Policy in Practice

Universal Credit:

Towards an effective poverty reduction strategy

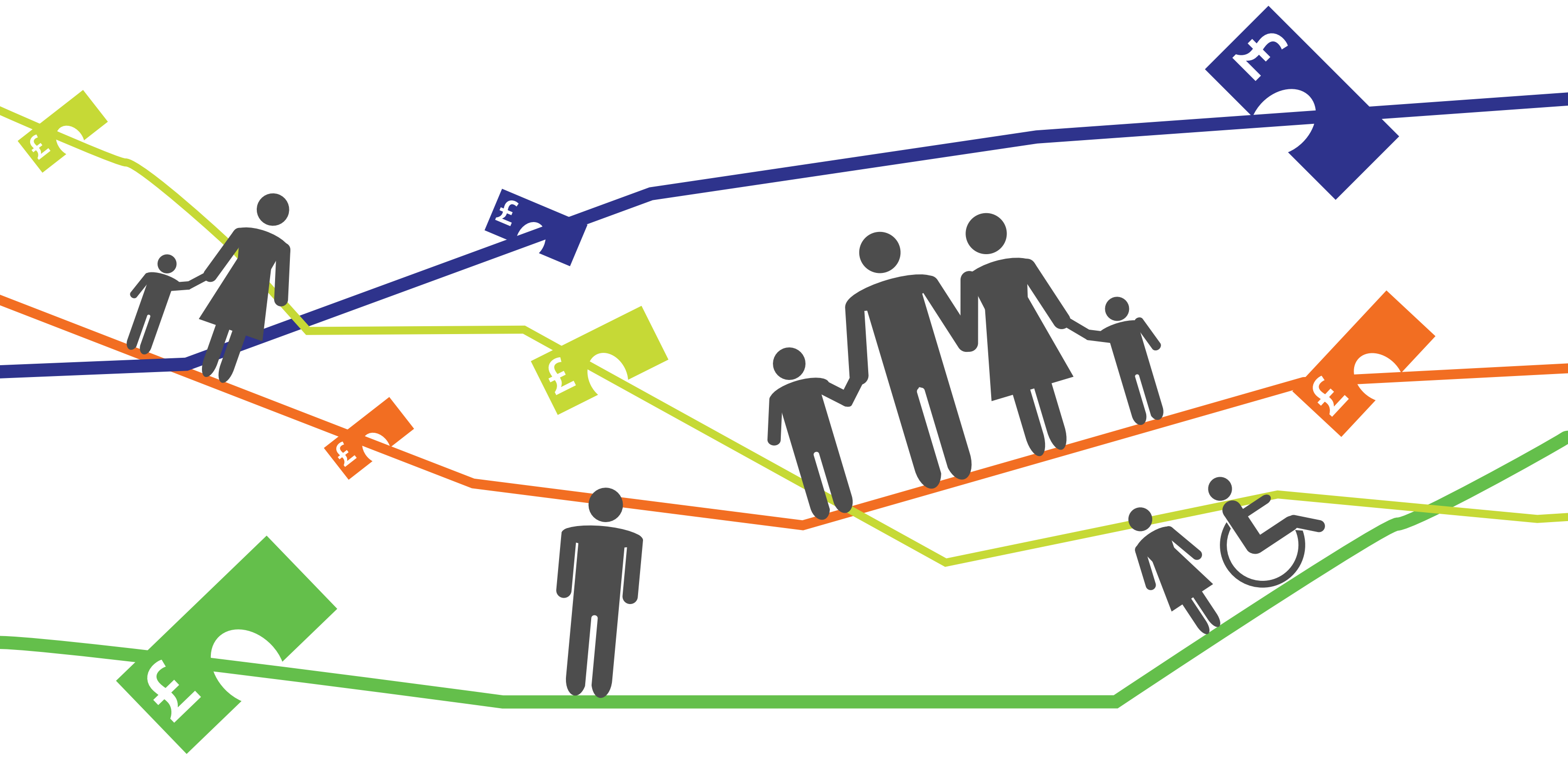

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TABLE OF CONTENTS

TABLE OF CONTENTS

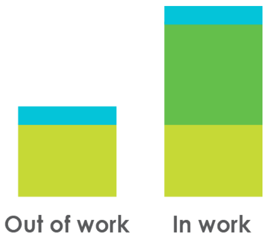
ABOUT POLICY IN PRACTICE

Policy in Practice was founded to ensure that policy is informed by the experience of people on the front-line of public services. We support central and local government, housing associations, employment and advice agencies with the effective implementation of policy and cost-effective, user-centred delivery.

Deven Ghelani is the founder of Policy in Practice, an organisation that works to ensure that policy is effective on the front-line. Deven led on welfare, employment and public spending policy for the Centre for Social Justice as a senior policy advisor.

Deven combines an in-depth insight into policy with the ability to utilise the power of technology to support policy analysis and service delivery.

Lisa Stidle is the Head of Operations at Policy in Practice. She has an MSc in Poverty and Development from the Institute of Development Policy and Management at the University of Manchester. She has previously worked for front-line organisations including Turning Point and Centrepoint.



The analysis in this report was carried out using the Universal Benefit Calculation Engine, a fast, comprehensive tool that illustrates welfare entitlement both in and out of work, and raises financial awareness. It is used by welfare and employment advisors across the UK. Please **contact us** if you would like to learn more about the Universal Benefit Calculator, and our **outcome-based software**.

The Joseph Rowntree Foundation has supported this project as part of a four year programme to develop anti-poverty strategies for the UK. The facts presented and views expressed in this report are, however, those of Policy in Practice and do not necessarily reflect the views of JRF.

FOREWORD

Deven Ghelani
Director
Policy in Practice

Since its inception, Policy in Practice has been working to ensure that Universal Credit (UC) works for people on the front-line. We believe it is critical that Universal Credit delivers on its original policy intent: a simple and cost-effective system that is focused on supporting people into work.

Universal Credit: Towards an effective poverty reduction strategy is focused on the policy design of Universal Credit, which we find will have a positive impact on poverty. However, policymakers also need to focus on how UC is perceived by recipients and advisors. Universal Credit is as much about a change in how the benefit system is understood as it is about incentives and entitlements. Policy design will need to be supplemented by effective front-line advice and support to ensure that Universal Credit supports people to take up, sustain, and progress in work.

Our clients are front-line advice organisations across the country. Their concerns are not the policy behind Universal Credit, but how it will work in practice, and how they can best support their clients through the transition to UC. They use the Universal Benefit Calculator to provide a quick, comprehensive and clear illustration of Universal Credit alongside the current welfare system. Though implementation is largely outside of the scope of this review, it is central to what Policy in Practice does in partnership with our clients across the local support sector.

Universal Credit is often seen in the context of other changes to the welfare system, which are driven largely by deficit reduction rather than welfare reform. This has negatively affected many people's perceptions of UC.

As Universal Credit rolls out across the country, reaching a growing number of low and middle income households, it is important that it feels different. It needs to be a true departure from the process driven, complex and often perverse welfare system we have today.

This report is intended to be an accessible review of Universal Credit. We hope that it will help policymakers within government to make sensible, long-term policy decisions that build upon the solid foundation of Universal Credit.

The balanced scorecard approach will, we hope, prove a useful and accessible tool for policymakers when deciding how best to tackle poverty through the welfare system. The findings are, in many cases, applicable to the current benefit system as well as Universal Credit.

In the short-term, focus must be on the implementation of UC and how it is felt in practice by low income households. In the medium-term, policymakers should aim to streamline policy that sits outside of UC but impacts on its effectiveness: council tax support re-introduces complexity and uncertainty into the welfare system, the future of Free School Meals remains undecided at the time of writing and housing administration remains complicated, and its future uncertain. In the long-term, the government should put Universal Credit at the heart of its anti-poverty strategy, and support a 'prospects' strategy alongside a 'pockets' approach to poverty reduction.

The ambition must be a new approach to the benefit system, one that is simple, rewarding and effective.

In conclusion, I would like to thank my friends and policy colleagues that commented on earlier drafts of this report. In particular I would like to thank Lisa Stidle for her dedication as a co-author, Daniel Kindley for the design and graphics, and the Joseph Rowntree Foundation for supporting the publication of this report.

LIST OF ACRONYMS AND ABBREVIATIONS

AHC	After Housing Costs
BHC	Before Housing Costs
CPAG	Child Poverty Action Group
CPI	Consumer Price Index
CSJ	Centre for Social Justice
CTC	Child Tax Credit
CTRS	Council Tax Reduction Schemes
DCLG	Department for Communities and Local Government
DFE	Department for Education
DWP	Department for Work and Pensions
EDP	Enhanced Disability Premium
ESA	Employment and Support Allowance
FSM	Free School Meals
HB	Housing Benefit
HMRC	Her Majesty's Revenue and Customs
IFS	Institute for Fiscal Studies
IS	Income Support
JRF	Joseph Rowntree Foundation
JSA	Jobseeker's Allowance
LAs	Local Authorities
LHA	Local Housing Allowance
LW	Living Wage
NMW	National Minimum Wage
NAO	National Audit Office
OBR	Office for Budget Responsibility
OECD	Organisation for Economic Co-operation & Development
ONS	Office for National Statistics
RPI	Retail Price Index
RSA	Revenu de Solidarité Active
SDP	Severe Disability Premium
TUC	Trade Union Congress
UC	Universal Credit
WTC	Working Tax Credit

EXECUTIVE SUMMARY

This review was commissioned by the Joseph Rowntree Foundation as part of a four year programme to develop anti-poverty strategies for the UK. The objectives of the report are to:

- Provide an accessible review of the literature, from official and independent sources, on the expected impact of Universal Credit on poverty and work incentives, as it is currently configured.
- Conduct original illustrative analysis on the impact of Universal Credit at a household level.
- Provide a literature review of policy issues within and related to Universal Credit.
- Identify the policy levers within and related to Universal Credit that can best be deployed to cost-effectively tackle poverty and improve work incentives.

The scope of this review is Universal Credit policy, set apart from its implementation. However, we recognise that policy implementation is critical and often overlooked, so we will cover implementation issues in our literature review.

Policy in Practice hopes that this review serves as a useful starting point, and leads to effective decisions that support the introduction of Universal Credit.

UNIVERSAL CREDIT WILL REDUCE POVERTY

Universal Credit is a major reform to the benefit system replacing six of the main means-tested benefits for 8 million working age households. One of its key objectives is to reduce poverty.

EXECUTIVE SUMMARY

The literature review finds that Universal Credit itself, set apart from other welfare reforms, will have a net positive impact on relative income poverty through two strategies: increasing household incomes ('pockets') and strengthening work incentives ('prospects'). Most recent estimates find that through 'pockets' alone, UC will lift 250,000 children and 350,000 working-age adults out of poverty (House of Commons, 2013a).

Household incomes are expected to increase by £16 per month per household on average (DWP, 2012a). This is through a combination of increased take-up of benefits (as households claim all benefits they are entitled to through a single claim process) and higher entitlements due to the higher work allowances and lower withdrawal rate of Universal Credit.

However while 3.1 million households will have a higher entitlement under UC, 2.8 million households will have a lower entitlement (without taking transitional protection into account). The impact varies by both income level and household type. In terms of income levels, Universal Credit will have a progressive impact on incomes, with poorer households seeing the largest increase in their incomes. All household types (e.g. lone parents, couples without children) include families that will see a lower and higher entitlement under Universal Credit.

Universal Credit is expected to improve 'prospects' through three different channels: increased financial incentives, simplicity and smoothing, and conditionality. The stronger, clearer work incentives of Universal Credit are expected to get 100,000-300,000 workless household into work, and households already in work are expected to increase their hours by an additional 1-2.5 million hours per week (DWP, 2012a).

Policy in Practice's own analysis at household level supports these findings. Three out of four of our case studies were able to

UNIVERSAL CREDIT WILL REDUCE POVERTY

escape poverty with a lower level of earnings under Universal Credit than the current system. This means that Universal Credit will be more effective at tackling in-work poverty for these household types than the current system.

Our analysis also finds that work incentives will be much clearer and relatively stronger than under the current system, with households being better off with each additional hour worked. Exceptions to this were our owner/occupier household who lost entitlement to housing support in work and our lone parent household when incurring high childcare costs.

It is important to note that other welfare reform measures may affect Universal Credit's ability to reduce poverty. The literature finds that gains from Universal Credit will not offset the negative impact of other welfare reforms.

ROOM FOR IMPROVEMENT

Although Universal Credit is expected to have a broadly positive impact on poverty, the literature has raised some issues with and related to Universal Credit which could affect its ability to tackle poverty. These issues typically lie outside of core Universal Credit policy.

Two issues have been identified that relate to the implementation of Universal Credit. Firstly, the assessment of entitlement, particularly for the housing element, remains complex and could maintain the uncertainty over entitlement that Universal Credit aims to remove. Secondly, the single, monthly, direct payment of Universal Credit one month in arrears is intended to make income from benefits more like income from work but could make it more difficult for households to budget their money. These issues will impact on Universal Credit recipients' experience of the new system.

ROOM FOR IMPROVEMENT

Savings and capital rules, the 'minimum income floor' for self-employed people, and in-work conditionality have all been raised as problematic under Universal Credit. Though they do not directly relate to poverty, these factors will all impact people who are in relative income poverty. People with savings or capital over £16,000 will not be eligible for Universal Credit, and this could make it difficult for families to save for a mortgage deposit. Universal Credit's 'minimum income floor' aligns the benefit system with national minimum wage legislation, but may make it difficult for self-employed people to manage difficult business periods. Finally, Universal Credit will extend conditionality to around 1 million people who are in work. While this could support progression in work, there are concerns that the conditionality regime may not be able to provide the necessary employment support required and that advisors may impose inappropriate requirements on recipients.

The literature also raised issues that will directly impact Universal Credit's ability to reduce poverty through 'pockets' and 'prospects': passported benefits, council tax support, tax policy, childcare support, and work incentives for second earners. In addition to the policy issues raised in the literature, we have carried out analysis on the impact of changing core elements of Universal Credit policy: The base level of support, the work allowance and the withdrawal rate. Finally our analysis examined wider economic factors that form part of the wider policy debate around Universal Credit and poverty reduction: wage levels and living costs.

This study has reviewed these direct and indirect issues and evaluated potential solutions through household analysis. The following policy scorecard presents the findings of our analysis, using a traffic light system on four key indicators: 'Pockets', 'Prospects', Targeting and Cost effectiveness.

Policy scorecard

Policy options for Universal Credit (UC)	Pockets	Prospects	Targeting	Cost effectiveness
Increase the **base level of support** within UC whether in or out of work	Directly increases incomes for all UC households.	May harm work incentives.	Can be targeted to different groups, but affects in and out of work households equally.	£1bn would increase incomes for all UC households by £129/year.
Create a **second earner work allowance** to support dual earning households	Increases incomes for dual-earner couples.	Improves work incentives for potential second earners.	Targeted at a large group in poverty that is responsive to work incentives.	£1bn would increase the incomes of dual earner couples by £3,292/year.
Increase the **household work allowance** so more can be earned before UC is withdrawn	Directly increases incomes for in-work households.	Encourages out-of-work households to move into work.	Can be targeted to particular groups in work.	£1bn would increase incomes for 3.3m in-work households by £302/year.
Lower the **withdrawal rate** so UC is withdrawn more slowly as earnings increase	Increases incomes for in-work households.	Improves incentives to enter and progress in work.	Targeted at all in-work households.	£1bn would lower withdrawal rates by 3.3%, to 61.7%. This would increase incomes by £230-£330/year for £10,000 of earnings.
Raise tax thresholds or lower **tax rates**	Small increase in incomes for households earning above the tax threshold.	Has a small positive impact on incentives to progress in work.	Targeted at in-work households with relatively high incomes.	£1bn would raise the personal tax allowance by £560, affected households would gain £39/year.
Integrate **council tax support** into Universal Credit	No direct impact, but would increase incomes through increased take-up.	Leads to consistent and clear work incentives.	Targeted at all households in receipt of UC.	Increased take-up could cost £717m. This would be partially offset by administrative savings of £74m.
Give **Free School Meals** to all UC households	Reduced costs for households, but no impact on relative income poverty measures.	Leads to consistent and clear work incentives.	Targeted at all households with children on UC.	Estimated to cost £500m-£750m, but could be reduced by lowering the work allowance.
Increase the **childcare** subsidy to 85% for all UC households	Increases incomes for 500,000 households that claim childcare support.	Promotes entry and progression in work for parents that need formal childcare support.	Targeted at UC households that need formal childcare in order to work.	£400m per year, benefitting 20% of in-work households with children on UC.
Higher **wages** (through increased productivity)	Improves incomes for in-work households, but they would only see 1/3 of the benefit due to UC withdrawal.	Supports progression in work.	Could be targeted at specific sectors.	Costless to the government and would benefit both the government and households.
Lower **living costs** (through reducing the poverty premium)	Improves disposable incomes for all households.	No direct impact on work incentives, but may lower the costs of work and improve mobility.	Can be targeted to types of expense, but not to types of households.	A sustainable fall in living costs would improve cost-effectiveness.

RECOMMENDATIONS

Policy parameters cannot be judged without a clear understanding of the objectives that policymakers are seeking to achieve. Some policy parameters benefit all household types, while others are targeted toward specific groups, and each policy can incur costs to the government and ultimately, to taxpayers.

The balanced scorecard is a useful and accessible tool for policymakers when deciding how best to tackle poverty through the welfare system.

Policy in Practice recommends:

- Policymakers should first focus on policy that sits outside of UC, but impacts on its ability to reduce poverty. Council tax support re-introduces a degree of complexity and uncertainty into the welfare system and the future of Free School Meals remains undecided at the time of writing. A future administration should aim to streamline these elements in order to support the principles of Universal Credit.

- Policymakers should combine 'pockets' and 'prospects' approaches to poverty reduction. A measure that targets the number of people lifted above a poverty line will favour a 'pockets' approach to poverty reduction, as it is an area where policymakers have more direct control. However, a 'prospects' approach may provide a more cost-effective method of reducing poverty in the long term.

RECOMMENDATIONS

- We favour additional increases in the work allowance partly because of their impact on take home incomes and the returns upon entering work for low income households, but also because they support other policy proposals that tackle work incentives and take-up challenges in Universal Credit, such as those for council tax support and Free School Meals.

- Over time, we favour a policy of reducing the withdrawal rate of Universal Credit, from 65% to 55%. This would be an expensive measure, and other measures may be better placed to immediately lift households above the poverty line. However we would argue that lowering the withdrawal rate would help a large number of working households in poverty and on low incomes, help improve the ‘prospects’ of households by letting them keep more of their earnings, and help other policy measures (e.g. lower rates of tax, higher wages) to filter down more to the pockets of low income households.

- Policymakers should consider the impact that policy decisions have on Universal Credit’s ability to reduce poverty. The literature finds that austerity-driven reforms to the welfare system will more than offset the positive impact that Universal Credit will have on poverty. Similarly, using savings from one element of Universal Credit (e.g. freezing the work allowance) to pay for additional expenditure elsewhere e.g. (increased childcare support) are trade-offs that may cancel out, or have a negative impact on poverty overall.

INTRODUCTION

Universal Credit (UC) has been described as the most fundamental reform to the welfare system since the Second World War. The concept was first introduced by the Centre for Social Justice (CSJ) in the report *Dynamic Benefits* (2009). The report found that the current benefit system disincentivises work through the rapid withdrawal of benefits and penalises the lowest earners as they try to increase their earnings.

Though many of the problems with the current system were well known, *Dynamic Benefits* was influential largely because it put forward a blueprint for how the current system should be overhauled. Universal Credit was adopted as a flagship policy by the Coalition Government, following the general election in 2010. It was introduced in the Welfare Reform Act 2012 alongside a number of other reforms to the welfare system.

Universal Credit will replace six existing means-tested benefits and credits for working-age people:

- Income-based Jobseeker's Allowance
- Income-related Employment and Support Allowance
- Income Support
- Housing Benefit
- Child Tax Credit
- Working Tax Credit

Replacing both out-of-work and in-work provision, Universal Credit will deliberately blur the distinction between these two categories. It will be a benefit that is just as much for people in work as it is for people out of work.

With the introduction of Universal Credit, the Government hopes to:

- simplify the system, making it easier for people to understand and making administration more efficient

- encourage recipients to start paid work or increase their earnings by making sure that work pays
- smooth the transitions into and out of work
- reduce poverty
- reduce fraud and error

(DWP, 2010a; DWP, 2011a)

The Government has spent around £425 million to implement Universal Credit to date, and this is forecast to reach £2.4 billion by 2023 (NAO, 2013). Once fully implemented, Universal Credit is expected to increase welfare spending on households by £300 million, reduce fraud by £200 million and reduce administrative costs by £200 million, while supporting an additional 300,000 households into work (DWP, 2012a).

OBJECTIVES AND SCOPE OF THE REVIEW

This review aims to provide an accessible literature review on the expected impact of Universal Credit (as currently configured) on poverty and work incentives, and an illustration of the impact of Universal Credit at a household level. It also aims to draw out the policy issues identified in the literature, and to identify the policy levers that can best be deployed to cost-effectively tackle poverty and improve work incentives.

The scope of this review is Universal Credit policy, set apart from its implementation. However, we recognise that the effective implementation of Universal Credit will be critical to its success. The sheer scale of Universal Credit means that implementation will greatly influence its effectiveness and its impact upon millions of people. We believe that implementation is too often overlooked in policy design and therefore we will explore implementation issues in the literature review.

We review Universal Credit in isolation, in order to properly assess the impact of Universal Credit and its associated policy parameters. However, we include the impact of other welfare reforms in the literature review in the context of poverty and income adequacy, as they have important implications for Universal Credit's performance.

OUR APPROACH

Chapter 1 provides a review of the relevant literature on Universal Credit and its predicted aggregate impact on poverty, income adequacy and work incentives.

Chapter 2 uses a case study approach to illustrate the impact of Universal Credit on poverty at a household level. We examine four different household types at a range of income levels.

Chapter 3 provides a review of issues identified in the literature with Universal Credit policy and with factors that impact on its effectiveness at tackling poverty.

Chapter 4 analyses the impact of a range of direct and indirect policy levers. We put the overall impact of each policy lever into context and provide a balanced scorecard, evaluating each policy in terms of its impact on poverty through 'pockets' and 'prospects', its ability to be targeted, and its cost.

Chapter 5 concludes with Policy in Practice's recommendations of short-term and long-term policies to improve the effectiveness of Universal Credit to better tackle poverty and improve work incentives.

CHAPTER 1:

UNIVERSAL CREDIT AND POVERTY

A great deal of work has already been done to assess the impact of Universal Credit, both by Government and independent organisations.

This chapter will review the relevant literature on Universal Credit and its impact on poverty and income adequacy, the winners and losers from reform, work incentives, and employment. Finally, we will review international evidence that has relevant lessons for Universal Credit.

However, there are a number of limitations in the literature to bear in mind. First, sources use different definitions of poverty which makes comparison difficult. Second, in many studies Universal Credit is not analysed in isolation, but is taken together with other welfare reforms to present a '2010 versus 2015' snapshot. This is helpful in assessing the overall impact of the Government's complete package of welfare reform, but it obscures the impact of Universal Credit itself. Third, they often do not identify the number of households that will be impacted by a given issue, recognise the trade-offs required to pay for a proposed remedy, or acknowledge the extent to which the same issues occur for within the current system.

WHAT IS POVERTY?

Joseph Rowntree Foundation's definition of poverty:

'When a person's resources (mainly their material resources) are not sufficient to meet minimum needs (including social participation).'

Poverty is a complex concept, and the literature uses a range of definitions and measurements. Most measures of poverty in a UK context are based on income. They count the number of people below a certain level of income – the poverty line.

Poverty lines can be *relative*, which are tied to the overall distribution of income or consumption.

