

# Escaping the Poverty Trap



How to help people on benefits into work

Lawrence Kay



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## About the Author

**Lawrence Kay** is a Research fellow at Policy Exchange, specialising in welfare reform. His work has included evaluations of welfare-to-work schemes and the use of conditionality in benefit systems across the world, both of which attracted acclaim from leading academics in the UK and abroad. Lawrence regularly appears in the national media and was educated at the University of Essex and London School of Economics.

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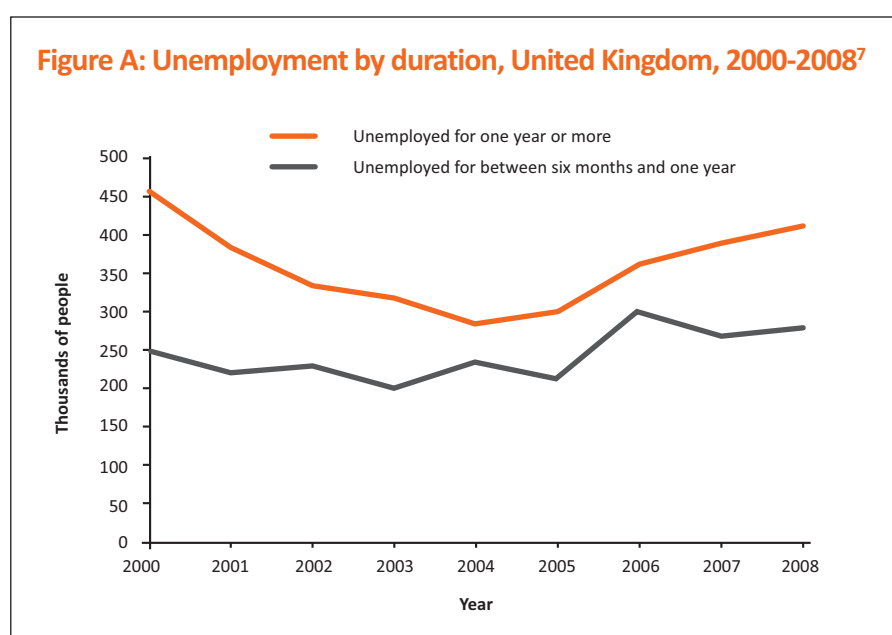
# Executive Summary

There are 5.8 million people on benefits in Britain.<sup>1</sup> This year, the welfare bill will be £81 billion.<sup>2</sup> If the people who have recently started claiming social security and are struggling to find work do not get jobs soon, the personal and social costs of the rise in unemployment will be catastrophic.

Financial work incentives will be crucial to whether this happens. Because of the way that people who move from benefits into work have their support withdrawn and face the levying of taxes, the incentives for them to work are so low that it is often not worth them leaving welfare.

This problem has been behind much of Britain's persistent problem with long-term benefit claims. As people were drawn into the comparatively generous Invalidity Benefit then Incapacity Benefit regimes in the 1980s and 1990s, the number of people claiming welfare for reasons of ill health began to grow. For the last ten years the number of people receiving Incapacity Benefit and its successor, the Employment and Support Allowance, has remained remarkably stable at around 2.5 million.<sup>3</sup> This is alarming, given that the economy has created 1.9 million jobs in this period.<sup>4</sup>

But this problem is not confined to health benefits. Around 60% of the lone parents claiming Income Support have been doing so for 2 years or more.<sup>5</sup> People on Jobseeker's Allowance are also affected: at least 54% of the claimants making a "new" claim are actually repeat claimants.<sup>6</sup> Quite simply, as shown by the graph below, long-term welfare claims have been Britain's blight for many years.



1 [www.nomisweb.co.uk](http://www.nomisweb.co.uk)

2 This is the sum of all Department for Work and Pensions "benefit" spending in Great Britain, minus spending on the State Pension. See Department for Work and Pensions, *Benefit Expenditure Tables*

3 Department for Work and Pensions, *Tabulation Tool*

4 In 1999 there were 29,127,000 "workforce" jobs in the economy. By 2009 this figure had risen to 30,897,000. Source: Office for National Statistics

