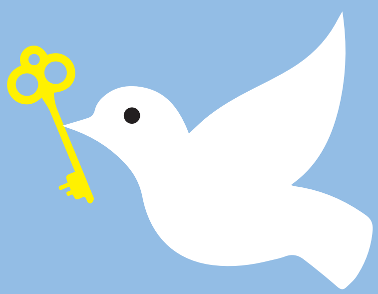
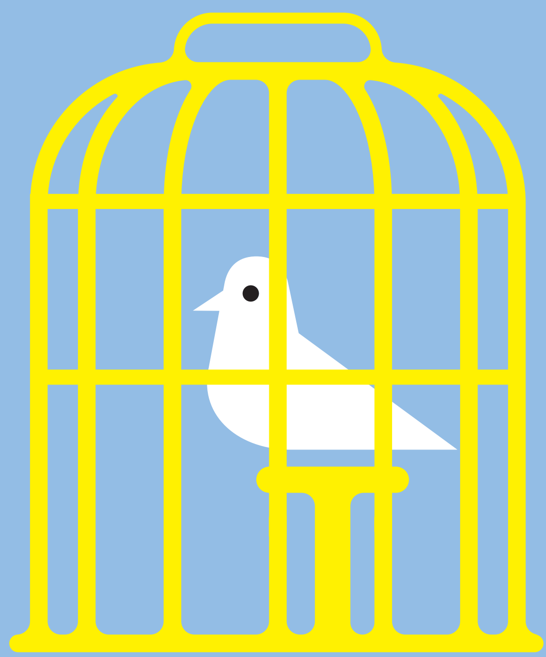
Tim Stacey and Lucy Shaddock

THE ASPIRATION TAX



How our social security system holds back low-paid workers



THE EQUALITY TRUST

CONTENTS

Most people agree that if someone moves from unemployment into work, works more hours or takes a promotion, they should be financially better off as a result. However, this report shows that many of the poorest working families see little benefit from extra work.

Working families on low incomes qualify for in-work support in the form of tax credits or Universal Credit. The government withdraws these payments as earnings increase. When Income Tax payments and National Insurance contributions are taken into account on top of this, many low-income families keep very little of the money that they earn from work.

Our current system of tax credits provides vital support to working families, but it removes this support extremely quickly when they start to earn more. This is one of the arguments for the move to a new system of in-work social security, called Universal Credit.

When Universal Credit was first proposed by the Centre for Social Justice (CSJ) in 2009, the think-tank, quite rightly, complained that the current system creates a "tax rate of more than 75% for low earners". The CSJ noted that for Universal Credit to incentivise work effectively, those receiving it should keep 55p of every £1 they earned after tax. The reality of Universal Credit is very different, with many low-income families keeping far less of what they earn. This, in turn, reduces their incentive to work.

Our report shows the high tax rates faced by low-income working families under Universal Credit, and details how unpopular these rates are with the public. It recommends that families on Universal Credit should be able to keep more of what they earn, with a return to the original plan for recipients to keep 55p of every £1 they earned after tax.

Our report finds that

- Families currently receiving tax credits, and paying Income Tax and National Insurance contributions, lose 73p of every additional £1 they earn.
- Families who move on to receiving Universal Credit, and who pay Income Tax and National Insurance contributions, can lose up to 76p of every additional £1 they earn.
- A single parent working full-time on the minimum wage under Universal Credit would lose 71p of every additional £1 they earned.
- Someone in the top 1% of household incomes, in comparison, loses just 47p of every additional £1 they earn

Amongst modern, developed economies, the UK's tax rates on low earners are abnormally high. Under the current system, a minimum wage household in the UK loses 73p of each £1 increase in earnings. Among OECD countries, the average loss is just 27p. Successive UK governments have prioritised keeping down the taxes of the rich whilst failing to tackle the barriers that impede the poor. This is both unfair and unpopular.

Our research conducted with Ipsos MORI shows

- When asked how much of any additional £1 earned a working parent receiving tax credits with a gross annual income of £10,600 should get to keep, 83% of online adults aged 16-75 gave an answer greater than the 27% of every £1 they currently earn over that amount.
- On average, the public believe a working parent earning £10,600 who is in receipt of tax credits should keep three-quarters (75%) of the next £1 they earn; in reality, that worker would lose almost three-quarters (73%) of the next £1 they earn.
- Most people (59%) think that a working parent earning £10,600 who is in receipt of tax credits should keep a greater proportion of the next £1 they earn than a parent earning £150,000 (i.e. someone in the richest 1%); a person paid £150,000 actually keeps 53p of every extra £1 compared to a person on tax credits who only keeps 27p.[I]
- Most people (70%) think a working parent in receipt of Universal Credit and earning £10,600 keeps too little, at just 24p of every extra £1 they earn.

[I] See methodology.

We propose for Universal Credit to return to its original plans and offer a withdrawal rate of 55%.

This would

- Directly lift people out of poverty: this would remove 94,000 children from poverty. At the moment 63% of children in poverty are in working families and more needs to be done to stop them from being trapped in persistent poverty. Poverty in the short term can be damaging, but persistent poverty has much worse effects on health and, in particular, on children's health and development.
- Increase incentives to work and to earn more: the evidence we outline in this report shows that allowing people on low incomes to keep more of what they earn increases the likelihood that they will work and earn more.
- Be popular: over one and a half times as many people support (35%) the proposal as oppose it (22%).

How to pay for this

Reducing the withdrawal rate of Universal Credit to 55p would cost almost £4bn per year. To fund this, our report calls for the cancelling of the planned increase in the Income Tax Personal Allowance. This provides a saving of over £4bn per year and is a practical, achievable measure.

Increasing the Personal Allowance has some of the same aims as in-work social security. Both policies were supposed to help improve the living standards of low- and middle-income workers and make sure that work pays more. However, the Personal Allowance is less effective at doing that. The Government's planned increases in the Personal Allowance will mainly benefit households in the top half of the income spectrum with no benefit at all for many low-paid families.

HMRC spends less than £30bn on the entire tax credit system, which not only provides work incentives but also combats poverty for parents with children. The Personal Allowance, on the other hand costs HMRC over £86bn and is much less effective at increasing work incentives.

INTRODUCTION

When the Government announced plans to cut £4bn of in-work social security in its Summer Budget last year, it was widely condemned by commentators and organisations for hitting some of the poorest working families hardest. The cuts, which focused on tax credits, were subsequently scrapped by the Government during its Autumn Statement, but this merely deferred the pain. Cuts were, instead, transferred to the new social security system of Universal Credit, now being rolled out. As a result, huge numbers of families will see their household income reduced as they move onto the new system.

Cuts to Universal Credit will hit the working poor financially, but this isn't the only problem they face under the new system. Due to a lack of focus on its design, Universal Credit will also fail to get people into work, or help them progress into better paid work.

When the social security system works well, it fights poverty by supporting those out of work, helping people back into work, and encouraging progress through work, so that people can exit poverty through employment in well paid jobs. As it currently stands, our social security system fails to do this. Instead, when combined with our tax system, it imposes extremely high tax rates on low-income households that aspire to leave poverty and insecurity behind. The Government is introducing Universal Credit in order to reduce poverty and increase work incentives but, as it currently stands, it fails to do so.

Being able to make ends meet, to begin to save for the future, and to be free of the blight of poverty and insecurity is an aspiration we all share. We all want to know we can secure a dignified retirement. We all want to build a better life and better opportunities for our children. Instead, Universal Credit acts as a brake on these goals.

This stands in stark contrast to the way that our system of taxes and social security treats individuals at the other end of the income spectrum. Successive governments have prioritised lowering the taxes of the rich, whilst failing to tackle the barriers that impede the poor. The result, as our report shows, is that families on lower incomes keep less of each £1 they earn than those in the richest 1 per cent, thereby entrenching existing inequalities. This is both economically and socially damaging, and deeply unpopular with the public.

The UK is one of the most unequal countries outside of the developing world. The result is that we have higher crime rates, poorer educational outcomes, and worse mental and physical health than developed countries with greater equality. Our system of in-work social security, and the new system of Universal Credit, do far too little to combat this inequality. But, as our report shows, with political will, this can be changed.

A THE CURRENT STATE OF IN-WORK POVERTY AND THE CASE FOR IN-WORK SUPPORT

The claim that "work is the best route out of poverty" is familiar. A large body of research suggests having someone in the household in work is indeed the most effective route out of poverty, but it is by no means an inevitable one. Between 2007 and 2012, 70 per cent of people in income poverty that entered employment moved out of poverty. This means that almost a third remained in poverty despite doing the 'right thing' by entering work. Of all employed people in 2013, around 8 per cent, or around 3 million people, were in poverty. This rate has been fairly stable for the past decade.[1]

These statistics represent people's lives. Employees in poverty often have families to support. The Institute for Fiscal Studies (IFS) has shown that the proportion of poor children in working families rose from 54 per cent to 63 per cent between 2009 and 2014.[2]

How can it be that working, an act that intuitively and practically should provide a significant boost to family incomes, cannot guarantee a route out of poverty? The problem is, in large part, because pay simply isn't enough to live on.

Low pay

The proportion of the workforce on low wages has more than doubled in recent decades. 1 in 20 employees are now paid at the legal wage floor compared to 1 in 50 just after the National Minimum Wage was introduced in 1999.[3] Much of the work available to parents in the poorest families is low paid, with industries such as hospitality, care and retail providing the lowest returns.[4] For working parents, and lone parents in particular, the number of hours they can be available for work is limited by their caring commitments.

Low-paid jobs also tend to be more precarious than those that pay more. Research has revealed evidence of a 'low pay, no pay' cycle wherein periods of low pay alternate with periods of unemployment.[5] Worryingly, it has been suggested that such periods of unemployment early in a person's working life can 'scar' their future earnings, with wages up to 15 per cent lower in later life, thereby perpetuating low pay.[6] Low-paid jobs are much less likely to offer opportunities for training and progression, becoming poverty traps that provide little prospect for advancement or increased pay.

In addition to low pay, precarity and lack of progression, other factors that help determine whether someone experiences in-work poverty include whether the individual has a partner and if that partner works, if they have children, what costs the household faces, and the kinds of support to which they are entitled.

The so-called 'National Living Wage', due in April 2016, will increase the minimum pay threshold for over-25s. However, it is likely that working families will always need help in making ends meet. There are limitations to the hours they can work and they face the high costs of housing and raising children. More generous wage floors mean employers take more responsibility for their workers' living standards, but minimum wages must remain feasible. It is reasonable for the state to offer support so that all families can achieve a decent standard of living.

Tax credits

The role of tax credits in our system is to take account of family size and ensure that families have enough to live on. The IFS has said that in-work support is good at targeting the 'lifetime poor' because people in the poorest 10 per cent (by income) over a lifetime spend more than two thirds of their working lives in employment. This shows the problem of persistent in-work poverty.[7]

The tax credits system has been a major government initiative for tackling low pay and incentivising work since its first form, the Family Income Supplement, was introduced in 1971. It expanded to become Family Credit in 1986. Following that, it became the Working Families Tax Credit, and then the Working Tax Credit and Child Tax Credit we know today. The next iteration will be Universal Credit, which combines the majority of benefits into a single household payment. The tax credits system has played a vital role in boosting earnings for low-income families and has improved support for working parents. For the poorest 20 per cent of households with children, earnings make up 45 per cent of their gross income, with a much-needed 50 per cent of gross income coming from government support.[8] This shows how vital in-work support can be for those on low pay.

