Breakthrough Britain

Dynamic Benefits

Towards welfare that works

EXECUTIVE SUMMARY

This is the Executive Summary of the **Centre for Social Justice** Economic Dependency Working Group's report **Dynamic Benefits: Towards welfare that works** published in association with Oliver Wyman**.** For further information or to download the full report please visit www.centreforsocialjustice.org.uk

Our benefits system is broken. Although it alleviates financial hardship, it does so at a price. High benefit withdrawal rates trap millions in worklessness and dependency, often over several generations.

To address Britain's unacceptable levels of poverty and social exclusion, we need to redesign the benefits system to boost employment and earnings over the long term. This will require a new approach: one that recognises how claimants respond to withdrawal rates.

The current economic downturn has merely served to expose further the already deep flaws in the system. A clear lesson from past downturns is that without reform of the benefits system, future economic recovery will bring only a slight reduction in worklessness.

Worklessness and poverty have both been rising over the last year. However, they are not solely – or even mainly – cyclical problems, but long-term structural ones. They are attributable in no small measure to the benefits system, which in alleviating the experience of poverty has also entrenched and perpetuated its causes: the lack of employment and earnings.

There is no doubt that work is a good thing. Earning money through gainful employment has many advantages, besides simply providing a source of income – for example better health, the development of social networks, and demonstrating the link between effort and reward. These are advantages that income from benefits does not provide.

With the likelihood that more than 2.5 million Britons will soon be officially unemployed, the need to reform the benefits system is more pressing than ever. To ensure that the number of workless people reduces as quickly as possible after the recession, it is imperative that we do not repeat the mistakes of previous downturns. Large numbers of claimants cannot be consigned to long-term worklessness by making it pointless for them to return to work. They must be given every incentive to participate in, and contribute to, future economic growth.

SUCCESSIVE GOVERNMENTS HAVE ATTEMPTED TO REFORM THE SYSTEM

Successive governments have attempted to address many of the problems of the welfare system. The current Government has also had high ambitions.

The Government recognised that "there is a wider gap between rich and poor than [there has been] for generations";[1] and declared their "historic aim will be for ours to be the first generation to end child poverty, and it will take a generation."[2] They were determined "not to continue down the road of a permanent have-not class, unemployed and disaffected from society."[3] Yet, Britain's benefit system has failed to address poverty in a *sustainable* way.

The failures of the old way of thinking: Poverty and dependency

- Child poverty and severe poverty have both been on the increase in recent years.[4]
- Income inequality is higher now than at any time in the previous 30 years.[5]
- While many lone parents have been lifted out of poverty, due to increases in benefit income, one of the unforeseen consequences of the system has been a growing number of couples with children living in poverty.[6]
- Approximately one in seven of all working-age households are dependent on benefits for more than half their income.[7]
- More than half of all lone parents depend on the state for at least half of their income.[8]

The Government also pledged to "get 250,000 young unemployed off benefit and into work";[9] and they despaired that "one million single mothers are trapped on benefits".[10] Tony Blair vowed "that we will have reduced the proportion we spend on the welfare bills of social failure."[11]

The failures of the old way of thinking: Worklessness

- Today, there are 10.4 million working-age people not working in the UK. Of these, 5.9 million are claiming out-of-work benefits.[12]
- Throughout the last ten years, prior to the recession, the number claiming out-of-work benefits has been at around 5.4 million.[13]
- At the end of many years of economic growth, there are 1.6 million children living with a lone parent who is not working.[14]
- The Government has spent well over £2 billion on the New Deal for Young People,[15] and yet the number of 16 to 24-year-olds not in education, employment or training (NEET) has hardly changed – 18.8% of young people were NEET in 1997, and 18.9% in 2006.[16] The number of young people who are NEET is now approaching the one million mark.[17]

1 The Labour Party, 'New Labour: because Britain deserves better' (Labour Party, 1997).
2 Tony Blair, Beveridge Lecture, Toynbee Hall, 18 March 1999.
3 The Labour Party, 'New Labour: because Britain deserves better' (Labour Party, 1997).
4 DWP press release, 'Government Response to Households Below Average Income Figures' (7 May 2009); Mike Brewer, Alastair Muriel et. al., *Poverty and Inequality in the UK: 2009* (IFS, 2009), p. 34. .
5 http://www.poverty.org.uk/09/index.shtml.
6 Mike Brewer and Alastair Muriel, *Poverty and Inequality in the UK: 2009* (IFS, 2009), p.42.
7 Department for Work and Pensions, *Family Resources Survey United Kingdom, 2007-08,* (DWP, 2009), Table 3.8.
8 Ibid.
9 The Labour Party, 'New Labour: because Britain deserves better' (Labour Party, 1997)
10 Ibid.
11 *The Observer* (2 October 1996)
12 ONS, *Labour Market Statistics August 2009* (ONS, 2009), Table 1; Department for Work and Pensions, 'Benefit Expenditure Tables', Table C1. Available at: http://research.dwp.gov.uk/asd/asd4/medium_term.asp [Accessed 21 August 2009]. Combines income and contribution-based JSA, IS, IB, ESA. A very small number of these claimants will be working a small number of hours per week.
13 Ibid.
14 Departmnent for Work and Pensions, *Households Below Average Income 2007/8* , Table 4.1.
15 Frank Field and Patrick White, *Welfare Isn't Working: The New Deal for Young People* (Reform, 2007), p.11; Department for Work and Pensions, Departmental Report 2009 (DWP, 2009), pp.110-111.
16 Adapted from Frank Field and Patrick White, *Welfare Isn't Working: The New Deal for Young People* (Reform, 2007), p.28-29.
17 Department for Children, Schools and Families, 'NEET Statistics: Quarterly Brief: August 2009' (DCSF, 2009), p. 10.