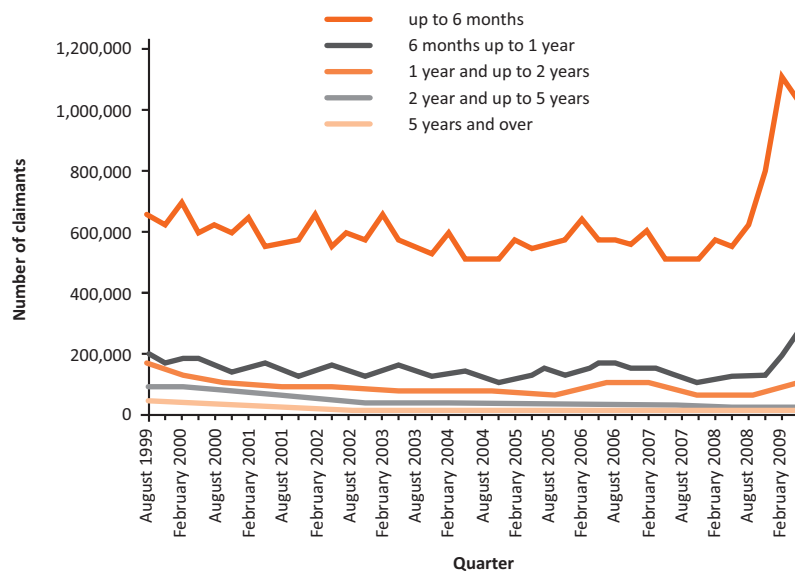
5 Department for Work and Pensions, *Tabulation Tool*

6 Carpenter H, *Repeat Jobseeker's Allowance Spells*, Department for Work and Pensions, 2006, p 1

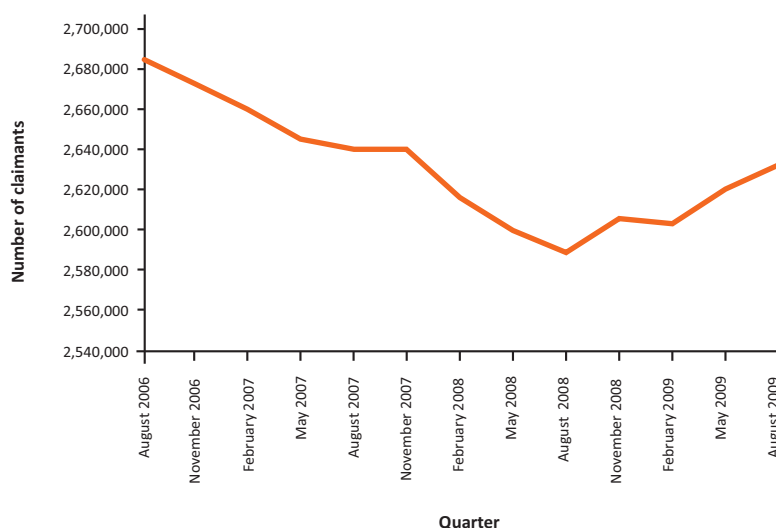
7 OECD

The recession has made this problem even worse. While pushing welfare claimants with the poorest skills to the back of the queue for any jobs going it has also meant that the recently unemployed will be out of work for longer. The graphs below show how this is already happening with claimants of Jobseeker's Allowance and the Employment and Support Allowance.

**Figure B: Claims for Jobseeker's Allowance by length of claim, United Kingdom, 1999-2009<sup>8</sup>**



**Figure C: Number of people receiving Incapacity Benefit or the Employment and Support Allowance, United Kingdom, 2006-2009<sup>9</sup>**



<sup>8</sup> www.nomisweb.co.uk

<sup>9</sup> Office for National Statistics, "DWP Monthly Statistical Summary," 16th December 2009

Quite simply, many of the people who have recently taken benefits will soon start to feel the pinch of the poverty trap. This report analyses where it exists,

which claimants it affects most and, when the government finances are tight, how spending in some areas of the social security budget can be cut so that incentives to work can be raised.

Nine of the most typical claims for welfare – encompassing Jobseeker’s Allowance, Income Support, Incapacity Benefit (the Employment and Support Allowance), Housing Benefit, Council Tax Benefit, Child Benefit, Working Tax Credit and Child Tax Credit – are compared to what a person would earn as they work for between one and 40 hours at the National Minimum Wage. In other words, how someone’s income changes as they start to work a normal week is analysed for how the withdrawal of benefits and levying of taxes affects the financial incentive to work.

However, unlike many other analyses of the work incentives that people on welfare face, this report also takes into account the costs of getting a job. Using up-to-date figures on what some of the poorest people in Britain spend on just travelling to work and being appropriately dressed, the analysis reveals the total financial decision that a person on welfare is likely to face.

The results are startling. After 16 hours of work, when the final entitlement to any of the main benefits such as Jobseeker’s Allowance, Income Support and Incapacity Benefit (the Employment and Support Allowance) expires, many claimants will have made no financial gain. Someone over 25 on Jobseeker’s Allowance will be £15.07 poorer, while someone in the Employment and Support Allowance Support Group will be £39.35 worse off. Those with children benefit most. The tax credits system leaves a lone mother with one child £28.30 better off. However, even here the gain from working for, say, ten hours per week is only £20 – equal to a wage rate of £1 per hour.