In-work support is not only about topping up low pay. While higher wages are evidently necessary, employers cannot be expected to pay parents more than non-parents to cover the costs of children. People need different levels of support at each stage of their lives. The IFS has shown that 93 per cent of people pay more in taxes than they receive in all forms of social security throughout their lives.[9] In-work support for parents acknowledges the additional costs of raising children and means the state shares some of the burden. It adjusts for family size and ensures everyone is provided for, stepping in where wages prove insufficient. In-work support can also boast some major successes. There is a clear inverse link between tax credits spending and child poverty rates. Although the target to halve child poverty was ultimately missed, tax credits have contributed to one of the biggest drops in post-war child poverty. The numbers of children living in families below the poverty line[II] dropped from 35 per cent in 1998/9 to 19 per cent in 2013/14.[10]

[II] Defined as less than 60 per cent of the median wage in 2010/11 before housing costs.

What's more, in-work support is popular. Research from the British Social Attitudes Survey shows that increasing social security support for working parents has been consistently popular since 1998. Even throughout the financial crisis, a significant majority thought the Government should spend more on this.[11]

B. THE IMPORTANCE OF WORK INCENTIVES

Another key function of social security targeted at people in work is to maintain and improve work incentives. In-work government support ensures that a person does not become worse off if they enter work and that working makes a person meaningfully better off.

Social security received by people who are out of work, even when it is at quite a low level, can be a lifeline. Unless the system also provides in-work support, people entering low paid work on a few hours a week would end up worse off in employment than out of it.

It is important that people see a real increase in their household budget when they enter work. There are substantial costs associated with working. These include financial costs like travelling to work, and emotional costs like a parent having less time to spend with their children. Hypothetically, if someone earns £100 a week from a small amount of part-time work and loses £100 a week in social security income, then they are much less likely to want to take that job than if they keep some of that income.

If in-work support continued at the same rate, even as income increased, then it would prove very costly. In order for social security to be affordable, most governments decide that it should be withdrawn as a person's income increases. This, in effect, functions like a tax. As a person increases their pay from work, their income from in-work support decreases. Dependent on the pace and scale at which social security decreases, this effectively disincentivises work.

There is plenty of political discussion of the disincentive effects of taxes, but this mostly focuses on those on high incomes rather than low ones. Many of the objections to the 50p top rate of Income Tax rest on the idea that raising the rate above 45p would cause people to work less, and make them less likely to invest in opportunities to increase their incomes.

Opponents of higher tax rates often cite the Laffer curve, a measure that purportedly shows that the higher a tax rate, the less likely a person is to work. It is highly questionable whether increasing the top rate of tax by a small amount would do this.[12] However, there is a large body of research suggesting that financial work incentives do make a difference in the decision of whether, and how much, a person on a low income will work.

Evidence from the expansion of the Earned Income Tax Credit (a form of in-work support) in the US has shown that it increased employment in the groups who were eligible to receive it.[13] Similar evidence from the UK demonstrates that the expansion of in-work support with the creation of the Working Families Tax Credit increased employment.[14]

The improvement of in-work support and the financial gains from this has been particularly successful in bringing women into the workforce, especially mothers who want to work. The Institute for Fiscal Studies found that a £100 increase in gains from work made men 6-9 per cent more likely to enter employment and women 18-20 per cent more likely to enter employment.[15]

The research is clear on a very specific point: the likelihood of a person working is directly related to the amount they get to keep from work. One study in Canada found that people who lost less of their social security when entering work increased their earnings substantially.[16]

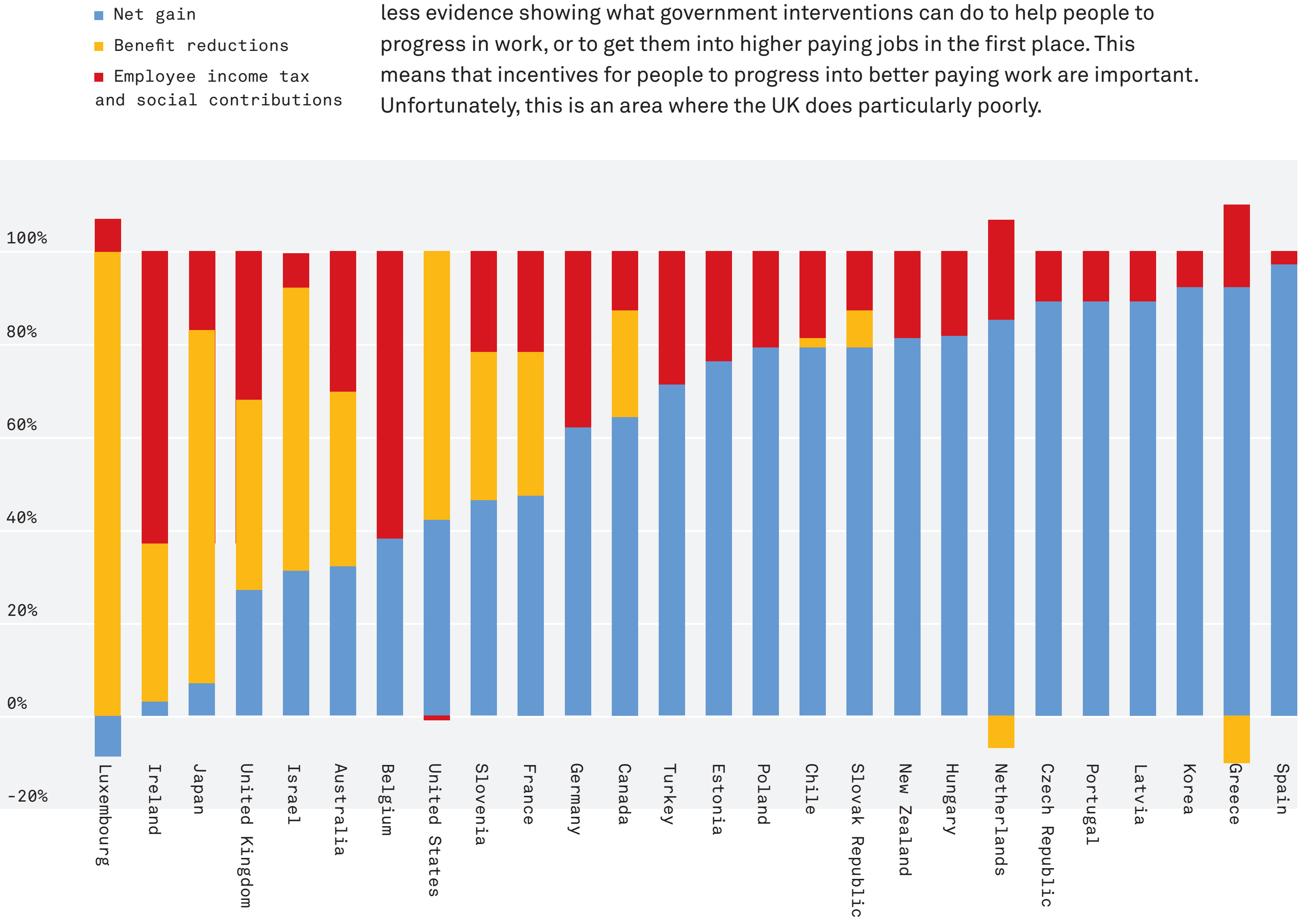
Progressing in work

There are other reasons besides financial incentives as to why people work. Interviews with low paid people on in-work support reveal that they want to work because they feel that work is good in itself.[17] These arguments are compelling in describing the decision to enter work or not work at all. However, once a person already has a job working part-time, this desire to work for the good of work might not extend into wanting to work full-time. If already working full-time, they may not want to take a higher paid, more stressful job if they gain very little from doing so.

Successive governments have increased the number of people going into some form of work, and so reduced the number of people relying on out-of-work social security.[18] This has been achieved through the tax credit system and active labour market policies providing strong incentives to enter work.

Despite these successes, in-work poverty is increasingly common. People are entering work but not leaving poverty. Many people are becoming stuck in low pay. There is now a collection of international and UK-based examples of successful active labour market policies to get people into employment. However, there is less evidence showing what government interventions can do to help people to progress in work, or to get them into higher paying jobs in the first place. This means that incentives for people to progress into better paying work are important. Unfortunately, this is an area where the UK does particularly poorly.

Share of wage increase that adds to net income, after accounting for taxes and benefit reductions, lone-parent family.



The speed at which in-work support is withdrawn from those who work means that low-income workers receive a comparatively smaller benefit from their wages rising compared to low-income workers in other countries. An OECD study found that a single parent with two children in the UK would benefit less from a 5 per cent rise in the minimum wage (or an equivalent pay rise) than other countries. The UK came 23rd out of 26 OECD countries.[19] While the average household in the OECD would see an average [iii] net gain of 73 per cent from a minimum wage increase, a household in the UK would see a gain of just 27 per cent.

[iii] The median result for these listed countries.

The OECD found that countries where people lost more of a wage increase in tax and benefit withdrawal had higher unemployment rates among low skilled people and higher total shares of part-time employment. The OECD specifically focused on the UK being particularly bad at incentivising people to make the transition from part-time to full-time work.[20]

This finding is mirrored in the research on why people get stuck in low pay and fail to progress into higher-skilled, better paying jobs. The Resolution Foundation and the Chartered Institute of Professional Development separately undertook research into why people get stuck in low pay, and both encountered the same phenomenon: employees were reluctant to take on a small promotion to a supervisory position if the 30-40p extra per hour in their pay would be mostly lost through social security withdrawal. Some worried that they would actually be worse off overall.[21]

These better paying jobs can require people to work more hours meaning that they spend less time with their children. They have to find, and often pay for, breakfast clubs and after-school clubs. Others require more travel or simply have more stress associated with the work. Taking on a new role can also mean taking a risk because of the challenge of mastering new skills and dealing with new responsibilities. For all these reasons, the people surveyed often concluded that the costs of progression outweighed the benefits.[22] This problem may grow this year: the new higher minimum wage in April might narrow the wage gap between entry level jobs and those just above, causing a bunching effect as it has in the past.[23]

This is a problem both for the individuals it affects and for the economy as a whole. People who are stuck in low paid jobs have seen their living standards fail to keep pace with those who leave low pay behind. Disincentives to increase their earnings effectively trap them in persistent poverty. Poverty in the short term can be damaging; persistent poverty has much worse effects on health,[24] and particularly on children's health[25] and development.[26]

Productivity and innovation

Many commentators have identified that the UK has a productivity problem. In response, some have focused on improving incentive structures for those at the top of the income distribution. Not enough have focused on the financial incentives affecting the rest of the population. It damages our economy if people do not have an incentive to progress in work and to increase their productivity. Reduced incentives to progress in work, or increase one's pay, also decrease the incentive for a person to invest in their own skills through in-work training or through pursuing additional training in their own time. This damages the UK's productivity as a whole. A less skilled workforce is likely to be a less productive workforce.

One of the central insights from the development of capitalism is that financial incentives can create great innovation and productivity. This applies to those who create companies as well as those who work for them. People will work harder, innovate more and invest in their own skills if there is a financial incentive for them to do so. Innovation by low paid staff can provide a massive boost to a whole company's productivity. The perfect example of this is Pizza Express where one pizza chef noticed that requiring waiting staff to slice lemons for drinks was far less efficient than if the pizza chef chopped lemons along with chopping pizza toppings. Copying this across almost 500 outlets globally brought Pizza Express a "significant financial saving".[27] The innovation by low paid staff is not always reflected in their pay packet, but when they are properly rewarded, members of staff stay longer and are more productive.

Properly structured, in-work social security can help people out of in-work poverty through further progression and productivity. This means that people receiving in-work support must be able to keep a reasonable amount of their increase in pay, and must have strong incentives to further increase their pay. If the tax and social security system overly damages this incentive, we would expect pay and productivity to suffer as a result.

