is essentially to limit the range of hours worked over which METRs are zero. Reform to the Housing Benefit has set the Local Housing Allowance (LHA) as based on the 30th percentile of local rents, introduced absolute caps to the Housing Benefit, abolished the £15 incentive for low rents, introduced a 10% reduction to the Housing Benefit for those who have been on JSA for more than 12 months, increased benefit deductions for non-dependents and increased the age limit for the "shared room rate" from 25 to 35 years. In addition the LHA will in the future be adjusted based on the Consumer Price Index (CPI) instead of market rents.[1] These changes will also have full effect in the Universal Credit, and will reduce benefit payments in the years to come.

1. Furthermore, the HM Treasury Autumn statement 2012 announced that most working age benefits will be uprated by 1% for three years from April 2013.

Figure A.2.1. **METR sensitivity to housing support[1]**



1. Earning 50% of average hourly wage. Extreme negative marginal effective tax rates have been capped at -50%.

Source: OECD calculations.

ANNEX 3.

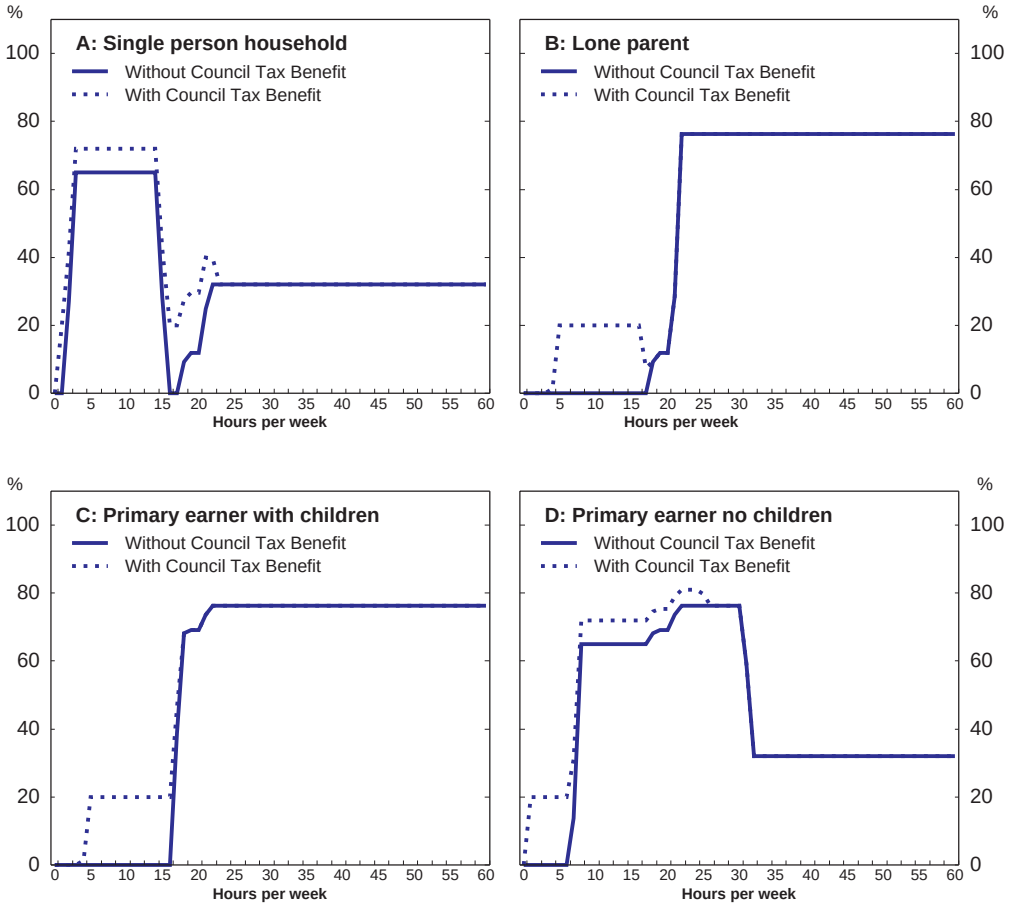
THE COUNCIL TAX BENEFIT – AN EXAMPLE

The eventual design of the Council Tax Benefit will have an important bearing on the incentives for individuals entitled to this benefit. In the example below, the Council Tax Benefit is included in the base cases presented in the main text, for households without housing support. For simplicity it is assumed that the Council Tax Benefit will remain separate from Universal Credit, and continue to be tapered off with the same rules as for Council Tax Benefit and Housing Benefit today.