WHAT IS POVERTY?

This is typically set at 60% of the median income, and thus the line fluctuates when median incomes rise or fall. *Absolute* poverty lines are generally anchored to a standard of basic needs or a fixed point in time.

There are issues with measuring poverty in this way. Firstly, when looking at a snapshot, these lines can only measure immediate poverty reduction through increasing incomes. But as the next section will explain, there are other ways of tackling poverty than simply putting money in people's pockets. Secondly, these measures fail to account for increases in income that do not push people across the arbitrary poverty line but will still make a difference to that family. Thirdly, as the poverty line is an income measure, they generally fail to account for rising or falling living costs, even though the cost of goods and services will clearly impact upon living standards.

However, some poverty measurement does take housing costs into account. Given that housing costs in the UK are high, whether household income is measured before housing costs (BHC) or after housing costs (AHC) can make a substantial difference to the overall number and which households are identified as being in poverty. While in 2011/12 16% of the UK population was in poverty before housing costs, this proportion rose to 21% when measured after housing costs (DWP, 2013a).

Table 1 illustrates the difference between these two measures among different household types. It shows out-of-work income relative to the BHC and AHC poverty lines for the selected households. While both the lone parent and couple in the ESA support group have an income that allows them to rise above the BHC poverty line, both of these households are measured as in poverty after housing costs. For all the households shown in Table 1, the level of deprivation is also higher using an AHC measure.

Table 1: Housing costs contribute to poverty

Household type	Out of work support relative to poverty line (BHC)*	Out of work support relative to poverty line (AHC)**
Single, under 35, no children, shared room	74%	53%
Single, over 25, 1 child under 5, 2 bedrooms	115%	86%
Couple, both over 25, no children, 1 bedroom	75%	49%
Couple, 2 children 5-15, 3 bedrooms	91%	65%
Couple, both over 25, no children, 1 bedroom, ESA Support Group	102%	79%

*Out of work support calculated using 2014/2015 rates for case studies of households. For comparison, all households are located in the Private Rented Sector, with rent of the median LHA for the property type.

**Poverty lines are sourced from the HBAI (DWP, 2013a, p.46) then equivalised and uprated to 2014/2015. See the methodology section in Chapter 2 for more detail.

In sum, poverty lines matter a great deal. Whether a family is identified as 'in poverty' will depend on the measure used, thus we should be cautious about being over-reliant on poverty lines to measure the impact of Universal Credit on those in poverty.

In order to address these limitations, our analysis in Chapters 2 and 4 will use multiple indicators to measure impact. We will use a relative poverty line of 60% of median income as this is the most commonly used and therefore the most comparable measure. We will use an AHC poverty line as they tend to be more meaningful for low-income groups because income growth (such as a rise in Housing Benefit) may overstate improvements in living standards.

In addition, we will measure the 'poverty gap', which is the difference between income and the poverty line, to show the level of deprivation. We will also examine household income, both below and above the poverty line, to capture any financial benefit to families. Finally, we will measure work incentives to capture the impact of different methods of poverty reduction, which will be explored further in the next section.

POVERTY REDUCTION STRATEGIES

'POCKETS' AND 'PROSPECTS'

There are different methods of reducing poverty. Some policies aim to increase disposable income, some aim to improve life chances, and others aim to improve communities. These three different poverty reduction strategies have been helpfully coined as 'pockets', 'prospects', and 'places' by the Scottish Government (2008).

Three Categories of Poverty Reduction Strategies

Pockets – Policies that aim to increase people's disposable income, either by increasing their incomes or reducing the cost of goods and services. These policies will have an immediate impact on poverty levels. (Examples: Child Benefit, social tariffs for utilities.)

POVERTY REDUCTION STRATEGIES

Prospects: Policies that aim to improve people's life chances and support progression in work. These policies will tend to impact on poverty in the medium to long term. (Examples: employment support services, further education.)

Places: Policies that aim to improve the supply of housing and to regenerate communities. They are usually targeted at places with a high level of deprivation. (Examples: social housing, allocating funding according to deprivation.)

(Scottish Government, 2008)

Both the current benefit system and Universal Credit attempt to reduce poverty through both 'pockets' and 'prospects'. The benefits themselves increase people's incomes. Benefit systems also attempt to reduce poverty through 'prospects' using various mechanisms, such as in-work benefits, work allowances and taper rates to provide incentives that promote entry into and progression in work.

Universal Credit puts particular emphasis on 'prospects' as a poverty reduction strategy, and attempts to enhance these mechanisms by making them more transparent through a simpler system. In addition, it seeks to remove additional barriers to work, for example by paying Universal Credit as a single monthly payment, direct to the household, thereby making income from benefits more like income from work.

Employment does not guarantee an escape from poverty. In-work poverty has been rising over recent decades and in 2011/12, over half of people in poverty (after housing costs) lived in a household where someone is in work (Aldridge, *et al.*, 2011; MacInnes, *et al.*, 2013; DWP, 2013a). However, for many, employment does offer the best route out of poverty.

POVERTY REDUCTION STRATEGIES

Table 2 below illustrates data from the DWP's *Low Income Dynamics* report (2010b). It demonstrates that households are more likely to escape poverty through employment than through a rise in benefits.

Table 2: Work offers a level of protection against poverty

Event	Overall poverty* exit rate (1991-2008)	Poverty exit rate for those in persistent poverty** (1991-2008)
Benefit income rises	46%	26%
Head of the household's earnings rise	63%	39%
Someone in the household takes up work	56%	28%
Someone in the household moves into full-time work	66%	42%
A worker joins the household	70%	47%
A full-time worker joins the household	76%	54%

Source: DWP, 2010b
*The poverty line used is 60% of the median income.
**'Persistent poverty' is defined as being in poverty for three consecutive years.

Work offers a level of protection against poverty. *Low Income Dynamics* found that the likelihood of a non-poor household moving into poverty when all members of the household were employed was only 3% (DWP, 2010b). For non-poor workless households, the likelihood that they would move into poverty was 14% (*ibid*.)

Ray *et al.* (forthcoming) have written a review on employment, pay, and poverty as part of the Joseph Rowntree Foundation's anti-poverty programme. They provide a more comprehensive review of the relationship between employment and poverty, so it will not be repeated here. They find that there is a strong relationship between worklessness and poverty, both in the UK and internationally. Families with 'low work intensity' – either in terms of working hours, number of earners or work duration – also have a relatively high poverty risk (*ibid.*).

POVERTY REDUCTION STRATEGIES

The characteristics of work are also important. Insecure, part-time and low-paid work are all associated with an increased risk of poverty (*ibid*.).

TARGETED POVERTY REDUCTION

Means-tested benefit systems are targeted to low income households. Policy levers within these systems can be further targeted to specific low income groups. For example, under both the current benefit system and Universal Credit, lone parents and disabled people have a higher work allowance (also known as the earnings disregard) than other groups in order to target more support to them.

If policy levers are to be targeted to households in poverty, then it is important to know the demographics of those in poverty. As discussed in the previous section, which poverty line is used will impact who is identified as being 'in poverty' and therefore will impact the targeting of policy.

In addition, targeting also depends heavily on which concept of poverty or low income is used. Four different concepts are shown in Table 3.

Table 3: Targeting will depend on the concept of poverty

	Sheer number in poverty	Over-representation	Level of deprivation	Sheer number on UC
	Proportion of people in poverty (AHC) in the household type*	Proportion of the household type in poverty (AHC)**	Out of work support relative to poverty line (AHC)***	Proportion of households in UC claimant base****
Single no children	24%	28%	53%	**38%**
Single with children	16%	**43%**	86%	27%
Couple no children	11%	13%	**49%**	10%
Couple with children	**36%**	21%	65%	26%

*Source: DWP, 2013a, p. 66 **Source: DWP, 2013a, p.68 ***See methodology in Table 1. ****Source: DWP, 2012a, p.14

TARGETED POVERTY REDUCTION

The data in Table 3 shows that:

- Couples with children are the most numerous household type in poverty.
- Lone parents are the group most likely to be in poverty.
- Amongst out of work households, couples with no children are in the deepest poverty when reliant on benefits for their income.
- Single people with no children are the most numerous group among the Universal Credit claimant base.

Targeting will also depend on the approach to poverty reduction as different groups may require different levels of support through 'pockets' or 'prospects'. For example, a 'pockets' approach may want to target couples without children as they are the group in deepest poverty when out of work. On the other hand, a 'prospects' approach may not want to target couples without children, as this group finds it the easiest to increase income through work under Universal Credit (Hirsch & Hartfree, 2013).

WILL UNIVERSAL CREDIT REDUCE POVERTY?

Reducing poverty is a key aim of Universal Credit and several key pieces of analysis have estimated the aggregate impact of Universal Credit on relative income poverty.

The DWP's own impact assessments found that Universal Credit will reduce poverty through increased entitlements for 3.1 million households, an increase in the take-up of benefits, and clear financial incentives that will encourage households to increase their income through work (DWP, 2011a; DWP, 2012a).

WILL UNIVERSAL CREDIT REDUCE POVERTY?

Under the current system, take-up of benefits can vary from 60-89% (see Table 4). Furthermore, 43% of working-age people in poverty do not receive any of the main means-tested benefits (DWP, 2013a, p. 172) which is likely in part due to low take-up.

Table 4: Current levels of benefit take-up

Jobseeker's allowance	60-67%
Income Support	77-89%
Employment Support Allowance	77-89%
Housing element	77-84%
Child element	83%
Working tax credit	64%

Sources: DWP, 2012b; HMRC, 2012

Universal Credit is expected to increase take-up of support for two reasons. Firstly, those currently only claiming some of the benefits that they are eligible for would receive all of them as part of a single claim process. Secondly, a simpler claim process may encourage those that do not currently take up any support to make a claim. However, the latter is not taken into account in the literature as it is difficult to estimate.

Accounting only for changes in entitlement and take-up, the literature finds that Universal Credit will have a broadly positive impact on poverty. In its original impact assessment of UC, the DWP (2011a) found that the policy would lift 900,000 individuals out of relative poverty, including 350,000 children and 550,000 working-age adults.

Independent analysis has concurred with the DWP's findings. A report by the Institute for Fiscal Studies (2011) found similar results using its own modelling. It found that between 2013 and 2015, Universal Credit would lift 450,000 children and 600,000 working-age adults out of relative poverty.

WILL UNIVERSAL CREDIT REDUCE POVERTY?

A review by the OECD also concluded that the DWP's estimates are reasonable (Pareliussen, 2013).

In January 2013, the Government's official poverty reduction estimates were revised downwards. It is now estimated that Universal Credit will lift 600,000 individuals out of poverty, including 250,000 children and 350,000 adults (House of Commons, 2013a). The impact was reduced by 200,000 individuals due to a projected upward shift in the poverty line itself. The original impact assessment compared Universal Credit to the existing benefits and tax credits system, projecting forward to 2014/15. By 2013 the projected median income had risen, accounting for some of the reduced impact. The remaining reduction of 100,000 individuals was caused by a simplification in the under-25 rates (*ibid*.), which will be explored below.

However, the poverty reduction estimates above are static: they do not take into account any behavioural change or the effects of transitional protection. Encouraging behavioural change through improved work incentives is a key mechanism through which Universal Credit aims to reduce poverty. The DWP (2012a) estimates that between 100,000 and 300,000 people will move into work and households already in work will take up an additional 1 to 2.5 million hours of work each week as a result of Universal Credit. If employment were to increase for people on low incomes, as is the intent of Universal Credit, poverty would be reduced further.

Transitional protection will ensure that existing recipients who would see a lower entitlement under UC than the current system do not lose out in cash terms. There will be no time limit on transitional protection, though its value will not be uprated and it will be lost through a change of circumstances. 2.8 million recipients will have a lower entitlement under UC, some of whom will receive transitional protection (and will therefore have a higher income than assumed). However, the official poverty reduction estimates assume that there is no transitional protection.

Taking these two factors into account, the poverty reduction estimates for Universal Credit would appear conservative.

On the other hand, while the literature finds that Universal Credit itself will reduce poverty, other welfare reform measures will affect its ability to do so.

The Institute for Fiscal Studies (IFS) (2011) found that gains from UC will not offset the negative impact of other welfare reforms. The shift to uprating benefits from the Retail Prices Index (RPI) to the Consumer Prices Index (CPI), which tends to give a lower measure of inflation, is shown to have a particularly adverse affect on poverty. So too will the subsequent decision to cap the uprating of most benefits at 1% for three years, which is below the rate of inflation. Although UC will help to limit the increase in relative poverty by 300,000 children and 100,000 working age adults, the IFS predict an increase in relative poverty by 300,000 children and 1 million working age adults between 2015 and 2020 (*ibid*.). Recent analysis has found that a three year freeze in the work allowance announced in the 2013 Autumn Statement (equating to a real-terms reduction in the work allowance) will have a negative impact on poverty for in-work households and work incentives (Resolution Foundation, 2013a).

WILL UNIVERSAL CREDIT HELP HOUSEHOLDS TO ACHIEVE INCOME ADEQUACY?

The concept of income adequacy is different to that of poverty. It is defined as the level of income that people need to have a socially acceptable standard of living. It is measured by the Minimum Income Standard (MIS), developed by the Joseph Rowntree Foundation, which effectively serves as an 'adequacy line'. The MIS is determined by discussion with the public on items that should be included in the household budget in order to participate in society.

When examining benefit systems in terms of their ability to enable households to achieve income adequacy, it is important to note that neither the current benefit system nor Universal Credit were designed to address this issue. Neither benefit system attempts to enable households to achieve income adequacy solely through 'pockets' (the base level of benefits paid), but through 'prospects' (progression in work).

Taking only 'pockets' into account, analysis by the Trade Union Congress (2013) found that Universal Credit would push 180,000 more families below and lift 20,000 children above the MIS by 2015. Although poor families would see their entitlements increase, it would not be enough to lift them above the MIS, and middle-income families who receive a lower entitlement under UC may then fall below the MIS. However, the study has only modelled the impact of changes in entitlements; it has not taken into account any increase in take-up of benefits or changes in behaviour.

The study also found that other welfare reforms affect Universal Credit's performance. Though Universal Credit would have a positive impact on certain households, when taken together with the other reforms to the welfare system they conclude that all household types would be worse off (*ibid.*).

WILL UNIVERSAL CREDIT HELP HOUSEHOLDS TO ACHIEVE INCOME ADEQUACY?

In terms of 'prospects', a study by Hirsch & Hartfree (2013) found that a household's ability to achieve income adequacy through progression in work under Universal Credit varies greatly by household type and income level. While households without children fall furthest below the MIS when out of work, the study found that those households would find it the easiest to reach the MIS through work. On the other hand, they found that the high cost of childcare makes it difficult for families with children who rely on formal childcare to achieve income adequacy through work.

However, this analysis was based on a 70% childcare subsidy as originally set in the Universal Credit regulations. The study found that the proposal to give UC households paying income tax an 85% childcare subsidy, put forth in the 2013 Budget, would provide families with a better opportunity to improve their income through work. The Budget 2014 took a step further to give an 85% childcare subsidy to all households on Universal Credit (not just those paying tax), and the implications of this will be discussed further in the following chapters.

WINNERS AND LOSERS

Although the literature generally agrees that Universal Credit will have a positive impact on poverty overall, further analysis reveals variation at a household level, based on both income distribution and household type.

The average increase across all households is expected to be £16 per month, however 3.1 million households will have a higher entitlement and 2.8 million households will have a lower entitlement under Universal Credit (DWP, 2012a). An earlier study by the IFS estimated that 2.5 million households would receive a higher entitlement and 2 million households will have a lower entitlement under Universal Credit (Brewer, *et al.*, 2012).

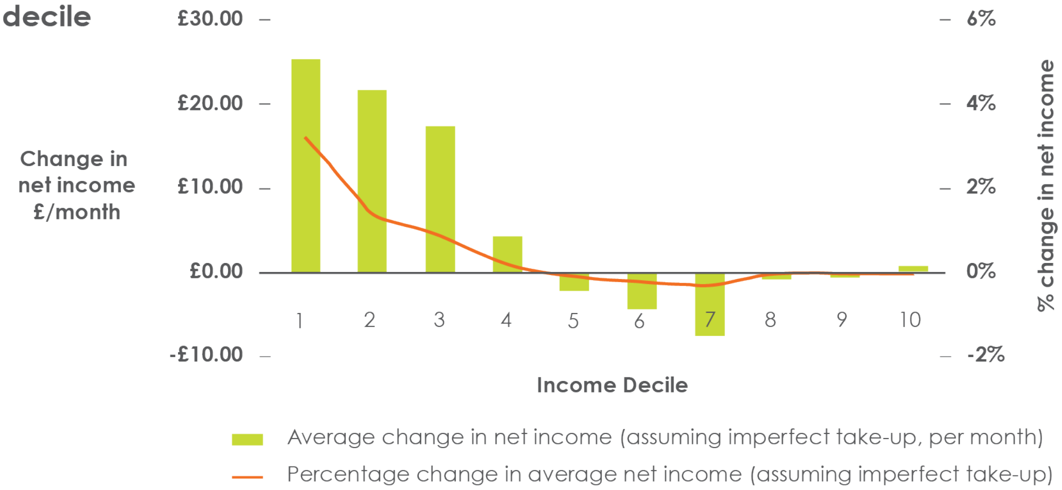
WINNERS AND LOSERS

To ensure that there will be no 'cash losers' as a result of Universal Credit, the DWP will provide transitional protection to recipients who would see a lower entitlement under UC. This will apply to existing recipients being migrated to UC by the DWP (not through a change of circumstances) and its value will erode over time. Transitional protection will be lost through a change of circumstances e.g. a partner leaving/joining the household, someone in the household stopping work (DWP, 2012b).

BY INCOME DISTRIBUTION

Disregarding transitional protection, Universal Credit's impact on incomes will be progressive, with poorer households seeing the largest increase both in cash terms and as a fraction of their overall income. While there are still winners and losers within each income decile, Figure 1 illustrates that overall the income gains will be concentrated in the bottom deciles while income losses will be concentrated in the middle deciles (DWP, 2012a; TUC, 2013; Brewer, *et al.*, 2012).

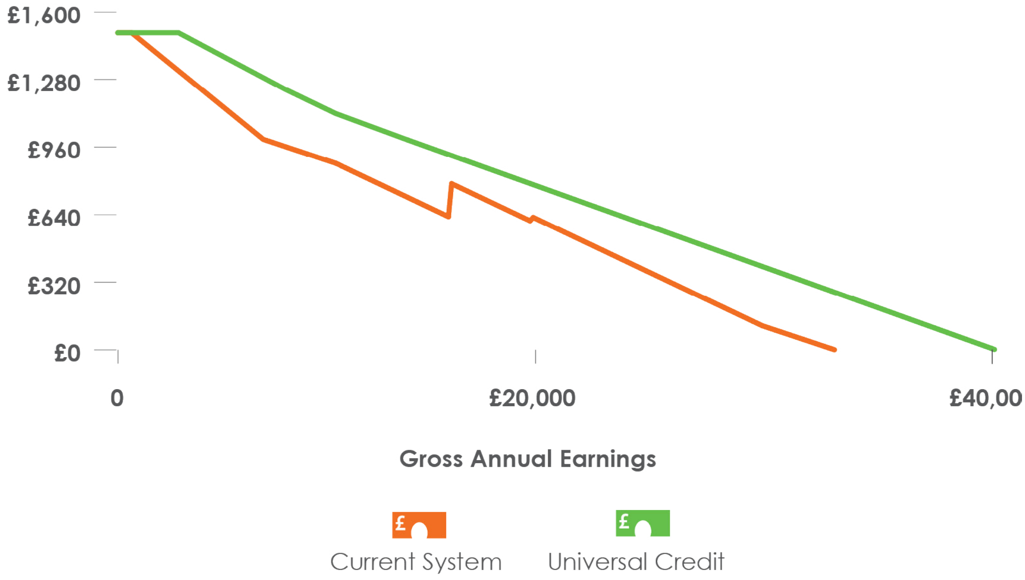
Figure 1: Average income changes by income decile



BY INCOME DECILE

Additionally, Universal Credit will extend eligibility for higher earners due to a reduction in the taper rate. Figure 2 illustrates this point using the case of a couple with two children. In this example, eligibility for benefits and tax credits under the current system ends at gross annual earnings of around £32,700 but the household can have annual income of up to around £40,000 and retain eligibility for in-work support under Universal Credit.

Figure 2: Universal Credit will extend eligibility to higher earnings



Wilcox & Perry (2013) have raised concerns that extending benefit entitlement higher up the income scale will increase benefit dependency. They argue that while Universal Credit may increase the incomes of low-paid workers, it will make it less likely that they will ever earn enough to exit the benefit system altogether.

BY HOUSEHOLD TYPE

The impact of Universal Credit will also vary by, and even within, household types (see Table 5). Every household type includes families that will see a higher entitlement under Universal Credit and families that will see a lower entitlement under Universal Credit.

Table 5: Changes to entitlement by household type (units in thousands)

	Higher Entitlement	No Change	Lower Entitlement	Total
Under 25 No Children	300	300	300	**700**
Single No Children	700	1,100	1,100	**2,400**
Couple No Children	300	100	100	**800**
Lone Parent - Renting	400	500	500	**1,400**
Lone Parent - No Rent	300	100	100	**800**
Couple with Children - Renting	700	200	200	**1,100**
Couple with Children - No Rent	400	-	-	**1,000**
All	3,100	2,300	2,300	**8,200**

Source: DWP, 2012a, p. 14

Some household types will see a change in their base level of entitlements under Universal Credit. This will cause some households to be better off and others to be worse off:

- People under 25 without children are not eligible for Working Tax Credit under the current system. Under Universal Credit they will be eligible for in-work support, improving pockets and prospects.

- The simplification of under 25 rates under Universal Credit will mean some household types will have a higher entitlement while others will have a lower entitlement:

BY HOUSEHOLD TYPE

  - Lone parents between 18 and 25 will no longer be entitled to the over-25 rate of personal allowance as they do under the current system. This change will mean a loss of around £65 per month and is expected to impact approximately 240,000 young single parent families (Gingerbread & The Children's Society, 2013) and reduce UC's impact on poverty by around 100,000 (House of Commons, 2013a).
  - Couples where at least one partner is under 18 will have a higher entitlement under Universal Credit.
  - Couples where both partners are over 18 but under 25 will have a lower entitlement under Universal Credit.

- Disabled children that are not entitled to the highest rate care component of Disability Living Allowance (DLA) or are registered blind could lose approximately half of the disability element of Child Tax Credit, a loss of around £128 per month. This will affect an estimated 100,000 disabled children and their families (The Children's Society, 2012).
- Universal Credit will abolish the Severe Disability (SDP) and Enhanced Disability (EDP) Premiums for disabled adults in an effort to simplify the system.
  - Those in the ESA Support Group (the Lower Capability for Work-related Activity element of Universal Credit) will benefit and see their entitlement for this element rise from £151 to £304 per month.

BY HOUSEHOLD TYPE

  - Approximately 230,000 disabled people receive SDP (House of Commons, 2011a). These households stand to lose £40 per week for singles and £106 per week for couples where both qualify. This may also impact young carers who are not entitled to the carer element due to their age (Royston, 2012; Gingerbread & The Children's Society, 2013).

- Under Universal Credit, homeowners will only be entitled to support for mortgage interest when out of work. Under the current system, homeowners must be receiving income-related Jobseeker's Allowance, Income Support, Employment Support Allowance, or Pension Credit to qualify. This effectively means that the current system puts limits on 'remunerative work' (usually 16 or 24 hours) while Universal Credit puts a limit on any work.

- People with savings above £16,000 will not be entitled to Universal Credit. The DWP estimate that this will impact around 100,000 tax credit recipients (DWP, 2011b).