A. EXPLAINING TAX CREDITS AND UNIVERSAL CREDIT

At present, there are effectively two different social security systems operating in the UK. Most people receiving social security payments are in the older system. This involves tax credits for those in work, Jobseeker's Allowance for those out of work, as well as Income Support and many other income-dependent elements. At the same time, a second system called Universal Credit is being rolled out, which combines all existing income-dependent elements of social security (aside from Council Tax Support) into a single credit. These two systems have different effects on work incentives and on the amounts that people on different incomes receive.

Out-of-work social security and tax credits

The introduction of Universal Credit is an attempt to combat the complexity of the current system, and the perverse incentives it creates. The separate systems of tax credits and out-of-work support can be hard to understand both for users of the system and for policymakers trying to change it.

Out-of-work social security, like Jobseeker's Allowance or Income Support, is currently withdrawn very quickly. For every £1 that a person earns from work, they lose £1 in social security entitlement. This can mean that people are not better off when they enter work for a small number of hours.

There are then two main types of tax credit: Working Tax Credit, which is paid as a top-up to households in work with low incomes, and Child Tax Credit, which is paid to low-income families with children (whether they are in work or not). A person is only eligible to receive Working Tax Credit if they work a minimum number of hours (30, 24 or 16 hours a week depending on their family circumstances).

A person can earn up to a certain income threshold before their tax credits begin to be withdrawn, just as the Personal Allowance functions to allow for a certain amount of earnings before taxation. Over this income threshold, the worker will lose 41p in tax credits for every £1 they earn (first Working Tax Credit withdraws, and then, if they receive it, Child Tax Credit is withdrawn until no tax credit remains). If a person is receiving Child Tax Credit but not Working Tax Credit, they do not have to work a minimum number of hours and will lose 41p over the Child Tax Credit income threshold. There is also an additional income rise disregard so that the first £2,500 of a person's income increase from one year to the next is ignored.

Housing Benefit, which goes to people both in and out of work, adds to the complexity of the system and substantially decreases the amount that people keep from what they earn. For every £1 a person earns over a certain level of income (separate from the previously discussed Working Tax Credit or Child Tax Credit threshold) they lose 65p of Housing Benefit. Housing Benefit mostly withdraws at lower earnings levels than tax credits. However, for some people with higher housing costs, Housing Benefit and tax credits withdraw at the same time. They will lose close to 80p of every £1 earned from work.

In summary, the system is a complicated mess, with some people losing all of what they earn and others losing only 41p of every £1 they earn. The consumer charity, Which, summarises this well: "The truth is it's virtually impossible for people claiming tax credits to work out how much they are entitled to."[28]

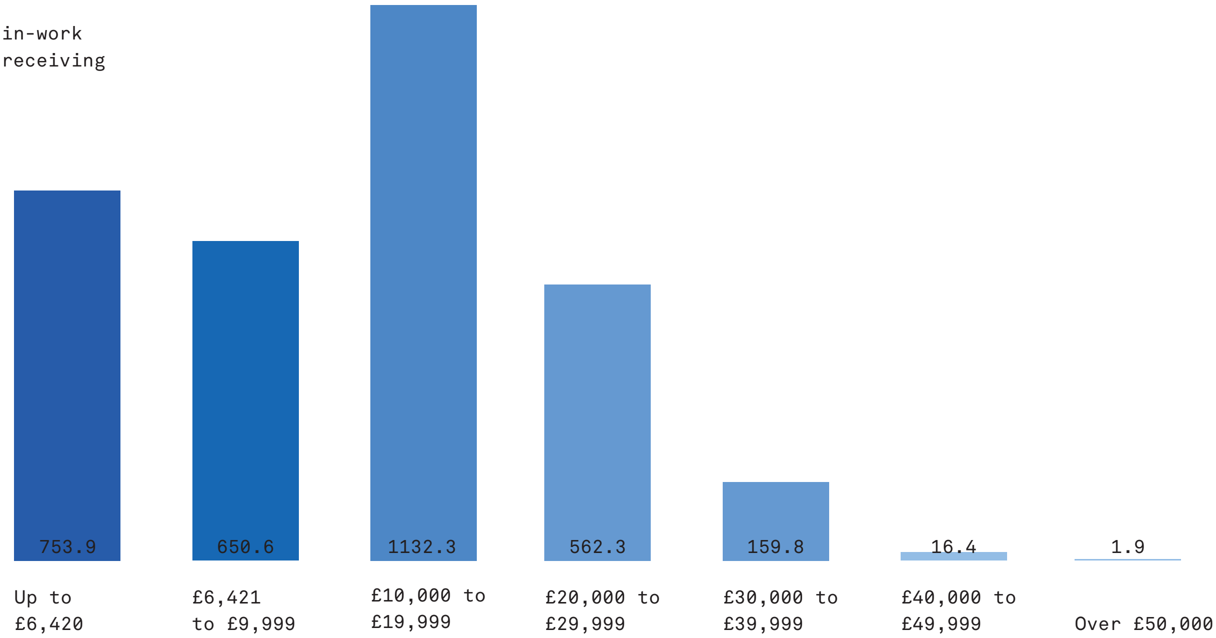
The combined effect of tax and the social security system

Some commentators have discussed the effects of the withdrawal rate on low-income working families. Too few have looked at the bigger problem of the combination of the withdrawal of in-work support and the tax system.

Once an individual is earning enough to pay Income Tax and National Insurance contributions then they keep even less of each £1 they earn. If they are just receiving tax credits (Working Tax Credit or Child Tax Credit) and paying both Income Tax and National Insurance contributions, then they lose 73p of every £1 they earn. If their Housing Benefit is also withdrawn, they lose a staggering 91p of every £1 they earn.

A large proportion of tax credit recipients experience these sorts of high withdrawal rates. Over 1 million families receiving tax credits are earning between £10,000 and £20,000. It would be reasonable to expect that individuals in these families are paying Income Tax because they earn over the Personal Allowance.[29]

Incomes of in-work households receiving tax credits



Universal Credit

Universal Credit was created to simplify the social security system in order to make it more understandable, and to make sure that people entering work keep more of their initial gains. The evidence so far suggests that it encourages more people into work than the current system, but that this work is "relatively few hours at relatively low wages".[30] Universal Credit provides a basic amount based on a family's circumstances (number of adults, number of children, housing costs, etc.) and then allows the family to earn up to a 'Work Allowance'. Above this, they lose 65p of Universal Credit for every £1 they earn.[31] However, once combined with the tax system, the actual withdrawal rate becomes substantially higher. Those families who are receiving Universal Credit and paying Income Tax and National Insurance contributions can lose 76p of every £1 they earn.

The next section will show what this means for some example families and show how much they will get to keep for entering work, increasing their hours and increasing their overall wage.

B. HOW UNIVERSAL CREDIT AFFECTS DIFFERENT FAMILIES

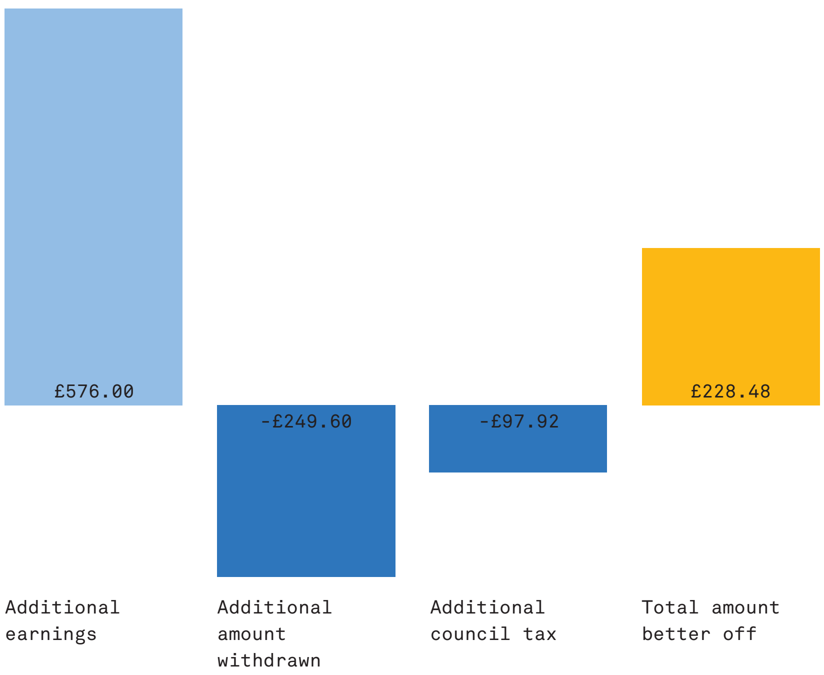
To show how the system of Universal Credit incentivises (or disincentivises) work for different households, we have illustrated the effect of the 65 per cent withdrawal rate in Universal Credit for a range of typical families. These are not real people, but are intended to show how real people on low incomes and people on high incomes face different incentives to earn each additional £1. All figures given are monthly, because Universal Credit is a monthly payment.

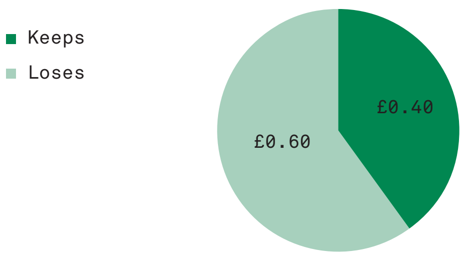
Example 1

Family of two adults, two children

Tom and Sarah live in Doncaster with their 14-year old daughter and 6-year old son. If neither parent works, the family is entitled to £1,456.40 of social security per month, which includes the Universal Credit basic amount, child allowances for the two children and help with housing costs. Tom had to leave his previous job after falling ill (one of the most common reasons for having to claim out-of-work support) so Sarah gets a job as a supermarket assistant for 80 hours per month on the minimum wage, for which she earns £576 each month. Sarah's annual salary is just £6,912, so she doesn't need to pay Income Tax or National Insurance, but she must pay £97.92 per month of Council Tax, with £2.79 of Council Tax Support provided by Doncaster Metropolitan Borough Council. Her earnings above the £192 Work Allowance in Universal Credit are subject to a 65 per cent withdrawal rate, meaning for every extra £1 she earns, the family keeps just 40p.