These figures show how the worth of taking a step into work through a part-time job – an approach to working that might be best for people who need to manage an illness or care for a child – is very weak. Even after a full week of work the incentive is still insignificant. Compared to an income at 40 hours of work, a couple on Jobseeker’s Allowance will only be £29.06 better off, and someone in the Employment and Support Allowance Work-Related Activity Group only £30.46 richer. For each of these claimants this means an average wage per hour of £1.28 and 60p respectively. Unsurprisingly, working for such paltry wages does not strike many people on welfare as a good deal.

But rather than just show how the incentives to work for people on welfare are weak, this report also reveals how egregiously high the tax rates on these people can be. The incentives outlined above are paltry because the combination of benefit withdrawal and levying of Income Tax and National Insurance contributions produces some of the highest tax rates on anyone in Britain.

In the report these tax rates are expressed as the “participation tax rate” (how much income someone will lose if they decide to start working) and the “marginal effective tax rate” (how much income someone will lose if they decide to work more after taking a job in the first place). The results using these methods are also shocking.

“ These figures show how the worth of taking a step into work through a part-time job – an approach to working that might be best for people who need to manage an illness or care for a child – is very weak ”



**Table A: The work incentives faced by the typical benefit claimants studied in this report**

Type of welfare claim	Total out-of-work income	Total change in income after 16 hours of work with work costs included	Total change in income after 40 hours of work with work costs included	Average per hour wage after 40 hours of work with work costs included
Jobseeker's Allowance, claimant under 25	122.42	-13.07	51.00	1.28
Jobseeker's Allowance, claimant over 25	151.77	-15.07	30.36	0.76
Jobseeker's Allowance, couple over 25	191.92	-31.75	29.06	0.73
Jobseeker's Allowance, couple over 25 with one child	289.87	8.80	29.06	0.73
Jobseeker's Allowance, couple over 25 with two children	345.98	8.80	29.06	0.73
Income Support, claimant over 25 with one child	249.72	28.3	55.13	1.38
Income Support, claimant over 25 with two children	305.83	28.3	55.13	1.38
Employment and Support Allowance (work group), claimant over 25	177.27	-20.6	30.46	0.76
Employment and Support Allowance (Support Group), claimant over 25	196.02	-39.35	23.9	0.60

When the costs of work are taken into account a person over 25 on Jobseeker's Allowance will face a participation tax rate that is above 100% for most of the first 20 hours of work, and then just under 100% after that, hence the paltry £29.06 gain after 40 hours in employment. Lone mothers get a better deal, but their participation tax rates are still mostly 75% until they have worked for 16 hours, and their marginal tax rates often just under 100% as they consider earning a bit more money each week.

But these are not the worst examples of high tax rates on the poor. People in the Employment and Support Allowance Work-Related Activity Group are thought of as being capable of work but in need of a bit more help than ordinary job seekers. However, after paying the up-front costs of getting a job they face around a 700% marginal effective tax rate on the first hour of work and then, after working for 15 hours, they lose £23 for working an extra hour. This means they face a marginal effective tax rate of over 700% twice in their working week. The participation tax rate they face is also over 100% for the first 22 hours of any work they might choose to do.

The tax rates shown in Figures D to L below matter both in terms of the reason that someone on welfare has for leaving work, but also for how the social security system fits the employment patterns in Britain's modern labour market. While creating many jobs over the past few decades, 1.2 million of them have been part-time posts. Many employers now ask their staff to take flexible hours, contract work or jobs that require short bursts of shift work. But there is little incentive for many people on welfare to try and take these opportunities.

This problem is particularly bad for the long-term unemployed. If someone has been out of work for several years they are likely to be worried about the consequences of getting a job. Surveys of people on disability benefits have found that around a third of claimants would like part-time employment, and lone mothers

on Income Support tend to like the idea of doing some work so that they can balance earning and caring.<sup>10</sup>

Part-time work can act as a stepping-stone for many of these people to find permanent, full-time work over time. Studies have found that lone mothers who do work for less than 16 hours a week one year do more hours a week the next year, and that people who do some work while on benefits are likely to leave the system completely eight months later.<sup>11</sup> Poor incentives to work part-time leave, in particular, the long-term unemployed in a situation where it is not profitable for them to take advantage of the changes in the labour market that should benefit them. This means they have less freedom to gradually move away from a benefits-dependent lifestyle.