- Couples with one partner above the state pension age and one partner below will no longer claim Pension Credit, they will claim Universal Credit. The amount they could receive through Pension Credit would be higher than Universal Credit.

UNIVERSAL CREDIT AND WORK INCENTIVES

The above analysis on poverty reduction and the winners and losers is static: it takes into account increased entitlements and take-up of benefits, but does not take into account the dynamic impacts of more people moving into work and increasing their earnings. Higher employment is a key rationale for Universal Credit, and a focus on 'prospects' is critical to the Government's poverty reduction strategy.

WHAT ARE INCENTIVES AND HOW DO PEOPLE RESPOND TO THEM?

Incentives motivate people to act. Work incentives motivate people to increase their effort, either by taking up work, increasing their working hours, or by putting more effort into their work. There are both financial work incentives (e.g. income) and non-financial work incentives (e.g. social benefits of work). There are also disincentives which discourage people from taking up work, such as a complicated administrative process during the transition into work.

The tax and benefit system can shape an individual's work incentives a great deal. For example, if income tax was set at 90%, work incentives to earn above the income tax threshold would be very weak because people would only receive 10p for every additional pound they earned. Means-tested benefits are withdrawn as individuals earn more, thus they act like an additional tax on earnings and affect work incentives.

People respond differently to incentives. The Mirlees Review found a general consensus that women respond more to work incentives than men (Meghir & Phillips, 2010). While men do respond to work incentives when deciding whether to work or not, they are 'almost completely irresponsive to changes in work incentives' when it comes to how many hours they work (*ibid.*, p. 44).

On the other hand, women are very sensitive to work incentives created by the tax and benefit system when deciding whether to work and how much to work, especially married women and lone mothers (*ibid.*).

Work incentives are not always transparent. Some people are deterred from taking up work even when there are financial incentives to do so. This could be because they are unsure of what in-work benefits and tax credits they would be entitled to, they are put off by the costs of moving into work, there is a fear of uncertainty and disruption, or they would experience a cash flow problem during the transition (Centre for Social Justice, 2009; Bashir, et al., 2011).

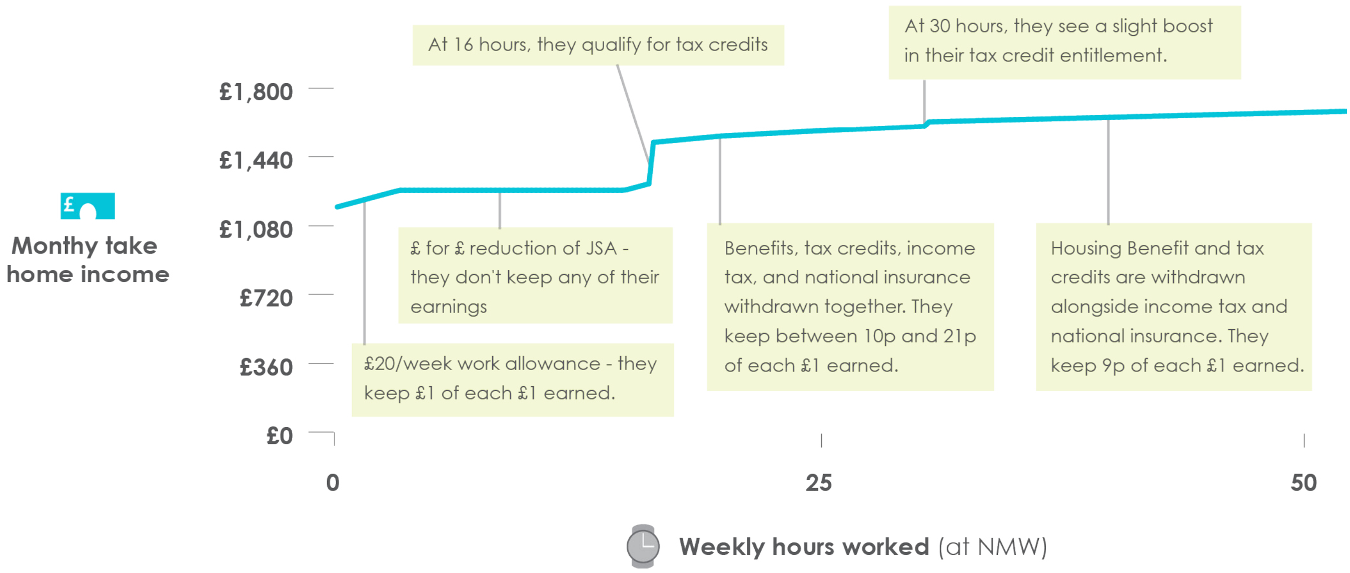
WORK INCENTIVES UNDER THE CURRENT BENEFIT SYSTEM

Under the current system, financial incentives to move into work or to take up more work can be very low. 1.1 million households lose 70p or more of each pound they earn, and 700,000 households lose 80p or more of their earnings through tax and benefit withdrawal (DWP, 2012a). For people in work who are still in receipt of income-related benefits (such as Jobseeker's Allowance) and whose earnings are above their work allowance, they lose 100% of each pound they earn. People in work who receive both tax credits and Housing Benefit can lose up to 91p of each pound they earn (*ibid*). These high withdrawal rates, along with the complexity of the system can create low financial returns from work and uncertainty over in-work entitlement, which can act as disincentives.

UNIVERSAL CREDIT AND WORK INCENTIVES

Figure 3 illustrates how a lone parent's take home income increases with hours worked when earning the National Minimum Wage under the current system. A flatter line indicates a weaker work incentive, as their take home income is increasing little with respect to their earnings.

Figure 3: Work incentives under the current system, for a lone parent on NMW

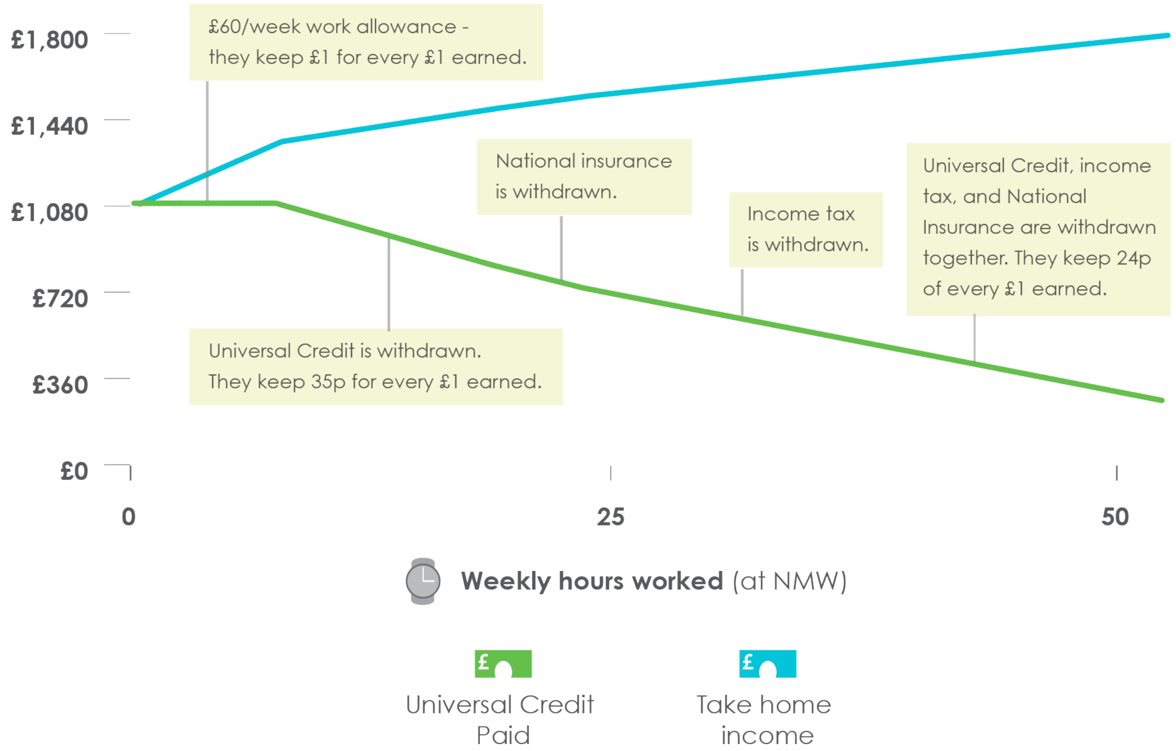


WORK INCENTIVES UNDER UNIVERSAL CREDIT

The DWP aims for Universal Credit to increase work incentives (both financial and non-financial) through three different channels: financial incentives, simplicity and smoothing, and conditionality.

Universal Credit will increase financial incentives through two mechanisms, as Figure 4 demonstrates. A higher work allowance will allow households to keep more of their earnings from work before any Universal Credit is withdrawn. A lower withdrawal rate (compared to Jobseeker's Allowance, Employment and Support Allowance, and Income Support) will allow households to keep a higher proportion of their earnings from work.

Figure 4: Work incentives under Universal Credit, for a lone parent on NMW



Universal Credit will ensure that 1.1 million people who keep less than 30% of their earnings upon entering work will keep more than 40% of their earnings under Universal Credit (DWP, 2012a).

For those already in work, Universal Credit will reduce the number of people losing 70% or more of their earnings from 2.5 million to 2.1 million (*ibid*.). Under Universal Credit, the maximum a household will lose will be 76.2% of their earnings (including tax withdrawal), compared to a maximum of 100% under the current system.

On average, the Institute for Fiscal Studies (2013) found that incentives to go from unemployment to employment will increase under Universal Credit, but the incentives for those already working to take up more work will barely change.

UNIVERSAL CREDIT AND WORK INCENTIVES

These averages conceal variation at an individual and household level. Broadly, first earners and those working up to 16 hours per week will see their financial incentives improve. However, second earners and those on higher earnings (in receipt of tax credits but not Housing Benefit and council tax support) will see their financial incentive to increase their earnings decline (Royston, 2012; IFS, 2013; Pareliussen, 2013).

More people will have lower financial incentives under Universal Credit, but they will see a relatively small decline compared to the comparatively large increase for those who have the weakest work incentives under the current system. The DWP (2012a) found that while 1.5 million people will see their financial incentives increase by 14 percentage points, 2.1 million will see their financial incentives decline by 4 percentage points.

As a result of the changes in financial incentives, the DWP (2012a) estimates that between 100,000 and 300,000 workless households will take up work and those already in work will take up an additional 1 to 2.5 million hours of work per week. Independent analysis from the OECD estimates that between 45,000 and 240,000 workless households will take up work as a result of Universal Credit (Pareliussen, 2013).

Simplicity and smoothing will also improve non-financial work incentives through several mechanisms. The single work allowance and taper rate of Universal Credit will make benefit entitlement easier to understand. A single application will reduce the recipient's administrative burden. There will also be a smoother transition into and out of work supported by a unified out-of-work and in-work benefit and real time information from HMRC. The DWP (2012a) estimates that simplicity and smoothing will encourage between 50,000 and 100,000 unemployed people to take up work.

UNIVERSAL CREDIT AND WORK INCENTIVES

Finally, there will be increased conditionality under Universal Credit which will apply to both out-of-work and in-work households. An earnings threshold will be determined for each household based on its circumstances (e.g. children, disability) and the household will be subject to conditionality if it earns below this threshold. For the self-employed, conditionality will be implemented through the 'minimum income floor', which will be discussed in further detail in Chapter 3. The DWP (2012a) estimate that 1 million more recipients will be subject to conditionality under Universal Credit. Analysis on the impact of this incentive is less clear, but the department estimates that between 50,000 and 100,000 unemployed people will take up work due to conditionality (*ibid.*).

To date, there is not yet any independent analysis on the impact of non-financial work incentives under Universal Credit to compare with the DWP's estimates.

Preliminary data from the Universal Credit pathfinders suggests that increased work incentives are not only clear to recipients, but are encouraging recipients to find work. Around 65% of Universal Credit recipients interviewed said that UC provided better financial incentives to work when compared to Jobseeker's Allowance and around 70% of UC recipients thought they would be financially better off for every additional hour they work under Universal Credit (DWP, 2013b). The surveys also found that Universal Credit recipients spent around twice as much time looking for work and applied to more jobs than Jobseeker's Allowance recipients (*ibid.*).

These early findings are promising, but should be treated cautiously as they are based on relatively small samples (three groups of 900 people each) (*ibid.*). The Universal Credit claimant base is also still small and selective, with only 3,610 recipients as of November 2013, all of whom are simple, single person cases in the pathfinder areas and 70% of whom are under 25 (DWP, 2014).

INTERNATIONAL EVIDENCE: THE RSA IN FRANCE

International comparisons of welfare systems are difficult because each system typically has different objectives, and policy measures are implemented in different cultural and economic contexts. Universal Credit has a scale and ambition beyond the attempts at reform made overseas, and as such other countries will be looking closely at the impact of Universal Credit on poverty and worklessness.

As a result, the international evidence on Universal Credit is limited. The best example of a similar reform in a similar context is in France, where the welfare system was, as one article put it, 'a generally inconsistent and confusing maze of transfers and taxes or contributions [and] weak incentives to return to work' (Bourgeois & Tavan, 2009, p. 1). In the summer of 2009, the *Revenu de Solidarité Active* (RSA) was introduced to overcome some of the very same issues that Universal Credit will try to address.

The RSA shared similar objectives to Universal Credit: to combat poverty, to boost the financial gains from returning to work and to streamline the benefit system. It was expected to boost take-up of benefits, and increase the incomes of people in work, particularly those in low-paid work. The number of households living below the poverty line was expected to fall by 6%, and the number of workless households was expected to fall by 11% (*ibid*.).

INTERNATIONAL EVIDENCE: THE RSA IN FRANCE

However, in February 2013 the *Cour des comptes* (Court of Audit) found that the RSA was failing to meet its objectives (Gomel, *et al*., 2013). The take-up of the RSA was much lower than expected, with only 32% of those eligible to claim in-work support actually doing so through the RSA, with the result that only €1.1 billion was claimed of the €2.23 billion that had been allocated to the RSA in 2011 (Léo, 2013).

It did not appear to notably help return people to work, with 69% of those receiving the unemployed amount of RSA in January 2010 still in receipt of the same amount 12 months later (Gomel, *et al*., 2013). Its impact on poverty (overall poverty, levels of deprivation and in-work poverty) is no longer tracked as the indicators were scrapped in 2012. However, its impact on poverty will have been diminished because of the two points made above (*ibid*.).

The failure of the RSA in France is likely due to a combination of policy design and implementation. The policy design itself is not as comprehensive as Universal Credit. It leaves out significant elements of the benefits system, notably housing benefit and tax credits, which still leaves the French welfare system complex and confusing. In addition, the RSA does not have a 'work allowance' similar to that in Universal Credit. Instead, it offers a lower withdrawal rate (38%) but when combined with the withdrawal of housing benefit, this increases to 73% (*ibid*.). This high withdrawal rate has contributed to low levels of take-up (*ibid*.).

In addition, the implementation and front-line experience of the RSA has also contributed to low take-up of the benefit. There has been low awareness of the RSA among the eligible population, recipients have found it a cumbersome and complex claim process, and many have shown low interest or disagree with the principle of the RSA (*ibid*.).

INTERNATIONAL EVIDENCE: THE RSA IN FRANCE

Universal Credit mitigates many of the challenges faced by the RSA through its scale and comprehensiveness, and its integration with information on earnings. However, there are some very relevant lessons for Universal Credit to be learned from France's experience. Primarily that the front-line experience of Universal Credit will be key: people need to perceive Universal Credit to be simple, without stigma, and rewarding for people in work.

CONCLUSION

The literature review concludes that the policy design of Universal Credit itself will have a net positive impact on poverty, and that it will benefit both 'pockets' by raising incomes in low income households and 'prospects' by encouraging workless households into work, and increasing the total number of hours worked overall.

However, its impact varies across and within income levels and household types. Overall, income gains as a result of Universal Credit will be concentrated in the bottom deciles of the income distribution while income losses will be concentrated in the middle deciles. All household types include families that will have a higher entitlement and a lower entitlement under Universal Credit.

International evidence from France's *Revenu de Solidarité Active* suggests that while the policy design of Universal Credit is an improvement, it is not clear that the policy design itself will be sufficient to achieve the aims of reducing poverty, reducing worklessness, and encouraging progression in work. The front-line experience of Universal Credit will likely be key to its success.

CHAPTER 2:

THE IMPACT OF UNIVERSAL CREDIT AT HOUSEHOLD LEVEL

In Chapter 1, we found that commentators agree that Universal Credit itself will have a net positive impact on relative income poverty.

In this chapter, we use a case study approach to illustrate what the aggregate poverty reduction and work incentive estimates in the literature mean at household level. We examine the impact of Universal Credit on poverty by modelling household incomes for four typical households at a range of income levels.

These calculations serve as the baseline for the analysis in Chapter 4 which will examine how different policy levers might be adjusted to improve the impact of Universal Credit.

METHODOLOGY

There are four main household types that make up both the working-age population in poverty and the Universal Credit claimant base: single people without children, single people with children, couples without children, and couples with children. In order to represent the widest range possible, we represent a household from each of these groups in our illustrative analysis.

In addition to these groups, we also analysed the impact of Universal Credit on households with a disabled person (ESA support group). The impacts were on-out-of-work entitlements, discussed earlier in the literature review and higher returns upon entering work (due to an increase in the work allowance). Further analysis on work incentives is possible, but would require consideration of the care and support needs of the household, which are out of the scope of this report.

As discussed in Chapter 1, housing costs are a huge factor in determining whether or not a family is in poverty. We represent households living in three different housing sectors which make up a large proportion of the working-age population in poverty: private rented sector tenants (34%), social rented sector tenants (32%) and owner/occupiers with a mortgage (23%) (DWP, 2013a, p. 171). Since social rented sector tenants are most likely to be in poverty (*ibid.*, p. 174), we have included two households from the social rented sector.

We use poverty lines calculated for 2014/2015[1], as we are using 2014/2015 benefit and tax rates to calculate income.

We conducted our analysis for each case both before housing costs (BHC) and after housing costs (AHC). We use an AHC poverty line in our core analysis because this tends to be a more meaningful measure for low-income groups. However, we draw attention to cases where BHC and AHC analysis is markedly different. Table 6 provides a detailed description of each of the four representative households in our analysis, as well as the poverty lines for each of these.

[1] To calculate our poverty lines, we started with the most recent poverty lines (as measured by 60% of median income) provided by the *Households Below Average Income* (DWP, 2013a, p. 46) which are for 2011/2012. We equivalised the lone parent poverty line using the OECD equivalence scales (*ibid.*, p. 275), then uprated all poverty lines by wage inflation outturn and forecasts from the Office for Budget Responsibility (OBR, 2013) as a proxy for rises in the median wage to reach our 2014/2015 poverty lines. It should be noted that though average earnings growth is the main driver of increases in the median wage, making it a reasonable proxy, this method of uprating does not include changes to the tax and benefit system, changes in other sources of income (e.g. pensions, savings), or changes in employment which may also affect median income.

Table 6: Four representative households

Household type	Poverty Line 2014/15 (AHC) £/month	Poverty Line 2014/15 (BHC) £/month
Single, under 35, no children, Private Rented Sector, shared room	£590.20	£793.08
Single, over 25, 1 child under 5, Social Rented Sector, 2 bedrooms	£791.24	£1,026.95
Couple, both over 25, no children, Owner/occupier with mortgage, 1 bedroom	£1,014.40	£1,180.40
Couple, both over 25, 2 children 5-15, Social Rented Sector, 3 bedrooms	£1,646.10	£1,807.48

We use Policy in Practice's Universal Benefit Calculation Engine[2] to calculate entitlements and take home incomes under both the current system and Universal Credit.

We use 2014/15 rates for benefits and Local Housing Allowance (LHA) and assume workers are earning the National Minimum Wage, in order to focus our analysis on the lowest earners. A full list of assumptions that have been made in order to calculate entitlements can be found in the Appendix.

Our analysis is based on 'take home income'. By this we mean the total sum of all benefits and credits the household is entitled to and earnings net of tax, less housing costs and where applicable, less the household's liability for childcare costs[3].

Rent and housing costs, and therefore their level of housing support, have a big impact on a household's income and whether or not they are in poverty. For the private rented sector household, we assume a rent of the median LHA for the property size. For the social rented sector household, we assume a rent of 80% of the median LHA for the property size. For the owner/occupier household, we assume a mortgage debt of £75,000, which is the average for the UK (ONS, 2013a), and an interest rate of 3.63% which is the standard rate used by the DWP to calculate Support for Mortgage Interest (SMI) payments.

Childcare costs and childcare support also greatly impact a household's take home income and work incentives. For our lone parent household, we assume that the household is not entitled to free early education, and thus needs one hour of childcare for every hour worked. We use a childcare cost of £3.93 per hour, based on the national average hourly charge for a childminder for a child under two (Daycare Trust, 2013).

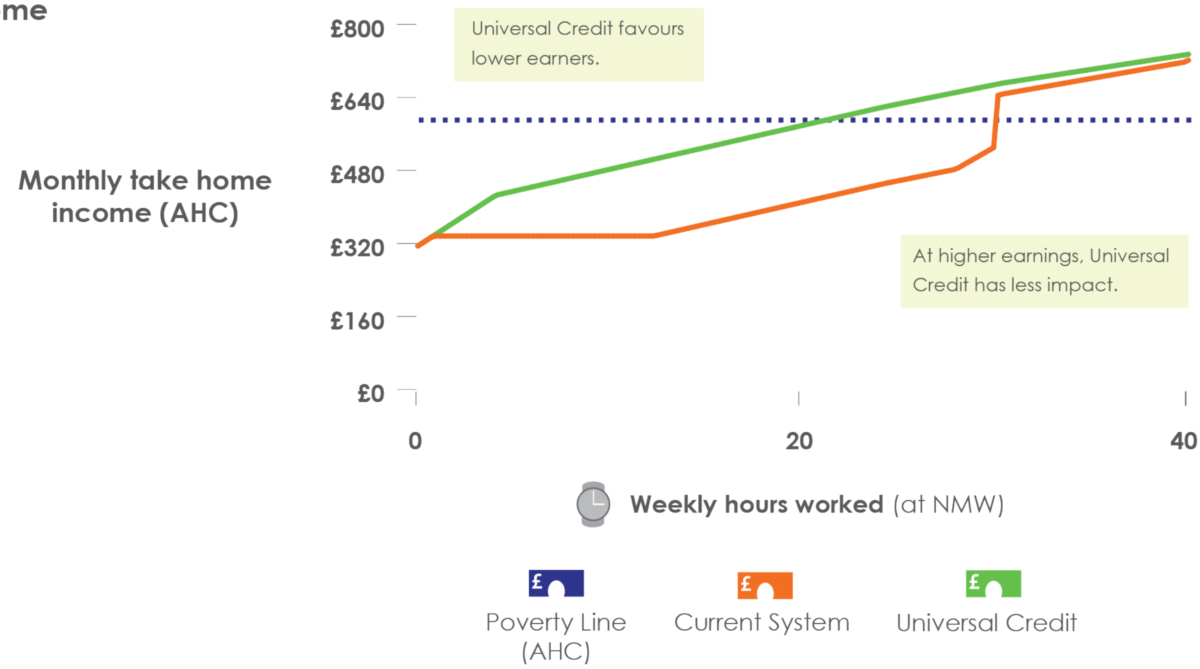
[2] http://policyinpractice.co.uk/universal-benefit-calculator/

[3] Our analysis adds the childcare subsidy (70% of costs under the current system, 85% of costs under Universal Credit) to the household's take home income, but deducts the parent's liability for childcare (i.e. what is not covered by childcare subsidy). This takes into account the value of childcare support that is received by the household, while also reflecting the impact on disposable income.