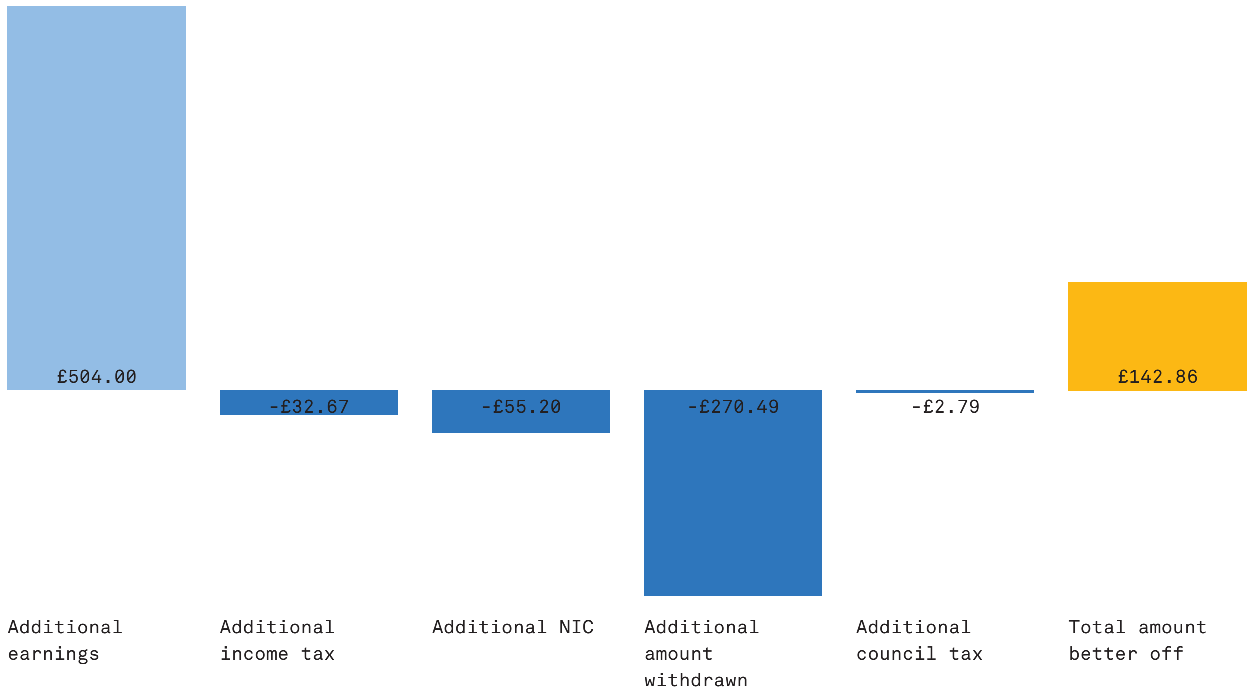
From no employment to Sarah working part-time



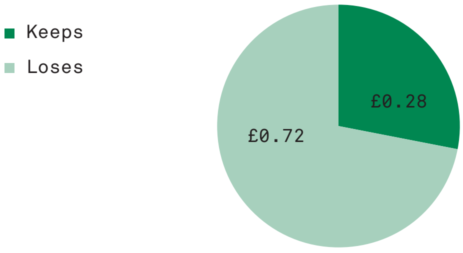


To try and boost the family budget while Tom cannot work, Sarah moves on to full-time hours, at 150 hours per month. She's now earning £1,080 each month so must pay £32.67 in Income Tax and £55.20 in National Insurance. That means her take-home pay is £992.13. However, the income reduction from the 65 per cent withdrawal rate and the fact she is now liable for the full amount of Council Tax means her reward for doubling her hours at work is just £142.86 a month.

From Sarah working part-time to Sarah working full-time

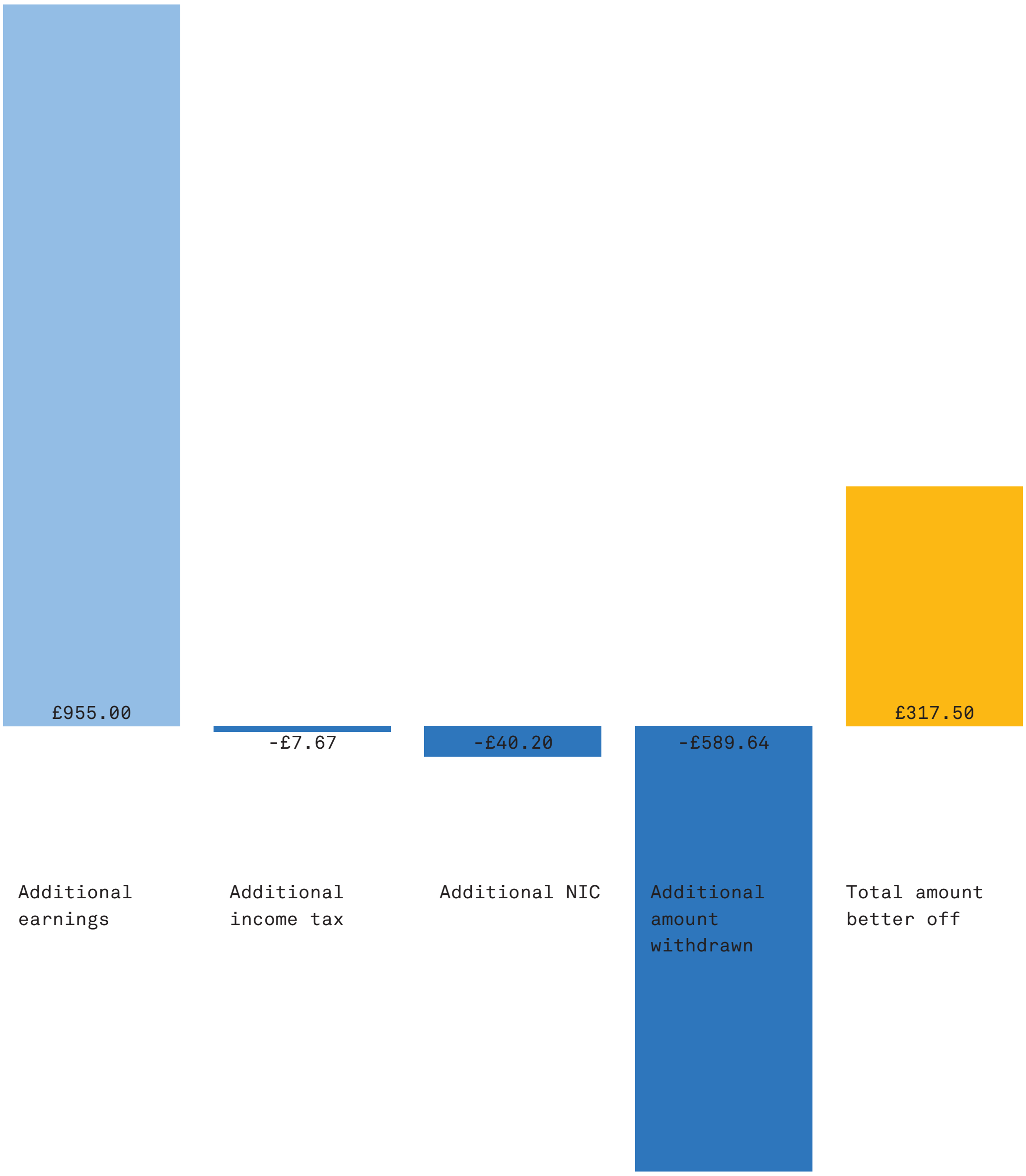


For moving into full-time work, for every extra £1 she earns, Sarah's family keeps just 28p.

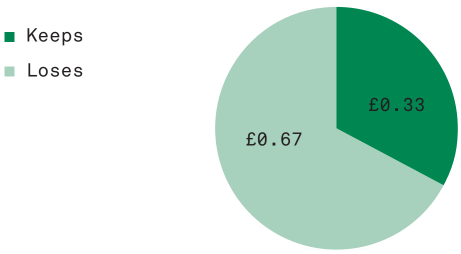


A couple of months later, Tom's health has improved and he manages to secure a job working in a warehouse, with almost full-time hours that still allow him to pick up and drop off their son from primary school. His wage combined with Sarah's means the family's earned income from work is now £2,035 per month, which still puts them in the poorest 20 per cent of households.[32] They pay £135.73 in Income Tax and National Insurance, and then lose £1,109.72 of their Universal Credit entitlement because of the 65 per cent withdrawal rate.

From Sarah working full-time to Tom also working almost full-time



After Council Tax, this means that for each additional £1 Tom and Sarah earn, working as many hours as is feasible, they keep just 33p.

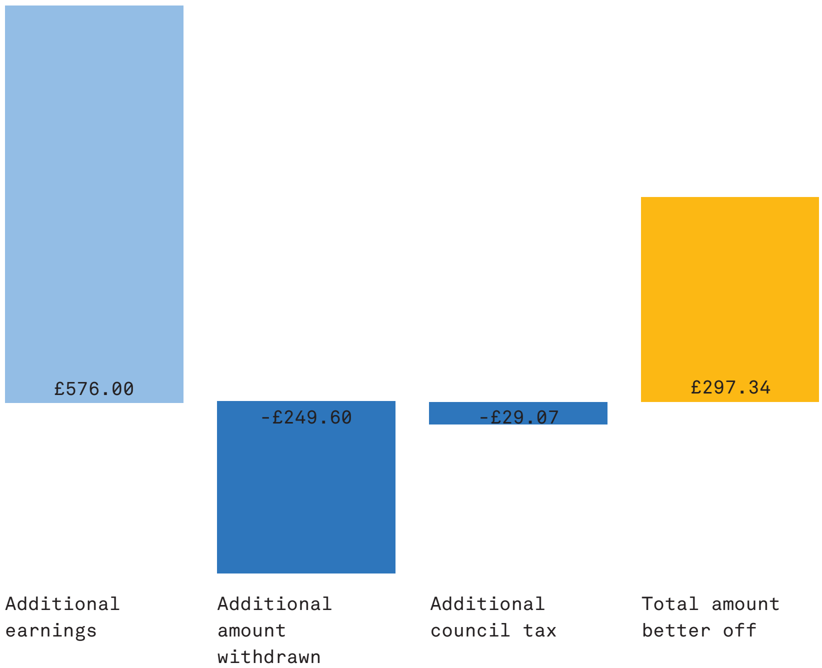


Example 2

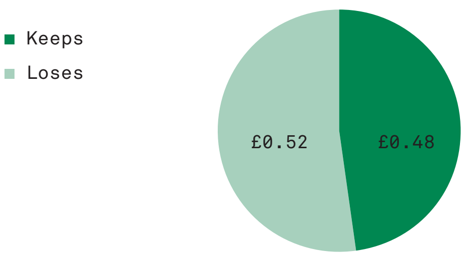
Family of two adults, one child, who is disabled

Meg and Jim live in West Wiltshire with their 10-year old son Andy, who is disabled. If neither parent works, the family receives a basic Universal Credit allowance of £498.89, a child allowance of £277.08, a disabled child addition of £126.11 to help with the extra costs of Andy's welfare, and a housing costs element of £545.74. They would also be liable for £19.90 of Council Tax because West Wiltshire Council requires a minimum payment. Meg has struggled to find work that she can fit around caring for Andy, but Jim starts work part-time as a school cook on the minimum wage for a monthly pay packet of £576. Above the £192 Work Allowance, those earnings are withdrawn at a rate of 65 per cent. Even with £50.50 of Council Tax Support, Meg and Jim must still find another £48.97 each month to pay Council Tax. For his part-time work, Jim's family is less than £300 better off each month.