It is assumed that household's residences are in band B of the Council Tax (corresponding to the 30th percentile). The national average Council Tax in this band is approximately £1 100 a year, which is the value used for the analyses below. The highest value of the Council Tax reported in band B is £1 319 a year (Communities and Local Government, 2012). In band C and D the respective values are 1 508 and 1 696.

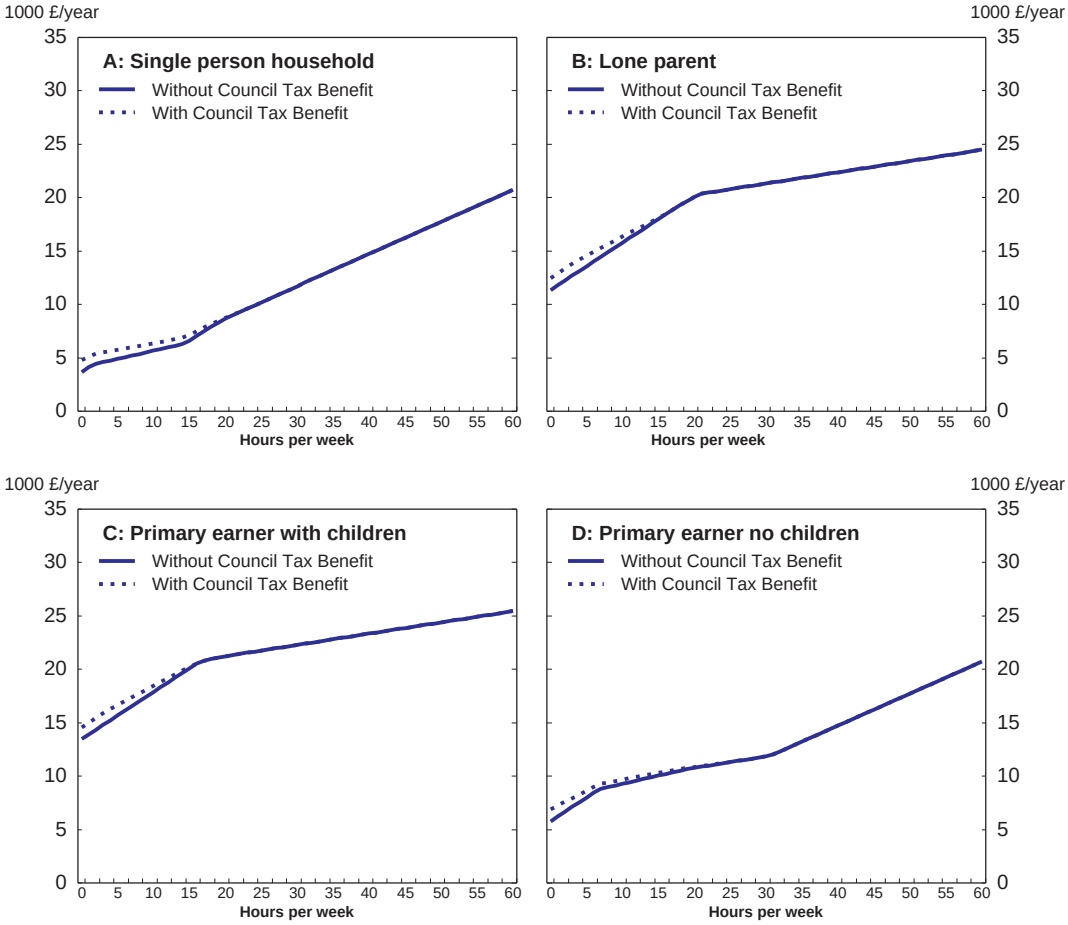
Looking at the incentives created in Universal Credit by including Council Tax Benefit (Figures A.3.1.), the applicable amount is reached fairly quickly for all household types, resulting in maximum METRs for primary earners with children and lone parents at the same level as without accounting for CTB, while a maximum of 81% is reached for primary earners in childless couples. Depending on individual circumstances METRs of 81% could be experienced. If local councils decide to withdraw the CTB in different fashions, *e.g.* against net earnings, METRs could go above 100%, but would do so for a relatively short interval as the tapering would be faster at higher effective taper rates. Including CTB does not affect second earners.