HOUSEHOLD TYPE 1: SINGLE PERSON WITHOUT CHILDREN

Our first household is a single person who is under 35 with no children, living in shared accommodation in the private rented sector, with rent of £271.66 per month (the median LHA). Figure 5 illustrates the single person's take home income (AHC) under the current system and under Universal Credit with respect to the poverty line.

Figure 5: Single person without children's take home income



The current system and Universal Credit both start this household off well below the poverty line when out of work, with a monthly income that is £276 less than the poverty line.

However, when the household begins to work just a few hours, there is a stark difference between the two. The pound for pound reduction of income-replacement benefits (e.g. Jobseeker's Allowance) means that under the current system, this household sees no financial gain from work at low hours after exhausting their work allowance of £5 per week, which is less than 1 hour of work.

On the other hand, Universal Credit gives this household both a more generous work allowance and only tapers away the financial gains from work by 65%. This helps the household to cross the poverty line at around 21 hours of work per week, instead of at 30 hours of work under the current system, when the household is eligible for Working Tax Credit.

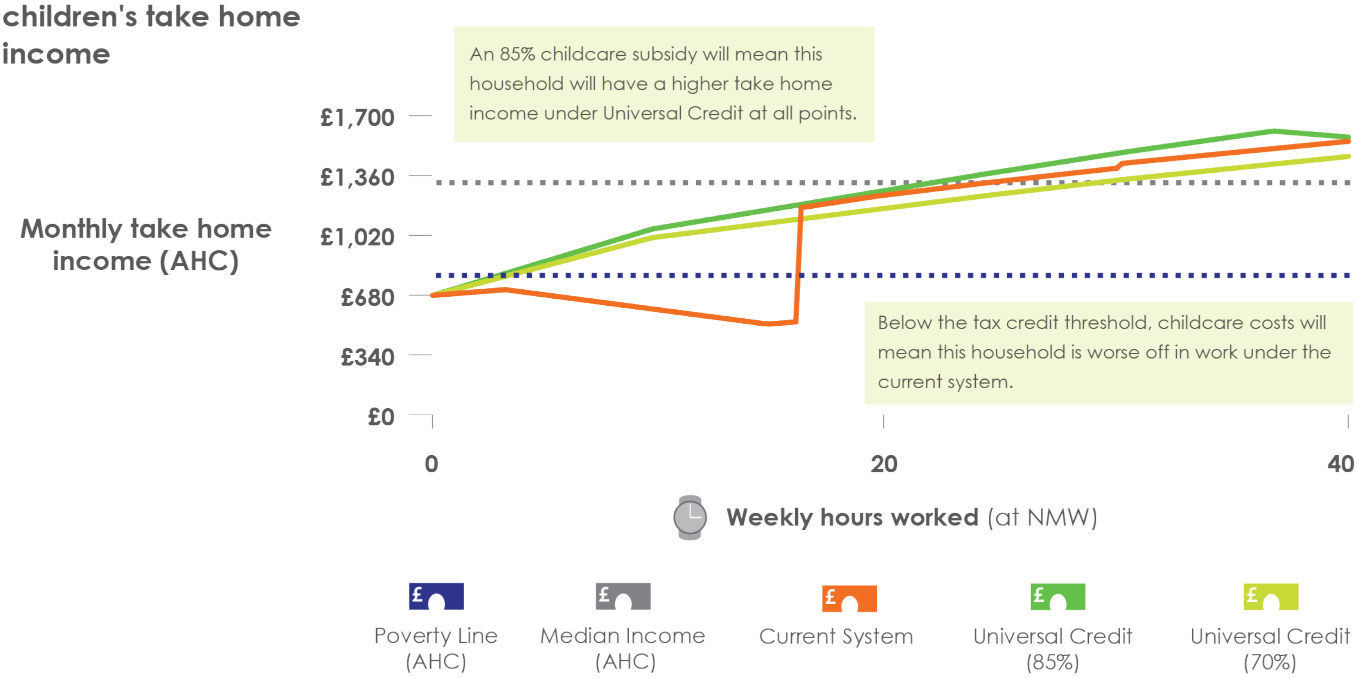
Overall, Universal Credit is more effective at tackling poverty in this case because it allows this household to escape poverty through a lower level of earnings when compared with the current system, and generally favours lower earners.

HOUSEHOLD TYPE 2: SINGLE PERSON WITH CHILDREN

Our second household is a lone parent with a child under 5, living in a 2 bedroom property in the social rented sector, with a rent of £399.95 per month (80% of the median LHA). In order to work, the lone parent needs to pay for formal childcare which costs £3.93 per hour before subsidy, and we assume that they require one hour of childcare for each hour worked.

Figure 6 below shows the household's take home income (AHC, less childcare liability) under the current system and under Universal Credit. In this case, we model Universal Credit with two different policy parameters: a 70% childcare subsidy, as UC is currently configured, and an 85% childcare subsidy which was announced in the Budget 2014 (HM Treasury, 2014).

Figure 6: Single person with children's take home income



This household starts off below the poverty line when out of work under both benefit systems, their income falling short of the poverty line by £113 per month, which is a substantially smaller poverty gap than for our single person without children. If we were to use a BHC measure, this household would be above the poverty line when out of work.

When the household enters work, there is a drastic difference between the current system and Universal Credit. Under the current system, the household sees a slight increase in income for the first three hours of work due to a higher £20 per week work allowance for lone parents. However after the work allowance has been exhausted, the household is worse off in work as they need to pay for formal childcare but are not yet entitled to childcare support on top of a pound for pound reduction of Income Support. The household is only able to escape poverty at 16 hours of work per week, when they become entitled to Working Tax Credit, which includes childcare support.

ILLUSTRATIVE ANALYSIS

On the other hand, Universal Credit offers both a higher work allowance and access to childcare support without a minimum number of working hours required. This allows the household to cross the poverty line at around 3.5 hours of work per week with a 70% subsidy and around 3 hours of work with an 85% subsidy. Furthermore, while a 70% childcare subsidy caused Universal Credit to be less generous than the current system above the tax credit threshold, the 85% childcare subsidy announced by the Government will make this household better off under Universal Credit at all points. However, with an 85% childcare subsidy, this household does hit the cap on childcare support (£532 per month for one child, £913 per month for two or more children) at around 37 hours of work. From this point on, the household receives no additional childcare support but incurs additional childcare costs, thus they 'pay' to work.

Unlike the other three households in this chapter, our lone parent household is able to achieve a median income when earning a minimum wage. Under the current system, they are able to reach the median income with around 24 hours of work per week. With a 70% childcare subsidy, the household is able to achieve a median income with 29 hours of work per week under Universal Credit, but an 85% childcare subsidy helps UC to outperform the current system, supporting this household to achieve a median income with 22 hours of work per week.

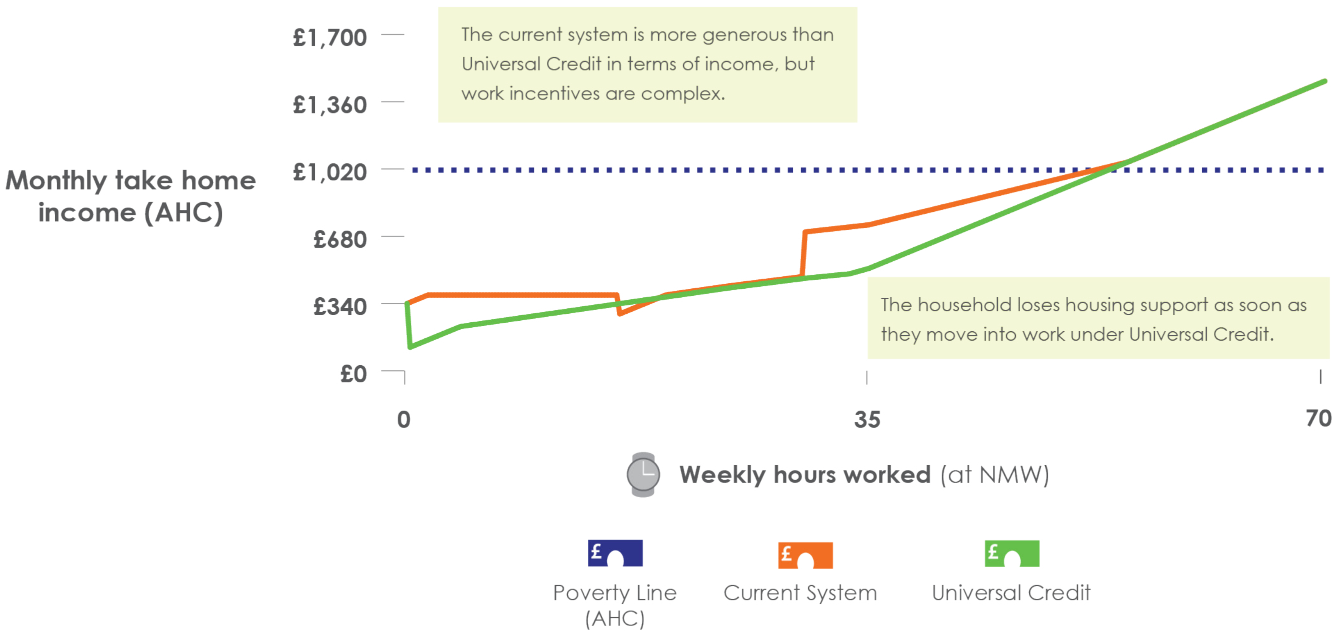
Overall, we see that a 70% childcare subsidy under Universal Credit would help this household to escape poverty at a lower level of earnings, but would be less generous above the tax credit threshold of 16 hours. However, the 85% subsidy that has been announced by the Government will not only help this household to escape poverty at a lower level of earnings, but will also provide a higher take home income at all points and enable the household to achieve a median income with fewer working hours.

ILLUSTRATIVE ANALYSIS

HOUSEHOLD TYPE 3: COUPLE WITHOUT CHILDREN

Our third household is a couple without children with both partners aged over 25. They are owner/occupiers of a one bedroom property with a mortgage debt of £75,000 and an interest rate of 3.63%, giving them a mortgage payment of £381 each month, £227 of which is interest. Figure 7 illustrates the household's take home income under both the current system and Universal Credit. We assume that the first 35 hours are worked by one partner, then each additional hour is worked by the second earner.

Figure 7: Couple without children's take home income



This household is well below the poverty line under both the current system and Universal Credit when out of work. With their income falling £674 short of the poverty line each month, they are in the deepest poverty when compared to our other three households.

Housing costs are contributing to this high level of deprivation because as owner/occupiers they are only eligible to receive partial support for their housing costs. They can receive support for their mortgage interest payments, but not payments toward the capital on their home. The poverty gap would be lower if BHC measures were used, at £459 per month, but the household would still be well below the poverty line.

Under Universal Credit, this housing support ends as soon as the household enters work, causing their income to drop sharply and for the household to be worse off in work. They then need to work 16 hours per week to reach an income equal to their out-of-work income. Their income then rises with each additional hour worked.

Though the household is eligible for housing support in work under the current system, they see no financial benefit from work after exhausting their work allowance and when working a low number of hours due to the pound for pound reduction of Jobseeker's Allowance (JSA). At 16 hours, the household loses entitlement to both JSA and housing support, leading to a fall in income that takes them below their out-of-work level of income.

From around 18 to 30 hours, both systems give the household a relatively similar income, with income under the current system being very slightly higher. However when the household is eligible for tax credits at 30 hours of work each week, the current system becomes more generous. It allows the household to cross the poverty line slightly earlier than under Universal Credit, with around 52 hours of work per week compared to 53 hours under Universal Credit.

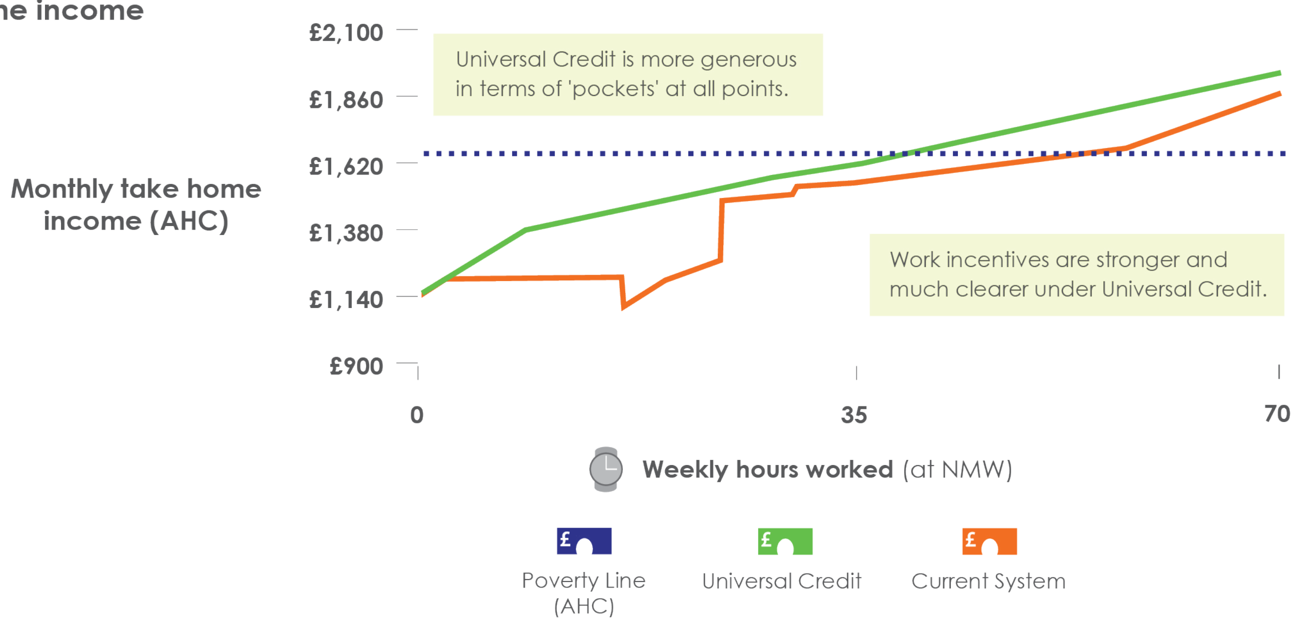
On the other hand, if this household rented their property, they would start off with a higher income out of work under both systems, as they would receive the full amount of their housing costs. This would reduce the poverty gap to £520 per month after housing costs. As renters, this household would not see their income fall upon entering work under Universal Credit as they would retain entitlement to housing support, making them better off in work with each hour worked. To escape poverty, the household would have to work 61.5 hours of work per week under the current system and 55.5 hours under Universal Credit. This means that under both systems, greater entitlement to housing support (and therefore greater withdrawal of benefits) means that this household would have to work more hours to cross the poverty line as renters as they would when owning their property, but Universal Credit outperforms the current system.

Overall, the current system performs better than Universal Credit in terms of 'pockets', notably below 16 hours and above 30 hours. While both systems offer poor work incentives at a low level of earnings, incentives are much more complex under the current system than under Universal Credit.

HOUSEHOLD TYPE 4: COUPLE WITH CHILDREN

Our final household is a couple with two children between 5-15, living in a 3 bedroom property in the social rented sector, with a rent of £459.99 per month (80% of the median LHA). Figure 8 illustrates the household's take home income under both the current system and Universal Credit. We assume that the first 35 hours are worked by one partner, then each additional hour is worked by the second earner. Childcare has not been included in this case.

Figure 8: Couple with children's take home income



This household is below the poverty line when out of work under both systems, with a poverty gap of £446 per month. When BHC measures are used, the poverty gap is reduced to £202 per month.

When the household moves into work, Universal Credit provides a higher income compared to the current system at all points. While Universal Credit helps the household to cross the poverty line at around 39 hours of work per week, they would need to work around 54 hours to cross the poverty line under the current system. However when using a BHC poverty measure, the household would need to work 7 hours per week under UC and 24 hours under the current system to escape poverty.

Work incentives are also strong and simple under Universal Credit, with the household being financially better off with each additional hour of work. On the other hand, the current system offers poor and complex work incentives. Before the tax credit threshold of 24 hours, the household sees little or no financial benefit from work. While tax credits give the household a boost in income, their incentive to take up more work remains low, only keeping between 9p and 21p of each pound earned until 57 hours of work.

Overall, Universal Credit is more effective both in terms of helping this household out of poverty and providing strong, clear work incentives.

FINDINGS AND CONCLUSION

In this chapter, we identified four households and examined the impact of Universal Credit on poverty reduction, household incomes, and work incentives. Broadly, we find:

- Each of our four households was in poverty (measured as 60% median income after housing costs) when out of work. The couple without children was the household in the deepest poverty both before and after housing costs.
- For three out of four of our households, Universal Credit favours low earners and helps families to escape poverty with a lower level of earnings than the current benefit system. This means that Universal Credit will be more effective at tackling in-work poverty than the current system for these groups. This is important in light of the rise of in-work poverty in the UK.
- The current system was more effective at reducing poverty in the case of the owner/occupier household, but not by much. This is due to a difference in housing support rules under the two systems.

FINDINGS AND CONCLUSION

- Childcare support has a big impact on each benefit system's performance in terms of household income. With a 70% childcare subsidy under Universal Credit, the current system is more generous above the tax credit threshold. An 85% childcare subsidy (as announced in the Budget 2014) will make Universal Credit more generous than the current system both below and above the tax credit threshold.

- Our lone parent was the only household that was able to reach the median income on the National Minimum Wage.

- Work incentives under Universal Credit are generally much clearer and relatively stronger than under the current system, with households being better off in work with each additional hour worked for most of the case studies explored here. Exceptions to this were the owner/occupier household, as they lost entitlement to housing support when moving into work, and the lone parent household after reaching the childcare support cap.

These case studies will serve as a baseline for our analysis on policy levers that could improve poverty reduction in Chapter 4. We will also examine the issues raised by this analysis: childcare support will be reviewed in Chapter 3 and analysed in Chapter 4, and housing support for owner/occupiers will be discussed in Chapter 4.

CHAPTER 3:

ISSUES IDENTIFIED WITH UNIVERSAL CREDIT

This chapter will review issues that have been identified in the literature either within Universal Credit, or due to their interaction with Universal Credit. While Chapter 1 and Chapter 2 found that core Universal Credit policy will have a positive impact on poverty, the scale of Universal Credit means that a range of other policies impact upon UC's ability to reduce poverty.

The policy issues identified in the literature are categorised into three themes:

- **Issues related to the implementation of Universal Credit** (administration, payment arrangements)
- **Issues not directly related to poverty** (savings and capital, self-employment, and in-work conditionality). However, these issues will still affect people in poverty.
- **Issues that impact poverty through 'pockets' and 'prospects'** (Passported Benefits, Council Tax Reduction Schemes, Income Tax and National Insurance, childcare support, and second earners)

The first two categories will not be analysed further in Chapter 4, as they are out of the scope of our analysis. The issues that impact poverty through 'pockets' and 'prospects' will then be further analysed in Chapter 4 to identify policy levers that can cost-effectively help to tackle poverty.

ISSUES RELATED TO THE IMPLEMENTATION OF UNIVERSAL CREDIT

ADMINISTRATION

Commentators broadly agree that the design of Universal Credit should simplify the move into work and increase certainty over take home income. However, some have made the case that the assessment of Universal Credit entitlement retains similar levels of complexity to the current system (ICAEW, 2012; IRRV, 2013). This affects certainty over entitlement, which can be important to securing and sustaining tenancies, and entering into work.

Feedback from local authority housing departments and housing associations has pointed out that the local authority role (and statutory responsibility) for housing will remain, while they will lose responsibility for administering Housing Benefit (House of Commons, 2013b). They argue that accurately calculating entitlement to housing support is challenging, yet also important to securing and sustaining tenancies. Assessment can require knowledge of tenancy law and entitlement can depend on separate pieces of complex legislation, while recent changes to housing benefit have further complicated this calculation.

Similarly, the Institute of Chartered Accountants in England and Wales (2012) has raised concerns about the complexity of the calculation of earnings, both generally, and in particular for the self-employed, which can lower certainty over income upon entering work.

In sum, it appears that opportunities to further simplify the rules governing entitlement to Universal Credit remain. Although administrative complexity is largely thought of as an implementation issue, it does have an impact on the recipient's experience of the system. A poor experience of the system can lower take-up, limit choices over housing and lead to uncertainty upon entering work.

PAYMENT ARRANGEMENTS

Universal Credit will normally be paid directly to the household as a single, monthly payment. This will combine all elements of the Universal Credit award, including the housing element.

ISSUES RELATED TO THE IMPLEMENTATION OF UNIVERSAL CREDIT

Under the current system, benefits are usually paid on a weekly or fortnightly basis and in some cases housing support is paid directly to the landlord (19% of private rented sector cases, 54% of social rented sector cases) (DWP, 2011c). This means that households will need to budget monthly and be responsible for paying their rent, possibly for the first time.

The intention is that Universal Credit payments will be more like income from work. This in turn will prepare recipients for entering the labour market and help overcome non-financial barriers to work. Monthly payments could also help households overcome the 'poverty premium' by providing the opportunity to make bulk purchases or pay bills monthly. A single payment rather than multiple payments at different times and intervals throughout the month could make budgeting easier for some households. Direct payments of Housing Benefit could encourage personal responsibility and make recipients aware of their rent.

Organisations that work with future Universal Credit recipients, such as City West Housing Trust (2012), Gingerbread (2012b) and St Mungo's (2012) among many others, have voiced concerns that some households may struggle to budget their money on a monthly basis, and will fall short at the end of the month. In a DWP survey of benefit and tax credit recipients, 42% of respondents said that getting monthly payments would make budgeting harder, with 80% of those saying that they might run out of money before the end of the month (Tu & Ginnis, 2012). Preliminary interviews with Universal Credit recipients in the pathfinder have revealed that 47% of respondents felt monthly payments were less convenient, while 37% felt monthly payments were more convenient (DWP, 2013b).

Single payments to the household could result in one partner having unequal access to the household funds. The Centre for

ISSUES RELATED TO THE IMPLEMENTATION OF UNIVERSAL CREDIT

Economic and Social Inclusion (CESI) has expressed concern that this will create an unfair bias against women (Tarr & Finn, 2012). They have also raised the point that child-related support will not necessarily be paid to the main carer of the child, meaning that Universal Credit support may be less likely to reach the children it aims to help (*ibid*.). However, in the DWP survey of benefit and tax credit recipients, only 9% of respondents said that having all benefits paid into one account would make budgeting harder, while 55% said it would make no difference, 14% said it would make it easier, and 20% already have their benefits paid this way (Tu & Ginnis, 2012).

Because Universal Credit will be paid one month in arrears, the Universal Credit award an individual receives one month will be based on their earnings from the previous month. This may cause problems for people with fluctuating earnings, the self-employed, or those in unstable employment for example.

Figure 9: The impact of payment in arrears on cash flow

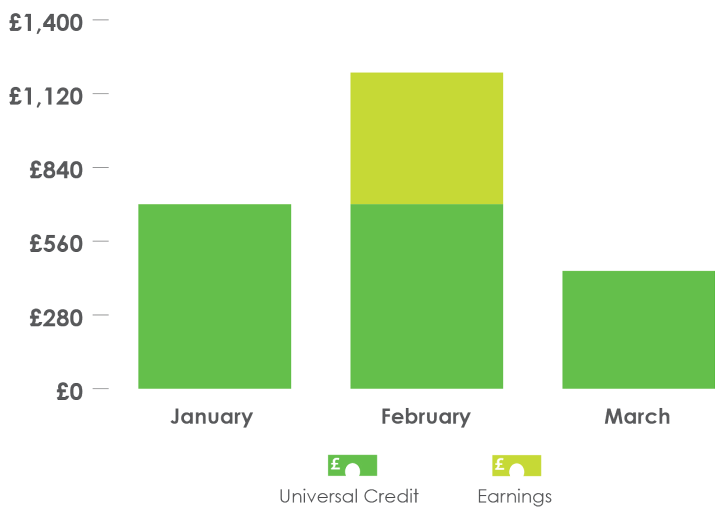


Figure 9 demonstrates the impact that monthly payments in arrears will have for a person with variable earnings. In this simple example, the out of work Universal Credit award is £700 per month. The household earns £500 in February, but does not see a reduction in their Universal Credit entitlement until the following month. This means that their take home income (BHC) is £1,200 in February, but without any earnings in March take home income falls to £447. While average take home income across the three months is higher than if there were no earnings, this household's fluctuating earnings are exacerbated by the payment of Universal Credit in arrears, creating a cash flow problem. This could create an additional budgeting challenge for families.