From no employment to Jim working part-time

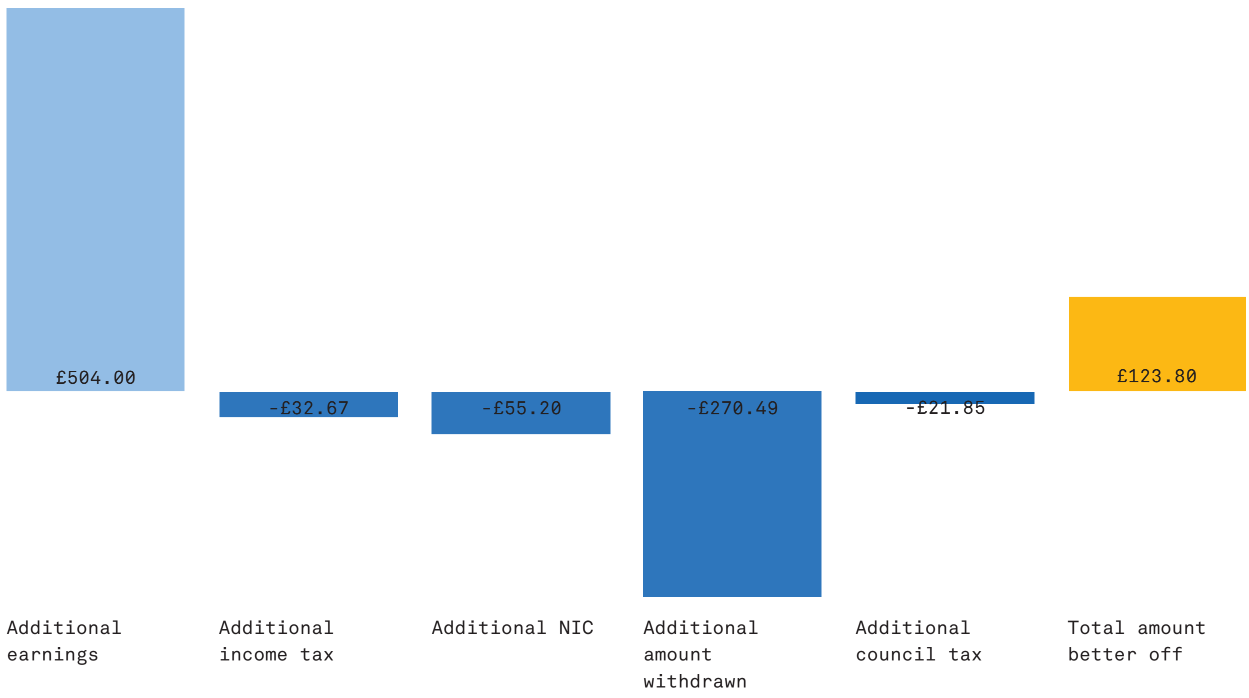


For every extra £1 Jim earns, the family keeps 48p.

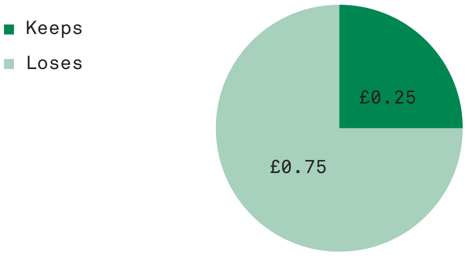


The family is struggling, and so Jim moves into a new job that can offer him full-time hours, providing a wage boost of £504 each month. However, he now earns above the threshold for paying both Income Tax and National Insurance, which reduces his take-home pay by £87.87. After this, the Universal Credit withdrawal rate reduces his income for all his earnings above the £192 Work Allowance, and Council Tax Support is withdrawn further, so they lose £70.81 to Council Tax. For doubling Jim's working hours, the family is only £123.80 better off each month.

From Jim working part-time to Jim working full-time



This means that for each additional £1 that Jim earns for the family, working full-time, they keep only 25p.



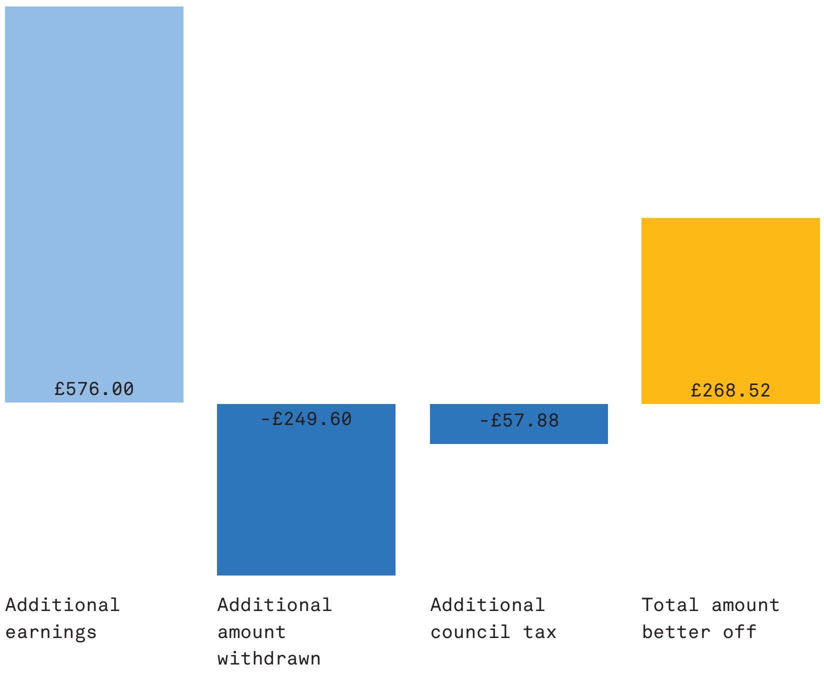
Example 3

Family of one adult, two children

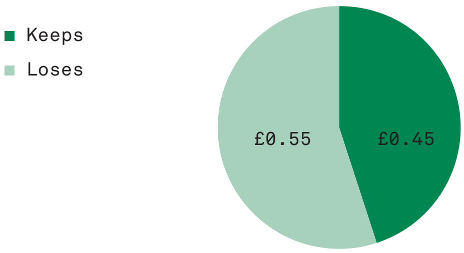
Alice lives in Lambeth with her 15-year old son and 5-year old daughter. Before her daughter started school, Alice did not work, so the family received £2,259.69 in Universal Credit (which includes the basic rate, first and second child allowances, and takes into account high housing costs in London) and paid £10.94 in Council Tax after the Council Tax Support she got from Lambeth Council.

Now that her daughter has started school, Alice takes on a part-time job as a care worker but can still only take on limited work during school hours because there is no one else to pick up and drop off her daughter. On the minimum wage, she earns £576 per month, but for all those earnings over the £192 Work Allowance, Alice's Universal Credit entitlement is withdrawn at a rate of 65 per cent. Lambeth Council can no longer provide her with Council Tax Support, even as a part-time single earner, so she needs to make sure she has £68.82 each month to pay Council Tax.

From no employment to Alice working part-time

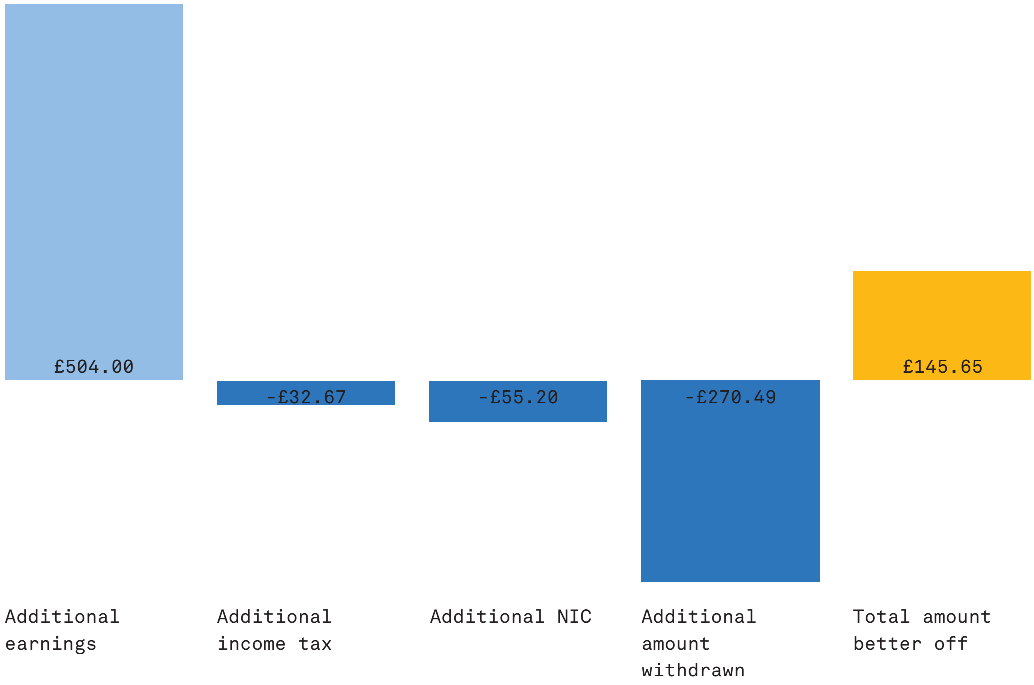


Alice has made the positive step of moving into work, and yet for every extra £1 she earns, she keeps just 45p.

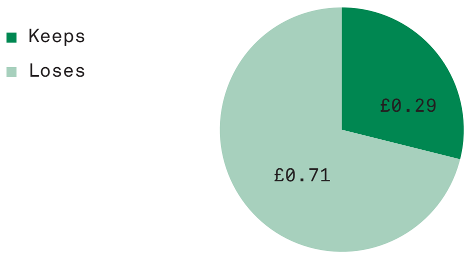


Luckily, Alice's mum moves into the borough and offers to drop off and pick up her granddaughter from school each day so that Alice can take on more hours at work. Now a full-time care worker earning £1,080 a month, Alice has to pay £87.87 in Income Tax and National Insurance. She also loses £520.09 of her Universal Credit entitlement, because much more of her income is above the £192 Work Allowance. She continues to pay Council Tax of £68.82.

From Alice working part-time to Alice working full-time



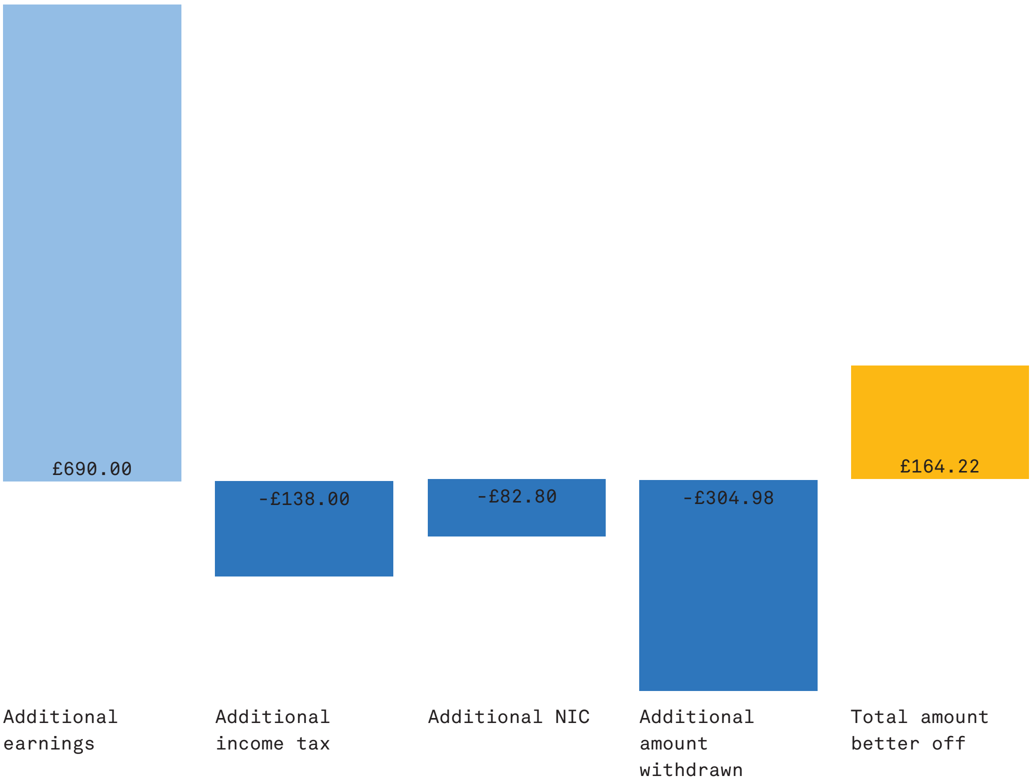
Even though she's working full-time and can spend far less time with her children, the system of in-work support withdrawal means Alice's family's income increases by just £145.65 a month. That means that for each additional £1 she earns, Alice now keeps just 29p.