Most recently, under the banner of "Ending the Something for Nothing Society," James Purnell, the former Secretary of State for Work and Pensions, issued reviews of individual benefits, and increased the conditions attendant on major benefits. Although these reforms represent modest steps in the right direction, they do not get to the heart of the matter; it remains financially pointless in many circumstances to take up employment, due to the cost in lost benefits.

The failure to look anew at the structure of the benefits system has, sadly, meant that this Government has not differed from its predecessors, and has failed to achieve many of its objectives. Not only are worklessness and poverty rising, but as a result, the costs of 'social failure' have not been reduced: last year £74.4 billion[18] was paid directly to working-age adults and children, about 40% of the total social security budget. It has outstripped inflation nearly every year since Beveridge's post-war reforms.

KEY CONCEPTS:

Earnings, income and poverty

The terms **earnings** and **income** are used here with a particular meaning.

Earnings is the total amount that an individual (or household) earns from work, before Income Tax and National Insurance are taken. **Income** is the resulting income after combining post-tax earnings and benefit income (including tax credits).

For example, if a single person has gross weekly wages of £165, these will be his *earnings*. £18.95 of Income Tax and National Insurance will be withheld, and he will receive £32.28 in Working Tax Credit (he will not receive the full amount because it has been partially withdrawn). His resulting net *income* will be £178.33 per week.

The poverty threshold, below which income a household is considered to be living in poverty, is defined as 60% of the *median household income,* adjusted for household size: £158 per week for a single person and £361 for a couple with two children.[21]

A NEW WAY OF THINKING IS REQUIRED

For many, the answer to unsustainable welfare bills is to introduce ever tighter rules for receipt of benefits, and to cut generosity for some claimants. However, this approach has never worked. It is not the particular levels and conditions that are at fault, but the structure of the system itself.

Government research has found that the *source* of income is more important than the *level* of income in determining levels of social exclusion.[19]A system that penalises work, and focuses on how much income people have, without distinguishing between earnings from work and income from benefits, merely considers the *symptoms* of dependency and poverty. It is counterproductive and must be reformed.[20]

To address the underlying causes of dependency, and make a real difference, the structure of the system itself needs to change. Work must be supported as the primary sustainable route out of poverty. Hence, this report focuses on how to reduce dramatically the existing barriers to entering work and earning more – in an affordable way.

18 £30.3 billion worth of Child Benefit, Child Trust Fund endowments and tax credits administered by HMRC; £3.86 billion expenditure directed at children by DWP; £40.26 billion expenditure directed at adults of working age by DWP. See: Department for Work and Pensions, 'Benefit Expenditure Tables', Table 6, available at: http://research.dwp.gov.uk/asd/asd4/medium_term.asp; and HM Revenue & Customs, Departmental Report 2008 (HMRC, 2008), p. 8.

19 Richard Berthoud, Mark Bryan and Elena Bardasi, The dynamics of deprivation: the relationship between income and material deprivation over time (DWP, 2004), Table 6.6.

20 Ibid.

21 Department for Work and Pensions, *Households Below Average Income 2007/8* (DWP, 2009), Table 2.3, p. 18.

Part I. The Benefits System

The benefits system is not just a passive money dispenser; it is also an active player in determining whether people work. This is not because of how benefits are awarded, but because of how they are withdrawn when a person starts earning. High average (or 'participation') tax rates are the main disincentive to work – and this can mean that the Exchequer loses more in tax receipts than it saves by withdrawing benefits more aggressively.

The benefits system in brief

The current benefits system is very complex. The following is a simplified description of the 1,784 page *Benefits Handbook*:[22]

- The three main **benefits for people who are out of work** are Jobseekers' Allowance (JSA), Employment and Support Allowance (ESA) and Income Support (IS).
  - JSA is available to everyone who is looking for a job; it pays at £64.30 per week for over-25s.
  - ESA is available to those who are unable, because of disability, to take a job; it pays at different rates depending on severity of incapacity. (ESA can be supplemented by Disability Living Allowance (DLA)).
  - IS is the benefit for the remainder, those who are not expected to work but do not have a disability – for example, single mothers with young children; it pays at the same rate as JSA, £64.30.
- There are **benefits that support living costs**, such as Housing Benefit (HB) and Council Tax Benefit (CTB). The value of these varies according to local rents.
- There is also an **in-work benefit**, the Working Tax Credit (WTC), which acts as an income top-up for those in low-paid jobs. This pays £1,890 per year at the basic rate. WTC is for people over the age of 25 who work 30 or more hours per week; it is also available to parents or disabled people who work 16 or more hours. Under-25s are only eligible if they are parents. Its restriction to those working more than 16 or 30 hours is referred to as the 'hours rule'.
- Child Benefit and Child Tax Credit are paid to **families with children**. Child Benefit is a universal benefit available to any parent regardless of income level. Child Tax Credit is worth £2,780 per year for the first child and £2,235 for each additional child. It is withdrawn gradually from families earning more than £50,000.
- **'Passported' benefits** are in-kind benefits and are attached to other benefits. Income Support, for example, acts as a passport to free school meals and free prescriptions.

The benefits system exists to relieve the effects of unemployment, and to make life without work less difficult. It also plays a central role in the economic choices made by the poorest in society.[23] However, it has three main failings which directly contribute to the rising levels of social breakdown in the country's most disadvantaged communities:

1. **It disincentivises work:** the swift withdrawal of benefits, offsetting any earnings from work, punishes the lowest earners trying to earn more. It makes leaving welfare a risky proposition;
2. It imposes **penalties** on desirable behaviour apart from work – such as marriage and cohabitation, saving, and home ownership;
3. It is very **complex** – making it costly to administer and reinforcing dependency.