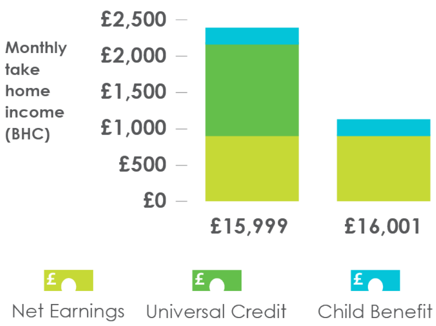
Finally, there is concern that the direct payment of the housing element to recipients could lead to increased rent arrears, and ultimately homelessness (Keohane & Shorthouse, 2012; Tarr & Finn, 2012). The direct payment of Housing Benefit is currently being tested in six project areas around the country. As of December 2013, after 14 payment periods, average collection rates across the projects stood at 94% (DWP, 2013c). However, around 26% of tenants who participated have had their payments switched back to direct payment to the landlord after falling into arrears (*ibid*.). Tenants are also receiving high levels of personal support for the project (*ibid*.), which has been considerably more resource-intensive than would be expected in a national rollout.

In order to address concerns about payment arrangements under Universal Credit, budgeting support will be provided through the Local Support Services Framework (LSSF), which will include local authorities and independent organisations. An interest-free, short-term advance may be available to households affected by the move to payment in arrears, and alternative payment arrangements (such as split payments between partners, more frequent payments, or payment of the housing element to the landlord) will also be available. The decision to award an alternative payment arrangement will be partly discretionary and partly based on a set of questions to determine the recipient's level of vulnerability.

SAVINGS AND CAPITAL

Under the current system, different benefits have different deduction rates and thresholds for capital (including personal savings). Income replacement benefits (e.g. Jobseeker's Allowance), Housing Benefit, and Council Tax Benefit have a capital limit of £16,000, with every £250 above £6,000 being treated as £1 of income each week. Tax credits have much more generous rules on capital. There is no capital limit and only gross income from savings is taken into account, with a £300 disregard.

Figure 10: A household's income could fall by 50% with an extra £2 in savings



Universal Credit will apply the same rules as current income-replacement benefits, Housing Benefit, and Council Tax Benefit, with a capital limit of £16,000 and every £250 above £6,000 leading to a £1 per week reduction in Universal Credit entitlement. The rationale for this is to focus Universal Credit on people with insufficient resources to meet their own needs (DWP, 2011d).

The DWP estimate this will eliminate entitlement for 100,000 to 200,000 households that would otherwise be entitled to Universal Credit (*ibid.*). It also significantly increases the disincentive to save for low-income households with savings at or around the £16,000 threshold. Figure 10 illustrates the impact that savings could have on a couple with three children, with one partner working full-time at the National Minimum Wage. Just £2 in additional savings causes their income to fall by more than half.

There is a six-month grace period for people who come into money suddenly (e.g. redundancy, inheritance). However, the savings threshold may encourage households on Universal Credit to spend this money (in order to fall below the threshold), instead of saving it, thus making it difficult for households on Universal Credit to save for a mortgage deposit.

The additional cost of increasing the savings threshold to £25,000 is estimated to be £70 million per annum (House of Commons, 2013c).

SELF-EMPLOYMENT

There are several concerns about self-employment under Universal Credit. Firstly, Universal Credit will introduce a 'minimum income floor' for the assessment of benefits. This will be set at the National Minimum Wage multiplied by the number of hours the individual is expected to work. This means that for self-employed people earning below this threshold, Universal Credit will be awarded on an assumed level of income rather than their actual level of income, but in line with National Minimum Wage legislation. The intention is that the minimum income floor will apply conditionality, just as conditionality applies to those in PAYE employment. However, Royston (2012) argues that the minimum income floor could compromise the self-employed's ability to manage difficult periods for their business, arguing that this is at odds with Universal Credit's goal of making work pay.

The Government have responded to these concerns by introducing a 12 month start-up period during which the minimum income floor will not apply. This will allow new businesses time to reach profit levels equivalent to the National Minimum Wage or greater. In addition, self-employed people already in receipt of benefits under the current system who are moved onto Universal Credit will not be subject to the minimum income floor for 6 months.

ISSUES NOT DIRECTLY RELATED TO POVERTY

Lastly, since Universal Credit will be assessed on a monthly basis, self-employed people will need to report their earnings to the DWP each month. Under the current benefit system, self-employed people only provide HMRC evidence of their earnings once each year in order to receive tax credits. There is concern that this increased administrative burden would disincentivise people from becoming self-employed (Tarr & Finn, 2012). However, a study that interviewed 45 self-employed tax credit recipients found that although they would not welcome monthly reporting, most felt that they would be able to meet the DWP's requirements (Sainsbury & Corden, 2013).

IN-WORK CONDITIONALITY

Universal Credit will, for the first time, introduce conditionality for recipients who are in work, but earning below a certain earnings threshold. The policy intent is to encourage progression in work and reduce benefit dependency (DWP, 2011e).

The conditionality threshold will be set at the number of hours the household is expected to work, multiplied by the National Minimum Wage (*ibid*.). The number of hours the household is expected to work will depend on the household's circumstances (e.g. ages of children, limited capacity for work, caring responsibilities) and are similar to the hours rule that determines eligibility for Working Tax Credit today. For example, a lone parent with a child aged 5-15 is expected to work 16 hours to qualify for Working Tax Credit today. Under Universal Credit, they will be expected to earn 16 hours x National Minimum Wage.

The key difference between the two systems is that under the current one, the Working Tax Credit hours rule only applies to Working Tax Credit, while Universal Credit conditionality applies to *all* elements that make up the household's entitlement, including the child and housing elements.

Under Universal Credit, those who do not meet their personal earnings threshold may be asked to increase their earnings by:

- Increasing their hours or wage with their current employer
- Taking on one or more additional jobs
- Finding a new job with a higher income (DWP, 2011f)

The DWP (2012a) estimate that 1 million more individuals will be subject to conditionality under Universal Credit. Independent analysis from the Resolution Foundation estimates this number to be around 1.2 million individuals (Pennycook & Whittaker, 2012).

The Government argues that the introduction of in-work conditionality helps to overcome a problem that exists today – a system that does not offer incentives for progression in work – and offers an opportunity to intervene in order to support skills development and progression in work (DWP, 2013d).

However, some commentators (e.g. Pennycook & Whittaker, 2012) are concerned about the implementation of in-work conditionality. Extending conditionality and employment support to another million or so recipients will mean that Jobcentres will need to manage increased caseloads. Without sufficient resources, the conditionality regime could be unable to provide the employment support needed to help people progress in work, which in turn could lead to increased expenditure on Universal Credit (*ibid*.).

There are also concerns about the feasibility of in-work conditionality in the context of a weak labour market (*ibid*.), as well as the possibility of advisors imposing inappropriate requirements on recipients (Simmons, 2011). However, the DWP

ISSUES NOT DIRECTLY RELATED TO POVERTY

has recognised the sensitive nature of imposing conditionality, and stated that a recipient's circumstances will be taken into account when setting goals and that conditionality requirements must be compatible with their paid employment (DWP, 2013d).

How in-work conditionality will work in practice is yet to be seen. The Government put out a consultation for ideas to find out what interventions can effectively support employment and progression (DWP, 2013e) and is currently running ten in-work conditionality pilots in Jobcentres.

ISSUES THAT WILL IMPACT POVERTY THROUGH 'POCKETS' AND 'PROSPECTS'

PASSPORTED BENEFITS

Passported benefits are benefits that people are automatically entitled to if they receive other qualifying benefits. They differ slightly in England, Wales, Scotland, and Northern Ireland, but the main passported benefits administered by central government departments are listed on the left. In addition, there are other passported benefits that are administered by local authorities, such as school clothing grants, free leisure services, and discounts on public transport.

Free School Meals (FSM) are the main passported benefit, with an estimated 1 in 5 children entitled to them. The Children's Society estimates that over half of children living in poverty – 700,000 – were not eligible for Free School Meals, and in addition to this 500,000 more children in poverty have an entitlement to FSM, but are not taking them up (Royston, *et al.*, 2012). They cost an estimated £367 per year to provide (Nelson, *et al.*, 2012).

List of Passported Benefits

- Free School Meals
- Free NHS prescriptions
- Free dental treatment
- Free eye tests
- Healthy Start vouchers
- Legal Aid
- Exemptions from Court Fees
- Cold Weather Payments
- Funeral Payments
- Sure Start maternity grant
- Help with travel costs (for healthcare, prison visits, and through Jobcentre Plus)

ISSUES THAT WILL IMPACT POVERTY THROUGH 'POCKETS' AND 'PROSPECTS'

The introduction of Universal Credit means that the current system for administering Free School Meals will have to change. Under the current system, the loss of Free School Meals is compensated for by entitlement to Working Tax Credits. However, under Universal Credit there will be no point at which the loss of FSM is covered by a sharp increase in other benefits. While the Government has announced its plan to extend FSM to all children aged 5-7, the treatment of FSM for older children under Universal Credit is yet to be decided at the time of writing.

If eligibility for Free School Meals is lost suddenly under Universal Credit, by for example using an income threshold, then this could create a cliff edge which would have a negative impact on work incentives (Centre for Social Justice, 2012; Royston, *et al*., 2012). As Table 7 demonstrates, families would need to achieve a level of earnings much higher than the value of FSM in order to compensate for their loss, due to the simultaneous withdrawal of Universal Credit.

Table 7: Families will need to earn more than the value of FSM to compensate for their loss

Number of Children	Value of FSM* (£/year)	Annual gross earnings required (below tax threshold)	Annual gross earnings required (above tax threshold)
1	£367	£1,049	£1,542
2	£734	£2,097	£3,084
3	£1,101	£3,146	£4,626
4	£1,468	£4,194	£6,168

*Source: Nelson, et al., 2012

Many, including the Children's Society, Child Poverty Action Group, and Save the Children, have argued that Free School Meals should be extended to all families in receipt of Universal Credit (DWP, 2012c). This would extend eligibility to 3.38m children in England (Royston, *et al*., 2012), but would increase the cost of providing Free School Meals by between £502m

(Royston, *et al*., 2012) to £750m per year (House of Commons, 2014). A more affordable option would be to have working families pay a proportion of their FSM through a reduced work allowance. This proposal will be explored further in Chapter 4.

COUNCIL TAX SUPPORT

Over 5.9 million households claimed Council Tax Benefit in 2013, which is more than any other means-tested benefit or tax credit (DWP, 2013f). 3.7 million Council Tax Benefit recipients were of working age, with an average weekly award of £15.63 (*ibid*.).

Unlike all other means-tested benefits for working age households, Council Tax Benefit was not included as part of Universal Credit. Instead, Council Tax Benefit was localised in April 2013. The new Council Tax Reduction Schemes (CTRS) are administered by each independent local authority, with their own locally-designed means test. The rationale for localised support was to encourage local authorities to play a greater role in promoting employment and growth in the local economy and to allow support to vary between local authorities to reflect local priorities (Adam & Browne, 2012). Central government funding for CTRS has been reduced by 10% (compared with Council Tax Benefit). This has increased poverty, with a number of out-of-work households having to pay Council Tax for the first time, increasing the cost of administering support (Bushe, *et al*., 2013).

The localisation of council tax support has been criticised for introducing complexity into the welfare system, which Universal Credit was intended to reduce. The Institute for Fiscal Studies (Adam & Browne, 2012) and the Centre for Economic and Social Inclusion (Tarr & Finn, 2012) have both argued that failing to include a key means-tested benefit within Universal Credit has the potential to undermine both the simplicity and improved work incentives that Universal Credit aims to achieve. Households will have to submit a separate application to claim council tax support, and face the simultaneous withdrawal of both Universal Credit and council tax support.

The IFS find that households could then lose 81-90p of each £1 earned, depending on how Universal Credit is treated for the means test (Adam & Browne, 2012). Some CTRS schemes introduce a minimum payment for council tax support, meaning that if entitlement to council tax support were to fall below a certain amount (e.g. £5 per month), the household would no longer be entitled to support. This introduces a small 'cliff-edge' back into the benefit system.

As a result, localised council tax support could reintroduce some of the extremely weak work incentives that Universal Credit is trying to address.

> "[T]he advantages of localisation seem to be strongly outweighed by the disadvantages, particularly in the context of the welcome introduction of Universal Credit" (Adam & Browne, 2012, p. 108).

In Chapter 4, we will analyse the impact of Council Tax Reduction Schemes combined with Universal Credit and the effect bringing council tax support within Universal Credit might have.

INCOME TAX AND NATIONAL INSURANCE

Tax and national insurance thresholds have risen from £6,475 in 2010 to £10,000 (HM Treasury, 2013a). The political momentum behind lowering income tax rates, and raising thresholds continues. However, commentators such as Hirsch (2013) have pointed out that many of the benefits of reductions in income tax will not reach lower earners.

This is because many low income households are either out of work, or earn below the income tax threshold. 2.7 million additional low income individuals will not pay any income tax in April 2014 compared with 2010, and will not benefit from further increases in the threshold (HM Treasury, 2013a). In addition, because Universal Credit is withdrawn based on net income, households that do benefit from paying less income tax will see two-thirds of this benefit withdrawn through lower Universal Credit entitlement (Hirsch, 2013).

CHILDCARE

Childcare support under Universal Credit has been the subject of much debate. In the original Universal Credit regulations, families were to receive support for 70% of their childcare costs through the childcare element of UC.

As illustrated by our lone parent case study in the previous chapter, Universal Credit was more generous than the current system at a low number of hours. This is because under the current system, parents have to work 16 hours or more in order to qualify for childcare support through tax credits. There is no such hours rule under Universal Credit, so parents will be eligible for childcare support no matter how many hours they work. The DWP (2011g) estimate that this will extend childcare support to a further 80,000 families.

On the other hand, our lone parent case study illustrated that above the tax credit threshold, Universal Credit is less generous than the current system with a 70% childcare subsidy. This is because under the current benefit system, families could receive childcare support through tax credits (70% of their costs) and also receive additional Housing Benefit and Council

ISSUES THAT WILL IMPACT POVERTY THROUGH 'POCKETS' AND 'PROSPECTS'

Tax Benefit since their childcare costs are disregarded, in effect giving the family up to 95.5% in childcare support overall (Royston, 2012). It is estimated that 100,000 families would have seen their level of childcare support fall under Universal Credit (House of Commons, 2011b). In addition, childcare support through tax credits is only withdrawn at 41% while under Universal Credit, it will be withdrawn at 65%.

As a result, a range of reports have argued that the high cost of childcare, compounded by low levels of subsidy and higher withdrawal rates, will mean that work will not pay for some that rely on formal childcare. Hirsch & Hartfree (2013) found that this leads to a 'plateauing' of take home income. Studies have also found that in some cases, particularly for people with high childcare costs and multiple children, families would actually be paying to work (Barnardos, 2012; Gingerbread, 2012a; Hirsch & Hartfree, 2013).

Figure 11: Some parents pay to work

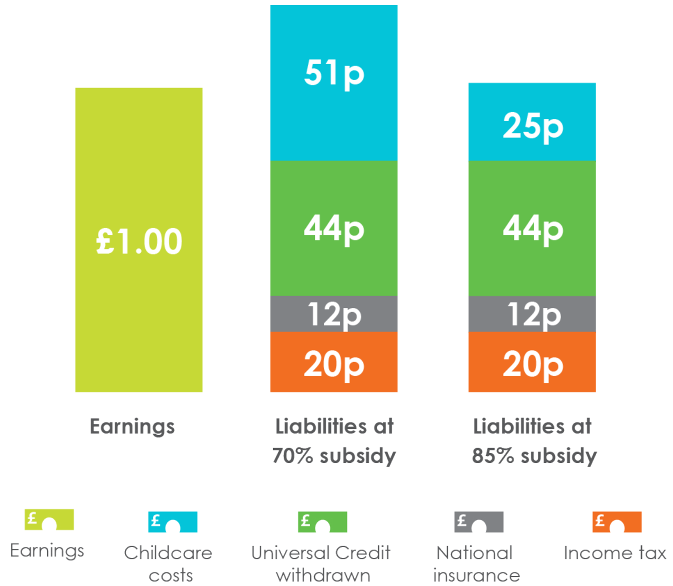


Figure 11 illustrates this point using the case study of a lone parent with two children, whose childcare costs are £5.33 per hour per child (the average cost of a nursery place in London) (Daycare Trust, 2013). When receiving a 70% childcare subsidy, this parent would have £1.27 of liability for each pound earned, leading to a net loss. At the same time, the government is paying £1.18 in childcare support for each pound earned, while seeing income tax and national insurance contributions increase, and Universal Credit payments withdrawn.

To address the concerns of a 70% childcare subsidy under Universal Credit, the Government proposed an 85% subsidy in the Budget 2013 (HM Treasury, 2013b) for households where each adult is paying income tax (and thus earning above £10,000). This was expected to cost an additional £200 million per year. However, commentators (e.g. Cory, 2013) argued that this would only help families on higher incomes and would create a cliff-edge in the system where parents would see a big jump in income.

Thus, many organisations (e.g. Barnardo's, the Children's Society, the TUC, CPAG, Gingerbread, Working Families, The Resolution Foundation, and The Women's Budget Group) campaigned for all parents receiving Universal Credit to be eligible for an 85% childcare subsidy. The DWP estimated that this would cost an additional £200 million (DWP, 2013g). The Budget 2014 responded to these calls and announced that all households receiving Universal Credit will receive 85% childcare support (HM Treasury, 2014).

However, the cost of increasing the childcare subsidy within Universal Credit – a total of £400 million - will be funded through savings within the Universal Credit Programme, but the exact details of this will not be provided until the Autumn Statement 2014 (*ibid.*; HM Treasury, 2013b). This could mean that other elements of Universal Credit, such as the work allowance, will be reduced in order to pay for a higher childcare subsidy and therefore families may not see much financial gain from this policy. In contrast, the government has committed £750 million of new money to fund tax-free childcare vouchers for families earning enough not to receive Universal Credit, and who could have a household income up to £300,000 per annum.

Furthermore, a subsidy of 85% may not be sufficient to address the problem for families with high childcare costs. As demonstrated in our lone parent case study in the previous chapter, an increased subsidy may cause households to reach the childcare support cap with fewer working hours. Additionally, the household in Figure 11 would still 'pay to work' by 1p per pound earned when receiving 85% of childcare costs in support and earning enough to pay tax and national insurance, while the government would be paying £1.44 in childcare support for each pound earned.

The cost of childcare itself – not just the level of support given – contributes to households having to 'pay to work' as well as incurring a high cost to the government. Childcare costs have recently been rising above the rate of inflation, and the cost of a nursery place has increased by 77% in the past ten years (Daycare Trust, 2013). Thus, policymakers should also look for ways to reduce the cost of childcare.

SECOND EARNERS

Under the current system, second earners may keep 59p of each pound earned if they are only in receipt of tax credits (or 21p if tax credits and Housing Benefit are withdrawn together). This means that work incentives for second earners in receipt of tax credits may be weakened under Universal Credit (CPAG & TUC, 2013; Hirsch & Hartfree, 2013; Lawton & Thompson, 2013).

This could have implications for Universal Credit's ability to reduce poverty, as the risk of poverty is greater for children in couple families with only one earner (Lawton & Thompson, 2013). Some commentators (e.g. CPAG & TUC, 2013) argue

ISSUES THAT WILL IMPACT POVERTY THROUGH 'POCKETS' AND 'PROSPECTS'

that a new category of work allowance for second earners should be introduced to address this issue.

However, the household work allowance is greater in real terms under Universal Credit than the current benefit system. For example, under the current system, a couple has a £10 per week work allowance whereas under Universal Credit, their work allowance will be about £25 per week. So while work incentives for second earners may be weaker under Universal Credit, the work allowance under UC provides greater protection against poverty both in terms of 'pockets' and the 'prospects' of the household as a whole.

We look at the impact of a second earner work allowance in Chapter 4.

CONCLUSION

The literature has raised a number of concerns about Universal Credit policy, and about policies that interact with UC. These issues have the potential to influence Universal Credit's ability to reduce poverty.

The literature finds that the implementation of Universal Credit will have an impact on poverty, as it will affect recipients' experience of UC, including their ability to secure and sustain tenancies, and the management of their household finances.

Changes to capital rules will introduce a savings 'cliff-edge' at £16,000, the minimum income floor may lower entitlement for self-employed people, and the impact of in-work conditionality is uncertain. Although these changes will affect people in poverty, they are not directly related to poverty. They will not, therefore, be analysed further in the next chapter.

CONCLUSION

This chapter also identified a number of issues that impact on poverty through ‘pockets’ and ‘prospects’. found that: a) the sudden withdrawal of Free School Meals is likely to have a negative impact on incentives to progress in work b) council tax support introduces the kind of complexity back into the benefit system that Universal Credit was aiming to eliminate c) the impact of changes to income tax and national insurance rates and thresholds are not felt by the lowest earners d) there are concerns about the impact of childcare costs on parents that need formal childcare support in order to work e) second earners may see lower work incentives under Universal Credit. Each of these are analysed further in the next chapter.

CHAPTER 4:

UNIVERSAL CREDIT POLICY PARAMETERS AND THEIR IMPACT

In the earlier chapters, we looked closely at the impact of Universal Credit as it is currently configured, drawing attention to particular policy parameters such as the base out-of-work award, the work allowance and the withdrawal rate, all of which are central to the design of Universal Credit. Our case studies in Chapter 2 and the literature review in Chapter 3 drew attention to factors that indirectly impact the effectiveness of Universal Credit in tackling poverty, such as childcare support, entitlement to Free School Meals and council tax support.

In this chapter, we will analyse the impact that changing a range of policy parameters, within and related to Universal Credit, would have on UC's effectiveness at tackling poverty through both 'pockets' and 'prospects'.

METHODOLOGY

Our analysis will examine direct policy parameters within Universal Credit and indirect policy parameters outside of Universal Credit (but within the control of the government). We will also examine wider economic factors, as these form part of the wider policy debate around Universal Credit and poverty reduction. Table 8 provides a list of the policy parameters analysed in this chapter.

Table 8: Policy Parameters

Direct policy parameters	**The base level of support:** The amount of Universal Credit a household receives when out of work. It has a direct impact on take home income for all households on Universal Credit. **Childcare support:** The level of subsidy that parents can receive for formal childcare costs. It can affect take home incomes for families in work and the financial returns from work. **Work Allowance:** The amount a household can earn before benefits are withdrawn. It can affect take home incomes for families in work, and the financial returns upon entering work. **The Withdrawal Rate:** The rate at which benefits are withdrawn as earnings increase. This impacts work incentives and the financial returns from work.

Table 8: Policy Parameters

Indirect policy parameters	**Income tax and national insurance:** Tax rates and thresholds are analogous to the work allowance and withdrawal rate in Universal Credit, but operate higher up the income scale. **Council tax support:** A locally administered means tested benefit that can affect poverty levels, work incentives and the complexity of the benefit system. **Free School Meals:** Free School Meals are a passported benefit. The criteria for administering passported benefits under Universal Credit is not yet decided.
Economic factors	**Wage levels:** Higher wages increase take home incomes for in-work households. **Living costs:** Lower living costs can lead to an increase in disposable incomes.