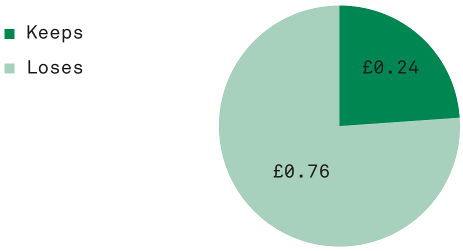
After working on the minimum wage for a while, Alice applies for and successfully gets a job in the local hospital as an assistant practitioner that makes better use of the healthcare skills she built up before having her daughter. Alice's pay is boosted so that she now earns £1770 a month, the same as the average worker, or just over £21,000 per year. [IV] She now pays over £300 a month in Income Tax and National Insurance before the 65 per cent withdrawal rate reduces the amount of Universal Credit her family receives by £825.07. As ever, she must pay £68.82 in Council Tax.

[IV] Median hourly wage: £11.80 (ONS Annual Survey of Hours and Earnings, 2015).

From Alice working full-time on the minimum wage to working full-time on the median wage



Her new wage means Alice earns the maximum amount possible before becoming ineligible for Universal Credit. She keeps a paltry 24p of each additional £1 she earns.

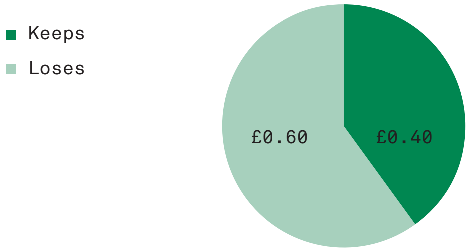


In all cases, these hard-working, low-income families are losing a huge amount of the money they earn and are often struggling. But this is not the case for everyone. Further up the income spectrum, things are quite different.

Example 4

Family of one adult, paid £50,000, two children

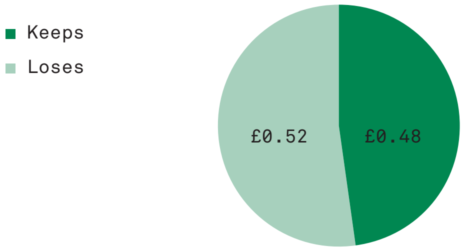
Claire earns £50,000 a year as an IT manager. She has two children, for whom she receives £1,823.20 in Child Benefit. She takes on additional responsibilities at work meaning she qualifies for a £5,000 pay increase. However, now that her pre-tax income is more than £50,000 she must pay the High Income Child Benefit Charge, which for her is £912. She also owes £2,100 in higher rate Income Tax and the lower rate National Insurance contributions. For each £1 of her £5,000 raise, Claire keeps 40p.



Example 5

One adult, paid £100,000

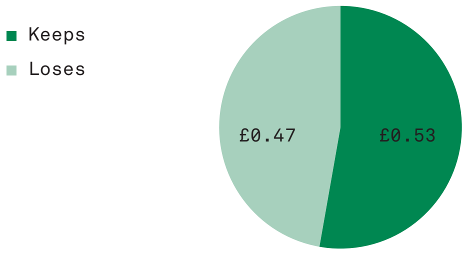
Laura is a lawyer, paid £100,000 a year, and is awarded a £5,000 pay rise. This 5 per cent pay increase takes her over the threshold for being eligible for the tax-free Personal Allowance of £11,000, and she now loses £1 of Personal Allowance for every extra £2 she is paid. Her £5,000 raise means she loses £2,500 of Personal Allowance entitlement, and so is taxed at the basic rate of 20 per cent, paying £500 in Income Tax. She also has to pay the higher rate of tax at 40 per cent and the lower National Insurance contribution of 2 per cent on the £5,000 raise, meaning she keeps £2,400 of her raise. For each additional £1 Laura is paid, she keeps 48p.



Example 6

One adult, paid £1 million

Martin is an investment banker, receiving pay and bonuses of £1m a year. His firm has a good year with record profits and he is awarded a pay rise of £200,000, which is taxed at the Additional Income Tax rate of 45p. Lower National Insurance contributions of 2 per cent also apply because Martin earns far more than £3,532 per month. So of each additional £1 that Martin receives from his £200,000 pay rise, he keeps 53p.



It is clear that typical families on the lowest incomes experience much higher income losses for each additional £1 they earn than typical people on high incomes. A millionaire investment banker firmly within the top 1 per cent of household incomes keeps 53p of each additional £1 he earns, while a single mother like Alice working full-time on the minimum wage keeps just 29p. Families that do everything expected of them, like Tom and Sarah, working as many hours as they can, still only keep 33p of every additional £1 they earn, while people like Laura, earning four times Tom and Sarah's combined wage, keep 48p. Despite the fact one of the principal aims of Universal Credit is to make work pay, the poorest families are offered precious little incentive to increase their hours, take on higher-paying roles, or even enter work in the first place. This is in large part down to the extremely high withdrawal rate of 65 per cent in Universal Credit which keeps people in work in poverty and acts as a barrier to employment and progression.

A WHAT DO PEOPLE THINK ABOUT IN-WORK SUPPORT?

The Equality Trust commissioned Ipsos MORI to examine public attitudes to the amount people receiving in-work support should keep of what they earn.[V]

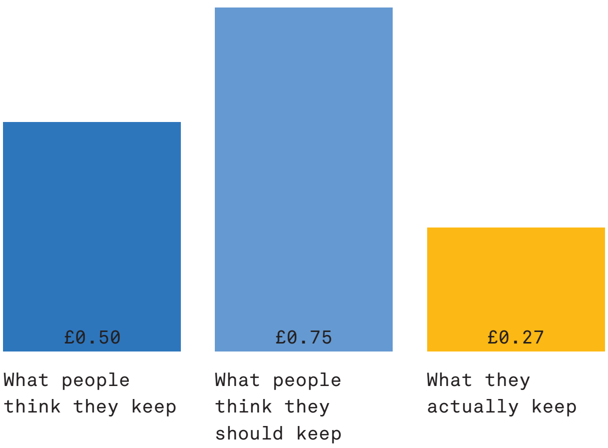
[V] Full results broken down by different demographics can be found on Ipsos MORI's website. The full questions can be found in the methodology section of this report.

As would be expected given the previously explained complexity of the tax credits system, the public struggled to correctly identify how much a parent earning £10,600 in gross annual income and receiving tax credits does keep if they increase their earnings. They actually only keep 27p of each additional £1 they earn.

The average person thought they would keep 50p of every additional £1. However, the results were spread out between 0p and £1. 65 per cent of people gave an answer greater than the 27p they actually keep. When people were asked how much a working parent earning £10,600 should keep if they increase their earnings by an extra £1, 83 per cent gave an answer greater than the 27p they actually keep. The average person thinks they should keep 75p of every additional £1 they earn.

These results indicate that, while people have a poor understanding of the existing system, they believe that low-income working parents should keep more of what they earn. In total, 60 per cent of those surveyed think a working parent in this situation should get to keep more of every additional £1 they earn than they think such a parent currently gets to keep.

£1 increase in earnings of a parent on tax credits

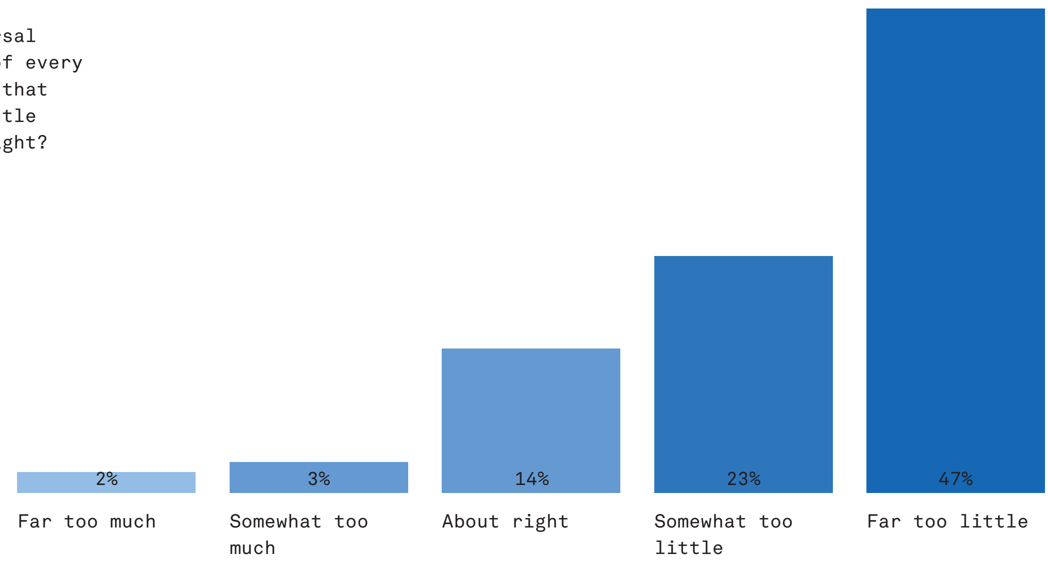


Currently, a working parent earning £10,600 receiving tax credits gets to keep 27p of each extra £1 that they earn after taxes and other deductions have been applied, whilst a working parent earning £150,000 gets to keep 53p of every extra £1 that they earn. A majority of the public believe that the parent on tax credits should keep more. Without knowing how much each of them currently keeps, 57 per cent believed that a parent on tax credits should keep more of what they earn, 23 per cent believe that they should both be able to keep the same amount, and only 10 per cent thought that the parent on £150,000 should be able to keep more.

When told how much they actually get to keep, support was higher. 59 per cent think a working parent on tax credits should be able to keep more of what they earn than one being paid £150,000. 21 per cent say they should get to keep the same, and only 9 per cent believe that a parent on £150,000 should get to keep more of what they earn (as is currently the case).

When asked directly about Universal Credit, and informed that under that system these parents keep only 24p of what they earn, a large majority said that was too little. 70 per cent stated that 24p was either far too little or somewhat too little. 47 per cent said that 24p was far too little. This shows the public disagrees with the current system that allows people to keep only a small amount of what they earn from work.

Parents on Universal Credit keep 24p of every £1 they earn. Is that too much, too little or is it about right?



B POSSIBLE POLICY OPTIONS

Increasing the Income Tax Personal Allowance

The Government's approach to helping those on low incomes focuses on untargeted cuts to Income Tax. The Government plans to increase the Income Tax Personal Allowance to £12,500 by the end of this Parliament. If this were applied in April, it would bring Sarah and Tom's family £17.50 extra per month when she is working full-time and he is working almost full-time, both on the minimum wage. It would also only slightly improve their work incentives. In none of the scenarios outlined in the previous section would they keep even 2p more of every £1 that they earn. Similarly, single parent Alice would only be £8.75 better off when being paid the wage of the average person. [VI] Her work incentive increases less than 1p for every £1 that she earns in each scenario. Increasing the Personal Allowance has very little effect on work incentives for these families or any other type of family.

[VI] Median full-time hourly wage £11.80. ONS Annual Survey of Hours and Earnings, 2015.

Increasing the National Insurance Contributions Allowance

Another possible option would be to bring the National Insurance contribution rate in line with that of the Personal Allowance in April (£11,000). This would mean more to both families. Sarah and Tom would be £19 better off from this increase when she is working full-time and he is working almost full-time on the minimum wage. Alice would be £9.50 better off when working full-time on the wage of the average person. However this would have a similarly small effect on work incentives as the Personal Allowance increases: neither household would receive increases above 1-2p per £1 extra that they earn.

