

## Unintended consequences:

**how the structure of Universal Credit undermines the coalition commitment to support low income workers through raising the personal tax allowance threshold**

### Introduction

Gingerbread works closely on issues relating to single parents' financial circumstances. Approximately half of the calls to our helpline relate to financial issues, and both our frontline advice work and our research and policy development focus on these issues as a key priority. Single parent families are still twice as likely to live in poverty as couple families, and even many working single parents are still below the poverty line. Successive governments have highlighted work as the primary route out of poverty, and over the past two decades have implemented a series of policy measures both to improve the single parent employment rate and to improve work incentives in order to 'make work pay'.

In October 2013, the government will implement a significant programme of welfare reform with the introduction of Universal Credit, which is designed as an integrated working-age credit – replacing a series of in-work and out-of-work benefits and credits – intended to “*radically simplify the [welfare] system to make work pay and combat worklessness and poverty*”<sup>1</sup>. Set against the backdrop of significant economic constraints, a series of choices have had to be made about where best to focus investment in Universal Credit to maximise work incentives and ensure that it delivers on its clear and overarching objective to make work pay.

In parallel to this, since it was elected in 2010 a central plank of the coalition government's taxation policy has been to increase the personal allowance for income tax “*to help lower and middle income earners*”<sup>2</sup>. In three successive Budgets, the government has increased the threshold in stages, with a stated ambition to increase it to £10,000 by 2015-2016.

However, new research commissioned by Gingerbread into the impact of Universal Credit on work incentives for single parents<sup>3</sup>, shows that the *interaction* of these policies from October 2013 will serve to undermine the principal aim of increasing the personal tax allowance threshold, which is to support lower and middle earners. Universal Credit will be calculated and delivered by tapering away support as post-tax income rises<sup>4</sup>. As a consequence, any

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<sup>1</sup> Department for Work and Pensions (2010) *Universal Credit: welfare that works*

<sup>2</sup> Cabinet Office (2010) *The Coalition: our programme for government*

<sup>3</sup> Hirsch, D (2012) forthcoming, autumn 2012

<sup>4</sup> Department for Work and Pensions (2012) *Universal Credit Regulations 2012: draft for consultation*

reduction in their tax bill for people on low to middle incomes who receive Universal Credit will largely be clawed back by government, by reducing the amount paid in the Credit. This means that people in this group will receive only just over a third as much from any increase in the personal tax allowance, compared with relatively better-off groups paying basic rate tax but not eligible for Universal Credit.

At a time of public debate into how to make the most effective use of necessarily limited government resources, and in particular how best to support lower earning households, Gingerbread is calling on the government to review its approach to increasing the personal tax allowance further, in order to ensure that all lower-earning households continue to benefit in full from policy reform and investment intended to protect their incomes.

## Background

A significant part of the coalition government's approach to helping working households on low incomes is to raise the personal income tax threshold to £10,000, in particular to make the taxation system "*simpler and fairer*"<sup>5</sup>. Following a clear commitment to introduce this in the coalition government agreement, progress has been made towards fulfilling this commitment in three successive Budgets<sup>6</sup>:

- The emergency Budget 2010 announced an increase of £1,000 to raise the threshold to £7,475 in April 2011, at a cost in 2011-2012 of £3.49 billion<sup>7</sup>
- Budget 2011 announced a further increase of £630 to raise the threshold to £8,105 in April 2012, at an additional cost in 2012-2013 of £1.05 billion<sup>8</sup>
- Budget 2012 announced a further increase of £1,100 to raise the threshold to £9,205 from April 2013, at an additional cost in 2013-2014 of £3.32 billion<sup>9</sup>.

It has been pointed out elsewhere that this policy is not very well targeted on people on low incomes, since all basic rate taxpayers benefit, many of whom do not live in low income families<sup>10</sup>. Indeed, the stated government intention for this policy has always been to help "*lower and middle income earners*"<sup>11</sup>.

Nonetheless, under the present system of in-work support for low income workers (delivered through working tax credits), all basic rate taxpayers should benefit equally from this policy measure.<sup>12</sup>

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<sup>5</sup> Cabinet Office (2010), op. cit.

<sup>6</sup> In all three cases this has been accompanied by adjustments to the basic and upper earnings limits so that higher rate taxpayers do not benefit from the full amount

<sup>7</sup> HM Treasury (2010) *Budget 2010*

<sup>8</sup> HM Treasury (2011) *Budget 2011*

<sup>9</sup> HM Treasury (2012) *Budget 2012*

<sup>10</sup> Browne, J (2012) *A £10,000 personal allowance: who would benefit, and would it boost the economy?* Institute for Fiscal Studies

<sup>11</sup> Cabinet Office (2010), op. cit.