We will model the impact of changing each policy parameter on poverty, household income, and work incentives using Policy in Practice's Universal Benefit Calculation Engine.[4] We use 2014/2015 benefit, tax, and Local Housing Allowance rates.

As in Chapter 2, we use a poverty line that is 60% of the median income after housing costs. This has been uprated for 2014/2015.

Our analysis is based on 'take home income'. By this we mean the total sum of all benefits and credits the household is entitled to and earnings net of tax, less housing costs and where applicable, less the household's liability for childcare costs.

We then evaluate each policy parameter using a balanced scorecard approach. Each parameter is scored against its impact on 'pockets', 'prospects', the extent to which it can be targeted, and an indication of its cost effectiveness (see Figure 12). Each of these indicators is evaluated using a traffic light system – red, yellow, and green.

[4] http://policyinpractice.co.uk/universal-benefit-calculator/

Figure 12: Scorecard indicators

Pockets: The direct impact the policy has on take home income.

Prospects: The policy impact on work incentives to either enter or progress in work.

Targeting: The ability for support from the policy to be targeted to particular groups of benefit claimants without complicating the existing system.

Cost effectiveness: An indication of whether the policy is likely to be expensive, or cheap and whether a many will benefit by little, or few will benefit by more.

The scorecard for costs indicates only whether a particular policy is likely to be cheap, or expensive. To support this, we provide an indicative calculation showing which households are expected to benefit from a particular policy at a given cost. However, the cost of a policy can be varied according to how much is available to spend (or how much needs to be saved). Cost estimates are based on the numbers that we expect to claim Universal Credit once it is fully rolled out.

OUR APPROACH

Policy parameters cannot be judged without a clear understanding of the objectives that policymakers are seeking to achieve. Clear objectives involve value judgements which typically involve political, rather than policy decisions: Would it be better that many benefit by a little, or a few benefit by more? Which groups are most in need of extra support, and what type of behavior should be encouraged and rewarded?

When we consider a relatively straightforward policy objective such as reducing poverty, even this proves difficult due to the way in which poverty is measured. As discussed in Chapter 1, there are drawbacks to using a relative income poverty line to evaluate the impact of policy. Firstly, a static analysis of Universal Credit will favour a 'pockets' approach. However, a 'prospects' approach may prove more cost-effective and sustainable over time thus, decisions will depend upon the dynamic effects that policymakers expect a particular policy to have.

Secondly, the measurable impact on poverty reduction is not necessarily indicative of the impact on people's lives. Increases in income below or above the poverty line would not be taken into account.

For example, a policy which increased a household's income from 59% of the median income to 61% of the median income would be measured as reducing poverty, since the household moved above the poverty line. On the other hand, a policy which increased a household's income up from 40% of the median income to 55% of the median income would not technically reduce poverty since the household has not crossed the poverty line. Though the latter policy may have a greater impact on household income, it has less of an impact on measured poverty reduction, unless a poverty gap measure is used.

Lastly, as an income measure, most poverty measurement fails to take into account the cost of living, though the cost of goods and services clearly also impacts upon living standards.

For these reasons, we do not wish to have too narrow an approach and will evaluate policies in terms of traditional poverty reduction, as well as through increased household income and improved work incentives.

METHODOLOGY

This chapter provides a clear framework for reaching decisions based on your own particular policy objectives. It can be read as a guide to the factors that policymakers should consider when making decisions about Universal Credit.

Finally, it is important to note that Universal Credit, though simpler than the current benefit system, shares many similar features. Work allowances, withdrawal rates and interactions with the tax system, wage levels and living costs are all part of the current system, and live areas of debate today. Although the interaction is more complex, many of the general findings can be applied to the current benefit system as well as Universal Credit.

DIRECT POLICY PARAMETERS

HOW SHOULD **THE BASE LEVEL OF BENEFIT** BE INCREASED TO REDUCE POVERTY?

The base level of support determines the amount received by an out-of-work household, with no other source of income. With the introduction of Universal Credit, the base level of out-of-work support was taken as given, so remains the same as under the current system. Ultimately, the level of out-of-work support, and the mechanism for the uprating of benefits requires careful consideration. This level of analysis is out of the scope of this report, however clear policies on the base level of support (e.g. setting support at a consistent level with respect to the poverty line for each household type) and on annual uprating (e.g. according to CPI, or wage growth) would help voters to differentiate between the aims and objectives of different political parties.

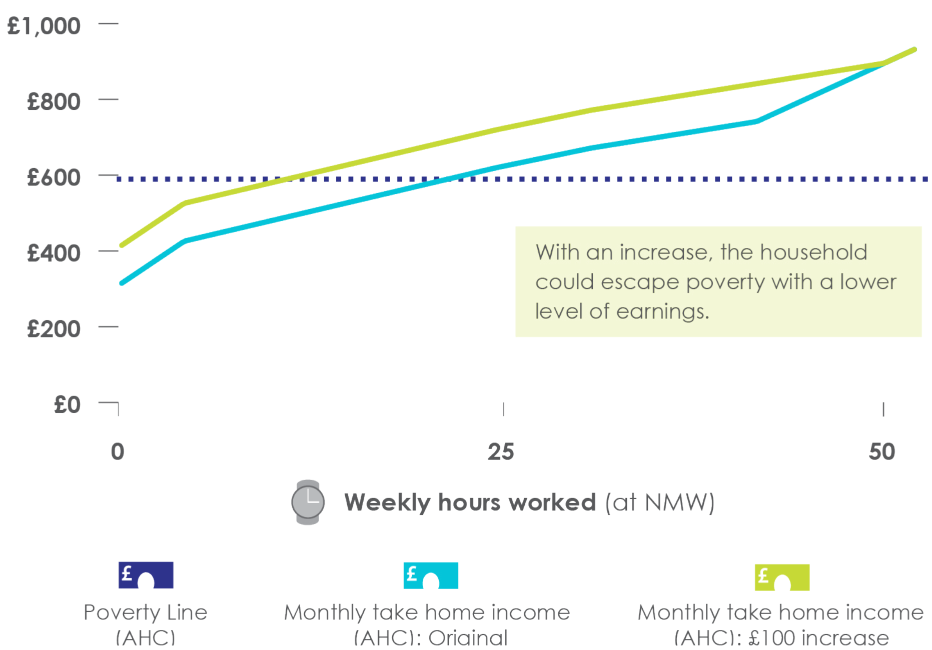
DIRECT POLICY PARAMETERS

With respect to poverty reduction, increasing the base level of support raises the incomes of all households on Universal Credit. This directly benefits 'pockets' and allows households to escape poverty at a lower level of earnings. However, the policy would have no impact on poverty through 'prospects', and could in fact weaken work incentives as households would be able to reach the same level of take home income with lower earnings.

Figure 13 illustrates the impact of an increase of £100 in the base level of support, using our single person household as the baseline. We see that while the increase would not help the household to escape poverty when out of work, their income still rises from 32% of the median income to 42% of the median. We also see that they are able to escape poverty at a lower level of earnings, with around 11 hours of work per week compared to 21 hours.

The chart also illustrates that the amount of Universal Credit paid will rise for both in-work and out-of-work households, and will therefore come at a cost to the government.

Figure 13: The impact of an increase in the base level of benefit



DIRECT POLICY PARAMETERS

There are a range of elements within Universal Credit that could be increased and could be used to target support to specific groups. Table 8 below provides a list of the elements within Universal Credit, along with an estimate of the number of households that would receive each element (based on current levels of take-up). It also identifies who would benefit from an increase in each element.

Table 9: The elements of Universal Credit and who would benefit from an increase

Element	Number of households (000's)	Who would benefit from an increase in this element?
Standard Element	**7,759**	All Universal Credit claimants benefit from an increase in the standard allowance. Support can be targeted to single or couple households.
Housing Element	**3,552**	Households that pay more in rent than is covered by their housing element.
Employment Support Element	**1,691**	Households with limited capability of for work.
Child Element	**7,930**	Households with children would benefit from an increase in the child element. Support can be targeted to single child families, or larger families.
Child Disability Element	**161**	Households with disabled children with care or mobility needs.
Childcare Element	**526**	Households that need formal childcare support in order to work.

Sources: DWP 2013a, HMRC 2013

As discussed in Chapter 1, the manor in which an increase in the base level of support should be targeted to households in poverty will ultimately depend on the concept of poverty used, the poverty reduction strategy, and the policy objectives:

- Couples with children are the largest group in poverty (DWP, 2013a). The couple rate of the standard element or the child element could be used to target this household type.

- Lone parents are the most over-represented group in poverty (DWP, 2013a). They could be targeted by creating a separate 'lone parent' rate of the standard element, or by increasing the child element.

- Couples without children are in the deepest poverty when out of work, as our analysis in Table 1 and Chapter 3 showed. The couple rate of the standard element could be used to target this household type.

- Single people without children are the most numerous among the Universal Credit claimant base (DWP, 2012a). They could be targeted through the single rate of the standard element.

- If the objective is to reduce child poverty (rather than working-age poverty), the child element could be increased.

- Some households may face greater barriers to work due to disability or family circumstances. The employment support element or child disability element could be increased to help reduce poverty through 'pockets' when a 'prospects' approach is more difficult.

- Some households may face greater barriers to work due to high childcare costs. Lone parents tend to rely on childcare support more than couples (HMRC, 2013). Increasing the childcare element would help improve the 'prospects' of these households.

- Poverty is significantly higher after housing costs, which suggests that high housing costs contribute to poverty in the UK. Increasing the housing element would help households with housing costs greater than their level of housing support, for example those living in the private rented sector with rent above the LHA rate. However, this would not help households with lower housing costs and could have an upward pressure on rents. An alternative strategy would be to lower housing costs, which will be explored in living costs section of this chapter.

- Our case study in Chapter 2 revealed that limiting housing support for owner/occupiers to only those out of work hindered poverty reduction and made the household worse off in work at low earnings. An alternative would be to extend eligibility to support for mortgage interest to owner/occupiers in work, treating their housing element as if they were renting. 23% of people in poverty are owner/occupiers with a mortgage (DWP, 2013a, p. 171) and extended eligibility to the housing element could help reduce poverty through both 'pockets' and 'prospects', as it will eliminate a disincentive to work.
- The standard element of Universal Credit is the only element that applies to all household types. Though expensive, an increase in the standard element would have the broadest impact on poverty.

WOULD A SECOND EARNER **WORK ALLOWANCE** OR AN INCREASE IN THE HOUSEHOLD **WORK ALLOWANCE** BETTER TACKLE POVERTY?

The work allowance refers to the amount a household can earn without losing any Universal Credit. It can affect take home incomes for families in work ('pockets'), and the financial returns upon entering work ('prospects').

Under UC, work allowances will be awarded at the household level. This means that if one partner in a couple has earnings above the work allowance, then the second partner of the couple would not have a work allowance upon entering work.

DIRECT POLICY PARAMETERS

In addition, the literature identified that work incentives for second earners in receipt of tax credits only will be weakened under Universal Credit, as they see their returns from work fall from 59p to 35p per pound earned. As a result, some commentators have called for the introduction of a second earner work allowance.

In Table 10 below, we compare the options of introducing a second earner work allowance and increasing the existing household work allowance of Universal Credit. We analyse which household types and the proportion of people in poverty each policy would benefit, both in terms of 'pockets' and 'prospects'. We find that in terms of sheer numbers, a household work allowance would be more effective at tackling poverty both through 'pockets' and 'prospects', while using an existing parameter within Universal Credit to avoid adding any additional complexity.

Table 10: Who benefits from a second earner or household work allowance?

	Percentage of households in poverty		Gain from a second earner work allowance?		Gain from increasing the household allowance?	
	With children	Without children	Pockets	Prospects	Pockets	Prospects
Workless couples	12%	7%	No	No	No	Yes
Single earner couples	31%	11%	No	Yes	Yes	No
Dual earner couples	16%	7%	Yes	No	Yes	No
Workless single people	21%	34%	No	No	No	Yes
Working single people	8%	18%	No	No	Yes	No
Total % of households in poverty who benefit***			11%	19%	44%	38%

*Source: Barnes & Lord, 2013, p. 21. Data from 2009/10–2010/11.

**Source: ibid., p. 40.

***Based on the percentage of households with and without children gaining, with 41% of working-age households in poverty with children and 59% of working-age households in poverty without children (DWP, 2013a).

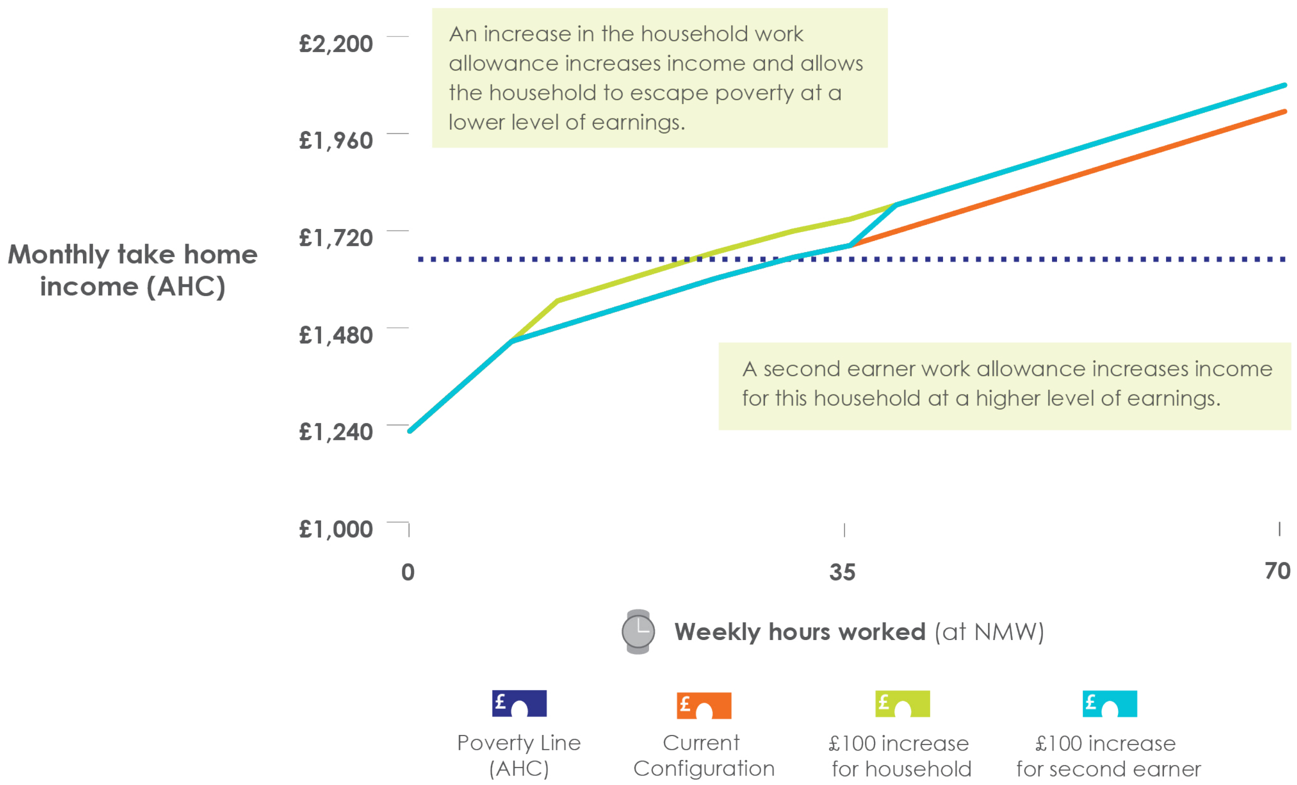
DIRECT POLICY PARAMETERS

An increase in the household work allowance would also be more effective in reducing poverty through 'prospects' in terms of the level of deprivation. While a second earner work allowance would improve work incentives for households with one partner already in work, and therefore on relatively higher incomes than workless households, an increase in the household work allowance would improve the 'prospects' of workless households (including couples) who are in 'deeper' poverty.

This is demonstrated in Figure 14 using our couple with children household, assuming that the second earner takes up work when the first earner is working 35 hours.[5] We see that an increase in the household work allowance helps the household to cross the poverty line at a lower level of earnings, with around 22 hours of work per week instead of 29 hours. An increase in the household work allowance also increases take home

[5] This is a reasonable assumption given that the large majority of dual earner couples in poverty have at least one partner in full-time work. Authors' calculations using data from Barnes & Lord (2013, p. 21, 40) find that 92% of dual-earner households in poverty have at least one partner working 30 hours or more.

Figure 14: The impact of a second earner work allowance



income at a lower level of earnings, while a second earner work allowance would increase this family's income at a higher level of earnings.

If we had assumed that the second earner took up work while the first earner was working fewer hours, the second earner disregard would kick in at an earlier point and help the household to cross the poverty line at a lower level of earnings than shown in Figure 14. However, an increase in the household work allowance ensures that this increase in income happens at the lowest level of earnings. In addition, increases to the household work allowance give the household greater choice about how to organise employment and caring responsibilities within the household.

On the other hand, an increase in the household work allowance would benefit more low-income households (an estimated 3.31 million in-work households[6]) and would therefore be considerably more expensive than the introduction of a second earner work allowance. Cost estimates of introducing a second earner work allowance worth £500 per year range from £130 million to £182 million (Lawton & Thompson, 2013), while our estimates (based on the expected number of UC households in work) find that an equal increase in the household work allowance would cost £1.66 billion.

[6] Authors' calculations based on current caseloads (DWP, 2013f; HMRC, 2013).

A second earner work allowance may also be better targeted to people who are responsive to work incentives. The literature review found that women, who are more likely to be second earners, are typically more responsive to work incentives.

In sum, we find that an increase in the household work allowance, though expensive, would be better targeted to those in poverty both in terms of the level of deprivation and sheer numbers. A second earner work allowance would be

DIRECT POLICY PARAMETERS

better targeted to those responsive to incentives, and would be less expensive, however it would not be as effective at tackling poverty.

WOULD CHANGING THE **WORK ALLOWANCE** OR THE **WITHDRAWAL RATE** OF UNIVERSAL CREDIT HAVE A BIGGER IMPACT ON 'PROSPECTS'?

THE WORK ALLOWANCE

The work allowance directly influences the financial rewards upon entering work, as it determines the amount a household can earn without losing any Universal Credit.

Table 11 shows work allowances for different household types under the current benefit system compared with Universal Credit, and the number of households in each group. Under Universal Credit, there will be two levels of work allowance: a lower work allowance for those who receive the housing element of UC and a higher work allowance for those who do not, but even the lower work allowance is substantially higher than under the current benefit system for all household types. This is designed to increase the returns from entering work for workless households, which will in turn improve incentives.

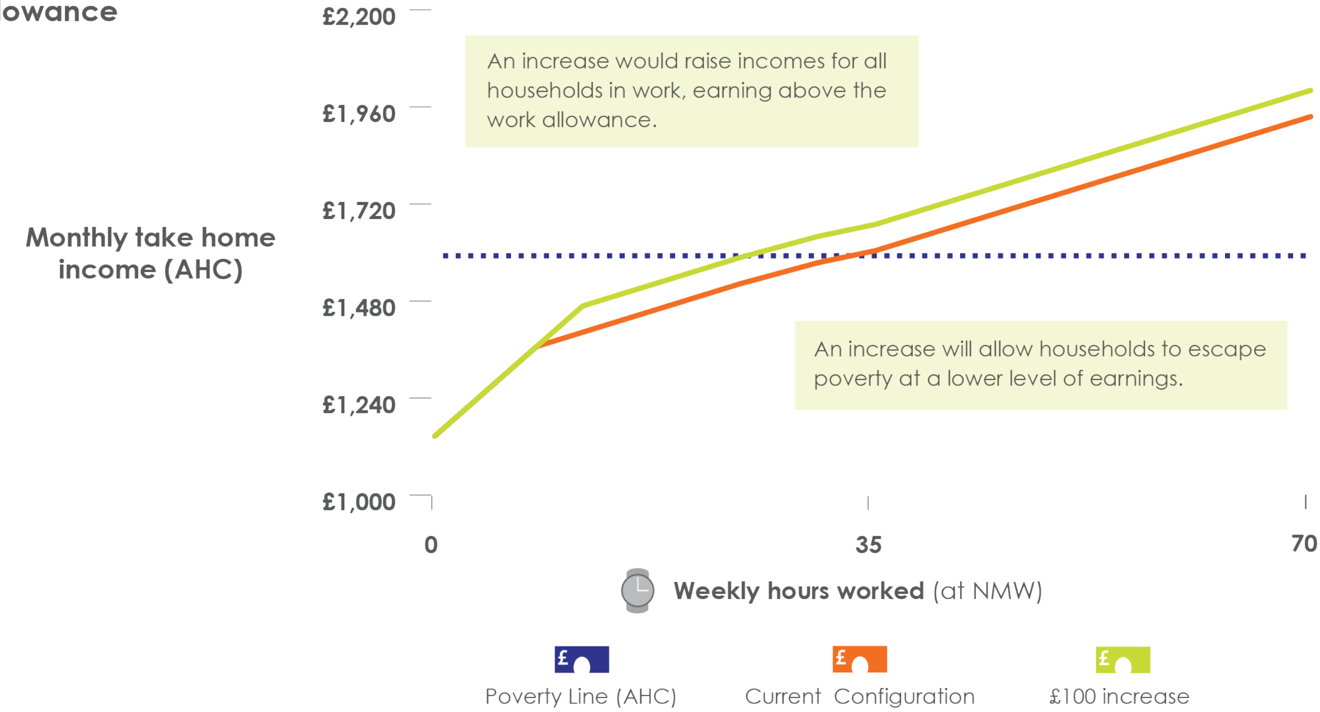
Table 11: Work allowances are substantially higher under Universal Credit

Work Allowance Category	Current system (£/month)	UC - with housing support (£/month)	UC - without housing support (£/month)	# of Households* (000's)
Single	£21.73	£111.00	£111.00	3,100
Lone Parent	£86.90	£263.00	£734.00	2,200
Couple	£43.45	£111.00	£111.00	800
Couple with children	£43.45	£222.00	£536.00	2,100
Employment support	£86.90	£192.00	£647.00	N/A

*Source: DWP, 2012a

To have a greater impact on poverty, the government could consider increasing work allowances even further. Figure 15 illustrates the impact of increasing the work allowance by £100 for our couple with children household. The increase would raise the take home income of the household and help them to cross the poverty line at a lower level of earnings, with around 25 hours of work per week rather than around 33 hours.

Figure 15: The impact of an increased work allowance



Increases in the work allowance could be used to target specific groups as there are different work allowance categories. As it stands, different household types have different work allowances and therefore different financial incentives to take up work. For example, a lone parent has a higher work allowance than both a single person with no children and a couple with children. This means that they will see a greater financial return from work.

However, it is important to note that policy proposals including the integration of council tax support and Free School Meals

DIRECT POLICY PARAMETERS

into Universal Credit may involve lowering work allowances. This is an effective way of controlling the cost of policy options, without affecting the single, simple withdrawal rate in Universal Credit.

Table 12 demonstrates the impact that these policies may have on our couple with children household. When combined, council tax support and Free School Meals integration funded through reductions in the work allowance reduce this household's work allowance by 83%. Other households with a lower work allowance, higher council tax, or more children may even see their work allowance eliminated.

Table 12: The impact of using the work allowance to pay for other policy parameters

	Reduction in work allowance	Work allowance remaining
Current configuration	N/A	£222.00
Council tax support integrated into UC	£68 council tax support* would lower work allowance by £105.	£117.00
Free School Meals policy option	A family with two children would see a £80 reduction in the work allowance.	£37.00

*Based on the average council tax benefit award (DWP, 2013c).