But how can this situation be changed, not least in an environment where public spending is under so much pressure? This report shows how, by making £6.5 billion in savings from the social security budget, reforms can be made that make a net gain for the exchequer, leave the unemployed poor no worse off, and increase work incentives. The ideas for saving money include **tapering tax credits and Child Benefit more aggressively (a £5.8 billion saving)** as outlined by the Institute for Fiscal Studies in its own work, and **clawing back the £700 million that the Government will unnecessarily splurge on uprating benefits in the next financial year.**<sup>12</sup>

It is these savings that allow for a significant increase in the amount of money that benefit claimants are allowed to keep when deciding to work, and particularly a big financial boost to taking a part-time job. What is most striking about the tax graphs shown below is the consistently poor incentives that exist below 16 hours of work. This could be changed by altering the withdrawal rates of the benefits that are causing this situation, or by paying more in tax credits when a certain number of hours have been worked. But there is a much simpler way: to **raise the earnings disregard on all means-tested benefits to £92.80** so that anyone leaving such benefits keeps what they would earn for 16 hours on the minimum wage. This would cost £5.1 billion, but be offset by the £6.5 billion savings made elsewhere.

This would mean that none of Housing Benefit, Council Tax Benefit, or income-based Jobseeker's Allowance, Income Support and Incapacity Benefit (Employment and Support Allowance) would be withdrawn until a claimant had earned at least £92.80. This would provide a massive boost to the financial reason for leaving unemployment or earning more for 2.8 million people, or anyone who is making an income-based claim for benefits.<sup>13</sup>

Most importantly, this should help the long-term unemployed most. Anyone on Incapacity Benefit who has wondered for many years why taking a job is at all worthwhile, the situation will be quite simple. When they ask an employment adviser how much better off they will be in work, the adviser will be able to say "By at least £92.80" rather than have to insert caveats about how a certain number of hours worked will maximise the financial gain to be made by the person, and how they must make sure to keep telling the taxman about changes in their circumstances. If the Government wanted to concentrate solely on long-term benefit claimants then it could restrict the change to those who are currently on a claim that has lasted, say, for a year or more.

10 Rowlingson K and Berthoud R, *Disability, Benefits and Employment*, Department of Social Security, research report 54, 1996; Bell A, Finch N, La Valle I, Sainsbury R and Skinner S, *A Question of Balance: Lone Parents, Childcare and Work*, Department for Work and Pensions, research report no 230, 2005; Rafferty A, "The Characteristics of Lone and Coupled Mothers Working Fewer than 16 hours per week," Department for Work and Pensions, in-house report no 125, 2003

11 Rowlingson K and Berthoud R, *Disability, Benefits and Employment*, Department of Social Security, research report 54, 1996; Bell A, Finch N, La Valle I, Sainsbury R and Skinner S, *A Question of Balance: Lone Parents, Childcare and Work*, Department for Work and Pensions, research report no 230, 2005; Rafferty A, "The Characteristics of Lone and Coupled Mothers Working Fewer than 16 hours per week," Department for Work and Pensions, in-house report no 125, 2003

12 Brewer M, Saez E and Shephard A, *Means Testing and Tax Rates on Earnings*, Institute for Fiscal Studies, 2008, pp 51

13 Department for Work and Pensions, *Tabulation Tool*

This would be a powerful change, not least for the long-term unemployed who need to take incremental steps into work. With this change any part-time work they do that is for less than 16 hours a week will leave them with all the money they have earned. There will be no question over whether taking some contract work that has come up will be a good idea or not. Quite simply, they will be able to give it a go, earn a bit of money, and start to familiarise themselves with work again.