Both the absence of work and the presence of family breakdown have a detrimental impact on the mental and physical health of adults[24] and the future life chances of children.[25]

22 Child Poverty Action Group, *Welfare Benefits and Tax Credits Handbook 2009-2010* (CPAG, 2009).
23 See Social Justice Policy Group, *Breakthrough Britain: Ending the costs of social breakdown* (CSJ, 2007) for further details.
24 Gordon Wadell and A Kim Burton, *Is Work Good for Your Health and Well-Being?* (2006).
25 Jenny Graham et al, *The Role of Work in Low Income Families with Children – a longitudinal qualitative study* (DWP: 2005); *Centre for Longitudinal Studies Briefing, The intergenerational transmission of disadvantage of disadvantage and advantage for various studies* (CLS, 2007).

DISINCENTIVES TO WORK

The swift withdrawal of benefits, offsetting earnings from work, creates a deeply regressive system that punishes low earners who are trying to earn more. Today's complex benefits arrangements often result in a participation tax rate of more than 75% for low earners – which means that their increased income from working is less than 25% of their earnings. The first steps into the world of work for many in a low hours/low pay job are all but pointless.

KEY CONCEPTS:

Benefit withdrawal rates

When a person who is on benefits earns more, the amount of benefit they receive, per week or per month, begins to decrease. This is known as benefit withdrawal. The **benefit withdrawal rate** shows how much benefit is lost per week for each extra £1 earned.

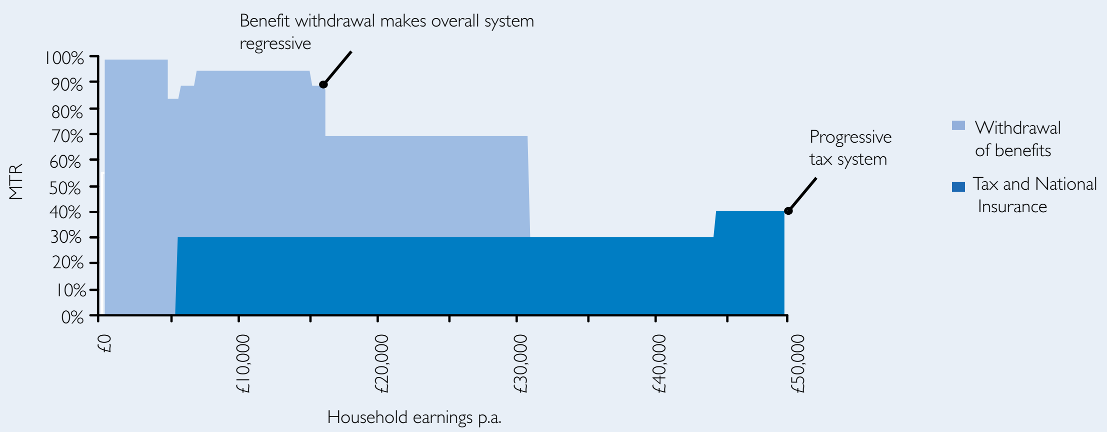
Normally there is also an amount of earnings, called the earnings disregard, below which no benefits are withdrawn.

Different benefits have different withdrawal rates, and some are on pre-tax and some on post-tax earnings. Different benefits can be withdrawn at the same time.

- As a person enters work, they face withdrawal rates of 100% for Jobseeker's Allowance (JSA) and Income Support (IS).
- After a claimant has made the full transition from JSA into work, Housing Benefit and Council Tax Benefit are then withdrawn at a combined rate of 85% of after-tax earnings.[26]
- For every £1 extra per week in gross earnings, 39p of tax credit is lost: its withdrawal rate is 39% of pre-tax earnings.

High benefit withdrawal rates create problems for low earners who wish to earn more by working longer hours, because they face high marginal tax rates.[27] In recent years, the lowest income deciles have experienced the largest rises in marginal tax rates (MTRs).[28] Nearly two million working people currently face MTRs of

Low earners have much higher MTR than high earners



26 Described in more detail inChapter 3

27 The only time a low earner has a low marginal tax rate is when they can cross from below to above the hours thresholds for the Working Tax Credit.

28 Stuart Adam, Mike Brewer and Andrew Shepherd, *Financial Work Incentives in Britain: comparisons over time and between family types* (IFS, 2006) p. 37.

more than 60% – some even of more than 90%. Compare this to the MTR experienced by the highest earners in the UK – soon to be 51%.

KEY CONCEPTS:
Marginal tax rate (MTR)

All taxpayers are familiar with the idea that higher tax rates create a disincentive to work harder. For benefit recipients, the withdrawal of benefits as earnings increase compounds the disincentive caused by taxation.

The effective **marginal tax rate (MTR)** faced by an individual in work measures the incentive to earn more. The MTR for those on higher wages, who do not receive benefits, is just their tax rate. However, for low earners it reflects not just the loss of income through taxation, but also the simultaneous, cumulative withdrawal of benefits that contributes to the MTR.

For example, if an individual is working and in receipt of Housing Benefit, then in earning an extra pound he not only loses 31p in tax, but has a further 45p of his weekly benefit income taken away. This leaves just 24p of any extra pound earned. The MTR is a huge 76%. For those also facing the withdrawal of tax credits and CTB, it reaches 95.5%. Working harder produces negligible financial gains.

KEY CONCEPTS:
Participation tax rate (PTR)

The **participation tax rate (PTR)** measures the average combined tax and benefit withdrawal rate as a result of moving from worklessness to employment. A high PTR means that a person's income after moving into work will be little different from that received when out of work. A low PTR means that person will be much better off in work.