THE WITHDRAWAL RATE

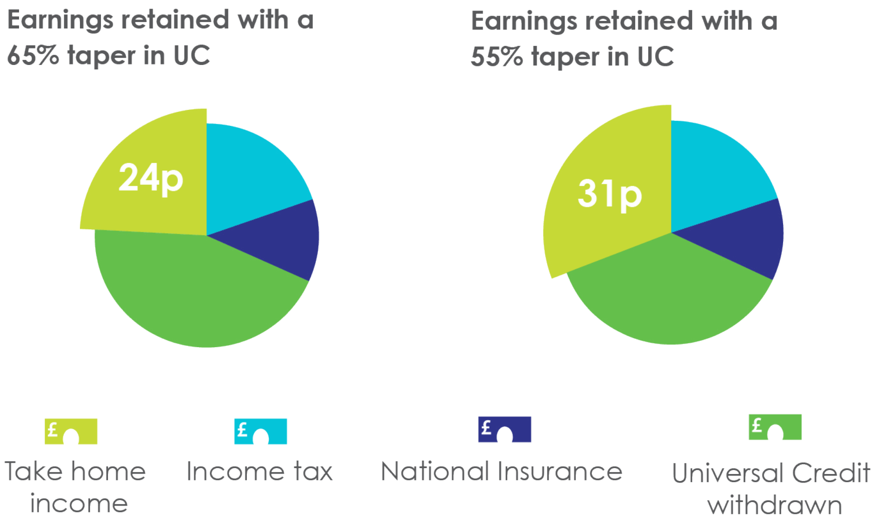
The withdrawal rate determines the rate at which benefits are withdrawn as earnings increase. It determines the share of earnings retained by the household (and by government), and the increase in take home income per pound earned. As a result, it influences both entry into work and the extent to which in-work households benefit from increasing their earnings.

DIRECT POLICY PARAMETERS

The withdrawal rate of Universal Credit is set at 65% of net income, meaning that the household retains 35p for each pound of income earned after tax. However, Universal Credit was first proposed in *Dynamic Benefits* (Centre for Social Justice, 2009) with a withdrawal rate of 55%. This would ensure that the maximum withdrawal rate would always be lower than it is under the current system.

Figure 16 shows how a reduction in the withdrawal rate from 65% to 55% would increase a household's take home income and returns from work. Below the tax threshold, take home income would increase by 10p for each pound earned, as households would get to keep 45p instead of 35p. Workers above the tax threshold would retain 30.6p per pound earned rather than 23.8p, allowing them to keep an extra 6.8p per pound earned.

Figure 16: A reduction in the withdrawal rate would increase incomes and returns from work*

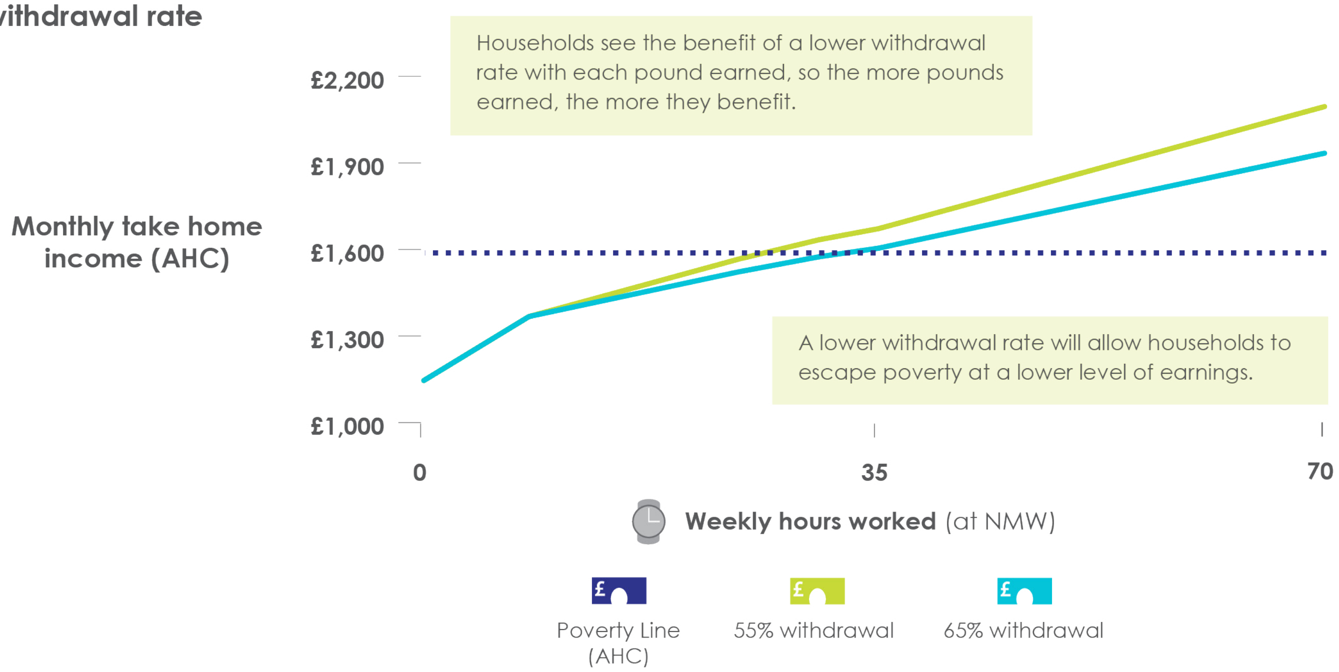


*Shown as returns from work for each £1 earned above the NI and income tax thresholds.

DIRECT POLICY PARAMETERS

Figure 17 illustrates the impact that a lower withdrawal rate would have on poverty, household income, and work incentives, using our couple with children household. We find that a 55% withdrawal rate would help the household to cross the poverty line at a lower level of earnings, with around 26 hours per work a week rather than 33 hours. All households in work earning above the work allowance would also see an increase in income. Since households see the benefit of a lower withdrawal rate with each pound earned, households earning more will benefit more.

Figure 17: The impact of a lower withdrawal rate



WORK ALLOWANCE OR WITHDRAWAL RATE?

Increasing the work allowance and lowering the withdrawal rate would both support an estimated 3.31 million in-work households on Universal Credit.[7] Both policies increase incomes for households in work earning above the work allowance and help households escape poverty at a lower level of earnings. They would also increase the number of households on Universal Credit, as eligibility for UC would be extended to higher earning households.

[7] Authors' calculations based on current caseloads (DWP, 2013f; HMRC, 2013).

DIRECT POLICY PARAMETERS

However there are three key differences between these two policies. Firstly, an increase in the work allowance benefits all affected in-work households by the same amount, while households would benefit more from a lower withdrawal rate the more pounds they earn. This means that the work allowance provides an increased work incentive for households out of work and earning below the work allowance, but is a 'pockets' policy for those earning above the work allowance. On the other hand, a lower withdrawal rate improves work incentives for all households earning above the work allowance, making it a 'prospects' approach to poverty reduction.

Secondly, increases in the work allowance can be targeted to specific household types in order to control costs while the withdrawal rate cannot, without introducing the kind of complexity back into the system which Universal Credit is intended to reduce.

Lastly, higher work allowances may be needed to support other policy proposals, such as the integration of council tax support and Free School Meals into Universal Credit, which are both discussed below.

Policymakers should seek to better quantify the impact that each policy has on entry into and progression in work. The choice between them depends largely upon the objectives that policymakers want to achieve. The analysis presented indicates that £1bn would increase the work allowance for 3.3m in-work households by £302 per year[8], and the additional increase in the work allowance would help to tackle poverty. This partly through the direct impact on the take-home incomes of low earning households ('pockets'), by enabling households to keep more of the money they earn before Universal Credit starts to be withdrawn. This approach would also support entry into work and other policy proposals that tackle work incentive

[8] Authors' calculations, £1bn divided by 3.31m in-work households on Universal Credit.

and take-up challenges in Universal Credit, such as those for council tax support and Free School Meals.

Over the longer term, a policy of reducing the withdrawal rate of Universal Credit from 65% to a lower level would support a 'prospects' approach to poverty reduction. It improves the incomes of those in work, but importantly also increases the rewards from progression in work by allowing households to keep more of their earnings. £3bn would lower the withdrawal rate by 10%[9] to 55%. At this lower withdrawal rate, all households would keep at least 30p of each additional pound earned. It is a broad measure that helps a large number of working households on low incomes, and all low-to-middle earners would see their work incentives improve. Finally, as we will see in later analysis it helps other policy measures to be more effective. A lower withdrawal rate helps lower rates of tax and higher wages to filter down as much as possible into the pockets of low income households.

[9] Based on a one per cent decrease in the withdrawal rate costing £300m (House of Commons, 2013c).

SHOULD THE GOVERNMENT INCREASE **CHILDCARE SUPPORT** TO REDUCE POVERTY?

The need for formal childcare can act as a barrier to work weakening the 'prospects' approach to poverty reduction. In Chapter 2, we found that childcare support at 85% under Universal Credit is more generous than the current system both above and below the tax credit threshold for our case study.

Increasing childcare support will improve both the 'pockets' and 'prospects' for low-to-middle earner families who rely on formal childcare. We estimate that 20% of all in-work households with children on Universal Credit would directly benefit from increases to childcare subsidies.[10]

[10] Author's calculations based on tax credit caseload tables (HMRC, 2013) and DWP estimates of increased take-up as a result of extending eligibility to people working fewer than 16 hours (DWP, 2011g).

DIRECT POLICY PARAMETERS

In addition, some parents would be expected to enter work or increase their earnings if subsidies increased, improving prospects. The fall in childcare support from 80% to 70% in 2011 reduced the number of childcare tax credit claims by 12% and the amount per claim by 15% (HMRC, 2013). An increase in support to 85% would be expected to more than reverse this effect.

While an increase in the childcare subsidy helps to tackle a specific barrier to work, spending on other elements could have a greater impact on poverty. This is of particular concern since the government stated that they will pay for the increase in childcare support by finding savings within the Universal Credit Programme (HM Treasury, 2014). If offsetting savings were found from, for example, a reduction in the work allowance for parents, then this would weaken both pockets and prospects for families with children, particularly for those that do not use formal childcare in order to work. Conversely, a higher work allowance could target financial support to families with children. Households may choose to spend this additional income on formal childcare support, or increase incomes for those that are able to access informal childcare.

In addition, alternative interventions outside of Universal Credit (e.g. free early years entitlement, extended school days, state-run childcare provision) may be more cost-effective, and help bring down the cost of childcare, both for the households and for the government. Further spending on the childcare subsidy within Universal Credit should be weighed against such policy alternatives which may prove more cost-effective.

INDIRECT POLICY PARAMETERS

WOULD THE **TAX SYSTEM** OR UNIVERSAL CREDIT BE MORE EFFECTIVE IN REDUCING POVERTY?

There are similar mechanisms within Universal Credit and the tax system which can be used to increase incomes. Income tax and national insurance thresholds are analogous to the work allowance of Universal Credit, while income tax and national insurance rates operate in a similar way to the withdrawal rate of Universal Credit, affecting the amount retained of each pound earned. Tax thresholds and rates can also affect the level of net earnings, which has a knock on impact on the amount of Universal Credit that is withdrawn.

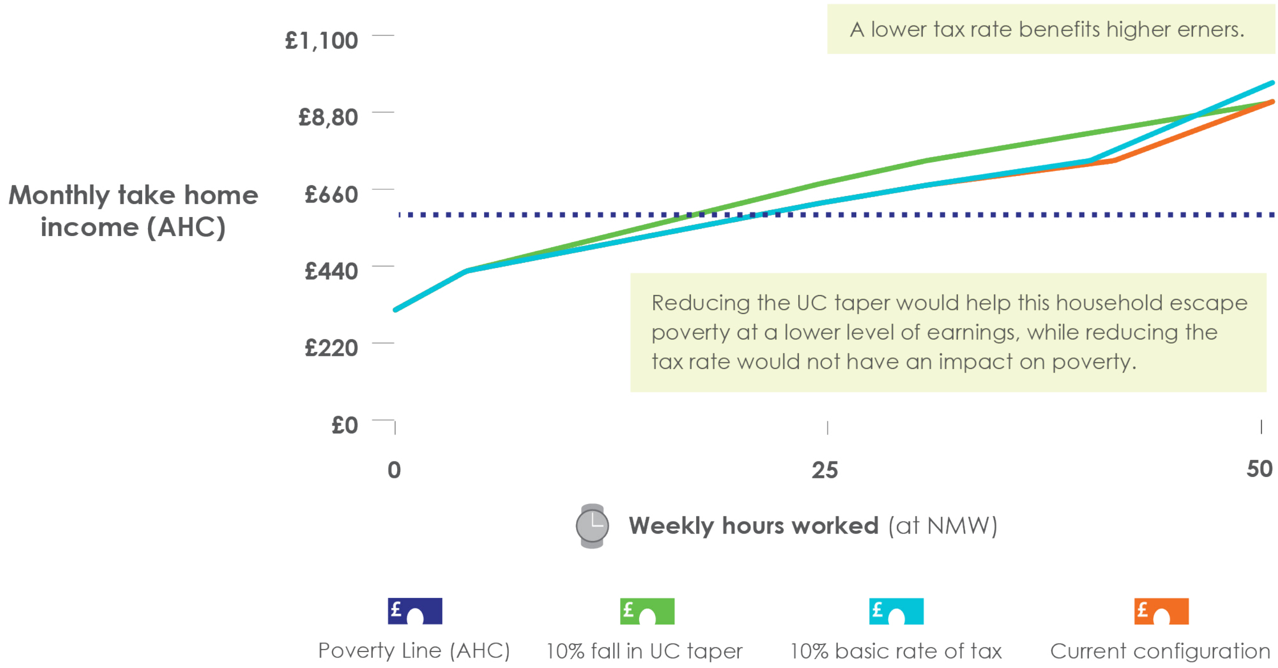
Many low income households would not benefit from changes to tax policy while they would benefit from changes to Universal Credit. Around six in ten households that will receive Universal Credit will either be out of work or will not earn enough to pay tax (Hirsch, 2013). Therefore, they would not benefit from any increases in the personal tax allowance or a reduction in the tax rate. The four in ten households on Universal Credit that would benefit from further increases in the personal tax allowance would see 65% of their increase in net income immediately withdrawn through reduced Universal Credit support, as the taper is applied after tax. Thus, they would only see one third of the increase in their take home pay.

On the other hand, all households on Universal Credit earning above the work allowance threshold (many more low-income households than those earning above the tax threshold) would benefit from an increase in the work allowance or a reduction in the withdrawal rate. They would also see the full benefit of a policy change under Universal Credit.

INDIRECT POLICY PARAMETERS

Figure 18 compares the impact of two like-for-like policy changes within Universal Credit and the tax system (though it should be noted that the cost of the two policies would be greatly different). We compare a 10% reduction of the Universal Credit withdrawal rate (from 65% to 55%) with a 10% reduction in the basic rate of tax (from 20% to 10%), using our single person without children household to illustrate.

Figure 18: Universal Credit would be more effective at reducing poverty than the tax system



In this example, changing the base rate of tax would have no impact on poverty as the household crosses the poverty line at the same point as they would under the current configuration. However, a 10% reduction in the UC withdrawal rate helps the household to escape poverty at a lower level of earnings, at around 17 hours of work per week rather than 21 hours. Take home income is also higher for lower earners when the UC taper rate is used, while higher earners see a higher take home income when the basic rate of tax is reduced.

In addition to being less effective at tackling poverty, changes in the tax system are costly. Spending £1bn would increase the personal tax allowance by £560 per year (HM Treasury, 2013b).

INDIRECT POLICY PARAMETERS

This would not benefit households earning below the personal tax allowance and those earning above the tax allowance while receiving Universal Credit would take home an additional £39 per year, due to the withdrawal of Universal Credit.

In sum, we find that using the tax system to reduce poverty would not be as effective as using mechanisms within Universal Credit, and would also be more costly. Many low income households would not benefit from changes to tax policy, and those that do would only see a third of the benefit due to Universal Credit withdrawal. Furthermore, when considering like-for-like policies, mechanisms within Universal Credit tend to benefit those on lower incomes, while mechanisms within the tax system benefit those on relatively higher incomes.

WOULD INTEGRATING **COUNCIL TAX SUPPORT** INTO UNIVERSAL CREDIT REDUCE POVERTY?

Council Tax Benefit was left out of the package of means-tested benefits included within Universal Credit. Commentators have argued that the localisation of schemes introduces a level of complexity and uncertainty back into the system, and can harm work incentives.

The Welfare Reform Club looked at a range of local support schemes that would integrate well with Universal Credit and scored them against their impact on work incentives, their financial cost to the council, and the expected cost of administration.[11]

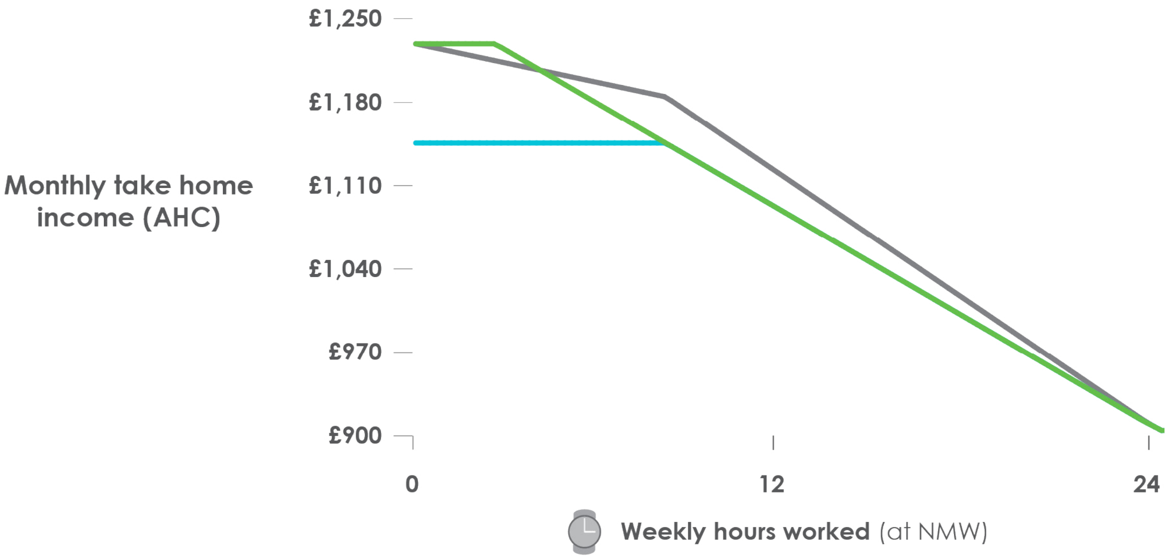
[11] This analysis was released in an unpublished report. Further information can be requested from the Welfare Reform Club (welfarereformclub.co.uk).

The two schemes that scored best included 1) the proposal put forward by the Department for Communities and Local Government (DCLG), which eliminated the work allowance and withdrew council tax support at a rate of 20% of income remaining after UC withdrawal and 2) a system that was in

INDIRECT POLICY PARAMETERS

effect identical to council tax support being integrated into Universal Credit, which would withdraw council tax support at the same taper rate as UC but lower the work allowance to control the cost. It should be noted that both of these schemes involve a reduction in the work allowance, meaning that households will need to work more hours in order to escape poverty. They found that the two schemes had broadly similar impacts on financial cost and work incentives, as shown in Figure 19.

Figure 19: Comparing council tax support schemes



Though the financial impacts of the two schemes are broadly similar, integrating council tax support into Universal Credit would help to tackle poverty by increasing take-up. Council tax benefit had one of the lowest take-up rates of all means-tested benefits (62-69%) (DWP, 2012d). We estimate that the increase in take-up could be as high as 880,000 additional households.[12]

Though higher take-up would incur a cost, this should be seen as positive – helping those entitled to receive support. In addition, the cost of this increased take-up would be partly offset by the administrative savings associated with simplification. A localised system requires local administration

[12] Based on current levels of Housing Benefit take-up (DWP, 2012d).

that the government estimates will cost £74m in 2014/15 (DCLG, 2013), while integrating council tax support into Universal Credit would have only a marginal impact on administration costs, if properly integrated into the UC claim process.

HOW SHOULD **FREE SCHOOL MEALS** BE INTEGRATED INTO UNIVERSAL CREDIT TO IMPROVE 'PROSPECTS'?

In Chapter 3, we found that the entitlement criteria for Free School Meals will have to change under Universal Credit. Some have called for FSM to be extended to all households in receipt of Universal Credit, but other alternatives have been suggested to keep costs down. One option is to 'cash up' FSM as a separate element of Universal Credit, to be withdrawn with the rest of the UC award, however this has not been viewed as a viable or desirable option by most commentators as there would be no guarantee that the extra income would be used to buy school meals (DWP, 2012c).

Another option would be to add an income threshold above which households would lose their entitlement to Free School Meals. However, commentators have drawn attention to the risk of introducing a 'cliff edge' for work incentives if entitlement were lost at a given income threshold and make millions of low income families worse off for earning more.

A solution to this problem would involve giving Free School Meals to all children in families in receipt of Universal Credit. This is a 'pockets' approach, as it would increase disposable incomes for households that became entitled to school meals. The Department for Education estimates that this would cost an estimated £750m per year (House of Commons, 2014), but the Children's Society estimates a lower cost of £502m per year (Royston, et al., 2012) due to a lower assumed level of take-up.

INDIRECT POLICY PARAMETERS

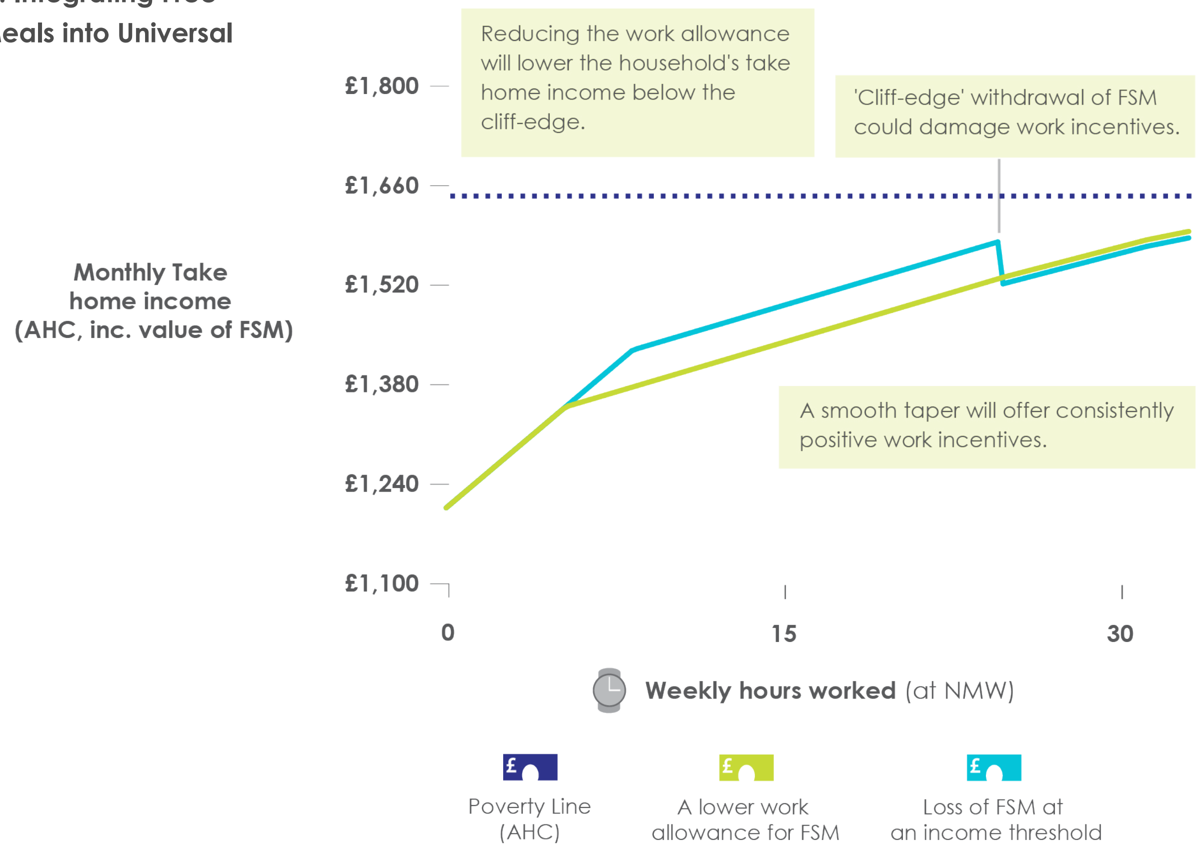
The cost of the proposal could be controlled by a reduction in the work allowance for households in receipt of Free School Meals (DWP, 2012c). Under this proposal, the school meal would remain free for out-of-work households and those earning below the work allowance. In-work households would, in effect, receive a partial subsidy for the school meal, however a reduction to the work allowance would also mean that they would need to earn more in order to escape poverty. In the case illustrated below, we assume that the reduction in the work allowance is £9.20 per week (£40 per month) per child, meaning that the household pays £6 per week for school meals over 52 weeks when earning above the work allowance, or 85% of the annual cost of school meals. The cost to the taxpayer under this proposal would fall to around £110m.[13]

Figure 20 compares two options for integrating Free School Meals into Universal Credit, using our couple with two children as a case study. We see that the income threshold option benefits low-earning households through 'pockets' as it gives them a higher take home income. However, it will damage the 'prospects' of the household as they would have to work an additional 7 hours each week in order to make up for the loss of Free School Meals.