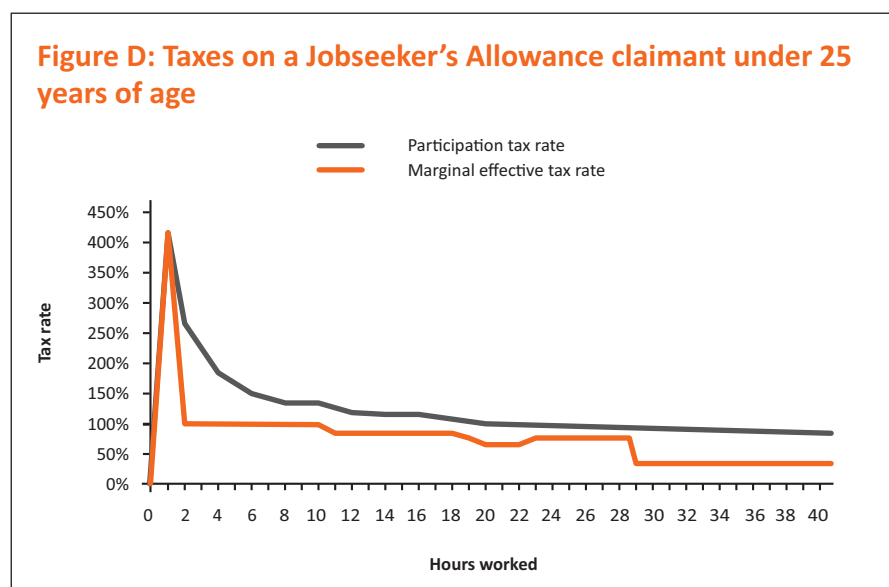
This should help Britain to start chipping away at its group of hardcore long-term welfare claimants and thus spread work within some of the most depressed areas of the country. In areas where people on welfare constitute more than a third of the local working-age population, they need help to start increasing their levels of employment. At the moment the welfare system does not incentivise many of the people in these places to stick their toe in the labour pool, with disastrous consequences for the communities affected.

#### The three recommendations in this report:

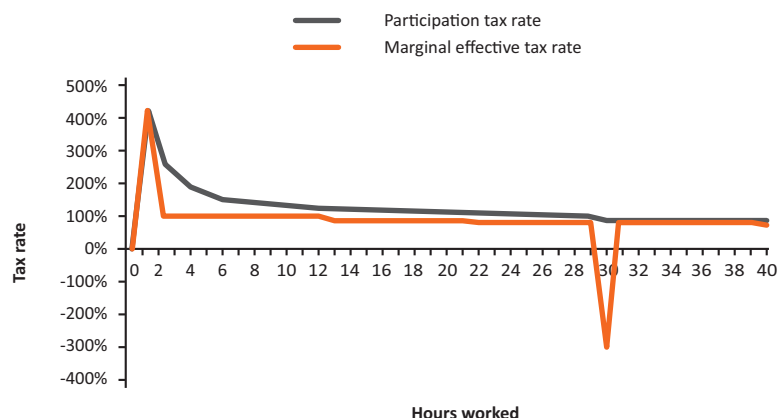
- **Recommendation 1: claw back the 3% increase in the value of some benefits in 2009-2010 by reducing expected rises in their value in the next few years. Saving: £700 million**
- **Recommendation 2: taper away the Family Element of the Child Tax Credit and Child Benefit at 39% once the Child Element of the Child Tax Credit has been exhausted. Saving: £5.8 billion**
- **Recommendation 3: raise the earnings disregard for all means-tested benefits to £92.80, or the minimum wage for adults times 16 hours. Cost: £5.1 billion**

Total projected financial gain from the three recommendations: £1.4 billion.

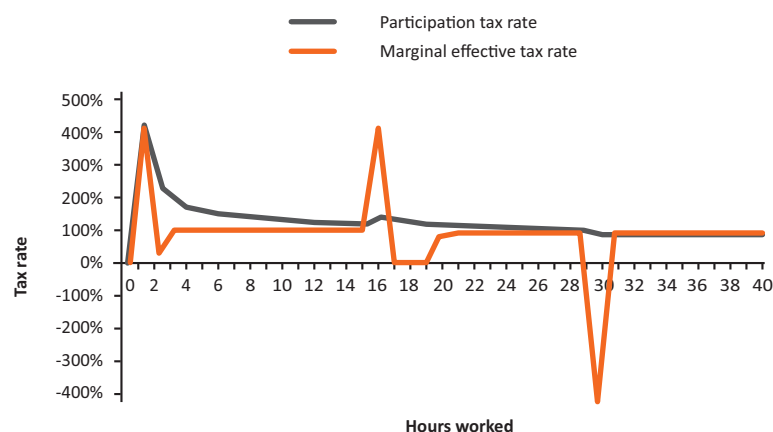
Tax rates faced by each of the typical claimant case studies in the report after the costs of work have been taken into account