The PTR represents the financial incentive to move from total benefit dependency into work (full- or part-time). In the case of a high PTR, the lack of a tangible difference in income, coupled with other associated costs of taking a job, such as travel and clothing, means it can be perfectly rational for a person to choose to remain on benefits.

As a result of these benefit withdrawal rates, the participation tax rate faced by many making the transition from total benefit dependency into low paid workis 75% or higher.[29] It is this participation tax rate (PTR)that has the biggest impact on decisions to enter work.

For many carers, a low-hours job is all they can take on; and for others an entry-level job represents a stepping stone to higher-earning employment. Yet, virtually all initial efforts to work are penalised – and for those in low-earning jobs (60% of median wage or less) their PTR is almost always higher than the average for other European countries.[30]

Those who do move into work also face the immediate withdrawal of the attached 'passported' benefits, such as free school meals and prescriptions. For those who rely on them, the loss of these passported benefits can be more significant than the gain in income from the Working Tax Credit. The security of keeping what a claimant already has often trumps the potential gain from work.

Only 25% of benefit claimants, when polled, thought they would be better off from working. In contrast, 17% said working harder would make no difference; 19% were unsure; and disturbingly,

29 This is lower than the 100% and 85% MTRs, because it also accounts for the earnings disregards.
30 Authors' calculation, based on an analysis of OECD data. See section 3.2.2 for further details.

39% thought they would be worse off if they worked more.[31]

The group that is most trapped by some of the highest PTRs comprises those adults under 25 without children: low earners in this group are not entitled to Working Tax Credit. Yet, those making up the growing NEET population[32] are the people most in need of encouragement to work, not least because of the long-term repercussions of youth unemployment: the Prince's Trust identified a long-term wage penalty of 10-15 per cent as a result of being NEET.[33]

CASE STUDY:

Why take a job? The PTR effect

Jane is a single mother who, though currently dependent on benefits for her income, wants to get a job. She needs to work part-time in order to look after her children. Jane finds a part-time job paying £80 per week. However, moving into work means her benefits will start to be withdrawn. Once this is taken into account she will be better off by just £20 a week. Fully 75% of her earnings would be negated by reduced benefits. In addition, Jane will have to pay for her bus fare to and from work, reducing this additional £20 income further, and is concerned about how she will cover childcare costs in school holidays. The economic incentive to move from welfare to work is negligible and Jane therefore decides to remain on benefits.

PENALTIES

Economic dependency is reinforced by factors beyond work. Being part of a family, owning a home and having some savings are all protections against economic dependency. However, the current benefits system penalises these life choices, particularly for those with the lowest earnings.

There is a well-established body of evidence that two parent families with at least one working member generally produce the best overall long-term outcomes for the whole household.[34]

Economies of scale mean that two single claimants will always need (and hence deserve) more than a couple. However, the Government reduces benefit payments to couples by far more than is saved through cohabiting: so, among families facing the greatest disadvantage, where strong, stable family units are needed most, they are most penalised.

CASE STUDY:
The couple penalty

Brenda and Brian are both workless and living separately from each other. They are each entitled to a single person's JSA of £64.30 per week and a HB/CTB award that would depend on where they lived.

If they choose to live together, then the Government recognises their joint income required to keep the same standard of living would be 75% of their combined separate incomes as singles.

However, as a couple they would be entitled to just the same HB as a single person, and between them would receive a joint JSA award of only £100.95 per week. This would typically leave them with approximately 66% of their previous income, less than the 75% required to make it equivalent for couples.

31 YouGov poll, commissioned by the Centre for Social Justice, May 2008.
32 Not in education, employment or training.
33 The Princes Trust, *The Cost of Exclusion: counting the cost of youth disadvantage in the UK* (The Princes Trust, 2007).
34 See Social Justice Policy Group, *Breakdown Britain: Interim report on the state of the nation, Volume 2: Family Breakdown* (CSJ, 2006) and Social Justice Policy Group, *Breakthrough Britain: Ending the costs of social breakdown* (CSJ, 2007) for further details.

Our research[35] shows that approximately 1.8 million low-earning couples are materially worse off – **each couple losing an average of £1,336 per year** – because they live together. The US, Germany, France, and Spain all have lower couple penalties than the UK.[36] In fact, only three of 26 OECD countries surveyed have larger couple penalties than the UK.

This is a strong disincentive to marriage or cohabitation, and is recognised as such by those who face it. Our polling showed that 77% of those who are out of work or in part-time work think low-earning/unemployed people are materially better off if they live apart than if they live as a couple.[37]

Low earners are 30-50% less likely than higher earners to live as couples.[38] It is a damaging policy that forces a member of the poorest segment of society to choose between making a significant income contribution and a family life with their own children. It also encourages fraud - the Institute for Fiscal Studies has estimated that there are 200,000 more people claiming tax credits as lone parents than actually exist in the UK.[39]

Mortgage and savings penalties

The UK is one of the few countries where Housing Benefit is available only to tenants: low earners with mortgages are not supported. In contrast, support for housing costs is available to all low-income home-owners in France, Germany, Sweden and the Czech Republic to help them pay their mortgage. This 'mortgage penalty' currently affects 1.9 million low- earning working households.

The Government also gives reduced benefits to people with savings, on the basis that they should be expected to deplete them when faced with economic hardship. More than 750,000 of the lowest-earning households lose over £1,000 per year in benefits as a result.