<sup>12</sup> We recognise, however, that those in receipt of in-work housing benefit and/or council tax benefit do not currently benefit in full from personal tax allowance increases, as these benefits are already tapered away (at a rate of up to 85%) on the basis of post-tax income.

## What changes under Universal Credit, and what impact will this have?

At present, a £1000 increase in the personal tax allowance is worth £200 per year to every basic rate taxpayer, because they pay 20 per cent tax on £1000 less of their income. This is true whether or not people are on tax credits, as these are calculated on the basis of total earnings without reference to how much tax a household is paying.

Universal Credit, on the other hand, will be assessed on the basis of *post-tax* income, with people getting less of the Credit the higher their income is after tax<sup>13</sup>. The effect of a £1000 increase in the tax allowance on a taxpayer receiving Universal Credit, therefore, will be:

- First, to raise their post-tax income by £200
- Then, to take that extra £200 into account when “tapering” the Credit at 65 per cent<sup>14</sup> (ie reducing it by 65p every time post-tax income rises by £1). This would trigger a reduction in the Credit of £130, leaving only a £70 net gain.

In other words, a £1000 increase in the personal tax allowance will give £200 per year to every basic rate taxpayer *except* those on Universal Credit, who will gain only £70.

Households will cease to be eligible for Universal Credit only when their earnings rise to a certain level. This level varies considerably according to family type and housing and childcare costs, but is at least £25,000 for a single parent and £23,000 for a couple with one child<sup>15</sup>. For those without children, the threshold will be lower (as low as £6,000 for a single person without children). Anyone with individual earnings up to the higher rate tax threshold whose family income is above the Universal Credit limit will gain £200 for each £1000 increase in the personal tax allowance. However taxpayers receiving Universal Credit – including those taken out of income tax altogether by an increased personal tax allowance – will gain at most £70 once Universal Credit has been reduced. This will particularly affect families with children on low to medium earnings, a large proportion of whom will be eligible for Universal Credit.

According to the impact assessment for Universal Credit<sup>16</sup>, approximately 4 million claimants are expected to be in work, and therefore potentially affected. These claimants will include the vast majority of the 1.17 million single parents in work.

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<sup>13</sup> Department for Work and Pensions (2012) *Universal Credit Regulations 2012: draft for consultation*

<sup>14</sup> 65% is the indicative level of the taper rate as set out by the Department for Work & Pensions in illustrative figures; the final agreed taper rate is expected to be announced in autumn 2012

<sup>15</sup> Using the illustrative Universal Credit rates for 2012, this is a simplified calculation based, in both the case of a single parent and of a couple, on a family with one child and no childcare costs

<sup>16</sup> DWP (2011) *Universal Credit: Impact Assessment*

## What are the alternatives?

Clearly, because it affects so many people, increasing the tax allowance is expensive. Under Universal Credit, however, any further increase in the personal tax allowance will not have the same benefit for any household in receipt of Universal Credit as it will for those on the basic rate of tax but earning too much to receive Universal Credit – meaning it will give least benefit to households on lower incomes. In light of this fact, Gingerbread is urging the government to rethink the planned future investment in raising the allowance.

At the very least, it is imperative that the government introduces a compensatory measure alongside the planned increase to the personal tax allowance which will be implemented from April 2013 (and alongside any future increases). The simplest way of doing this would be to increase the Universal Credit disregard (the amount you can earn before the Credit starts being reduced with rising earnings) from its current planned level, to neutralise the impact outlined above. If the Universal Credit disregard is raised by £200 for every £1,000 increase in the personal tax allowance, it would allow everyone to keep the full £200 gain. Conversely, if the disregard is not raised then this will reduce the overall cost to the Treasury of any tax allowance increase – essentially giving a windfall to the Treasury at the expense of working households on low incomes.

However, the government could instead consider reallocating some or all of any planned future spending on increasing the personal tax allowance to a series of measures which are better targeted specifically on lower income households. In light of the planned £3.32 billion to be spent in 2013-2014 on raising the tax allowance by a further £1,100, we have modelled a series of alternative ways of spending this amount on more targeted measures within Universal Credit, as follows:

- Reducing the Universal Credit taper rate from 65% to 62%;
  - Approximate cost: £600 million
- Raising the percentage of childcare costs covered from 70% to 80%;
  - Approximate cost: £400 million
- Raising the per child allowance in Universal Credit by £300 per year;
  - Approximate cost: £2.4 billion
- All three measures taken together;
  - Approximate cost: £3.4 billion.