**Figure E: Taxes on a Jobseeker's Allowance claimant over 25 years of age**



**Figure F: Taxes on a couple over 25 years of age making a claim for Jobseeker's Allowance**



**Figure G: Taxes on a couple over 25 years of age with one child making a claim for Jobseeker's Allowance**

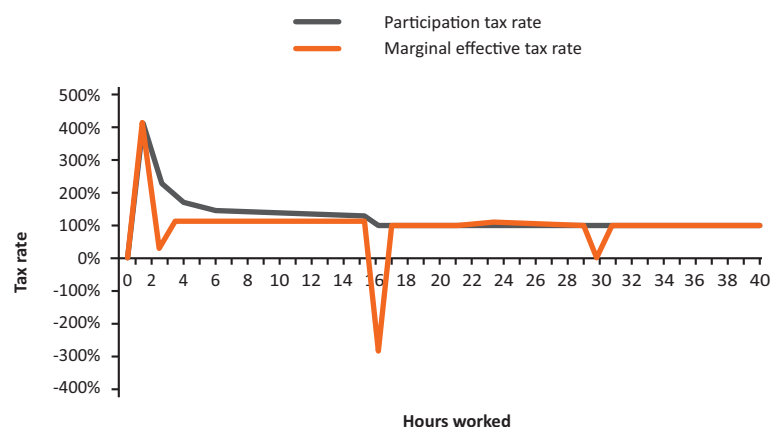


Figure H: Taxes on a couple over 25 years of age with two children making a claim for Jobseeker’s Allowance

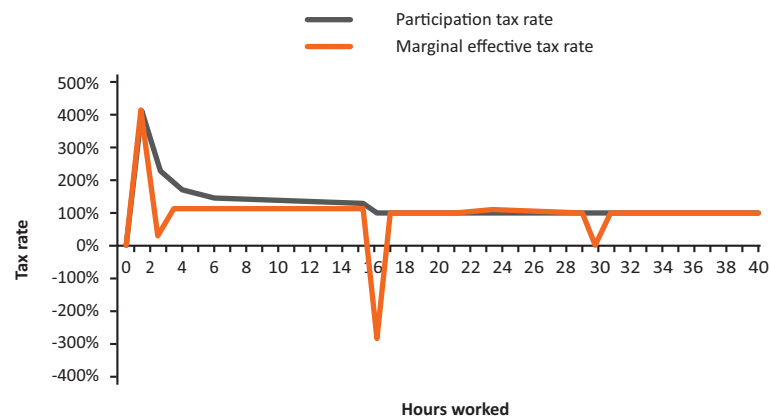
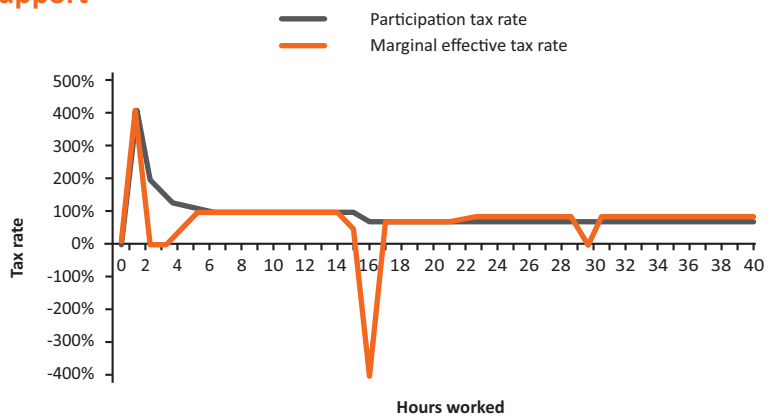


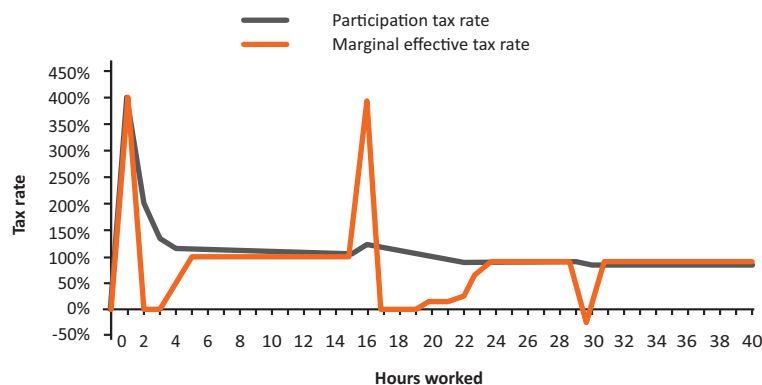
Figure I: Taxes on a lone parent over 25 years of age with one child under 7 years of age making a claim for Income Support