We agree with this principle, but it must be balanced against the need to encourage financial prudence. The amount by which benefits are reduced currently is punitively high,[40] and so creates a clear disincentive to save. Other countries (such as Australia) have recognised the corrosive effects of capital limits on benefits, and have higher thresholds and less punitive tapers.

COMPLEXITY

Successive Governments have tweaked and patched the benefits system in the hope of improving it. But the unintended consequence has been a system of 51 different benefits of bewildering scope and complexity, which is extremely complex to administer. This has itself entrenched benefit dependency, as claimants are afraid to change their situation, and even advisers are unsure whether to recommend they take a job.

The difference between all these benefits is confusing.[41] The Department of Work and Pensions (DWP) issues 8,690 pages of guidance to help its decision makers to apply DWP benefits, with a further 1,200 pages covering Housing and Council Tax Benefits. Benefits pay at different rates for similar circumstances. Some are paid weekly, and others monthly. Some depend on hours, and some can only be awarded through one benefit, but not through another.

Reporting any change in circumstance is time-consuming, and can jeopardise stable payment of benefits. Any such change, for example an increase or decrease in earnings, requires multiple forms to be filled – in some cases up to ten forms and 1,200 questions.[42]

35 We have used the Family Resources Survey's representative set of 24,000 different couple and ingle households and aggregated them to calculate the current penalty to all couples in the UK. See section 4.2.3 for further details.
36 Authors' calculation, based on analysis of OECD tax and benefit tables.
37 YouGov poll, commissioned by the Centre for Social Justice, May 2008.
38 Controlling for age.
39 Mike Brewer and Alastair Muriel, *Poverty and Inequality in the UK: 2009* (IFS, 2009), Appendix D.
40 Reduction in annual benefits equivalent to 20% of the total value of their savings above £6,000.
41 This is addressed in more detail in Chapter 5.
42 David Martin, *Benefit Simplification: How, and why, it must be done* (CPS, 2009), p.5.

Furthermore, numerous agencies need to be informed, including JobcentrePlus, the local Tax Credit Office, the relevant local authority, and the other agencies of the DWP, such as the Pension Service and the Disability and Carers Service. A judge recently ruled, in finding for the Department for Work and Pensions, that simply because a claimant had notified a change of circumstance to one part of the DWP, the claimant could not assume that other parts of the DWP had been informed.[43] This is an absurd organisational breakdown.

Claimants who have spent hours ensuring their benefits are set up correctly are understandably anxious about changing their financial position as a result of getting into work, especially if this might not even result in an increased income, or cause delays in payments. For many, debt has been the ultimate consequence of trying to get and hold down a job. Thus, many believe they are better off staying on benefits, or are deterred by the uncertainty and risk associated with their income, upon taking up a low-earning job.

Part II. Better Benefit Design

DYNAMIC MODELLING

To redesign the benefits system so that it relieves poverty over the long term, we must understand how its shape and structure influence people's movement into and out of work. People need to be recognised as dynamic, active participants in the economy, not as static, passive recipients of cash transfers.

Existing dynamic models have not captured the full effect of benefits withdrawal on employment. We have developed our own model, drawing on recent research published by the Institute for Fiscal Studies. It enables us to understand how changes to the system would affect employment, earnings, the income distribution and the cost to the taxpayer, thus allowing us to design a system that will reduce barriers to work and reduce poverty.

Successive governments have failed to acknowledge adequately the economic incentives created by the benefits system. Clearly, tax and benefits are not the only factors influencing movement into or out of work, and may not even be the main factors for many individuals; but they are a greater influence on those with lower earnings potential. Nonetheless, there has not been any systematic scrutiny of how changing the benefits system affects the decisions made by those dependent upon it. Instead policy has been determined mostly by making static assumptions about welfare benefits: 'increase benefits and claimants will be better off'.

Dynamic modelling is a way of accounting for people's responses to changed incentives. It is a form of economic analysis that is well established in the private sector, but is not in widespread use for developing government policy.

Academic analysts have developed models to predict how high earners will vary their earnings in response to changes in taxation levels, but these have little relevance to people who are deciding whether to come off benefits and into employment. This is because they fail to differentiate between employment, earnings and income; they do not capture the fundamental value of work for a household. At the lower end of the income scale such differentiation is essential.

We have built a dynamic model[44] that incorporates the work choices made by people at all earnings levels, drawing on recent research by the IFS that identifies two distinct "elasticities" (the level of people's responsiveness to the amount of benefit received and withdrawn):

43 House of Commons Work and Pensions Committee, B*enefit Simplification: Seventh Report of Session 2006-2007*, HC (2006-07) 463-I [196].
44 For more details, see Chapter 10.

1. **The employment elasticity**, related to making the transition from total benefit dependency into work, which is driven by the PTR; and
2. **The earnings elasticity**, related to taking on more work when working low hours, which is driven by the MTR.

The model can measure the impact of any welfare reform with hitherto unprecedented robustness; and we can use it to quantify the longer-term effects of reform. We can review various options for benefit reform, from flat tax to "super-benefits", and assess whether they encourage claimants to enter work or to work longer hours. By modelling a particular proposal for reform, we can predict the consequences for society: we can estimate the cost to the Exchequer, the change in GDP, the number of people in work and the reduction in poverty.

OBJECTIVES

Better benefit design also requires clear objectives distinguishing between the distribution of income and the distribution of employment and earnings; it also requires that we recognise the limits of possible reform.

At the heart of our proposal are four core objectives for the benefits system: (1) continue to relieve poverty;[45] (2) reduce worklessness and benefit dependency; (3) support positive behaviours by reducing the couple, mortgage and savings penalties; and (4) increase the affordability of the system.