Reducing VAT

As well as the disincentive effects of the tax system, families on low incomes also pay many other taxes which do not directly affect their work incentives, but do influence their incomes. In a previous report, we highlighted how the tax system as a whole disproportionately takes from those on low incomes. Households in the bottom 10 per cent of incomes pay a greater proportion of their income in tax than households in the top 10 per cent of incomes.[33] This is mostly due to the large amounts that they pay in indirect taxes. If we consider one of the households discussed earlier then we can see how indirect taxes affect a typical household.

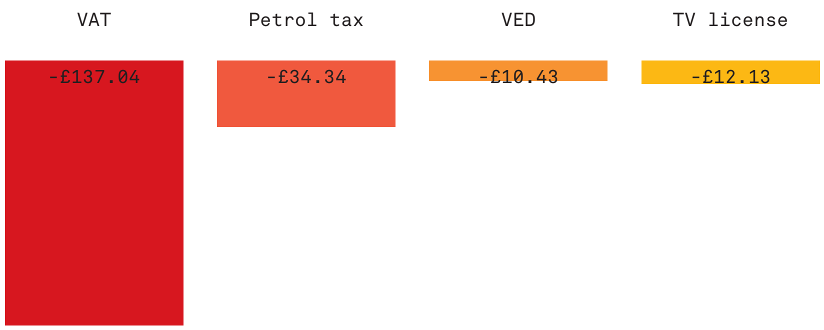
There are four main indirect taxes that you would expect a household with two adults and two children like that of Sarah and Tom to pay.[34] [VII] These are Value Added Tax (VAT), Petrol Duty, [VIII] Vehicle Excise Duty (VED) and a TV licence. These would cost a monthly equivalent of roughly £137 in VAT, £34 in Petrol Duty, £10 in Vehicle Excise Duty and £12 for a TV licence. The data suggests that they probably don't travel by plane, so pay no Air Passenger Duty, probably don't gamble, so pay no betting taxes, probably don't smoke, so pay no Tobacco Duty, and probably don't drink, so pay no duty on any sort of alcohol. Only a small number of households of a couple and two children in this income range do any of these things. Those that do pay substantially more tax. We would expect a couple with two children like Sarah and Tom to be paying £194 in indirect taxes, whilst a mean average of this group would pay £254 in indirect taxes, about £64 of which comes from Tobacco Duty.

[VII] See methodology section for details on how these are calculated.

[VIII] Refers to all duties on hydrocarbon oil.

As you can see from this graph, the only major indirect tax that impacts their budget is VAT. If VAT were reduced by 2 per cent, Sarah and Tom would be less than £14 better off per month. These changes would also not alter their work incentives directly.

Indirect taxes paid by family of two adults, two children



A Mandatory Living Wage

An alternative popular solution that wouldn't require government spending would be to increase the minimum wage to the Living Wage, as set by the Living Wage Foundation. This would make Alice £37.48 better off when working full-time on the minimum wage. It would make Sarah and Tom £70.63 better off when she is working full-time and he is working almost full-time on the minimum wage. For both these families, this is lower than the amount better off they'd be if the withdrawal rate were reduced. As discussed in a previous section, raising the minimum wage can cause bunching of jobs around that rate. This would probably have the effect of reducing the wage increase involved in progression to more senior roles. Overall, increasing the minimum wage to match the Living Wage would increase the attractiveness of entering work but reduce the incentive to progress further. There could also be other negative effects from increasing the minimum wage by that much, including decreased employment.

Citizen's Income

One way to increase household incomes and work incentives would be to decrease the withdrawal rate of social security. The most radical version of this approach would be to institute a Citizen's Income where people would receive an unconditional amount of money based on their household size. This would not be withdrawn as their income rises. This would be very expensive for the Government to implement especially if it were to be as good at supporting low-income households as the current social security system.

The Citizen's Income Trust has proposed implementing a system that is both redistributive (making no one in the bottom half of the income spectrum worse off) and not excessively expensive. Its proposal is to fund the Citizen's Income by abolishing the Income Tax Personal Allowance and National Insurance contribution allowance. It also keeps the existing social security system in place, treating the Citizen's Income as post-tax earned income.[35] This would not mean that much to a single parent like Alice at most stages of her income. She would see a substantial increase in income when out of work, being £203.42 better off, and £72 better off in part-time work. However, after that point, as soon as she enters full-time work she is better off than the current system but less well off than she would be if the withdrawal rate of Universal Credit were reduced by a few percentage points.

It would also dramatically reduce her work incentives. Working either part-time or full-time on the minimum wage, she would lose 76p of every £1 she earned. This does not include the negative effect of increases to Income Tax which the Citizen's Income Trust suggest would be needed to pay for the additional cost. That would make those in work worse off and reduce work incentives further. The substantial increase to out-of-work incomes would have a powerful effect at reducing inequality; however, the effect on work incentives could decrease employment and trap people on low incomes, potentially having the opposite effect. A better model would be one that also reduced the withdrawal rate of social security benefits alongside a Citizen's Income, but this would probably be seen by most policy makers as prohibitively expensive. We believe focusing on reduction of the withdrawal rate of Universal Credit is more realistic and achievable.

A number of policy recommendations of varying costs and effectiveness have been put forward. Far and away the most effective in supporting low-income families, making work pay, and reducing inequality would be to reduce the withdrawal rate of Universal Credit. If the withdrawal rate from Universal Credit is reduced from 65p for every post-tax pound to 55p of every post-tax pound, the households discussed in this report would experience a much larger improvement in income.

Sarah and Tom's family would be £170.73 better off each month when she is working full-time and he is working almost full-time on the minimum wage. It would also substantially improve their work incentive at all levels. The incentive for one of them to enter part-time work increases by almost 5p in every £1. To progress into full-time work, it increases by over 10p in every £1. For the second earner to also work full-time, the incentive increases by almost 10p in every £1. For increasing their pay beyond that point, they get to keep almost 7p extra per £1. This would mean they lose 69p of every £1 they earn rather than the 76p they currently lose. Single parent Alice would also see large gains from a reduced withdrawal rate. She would be £126.93 better off each month when paid the wage of the average person. Her incentives also increase at similar rates to Sarah and Tom. This has a much higher effect on incentives to earn more at all levels when compared to the other proposals and makes the household involved better off in work than any other suggestion.

When Universal Credit was first suggested by the Centre for Social Justice, in a report with a foreword by current Secretary of State for Work and Pensions Iain Duncan Smith, it suggested that Universal Credit should have a withdrawal rate of 55 per cent. The report attacked "huge" marginal tax rates in the current system of 76 per cent.[36] Yet Universal Credit will routinely force people to face a 76 per cent marginal tax rate. This is bad for work incentives and bad for progression. It needlessly traps people into in-work poverty rather than encouraging them into better-paid jobs. The best way to improve work incentives and make recipients of Universal Credit better off would be to return to the original plan and offer a withdrawal rate of 55 per cent.

A static estimate of the cost of this change made before the Summer Budget is £4.04bn per year once Universal Credit has been fully rolled out.[37] However, this is probably an overestimate. The changes in the Summer Budget will decrease this cost as they have reduced the number of people eligible for Universal Credit. Additionally, as outlined earlier, increasing work incentives increases the amount that people work. You would expect that a 7 percentage point drop in the marginal rate that people face would have an impact on the likelihood of them increasing their earnings. This would lower the cost of this policy, because it would incentivise people to earn more. As earnings increase, social security payments decrease and the country's income from taxes increases substantially, improving the picture for the Government's finances.

How to pay for it

The simplest and most effective way of paying for this change would be to cancel the planned increases in the Income Tax Personal Allowance which will cost over £4bn.[38] Increasing the Personal Allowance has some of the same aims as in-work social security. Both policies were supposed to help improve the living standards of low and middle income workers and make sure that "work pays more".[39] However, as discussed above, the Personal Allowance is not very effective at doing that. The Government's planned increases in the Personal Allowance will mainly benefit households in the top half of the income spectrum,[40] who already have much better work incentives. It is not right to continue to cut their taxes whilst effectively imposing such high tax rates on families with low incomes. The other cited aim for the Personal Allowance is so that "no one working 30 hours a week on the National Minimum Wage pays tax".[41] It will fail to do this. Not only will the Personal Allowance not reach the new higher minimum wage but it will not affect the majority of tax that low-income households pay. As we have shown previously,[42] low-income families pay far more in National Insurance contributions and Value Added Tax than they do in Income Tax.

One argument used against in-work social security is that it is far too costly. However, comparing the size of the cost of the Personal Allowance in total against the cost of the entire tax credit system places it in a much more flattering light. HMRC spends less than £30bn on the entire tax credit system,[43] which not only provides work incentives but also combats poverty for parents with children. The Personal Allowance on the other hand costs HMRC over £86bn and is much less effective at increasing work incentives. The cost of the Personal Allowance is also growing. Between 2013/14 and 2014/15, it increased by £5.1billion (more than the cost of this suggested reform).[44] It is expected to continue to increase in cost but is not expected to become any more effective at achieving its aims.

Whilst increasing the Personal Allowance fails to present many benefits, decreasing the rate at which Universal Credit is withdrawn has many other benefits on top of those listed so far. Analysis by the Child Poverty Action Group and the Trade Union Congress shows that reducing the withdrawal rate to 55 per cent would remove 94,000 children from poverty as well as drastically improving the gains to work for currently non-working households.[45] Previous research by the Joseph Rowntree Foundation has shown that reducing the rate is the cheapest way to improve the finances of full-time low-income households, better than increasing any other element of Universal Credit, increasing childcare subsidy, or any tax cut.[46] This change is also popular with the general public. 70 per cent of the public think that a working parent with a gross annual income of £10,600 and on Universal Credit keeps too little of the extra income they earn. When asked about reducing the withdrawal rate so that a working parent would get to keep 31p of every additional £1 earned rather than 24p and told that this change costs £4bn, over one and a half times as many people support it (35%) as oppose it (22%).

There is an important moral argument to make for reducing the withdrawal rate of Universal Credit: if you care about equality of opportunity, you should not place larger barriers to low-income households increasing their incomes than you place on households further up the income spectrum. It is wrong that low-income working households lose more of their income than any other group. The public agrees: they think that those people should keep three quarters of what they earn. The Government should not tax the aspirations of low-income families more than they do the richest households in the country. Reducing the withdrawal rate is the most effective way to address this problem. Any government truly concerned about fairness, equality of opportunity and social mobility should reduce this aspiration tax.

CONCLUSION

When it works properly, the social security system fights poverty directly by supporting people who are out of work and helping the unemployed back into work. But, as our analysis shows, in its current form it fails to do this, instead imposing a tax on aspiration for households with low incomes.

High-income households have their taxes cut, in spite of evidence that lowering the tax rate is not effective at increasing the hours of people in the top 1 per cent.[47] Low-income working families, meanwhile, face sky-high tax rates that prevent them from progressing into better-paid work despite evidence that lowering their tax rates helps them into better-paid work. A tax and social security system which aims to incentivise the better off, whilst disincentivising the less well-off further entrenches our already extreme level of inequality.

This matters because we know inequality has a profound effect on our society. The UK is one of the most unequal countries in the developed world and that inequality hurts our society, economy and democracy. Extreme inequality damages trust and social participation, encourages crime, decreases social mobility, shortens life expectancy and increases debt.[48]

All parents aspire to have security and to provide a decent life for themselves and their children, but the social security system, both under tax credits and Universal Credit, prevents them from achieving these things.

The current system is not only unfair, but also unpopular. The public supports reducing this tax on aspiration and believes that people on low incomes should be able to keep more of what they earn. The Government should listen to them and remake Universal Credit to reconnect it to its original objectives of a fairer, simpler system that truly helps low-income working families to progress.

Average — Unless we state otherwise in the report (or the relevant section of the methodology) when we use the term average we are referring to the median.