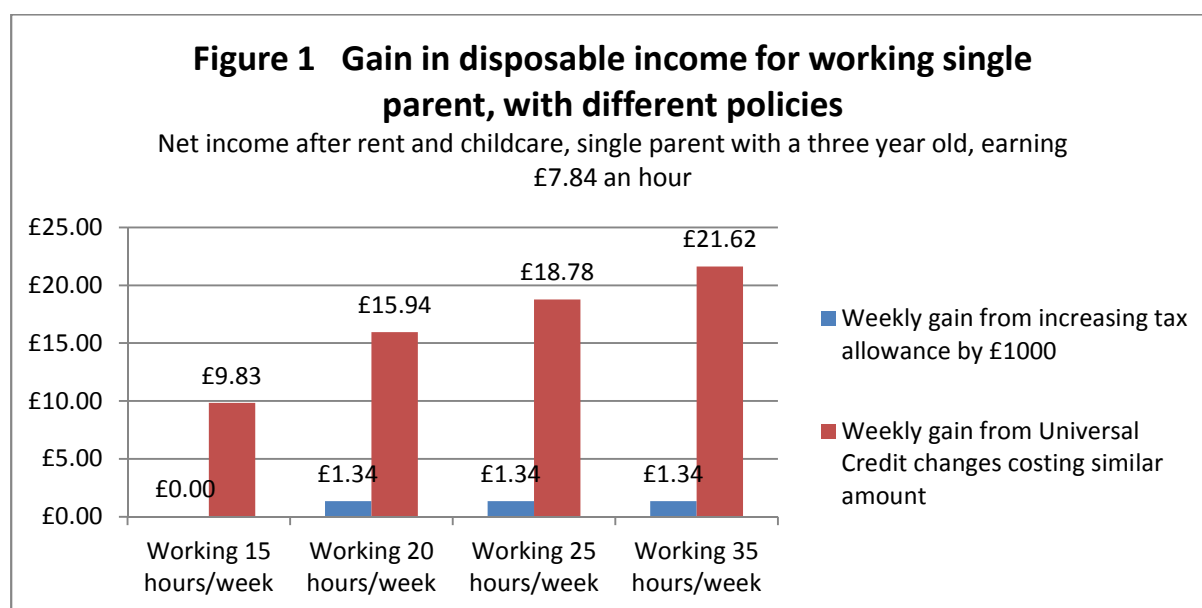
We know that a series of broadly equivalent cuts to tax credits implemented in the 2011-2012 financial year<sup>17</sup> have already had a negative impact on the household budgets of lower income families<sup>18</sup>; therefore we would suggest that further consideration could usefully be given to how best to allocate government spending intended to support lower and middle income working families, in order to target support towards the lowest income working households.

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<sup>17</sup> Increasing the tax credit taper rate by two percentage points; reducing the proportion of childcare costs covered from 80% to 70%; and removing the baby element of child tax credits

<sup>18</sup> As detailed in e.g. Resolution Foundation/Netmums (2011) *Childcare Tax Credit Survey*; Gingerbread (2011) *Working but losing*

For the purposes of illustration, Figure 1 below models the relative effectiveness of implementing the three Universal Credit policy changes outlined above against increasing the personal tax allowance (without changing the disregard level), for a typical single parent family. It is clear that increasing investment in Universal Credit has a much more tangible impact on the adequacy of a working single parent's income. In the example shown, a single parent working full time on a "typical" low wage (one that a quarter of workers earn below), supporting one young child, would gain only just over £1 a week from the higher tax allowance, but about £22 a week from improving Universal Credit.



## Conclusion

The structure of Universal Credit – tapering away support from lower income households on the basis of post-tax income – will serve to undermine the support offered through increasing the personal tax allowance, which to date has benefited all basic rate taxpayers equally. Anyone in work and in receipt of Universal Credit will gain significantly less money from further increases in the personal tax allowance, compared to higher earning (basic rate) taxpayers who are not in receipt of Universal Credit.

In light of the fact that it is probably unrealistic – at this stage in its development – to restructure Universal Credit away from its basis on post-tax income, Gingerbread is calling on the government to review its approach to increasing the personal tax allowance further, in order to ensure that all lower-earning households continue to benefit in full from policy reform and investment intended to protect their incomes. At the very least, the government must increase the disregard level within Universal Credit to ensure that all households continue to benefit equally from planned future rises to the personal tax allowance.

Furthermore, we would encourage the government to review future planned investment in increasing the personal tax allowance further and consider reallocating some or all of this to a range of different policy measures under Universal Credit which will target support more clearly towards households on lower earnings.