A dynamic model on its own is not sufficient to design a better benefit system. We also need to define precisely what we mean by 'better': we must have clear objectives, distinguishing between the distribution of income and the distribution of employment and earnings. To date, there has been too little debate about what the benefits system is trying to achieve.

We also explore in greater detail than previous reviews the mathematical and logical constraints on benefit design. These constraints mean that no one system can satisfy all possible objectives at the same time: we believe that the necessary trade-offs must be made explicit.

Having reviewed different possible social objectives for the welfare state, and the different implied configurations of tax rates and benefits, we conclude that sustained poverty relief must be driven by boosting *earnings* – in other words, by increasing employment through low PTRs – rather than simply by the transfer of money.

Furthermore, it is *household* rather than *individual* employment that should be of greatest concern for policy makers. Increasing the number of households in which at least one person works, even if only part-time, will reduce the causes of poverty and dependency more than increasing the number of households in which a second adult works.

In addition to encouraging people to find work, we want to reward decision-making that enhances self-sufficiency, and provide a degree of security for people taking tentative steps into the workforce.

BENEFIT DESIGN

The employment decisions of low earners are particularly responsive to changes in tax and benefits. Hence, to reduce worklessness, we must reduce participation tax rates for low earners, and do so in a way that the increase in employment makes it self-financing.

Designing a benefits system that increases the rewards from work and reduces complexity, while minimising the number of losers and containing costs, raises many challenges.[46] Reducing PTRs, by increasing generosity of in-work benefits, risks increasing the cost of the system as a whole. Furthermore, reducing complexity could either create as many losers as winners – or else could be very costly.

45 We do not propose reducing any levels of out-of-work benefits.

46 There are many other challenges, such as the confounding 'More workers, less work' effect. See section 13.1.

Balancing all these considerations will require exploiting the dynamic effects to the full. This requires us to be confident that our model is robust, and to be very clear and explicit in our objectives. This will ensure that we focus spending to greatest effect, and avoid increasing the generosity of in-work benefits beyond the point of diminishing returns.

In order to make the first steps into work much more rewarding, the reduction in participation tax rate needs to be focussed on low earners. However, this needs to be structured in a way that also optimises the tax raised from higher earners: i.e. we need relatively high MTRs on their lower earnings (in contrast to lower MTRs for their higher earnings.)

Therefore a simplified benefits system that satisfies these conflicting objectives will be one that:

- Provides generous earning disregards for benefits, to reduce PTRs;
- Has higher MTRs for low earnings, to capture optimal tax take from higher earners;
- Avoids increasing generosity of in-work benefits beyond the point of diminishing returns.

In Part III we provide the details of how such a system would work.

Part III. Dynamic Benefits

UNIVERSAL CREDITS – A NEW BENEFITS SYSTEM

As well as describing a new and more rigorous way of thinking about benefits design, this report presents specific proposals to address Britain's unacceptable levels of poverty and social exclusion, of which worklessness is a major contributory factor.

Our proposals would dramatically reduce PTRs and cut complexity. The key measures are:

- ***Reduce the rates at which benefits are withdrawn to an across-the-board rate of 55% of post-tax earnings;***
- ***Increase the 'earnings disregards' – allowing low earners to earn more, before any benefits are withdrawn;***
- ***Simplify the benefits system by moving from the current 51 possible benefits, to two streamlined payments – Universal Work Credit, and Universal Life Credit;***
- ***Reduce the penalties for couples, those with mortgages, and low-earning savers.***

We propose to replace the current system with the Universal Credits scheme[47] – a simplified system that provides greater rewards for work. It maximises the number of working-age households with at least one member in work – thereby directly tackling severe poverty and increasing the life chances of adults and children – while ensuring all households receive a fair minimum income.

A SIMPLIFIED, TWO-COMPONENT SYSTEM

The Universal Credits scheme is a single benefit with two components:

- *Universal Work Credit*, for those out of work or on very low wages. This will combine JSA, IS, IB/ESA;
- *Universal Life Credit*, to cover additional living expenses for all those on low incomes. This will combine HB, CTB, DLA, WTC, CTC.

47 See Chapter 16 for further details.

While the assessment for each of the two components depends on different factors, they will be received as one payment and will be withdrawn at the same rate. Universal Life Credit begins being withdrawn only after Universal Work Credit has been completely withdrawn.

There will be a single application form which would need to record only household characteristics and asset levels, to calculate the sizes of the initial award and disregard. This contrasts with the numerous forms currently required to inform of a change of circumstances.

We do not propose any changes to the existing sizes of the initial benefit awards for different households – this is a decision which requires significant political debate.

Standard Withdrawal Rate

We propose to end the current confusion and multiplicity of benefit withdrawal rates, and make them much more transparent and consistent. We propose a single universal benefit withdrawal rate of 55% on post-tax earnings above the earnings disregards. This will make it simpler for claimants – and benefits advisors – to project how much better off they would be if they take a job, or increase their working hours. This rate represents the best compromise between improving incentives and containing costs.

Passported benefits will continue to be available to those earning above the current hours thresholds. Higher earners who choose to receive them will be expected to pay a notional value imputed to them. In this way, low earners will not face the cliff-edge withdrawal of these benefits. Instead, their value will taper away, like other benefits.[48]

Earnings Disregards

The earnings disregards – the earnings level at which benefits begin to be withdrawn – play a key role in our proposed system. To encourage workless households into work, we propose to raise significantly the household earnings level below which all benefits are retained. It is those with low earnings potential who are most responsive to changes in the PTR, and therefore this move will provide a significant incentive to find employment.