Although reducing the work allowance would give the household a lower take home income below the cliff-edge, they would have consistently positive work incentives, improving the 'prospects' of the household.

[13] The Department for Education estimate that extending Free School Meal entitlement to all children on Universal Credit would cost £750m per year (House of Commons, 2014). The Children's Society, accounting for less than full take-up reduce this cost to £502m per year (Royston, et al., 2012). This however does not take into account universal Free School Meals for 5-7 year olds, which would further reduce the cost. We use £502m as a central cost estimate.

Figure 20: Integrating Free School Meals into Universal Credit



The effective integration of Free School Meals into Universal Credit would eliminate a potentially serious threat to work incentives for families with children. The proposal would give millions of low income households' access to a subsidised school meal, while controlling the cost to taxpayers.

WIDER ECONOMIC FACTORS

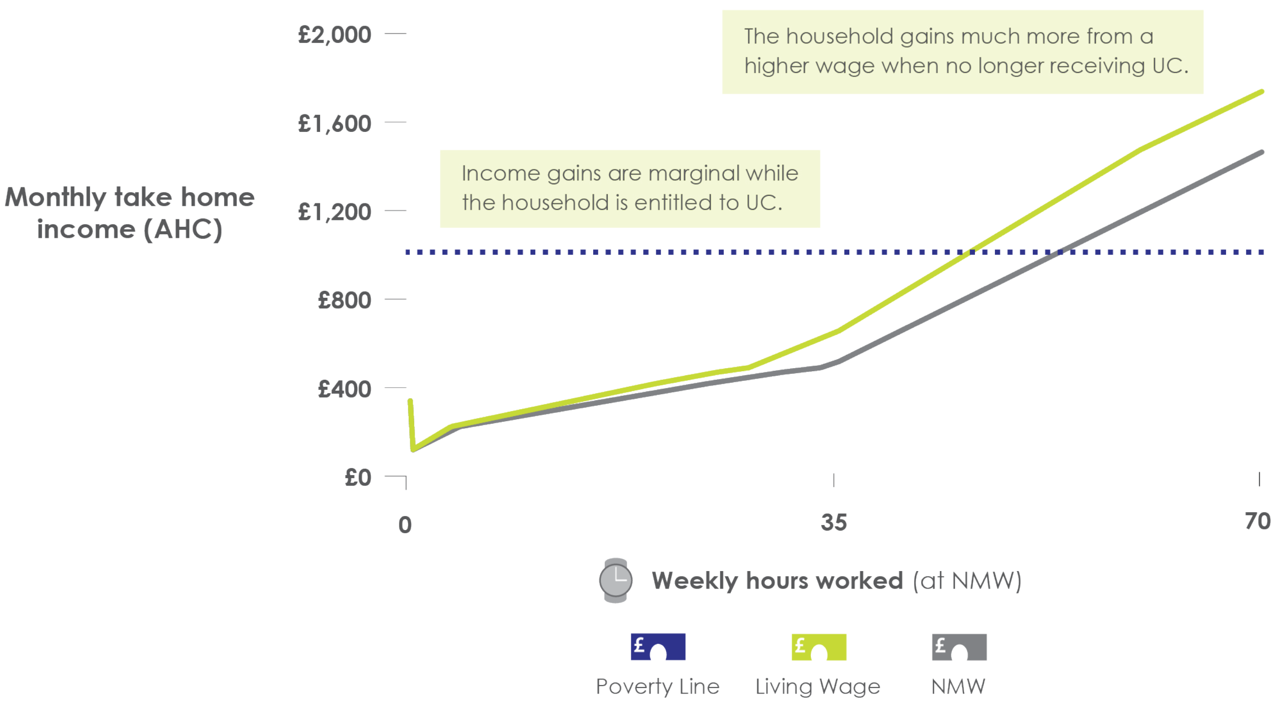
WOULD UNIVERSAL CREDIT HOUSEHOLDS BENEFIT FROM **HIGHER WAGES?**

Higher wages increase take home income. In this section we analyse the impact of higher wages, by modelling an increase in the hourly wage from the National Minimum Wage (currently at £6.31 per hour), to the Living Wage outside of London (currently set at £7.65 per hour).

DIRECT POLICY PARAMETERS

Figure 21 demonstrates the impact a Living Wage would have for our couple without children. A Living Wage would enable the household to cross the poverty line by working 46 hours each week, while they would need to work 53 hours at the National Minimum Wage. However, the withdrawal of Universal Credit dampens the impact of higher wages.

Figure 21: The impact of a Living Wage



The government will also gain from an increase in earnings through a lower Universal Credit payment. Table 13 shows that the government actually gains more than the household through lower Universal Credit payments. Below the personal tax allowance, the government gains by almost twice as much and above the personal allowance, the government gains over three times as much as the household.

Table 13: The government gains more from a Living Wage than households

	Employer Cost	Household Gain	Government Gain
Living Wage (below the tax threshold)	£1.34	£0.47	£0.87
Living Wage (above the tax threshold)	£1.34	£0.32	£1.02

[14] Authors' calculations based on the data on weekly hours worked (ONS, 2013b) and market research on the proportion paid at below the living wage across the economy (Markit, 2013).

We estimate the cost of adopting the Living Wage across the economy at £7bn[14], with two-thirds of the benefit accruing to the government through lower Universal Credit payments to low wage households.

From the perspective of tackling poverty, there are three key points to make. Firstly, while higher wages are clearly desirable, they are only sustainable if matched by associated levels of productivity. If the value to employers was outweighed by the cost of labour, wages would be unsustainable and this could have a negative impact on competitiveness, and increase unemployment, poverty, and costs to the government. Secondly, out-of-work households do not benefit from this policy and the position of those furthest from the labour market may worsen, particularly for those that struggle to enter the labour market at the National Minimum Wage today. Thirdly, in-work-households on Universal Credit only see one-third of the increase in their wages (one-quarter for those earning above the income tax threshold), as 65% of net income will be withdrawn from their Universal Credit award.

Ultimately, higher wages are clearly desirable, if sustainable, as they lead to higher take home incomes for families, and savings for the government which could in turn be used to fund further improvements to Universal Credit. However, the withdrawal of Universal Credit means that households lose out on the majority of the benefit. Combining a lower withdrawal rate alongside higher wages would mean that households would see more of the benefit.

WILL **LOWER LIVING COSTS** REDUCE POVERTY?

In this section, we look at the impact of a fall in the cost of living, through lower housing costs and general living costs.

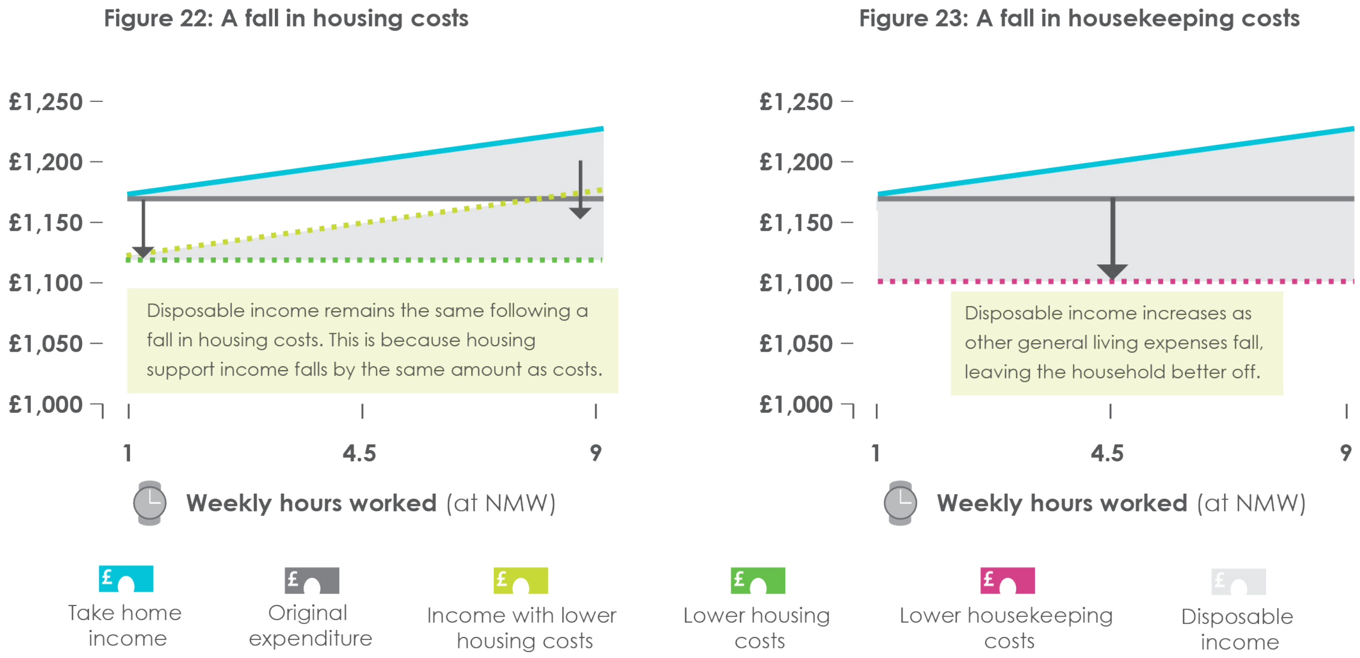
DIRECT POLICY PARAMETERS

The cost of living is relevant to our discussion on Universal Credit and poverty reduction for three reasons. Firstly, the cost of living can have a large impact on the living standards of households on low incomes who pay a 'poverty premium' on goods and services for a range of reasons. Though the cost of living does have an impact on disposable income, and on poverty as defined by the JRF, the impact of most living costs is not reflected in poverty measurements as the poverty line is measured by income. Tackling the poverty premium (for example, by enabling households to pay by direct debit) would increase disposable income at little or no cost to the government. Secondly, living costs also affect the amount of Universal Credit received by households and paid for by taxpayers, as certain elements are linked to the cost of living (e.g. housing element, childcare element). Thirdly, high housing, transport and childcare costs restrict where people live, how far they can travel to work, and the financial returns from work, all of which impact upon 'prospects'.

In our analysis, we assume that living costs have fallen through policy measures that are achieved at no cost to the government (e.g. tackling the poverty premium). We also assume that the household rents privately, at or below the maximum level set by the Local Housing Allowance (LHA). Households with rent above the LHA level would benefit from lower housing costs.

Figures 22 and 23 compare the impact of a 10% fall in housing costs with a 10% fall in general living costs for a lone parent household. The household sees an increase in disposable income when general living costs fall, however disposable income remains the same when housing costs fall, as their level of housing support (and therefore income) falls by the same amount. The government benefits from a fall in housing costs through a reduction in welfare spending.

Figure 22 - 23: The impact of a fall in livings costs on disposable income



Lower living costs are clearly desirable. Tackling the 'poverty premium' can increase the standard of living for low income households at little or no cost to the government. However, the impact of lower living costs is not reflected in current measures of poverty. An increase in housing support would not affect poverty levels for those with lower rents, but would help those paying rents above the amount set by the Local Housing Allowance. Lowering the cost of work-related expenses (e.g. childcare, travel, housing) could also have an impact on 'prospects' by lowering barriers to work, and increasing the financial returns from work.

FINDINGS

In summary, the analysis in this chapter on policy parameters finds that:

- The base level of out-of-work support is solely a 'pockets' strategy that impacts upon the take home incomes of all households on UC.
- Higher out-of-work support will impact on levels of poverty, and allow people in work to cross the poverty threshold at a lower level of earnings.
- Changing the different elements of Universal Credit allows this 'pockets' approach to be targeted to households with particular characteristics.
- Policy levers within Universal Credit (work allowance, withdrawal rate) would be more effective in tackling poverty than policy levers within the tax system (personal allowance, tax rate).
- The work allowance has a direct impact on the take-home incomes of in-work households, impacting all those in work by the same amount ('pockets'), and also supports entry into work ('prospects').
- While introducing a work allowance for second earners would be targeted towards people more likely to respond to work incentives, an increase in the household work allowance would have a bigger impact on poverty in terms of numbers and level of deprivation, both through 'pockets' and 'prospects'.

FINDINGS

- A higher work allowance supports policy proposals that tackle work incentives and take-up challenges in Universal Credit, such as those for council tax support and Free School Meals.
- A lower withdrawal rate increases incomes for in-work households, particularly for higher earners. It also increases the rewards from progression in work by allowing households to keep more of their earnings.
- A lower withdrawal rate also helps other policy measures to be more effective, helping lower rates of tax and higher wages to filter down as much as possible into the pockets of low income households.
- An increase in childcare subsidy helps to tackle a specific barrier to work, however, spending on other elements could be more cost-effective and have a greater impact on poverty.
- Integrating council tax support into Universal Credit is likely to increase take-up of support, which will help to tackle poverty.
- Extending entitlement for school meals to all children on Universal Credit would increase disposable income ('pockets'), and avoid a potentially damaging cliff-edge impact on work incentives ('prospects'). The cost of extending free school meal entitlement could be controlled using the work allowance.
- Higher wages increase take home incomes, but the government benefits more than households through lower Universal Credit payments.

- Lower living costs may benefit low income households (though this will not be reflected in income-based measures of poverty) and improve both ‘pockets’ and ‘prospects’.
- Lower housing costs will not benefit households with low housing costs through ‘pockets’, but will lower costs to the government and help those with higher rents.

SCORECARD

Policy parameters have wide and varying impacts on poverty reduction, household income, and work incentives. Some policy parameters benefit all household types, while others are targeted toward specific groups, and each policy can incur costs to the government and ultimately, to taxpayers. The most appropriate policy will depend upon the policy objectives that are sought.

Each policy parameter has been scored according to its impact on poverty reduction. As well as a direct impact on ‘pockets’, Universal Credit seeks to improve incentives to work (‘prospects’) in order to raise incomes over time. We also give an indication of the cost of each policy and how easily it can be targeted to improve cost-effectiveness.

Policy scorecard

Policy options for Universal Credit (UC)	Pockets	Prospects	Targeting	Cost effectiveness
Increase the **base level of support** within UC whether in or out of work	Directly increases incomes for all UC households.	May harm work incentives.	Can be targeted to different groups, but affects in and out of work households equally.	£1bn would increase incomes for all UC households by £129/year.
Create a **second earner work allowance** to support dual earning households	Increases incomes for dual-earner couples.	Improves work incentives for potential second earners.	Targeted at a large group in poverty that is responsive to work incentives.	£1bn would increase the incomes of dual earner couples by £3,292/year.
Increase the **household work allowance** so more can be earned before UC is withdrawn	Directly increases incomes for in-work households.	Encourages out-of-work households to move into work.	Can be targeted to particular groups in work.	£1bn would increase incomes for 3.3m in-work households by £302/year.
Lower the **withdrawal rate** so UC is withdrawn more slowly as earnings increase	Increases incomes for in-work households.	Improves incentives to enter and progress in work.	Targeted at all in-work households.	£1bn would lower withdrawal rates by 3.3%, to 61.7%. This would increase incomes by £230-£330/year for £10,000 of earnings.
Raise tax thresholds or lower **tax rates**	Small increase in incomes for households earning above the tax threshold.	Has a small positive impact on incentives to progress in work.	Targeted at in-work households with relatively high incomes.	£1bn would raise the personal tax allowance by £560, affected households would gain £39/year.
Integrate **council tax support** into Universal Credit	No direct impact, but would increase incomes through increased take-up.	Leads to consistent and clear work incentives.	Targeted at all households in receipt of UC.	Increased take-up could cost £717m. This would be partially offset by administrative savings of £74m.
Give **Free School Meals** to all UC households	Reduced costs for households, but no impact on relative income poverty measures.	Leads to consistent and clear work incentives.	Targeted at all households with children on UC.	Estimated to cost £500m-£750m, but could be reduced by lowering the work allowance.
Increase the **childcare** subsidy to 85% for all UC households	Increases incomes for 500,000 households that claim childcare support.	Promotes entry and progression in work for parents that need formal childcare support.	Targeted at UC households that need childcare in order to work.	£400m per year, benefitting 20% of in-work households with children on UC.
Higher **wages** (through increased productivity)	Improves incomes for in-work households, but they would only see 1/3 of the benefit due to UC withdrawal.	Supports progression in work.	Could be targeted at specific sectors.	Costless to the government and would benefit both the government and households.
Lower **living costs** (through reducing the poverty premium)	Improves disposable incomes for all households.	No direct impact on work incentives, but may lower the costs of work and improve mobility.	Can be targeted to types of expense, but not to types of households.	A sustainable fall in living costs would improve cost-effectiveness.

CHAPTER 5:

CONCLUSION AND RECOMMENDATIONS

The core finding of this review is that the impact of Universal Credit on poverty is broadly positive, but there is more that can be done.

For a new administration, we hope that the balanced scorecard approach in this report provides a useful and accessible tool for policymakers. We hope that it will help them to make sensible policy decisions that build upon the solid foundation of Universal Credit.

They should bear in mind that even a relatively straightforward policy objective such as reducing poverty is made complex because of the way poverty is measured. A static analysis may favour a 'pockets' approach to poverty reduction, while a 'prospects' approach may prove more cost-effective and sustainable in the long term. Measuring poverty reduction through a poverty line will also fail to capture increases to income below or above the poverty line, or a fall in living costs, which will ultimately improve the standard of living. Policymakers should keep in mind the drawbacks of relying too narrowly on a poverty line and combine both 'pockets' and 'prospects' approaches to poverty reduction.

In addition, as with all policy, poverty reduction strategies involve trade-offs, most notably in deciding how to target support. This ultimately depends on one's objectives (e.g. reduce child poverty) and the concept of poverty used for targeting (e.g. target over-represented groups). The trade-off between targeting support to a greater number of households, or a smaller number of households with higher need is a common feature in our analysis. Policymakers should be aware of this trade-off when making policy decisions.

Particular attention needs to be paid to how the impact of policy changes are felt in practice by low income households.

CONCLUSION AND RECOMMENDATIONS

Lower taxes and falling living costs are typically positive, but the distribution of their benefits may not reach households in poverty. Policymakers should consider the distribution of benefits from a policy, whether they accrue to government, to higher-income households, or to households below the poverty line.

It is worth remembering the original reasons behind the introduction of Universal Credit, which are evident in the complex welfare system we have today, does not always reward work. Policy decisions related to Universal Credit need to consider and not undermine Universal Credit's ability to achieve the aims of a simpler system that reduces poverty and rewards work. The immediate focus has to be on getting Universal Credit up and running in such a way that it is viewed as simple, rewarding and effective by recipients and front-line workers.

Policymakers should then focus on policy that sits outside of Universal Credit, but impacts on its effectiveness. Council tax reduction schemes re-introduce a degree of complexity and uncertainty into the welfare system, housing policy remains complex and the future of Free School Meals remains undecided at the time of writing. A future administration should aim to streamline these elements in order to tackle poverty and support the principles of Universal Credit.

Ultimately, policymakers should use Universal Credit rather than the tax system to target households in poverty. We support additional increases in the work allowance partly because of the impact on take home incomes and the returns upon entering work for low income households, but also because they support other policy proposals that tackle work incentive and take-up challenges in Universal Credit, such as those for council tax support and Free School Meals.

CONCLUSION AND RECOMMENDATIONS

Over time, we favour a policy of reducing the withdrawal rate of Universal Credit, from 65% to 55%. Though this would be an expensive measure, and other measures may be better placed to immediately lift households above the poverty line, we would argue that it has merit for the following reasons:

- Lowering the withdrawal rate of Universal Credit is a broad measure that helps a large number of working households in poverty and on low incomes.
- It increases ‘prospects’ by improving the incomes of those in work, but importantly also increases the rewards from progression in work as well, a particular problem when we consider the rise of in-work poverty.
- It helps other policy measures to be more effective. A lower withdrawal rate helps the benefit of lower rates of tax, or of higher wages, to filter down as much as possible into the pockets of low income households.
- Middle earners may not see their work incentives improve under Universal Credit. A lower withdrawal rate would reduce effective tax rates for this group.

However, these policy issues are not for us to decide and will likely be decided by a future administration. As we consider the implications of changes to the design of Universal Credit, and as it begins to affect ever greater numbers of low income households, we will need to look at how people respond, learn from this, and develop appropriate and fully informed policy to help tackle poverty.

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APPENDIX

The following assumptions have been made in order to calculate entitlements for our household types:

- Under the current system, benefit entitlements include:
    - Income-replacement benefits (Jobseeker's Allowance, Income Support)
    - Housing Benefit (Support for Mortgage Interest for the owner/occupier case)
    - Child Tax Credit
    - Working Tax Credit (including the childcare element)
- Council tax support has not been included under either system, as this remains outside of Universal Credit.
- Child Benefit has been included under both systems for households with children. While this remains outside of Universal Credit, it is important to highlight this extra support for certain household types.
- For private sector tenants, rent is assumed to be the median 2014/15 Local Housing Allowance rate for the property size. For social sector tenants, rent is assumed to be 80% of the median LHA rate.

	Shared Room	1 Bedroom	2 Bedrooms	3 Bedrooms
Median LHA	£271.66	£394.98	£499.94	£574.99
80% Median LHA	£217.33	£315.99	£399.95	£459.99

- For the owner/occupier household, we assume a mortgage debt of £75,000 (the national average), a mortgage length of 25 years (the standard length) and a mortgage interest rate of 3.63% (the standard rate to calculate SMI).

- All cases assume the same income last year for tax credit purposes. Assuming no income in the previous tax year can lead to an overpayment which creates uncertainty and has to be corrected in the following year. Our analysis assumes that the household was earning a similar amount to that shown in the previous year, in order to allow for a fair comparison with Universal Credit.

- All cases assume no savings, unearned income, or other non-means-tested income.

- In couple households, it is assumed that one partner works the first 35 hours and the second partner works additional hours thereafter.

- Childcare costs are assumed to be £3.93 per hour, which is the national average cost of a childminder for a child under 2. We assume that the parent needs 1 hour of childcare for each hour worked.