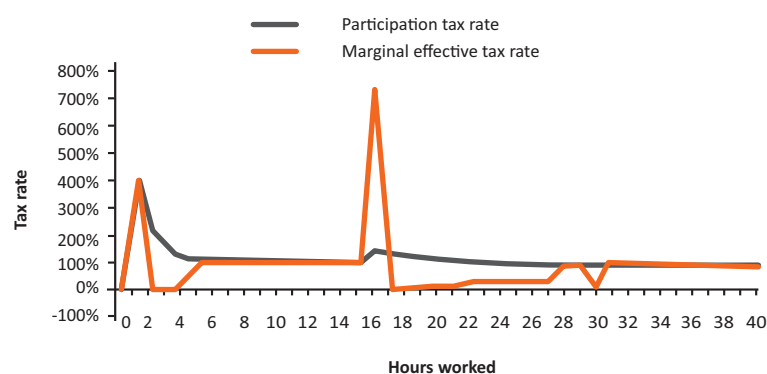
Figure J: Taxes on a lone parent over 25 years of age with two children under 7 years of age making a claim for Income Support



**Figure K: Taxes on an Employment and Support Allowance claimant in the Work-Related Activity Group**

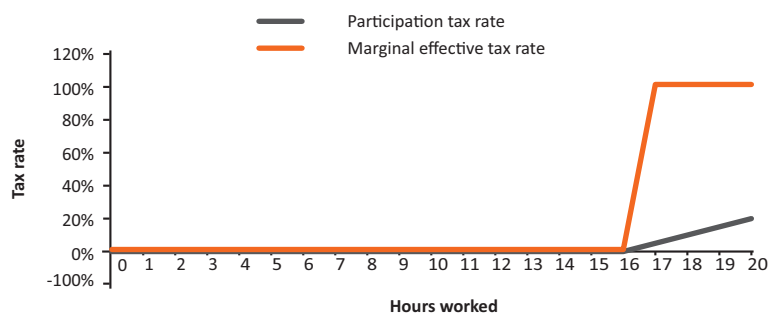


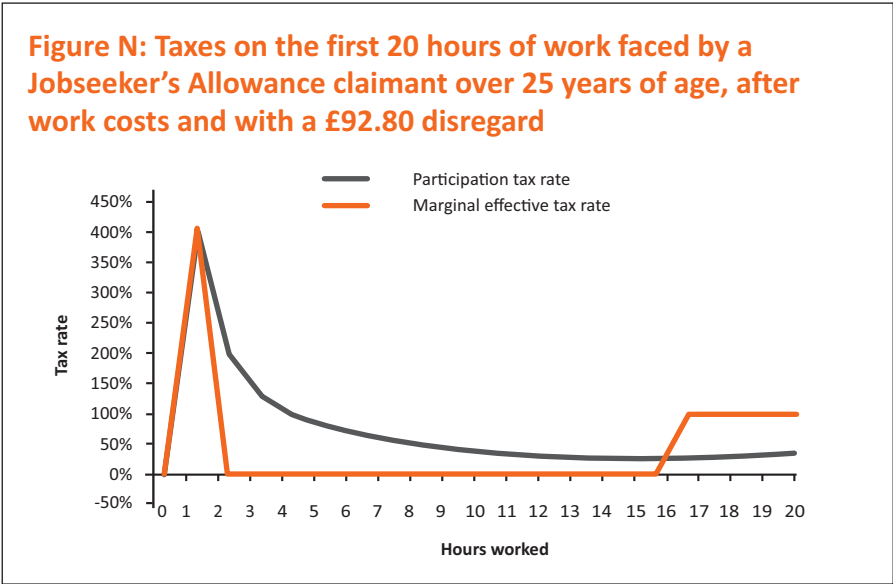
**Figure L: Taxes on an Employment and Support Allowance claimant in the Support Group**



After increasing the disregard to £92.80, the tax rates faced by someone over 25 years of age on a typical Jobseeker's Allowance claim would change to the ones shown by Figures M and N. Over the first 20 hours of work the participation tax rate before work costs would fall to a maximum of 20%, while after work costs it would fall much more quickly to under 50%. After 16 hours of work this would leave the claimant £92.80 better off before work costs, and £69.20 better off after it.

**Figure M: Taxes on the first 20 hours of work faced by a Jobseeker's Allowance claimant over 25 years of age, before work costs and with a £92.80 disregard**





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# Introduction

There are now 5.8 million people on welfare in Britain.<sup>14</sup> In 2009-2010, the bill for spending on benefits will be £81 billion.<sup>15</sup> If many of the people who have recently started claiming benefits do not find jobs soon, the personal and social costs of the recent rise in unemployment will be catastrophic.

But a lack of jobs is not the only reason why these people might not find employment. Because of the way that people who move from benefits into work have their financial support withdrawn and are then taxed for their efforts, the financial incentives for them to be employed are so low that it is often not worth them leaving welfare. This report analyses how the social security system affects the financial value of trying to get a job.