Figure A.3.1. **Marginal Effective Tax Rates**[1]
Including Council Tax Benefit



1. Earning 50% of average hourly wage. Extreme negative marginal effective tax rates have been capped at -50%.
Source: OECD calculations.

Figure A.3.2. **Take home pay[1]**
Including Council Tax Benefit



1. Earning 50% of average hourly wage. Extreme negative marginal effective tax rates have been capped at -50%.

Source: OECD calculations.

ANNEX 4.

RECENT CHANGES TO THE UK BENEFIT SYSTEM

While the Universal Credit is a comprehensive reform of the way the benefit system is administered and will change the way it works in terms of tapers and disregards, other significant changes to the benefit system have already been implemented by the Coalition Government. An overview of changes presented in the June 2010 budget and the Spending Review affecting working-age individuals with low earnings and no disabilities is shown in Table A.4.1. The change assumed to have the largest impact is the indexation of all benefits mentioned in this paper on the Consumer Price Index (CPI) from 2011-2012.[1] Universal benefits have previously been up-rated by the Retail Prices Index, and means-tested benefits have been up-rated by the Rossi Index.[2] The change in indexation is expected to save over £5.8 billion in 2014-2015. This change would affect the current system and universal Credit equally. All the changes will affect the income of households with low earnings. Some of them will be carried over to Universal Credit, while some of them will continue to work in parallel. Some impacts, specifically to the Tax Credit system, will be cancelled by the introduction of Universal Credit.

1. Furthermore, the HM Treasury Autumn statement 2012 announced that most working age benefits will be uprated by 1% for three years from April 2013.

2. This is a measure of inflation, defined as the all-items retail prices index excluding rent, mortgage interest payments, council tax and depreciation costs, since these costs are supposed to be dealt with explicitly by the benefit system.

Table A.4.1. **Benefit changes implemented before Universal Credit**

Overarching changes	Impact on Universal Credit
Indexation by CPI	Full impact on total benefits
Changes to Tax Credits	
Reduction of second income threshold	No impact
Increase of both tapers	No impact
Baby element removed from CTC	Full Impact on Child Addition
Reduce refundable childcare costs from 80 to 70 per cent	Full impact on childcare refund
Reduce maximum backdating to 1 month	Full impact on total benefits
Disregard for fall in income	No impact
Reduced disregard for increases in income	No impact
Cancelling proposed CTC addition for children aged 1 or 2	Full Impact on Child Addition
Withdrawal of family element CTC immediately after child element	No impact
Removal of the 50-plus element of WTC	No impact
Tightening the WTC working hours condition for couples with children	No impact
Increasing the child element of the CTC by more than indexation	Full impact (increase) of Child Addition
Changes to Housing Benefit	
Absolute caps to LHA rates	Full impact on Housing Addition
Increasing deductions for non-dependents by prices (backdated)	Full impact on Housing Addition
Abolishing max £15 incentive for low rents	Full impact on Housing Addition
Increasing age limit the 'shared room rate' from 25 to 35	Full impact on Housing Addition
Increasing the government contribution to Discretionary Housing Payments	No direct impact, but will affect individual households
Setting LHA rates based on the 30th percentile of local rents	Full impact on Housing Addition
10% reduction to the HB of those who on 12 months on Jobseeker's Allowance	Full impact on Housing Addition for the affected
Restricting HB in social rented sector to reflect household size	No impact
Other changes	
Cancelling introduction of Savings Gateway	No impact
Changing mortgage interest rate in calculation of housing costs JSA and IS	No direct impact, but will affect individual households
Extending temporary changes Support for Mortgage Interest	No direct impact, but will affect individual households
Requiring lone parents to claim JSA when child reaches 5	No direct impact, but will affect individual households
Cap on total benefits received by a family	Full impact on total benefits
localising Council Tax Benefit and reducing total spending on it by 10%	No direct impact, but will affect individual households

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