The level of earnings disregard is different for different household types. The basic principle is that the larger the household, the more generous the disregard (noting as well that the initial award has not been affected, so households with greater need will generally also be receiving more benefit to start with). The disregard for a couple with one child is bigger than for a childless couple, therefore the first couple keeps more of their earnings before the withdrawal of benefits. This ensures larger families are better able to support themselves through working.

We use the following table[49] to calculate the earnings disregard for particular household types:

Household Earnings Disregards	**Proposed Annual Disregard**
Households	£1,500
Over 25/ Parent Addition	£3,500
Lone Parent Addition	£3,000
Each of 2nd and 3rd children	£350
Rent	-1.8 x rent supplement[50]
Council Tax	-1.3 x Council Tax supplement[51]

With a 'disregard floor' of £260 per adult + £650 per child + £1,660 for lone parents, should the formula above suggest a lower disregard.

48 See section 16.6 for further details.

49 This table is additive, each applicable component contributes to the overall disregard for a household.

50 For every £1 provided in benefits to cover housing costs, £1.80 is reduced from the benefits disregards. In this way those households with large support for housing costs have a lower disregard than those with low or no housing support included in their Universal Credit.

51 The same reduction in allowance applies to the amount of Universal Credit provided to cover Council Tax. However, this deduction in the allowances is not applicable to those under 25 who have the youth penalty. There is also a floor for these allowances.

These earnings disregards are set at a level to ensure that those working at the 16/30 WTC hours thresholds will have the same net income as they do today (when in receipt of WTC).

Those under-25s who are not currently eligible for WTC would be entitled to an earnings disregard that is lower than for older claimants, but much more generous than they receive today. Over time, this disregard would be equalised: younger people need as much of an incentive and equal reward from working as older ones. Any differences in the level of financial support for younger people should ultimately come from the benefit levels, not from differential withdrawal rates or disregards.

It is the way in which the earnings disregard changes based on family size and out-of-work award entitlement that marks our scheme out from all others. It allows us to balance fairness, control costs and limit the number of people who would lose out from our reforms. By having the variation in the disregard rather than in the withdrawal rate, the experience of the claimant with fluctuating earnings is much more stable. Changes in disregards are aligned with changes in the level of benefit entitlement, i.e. at the major events in life such as house moves or changes in family structure.

Simpler payment and withdrawal

All benefits will be paid in full by a single agency based in the Department for Work and Pensions, regardless of whether a person is in work or not. HM Revenue and Customs would no longer be involved in the payment of benefits. However, it would be involved in the *withdrawal* of benefits. Those who are employed will find the value of the benefit gradually withdrawn through the 'pay as you earn' (PAYE) mechanism, with employers withholding payments in a similar way to Income Tax and National Insurance.

This ensures continuity of income as a person moves into work, and means people will not have to manage their benefits level on an ongoing basis. It also eliminates up-front means testing for benefits, as the application for initial award and disregard has nothing to do with how much is being earned.

Reduced working-couple penalty

The proposed earnings disregards and withdrawal rate will reduce the working couple penalty by a modest amount, helping mostly low-earning childless couples. However, for out-of-work couples, whose benefit levels would remain unchanged, the material couple penalty would persist at the same level as today – an immediate reduction would be prohibitively expensive.

Reduced mortgage and savings penalties

The proposed earnings disregards for Universal Credits have been structured so that those not in receipt of support for renting have higher disregards. Hence, low-earning mortgagors will benefit more than low-earning renters. Low-earning renters would still receive higher benefits, but the gap would be narrowed by approximately £300 per year.

The increased disregards and simplification of benefits mean that low-earning savers lose less in the way of benefits. While the penalty has not been eliminated, it is concentrated more on benefit recipients who are also higher earners. Hence, the illogical and unfair elements in the current system have been significantly reduced.

We recommend that as funds become available, future budgets continue to reduce the remaining couple, mortgage and savings penalties.

ADVANTAGES

The Universal Credits scheme is a cost-effective way of greatly increasing household employment and tackling poverty and child poverty.[52]

A total of 4.9 million households with low-earning workers would see their incomes rise by an average of £1,000 per year. By careful design we can minimise the number of low earners who lose out. 600,000 previously workless households would enter employment, and the national income (GDP) would increase by £4.7 billion. Consequently, 829,000 households – including 210,000 children – would move above the poverty threshold.

Winners / Losers

The net effect of our reforms is to increase income for low-earning households: 4.9 million working households would see their incomes rise under this proposal, by an average of £1,000 per year. They are mostly those in entry-level jobs, especially working below the current 16/30 hours thresholds, including 1.8 million working couples with children, 1.6 million working single households and 750,000 working lone parents.

While the average low earner gains under this system, there are some who will lose a small amount. In particular, two categories of people are made marginally worse off by these reforms:

- The largest group comprises those higher-earning families earning above £30,000 per year currently receiving the Family Element of Child Tax Credit (£545 per year). This benefit currently starts to be withdrawn when earnings reach £50,000 per year. Under these proposals it would be subsumed into the Universal Credit, and thus tapered away at lower earnings.
- The other group comprises a subset of those working just above the hours thresholds for the Working Tax Credit, who under the new proposals would be affected by a slightly different schedule. This is especially true for home-owners and those with savings.[53]

Incentives

The graph below compares the current average PTR for all households with the PTR resulting from our proposal. It shows a dramatically lower average PTR for those households earning up to £15,000 per year, although this varies by household type and housing tenure. It is a clear contrast to the extremely high average PTR for the same group in the current system.

Impact of proposal on average Participation Tax Rates

52 See Chapter 17 for further details.

53 Those with savings are currently eligible for the full value of the WTC award – yet lower earners are currently penalised. Under our proposals, savers with lower earnings are penalised less, but those working at the hours thresholds are more likely to experience a penalty.