Describing the 'aspiration tax' — The phenomenon that we call the aspiration tax in this report has many different names and has been conceptualised in many different ways in different reports and journal articles. Our conceptualisation has most in common with the marginal effective tax rate, and where we discuss how much a person keeps of the next £1 they earn, this is the inverse of their marginal effective tax rate. We also discuss how much people keep from each labour market decision they make (in the 'How Universal Credit affects different families' section). This is similar to the participation tax rate which is the proportion of total earnings lost in tax and withdrawn social security when a person enters work. Another way of conceptualising the decision of whether to enter work or not is using the replacement rate, which measures net income out of work divided by the net income in work. As discussed in the section on 'The importance of work incentives', you would expect financial incentives to have different effects on the extensive margin (going into work) to the intensive margin (working or earning more); however we are conceptualising them in the same way in order to show the continuity in the system. Other names describing this same concept include the deduction rate and the combined withdrawal rate.

Withdrawal rate — This is also sometimes called the benefit withdrawal rate, the taper rate or the single taper rate. This describes how much a benefit decreases as income increases. For example Working Tax Credit has a withdrawal rate of 41 per cent of pre-tax income so for each £1 that a person earns (before tax) they lose 41p.

Minimum wage — Where we use the term "the minimum wage" we are referring to the new higher rate of minimum wage as it will apply to most people in the labour market (£7.20 per hour for those aged 25 and over). This is sometimes called the "National Living Wage".

Throughout this report we focus on household income rather than that of an individual and assume that households pool their incomes rather than individuals having separate budgets.

Calculating simplified marginal tax rates

A person earning above the Personal Allowance under the current system will lose £4.10 of every £10 increase in income in tax credits because they have a 41 per cent withdrawal rate as a percentage of gross income. They will also lose £2 in Income Tax and £1.20 in National Insurance contributions. This leaves them with £2.70 left of that £10. Under Universal Credit, for every £10 increase in income for a person earning above the Personal Allowance, the person will lose £2 in Income Tax, £1.20 in National Insurance. This leaves them with £6.80 after tax. They then lose 65 per cent of that post-tax £6.80 through Universal Credit withdrawal. This leaves them with £2.38 left of that £10 increase. For people whose incomes are high enough to make them ineligible for tax credits or Universal Credit, their simplified marginal tax rate is composed of Income Tax and National Insurance contributions. For example, for every £10 increase in income for a person earning above £150,000, they lose £4.50 in Income Tax and 20p in National Insurance contributions.

Calculating Universal Credit entitlement and post-tax wages

We have constructed a simple model of what three different families would experience under Universal Credit. This includes Universal Credit (the personal amount, the child amount, the housing costs amount, the disabled child addition and the Work Allowance), Council Tax, Council Tax Support, Income Tax and employee National Insurance contributions. We have not included the non-means tested elements of support that they could also receive (e.g. Child Benefit). The couple with two children are living in private accommodation that costs the limit of their Local Housing Allowance (LHA) for a three bedroom property for their area in Doncaster valued in band C for Council Tax. The couple with one disabled child are living in private accommodation that costs the limit of their LHA for a two bedroom property in their area in West Wiltshire that is valued in band B for Council Tax. We have assumed neither parent qualifies for the Carer's Allowance. The single parent with two children is living in private accommodation that costs the limit of their LHA for a three bedroom property for their area in Lambeth valued in band A for Council Tax.

Calculating Council Tax Support

The Council Tax Benefit system has been localised so that local authorities now develop their own Council Tax Support Schemes and can set minimum payments and withdrawal rates, and restrict support to particular bands. Council Tax Support has not been incorporated into Universal Credit, though a review is forthcoming. This makes it more difficult to calculate what counts as income for the purposes of withdrawing support. For this reason, our figures for Council Tax Support may be inaccurate, particularly for the family with a disabled child, because councils protect Council Tax Support in the case of disability in different ways. We count Universal Credit as income and take the basic entitlement amount to be the 'applicable amount' that the Government and local authorities refer to as the minimum income each family needs, with support being withdrawn based on income above that amount. The family living in Doncaster are not required to make a minimum payment, but support is withdrawn at a rate of 30 per cent as their income rises. The family living in West Wiltshire have a 20 per cent minimum payment and a 15 per cent withdrawal rate. The family living in Lambeth have a 15.9 per cent minimum payment and a 25 per cent withdrawal rate.

Polling

Research was conducted online by The Equality Trust in partnership with Ipsos MORI among a quota sample of 2,246 adults aged 16-75 in the United Kingdom from 27th November – 2nd December 2015 via its Online iOmnibus Survey. The survey data were weighted by age, gender region, social grade and working status to the known profile of the UK population aged 16-75. Participants were asked to provide their best guesstimate for the first two questions if they did not know the answer and not until later questions were they made aware of the actual figures for the proportion of earnings a person on tax credits keeps as their incomes increase.

They were told:

"Tax credits are state benefits that provide extra money to certain people responsible for children, disabled workers and other workers on lower incomes."

There are currently two types of tax credits – working tax credit and child tax credit. Tax credits are 'means-tested' and are available to people who can show that their income and other sources of wealth (including savings, investments and property other than their home) are below certain limits. For tax credits, the amount people are entitled to decreases depending on their gross annual income or the combined total of their and their partners' gross annual income. This means the more this gross annual income figure is, the lower their entitlement to tax credits is. The rate at which people's entitlement to tax credits decreases as their income goes up is the same for both working tax credit and child tax credit. Just a reminder, "gross annual income" is income before tax (i.e. income before income tax and national insurance has been taken out). We'd now like you to think about a situation involving a working parent who currently is entitled to and receives tax credits and whose gross annual income from their employer is £10,600. As a reminder "gross annual income" is income before tax and National Insurance have been deducted."

Then they were asked:

1

"Imagine that this working parent earns an extra £1. After income tax and National Insurance have been deducted from this extra £1 and tax credits decrease as their income has gone up by £1. How many pence, if any, of this extra £1, do you think they get to keep?"

2

"Still thinking about this working parent who earns an extra £1. After income tax and National Insurance have been deducted from this extra £1 of income and tax credits decrease as their income has gone up by £1. How many pence, if any, of this extra £1 of income, do you think they should get to keep?"

3

"We'd now like you to think about two different people. If each person was to earn an extra £1 in income, which, if any, do you think should get to keep the most after tax and other deductions have been applied?" Initially those surveyed were told:
"Person A: A working parent in receipt of tax credits with a gross annual income from their employer of £10,600. Person B: A working parent, with a gross annual income from their employer greater than £150,000 (in the highest income tax bracket) and who is not in receipt of tax credits." After this question, they were told
"Person A: A working parent in receipt of tax credits with a gross annual income from their employer of £10,600. Currently after income tax and National Insurance have been deducted from this extra £1 of income and tax credits decrease as their income has gone up by £1, Person A would get to keep 27p. Person B: A working parent, with a gross annual income from their employer greater than £150,000 (in the highest income tax bracket) and who is not in receipt of tax credits. Currently after income tax and National Insurance have been deducted from this extra £1 of income, Person B would get to keep 53p."

4

"As you may be aware, the UK government is in the process of replacing six individual means-tested benefit entitlements (i.e. Working Tax Credit, Child Tax Credit, Income Support, income-based Jobseeker's Allowance, income-related Employment and Support Allowance and Housing Benefit) with a single entitlement. This single entitlement is known as 'Universal Credit'. The amount of Universal Credit people are entitled to will be means-tested and will depend on their gross annual income or the combined total of their and their partners' gross annual income and other circumstances. If a working parent in receipt of Universal Credit who has a gross annual income of £10,600 earns an extra £1: They will pay 32p in income tax and National Insurance and lose 44p of their Universal Credit entitlement as their income has gone up by £1. This means that overall they will get to keep 24p after income tax and National Insurance have been deducted from this extra £1 and their Universal Credit decreases as their income has gone up by £1. To what extent would you say the amount they will get to keep – that is 24p – is too much, too little, or is it about right?"

5

"Some supporters of changing Universal Credit propose the following: a system where a working parent with a gross annual income of £10,600 who earned an extra £1 would get to keep 31p, rather than 24p, after income tax and National Insurance have been deducted from the additional £1 of income and their Universal Credit decreases. A working parent would: pay 32p in income tax and National Insurance; and lose 37p, rather than 44p, of their Universal Credit entitlement as their income has gone up by £1. On the one hand, [SHOW HALF SAMPLE A: the Trades Union Congress (TUC) and Child Poverty Action Group (CPAG) calculate that this change would cost the UK government approximately £4 billion per year.; SHOW HALF SAMPLE B: supporters of this change argue that it would help encourage more parents to work as working parents would get to keep more money.] On the other hand, [SHOW HALF SAMPLE A: supporters of this change argue that it would help encourage more parents to work as working parents would get to keep more money.; SHOW HALF SAMPLE B: the Trades Union Congress (TUC) and Child Poverty Action Group (CPAG) calculate that this change would cost the UK government approximately £4 billion per year.] To what extent do you support or oppose this change to Universal Credit?"

Calculating the effect of indirect taxes

The amount of indirect taxes that we could expect a household of this type to receive were calculated using micro data from the Effects of Tax and Benefits on Household Incomes 2013/14 release, produced by the Office for National Statistics from the UK Data Archive. In this dataset, the ONS use information from the Living Costs and Food Survey combined with known information about tax and benefit rates to impute estimated tax and benefit values for the sample of households. Our results should be seen as indicative estimates of the amount of indirect taxation a household of this type may pay and have not been subject to significant tests to see how generalisable they are to the general population. They represent an informed estimate of what a family might pay rather than an estimation of how indirect taxation hits this group in total. We created a filtered data set containing all the families in the data with 2 adults and 2 children and with an original income less than £470 per week (the maximum wage that family had in our Universal Credit entitlement model). This subset had a sample size of 85 families. We then examined the median results for each of this subset for each of the indirect taxes in this dataset. Since this dataset is looking at information from 2013/14, we have uprated the amounts expected to be paid in each indirect tax for inflation using the CPI estimation to the present and the Bank of England's prediction for inflation to bring it level with the rest of the model for figures for April 2016. The only exception is the cost of the TV licence, which has been frozen for the entire period. The simple averages also discussed in the text represent the mean results for each of these. These do not necessarily present a good indication of the average of the group but should merely highlight the increased tax payments associated with cigarette usage. Another large increase in indirect taxation for the simple average comes from alcohol usage although they have higher rates of indirect taxes all round. This could be partly due to households who have a normal income of much higher than the rest of this group who have seen a temporary income fall but have not adjusted their spending to compensate.

Calculating tax cuts

The VAT cut was estimated by simply dividing the current amount of VAT by the current rate (20 per cent) and multiplying it by the proposed rate (18 per cent). This will mean that the suggested gain is an overestimate of the actual gain as this does not adjust for reduced rate VAT products. The other suggested tax cuts necessitated altering our existing Universal Credit model families in line with each of the cuts laid out in the text.

ABOUT THE EQUALITY TRUST

The Equality Trust is a charity that works to improve the quality of life in the UK through reduced economic inequality.

We conduct robust research and analysis of the scale, drivers and effects of economic inequality in order to increase understanding of economic inequality among policy-makers, business and the public.

The Equality Trust was launched in 2009 by Bill Kerry, Richard Wilkinson and Kate Pickett. It is primarily funded by the Network for Social Change and the Joseph Rowntree Charitable Trust with additional support from many generous individuals, organisations and groups.

For more information about our work, please visit our website at http://www.equalitytrust.org.uk/

For those who would like to donate to support our work, this can also be done through our website here http://www.equalitytrust.org.uk/support

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