Impact of proposal on average Marginal Tax Rates

The more generous earnings disregards mean that for those taking up employment in entry-level jobs at hours levels below the current WTC thresholds, there would be minimal impact on their benefits entitlement, thus providing much greater security.

The PTR reduction may be particularly attractive to lone parents for whom working fewer than 16 hours is the right option, or for childless people whose first attainable job offers fewer than 30 hours work per week.

The more generous earnings disregards mean that benefits start to be withdrawn with higher earnings; this and a withdrawal rate capped at a lower level will result in many households receiving benefits which previously would not have done. This means they will be better off financially; however they will also experience withdrawal of these new benefits.

As the graph above shows, this results in an increase in MTR for many low-to-middle earning households. Unfortunately this group will have a reduced incentive to earn more.

Changes to employment and poverty

Our proposal would result in 600,000 households, mostly childless, entering work. National earnings would increase by more than £1.1 billion per year. The effects on earnings and employment mean that the overall increase in income would be £4.7 billion.

The combined effects of reduced benefit withdrawal and increases in employment mean that 829,000 households – including 210,000 children – would move above the poverty threshold. The main reduction in poverty would result from people entering work, rather than from income transfers, therefore bringing accompanying benefits in health and wellbeing.

Additionally, the reduced number of benefits and automatic payment of the full amount will increase the take-up, particularly among low earners, who are most likely to comprise today's working poor.

FINANCIAL IMPACT

While direct benefit costs would increase in the short-term, the tax gains from increased employment and earnings, together with reduced administration costs make these reforms self-financing over the medium-term.

The change in benefit withdrawal rates, earnings, and employment resulting from these proposals would increase the total annual benefits bill by £3.6 billion. However, this cost would be partially offset by increased tax. The increase in receipts from Income Tax and National Insurance would be small (about £80 million per year), because a lot of earnings gains would be in low earning jobs which are not taxed. On the other hand, there would be an additional £800 million per year in VAT/Duty raised from the extra income and hence expenditure.

Hence, the total short-term cost of these proposals is £2.7 billion per year, an increase of 3.6% on current annual benefits expenditure of £74.4 billion. This will be funded from the broader cost savings detailed below, so in the longer term our proposals will produce net gains to the Treasury.

The reduction in worklessness would save money as a result of fewer demands on the administration of the benefits system. The dramatic simplification would reduce the number of government departments involved in administering benefits and reduce the number of tasks involved, besides offering significant potential to cut error and fraud. Broader savings would also come from reducing the indirect cost of unemployment – reduced expenditure on health, crime, policing, and other social costs. We estimate that the total cost savings that could be achieved by these reforms would be £3.4 billion per year, meaning they would more than cover the direct costs.[54]

Alternative proposals

The full report includes details of the alternative options that we considered, some of which are more expensive but lead to greater income equality than our proposal, and some which are less expensive but also less effective in reducing worklessness. The differences between the options are all in the earnings disregards. Our favoured option should be seen in the context of these other options having been considered. We ultimately rejected them because they are less cost-effective ways of increasing employment, or would leave many low earners worse off.

Conclusion

The more we struggle to end poverty through the provision of benefits, the more we entrench it. By focusing on income transfers rather than employment, the system makes people dependent on benefits. Habituation to dependency destroys both individuals and communities, as well as reducing the overall competitiveness of the UK. To accept a system that produces this is to despair of the idea that we could ever offer every member of society the chance to progress.

We must continually encourage the desire for a job; and we must also clearly determine that a life on benefits, no matter what their level, should not be a sensible choice for those able to work.[55] The next Government will likely make the same predictions and declarations as the last one; and it is right that they should have these aspirations to reduce worklessness and dependency.

But they also have the option to learn from the mistakes of the past, and approach the benefits system in a new way: not just to change the system, but also to change the way we think about it. In particular, policy-makers need to consider how the system can deplete the incentive to work.

The answer is not about the generosity, or about ever more precise targeting of benefits to particular groups. Such piecemeal reform can only further complicate the system and obscure the route from dependency to independence.

54 Details of this calculation can be found in Appendix G.

55 See Social Justice Policy Group, *Breakthrough Britain: Ending the costs of social breakdown* (CSJ, 2007).

The key is to encourage and support the efforts of claimants to reduce their dependency on benefits. Dynamic modelling brings rigour to the analysis, and can allow us to design a coherent system that deploys the vast welfare budget to better help those in need. The system we have proposed is designed to create a stronger society, in which work pays and in which socially beneficial decisions do not face a financial penalty.

Whether or not those in government agree with our objectives, we urge them to embrace this new rigorous, empirically grounded way of thinking about the benefits system, so that decisions can be made on a more informed basis.

With no change in the way that governments think about benefits, the future will repeat the past: more broken promises, more expense, and more dependency.

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About the Centre for Social Justice

The Centre for Social Justice aims to put social justice at the heart of British politics.

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We are not a typical Westminster 'think-tank'. In addition to policy development, we foster an alliance of poverty fighting organisations that reverse social breakdown and transform communities.

We believe that the surest way the Government can reverse social breakdown and poverty is to enable individuals, communities and voluntary groups to help themselves.

The CSJ was founded by the Rt Hon Iain Duncan Smith in 2004, as the fulfilment of a pledge he made to Janice Dobbie, a mother whose son had recently died from a drug overdose after he was released from prison.

Chairman: Rt Hon Iain Duncan Smith MP
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"Our existing complex and inefficient benefits system should finally be laid to rest. Otherwise all the talk about improving the number of people going back to work will be just another form of empty rhetoric."

IAIN DUNCAN SMITH MP, *Dynamic Benefits*

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