The analysis is based on simple projections of what people on the most typical benefit incomes would get were they to start working on the National Minimum Wage. The package of recommendations shows how the social security bill could be reduced in order to meet the demands of the coming fiscal squeeze and, through putting money into improving the financial gains from working for people on benefits, how the government can encourage welfare claimants to take any work that comes their way.

<sup>14</sup> [www.nomisweb.co.uk](http://www.nomisweb.co.uk)

<sup>15</sup> This is the sum of all Department for Work and Pensions “benefit” spending in Great Britain, minus spending on the State Pension. See Department for Work and Pensions, *Benefit Expenditure Tables*



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# 1

## The State of Welfare in Britain Today

16 In 1997 the party wrote in its manifesto that it was “...determined not to continue down the road of a permanent have-not class, unemployed and disaffected from society...Labour’s welfare-to-work programme will attack unemployment and break the spiral of escalating spending on social security.” See the full text of Labour’s 1997 manifesto at [http://www.bbc.co.uk/election97/background/parties/manlab/4la\\_bmanecon.html](http://www.bbc.co.uk/election97/background/parties/manlab/4la_bmanecon.html)

17 Brewer M and Browne J, “The Effect of the Working Families’ Tax Credit on Labour Market Participation,” Institute for Fiscal Studies, briefing note no 69, 2006 found in a review of a handful of studies that had looked at the introduction of Working Families’ Tax Credit (WFTC) in 1999 (it replaced Family Credit) that “...there is broad agreement that WFTC increased the proportion of lone mothers who were in work, the proportion that worked at least 16 hours and the proportion who worked more than 30 hours.” See pp 10

18 This is the sum of the “income tax credits” and “tax credit” lines (£6.5 billion plus £22.8 billion respectively) in HM Treasury, *Securing the Recovery: Growth and Opportunity, Pre-Budget Report December 2009*, HM Treasury, 2009. Brewer M and Browne J, “The Effect of the Working Families’ Tax Credit on Labour Market Participation,” Institute for Fiscal Studies, briefing note no 69, 2006 find that expenditure on employment tax credits increased from £2.68 billion to £4.81 billion between 1998-99 and 2000-01. The Working Families’ Tax Credit, which replaced and was more generous than the Family Credit, was introduced in 1999

19 “The life span of a tax credit claim includes many potential hazards that can lead to an incorrect award. From completion of the initial and renewal claim forms, through changes in circumstances to disputing decisions and dealing with overpayments, a degree of tactical expertise is required of the claimant...[w]hen things go wrong, the consequences can be drastic and can result in a substantial reduction in the amount of tax credits claimants receive.” Citizens’ Advice Bureau, *Tax Credit Take-Up Resource Pack*, Citizens’ Advice Bureau, 2006

As it comes to the end of its third term in power, the Government has had well over a decade to reform Britain’s social security system. Back in 1997, Tony Blair promised that “...[b]y the end of a 5-year term of a Labour government, I vow that we will have reduced the proportion we spend on the welfare bills of social failure... This is my covenant with the British people. Judge me upon it. The buck stops with me.”<sup>16</sup> The Government clearly saw unemployment, its social effects and the amount of money being spent on benefits for the unemployed as areas worthy of serious attention. Has it yet managed to change anything?

The Government has attempted reforms to the way that the unemployed both receive money and are helped to find work. To make work more financially attractive for people who are on low pay or are considering a job that does not pay very much, it introduced the minimum wage in 1999 and created tax credits. Tax credits have taken a few different forms since they were first introduced, also back in 1999, but the essential idea is that by working for a certain number of hours someone who is on a low wage will receive a total income that makes relying on benefits instead look unattractive.

There is much debate over whether tax credits have worked. Several studies cite improvements in the rate with which the low paid have taken work and then stayed in it rather than falling back on to benefits.<sup>17</sup> But tax credits now cost £29.3 billion per year and their design means claimants can find them very difficult to navigate.<sup>18</sup> Their complexity can make the answer to the most important question for someone on benefits or in a low-paid job, “How much money will I receive if I work more, or if I work more than I currently am?” very difficult to answer without professional help.<sup>19</sup> See Box 1 for a discussion of the logic behind the introduction of tax credits.

To help the unemployed with the search for a job and development of the skills that employers want, the Government introduced the New Deal in 1998. It constituted seven schemes, each one for a different type of benefit claimant.<sup>20</sup> In October 2009 these schemes were rolled into one programme, the Flexible New Deal, which uses private organisations (whether companies or charities), rather than the Jobcentre Plus network to help everyone who has been unemployed and on benefits for twelve months or more to get a job.

By promising to use a “black box” method in the way that it uses private organisations to provide help to the unemployed under the Flexible New Deal, i.e. to simply pay them a fee for each person that they help into a job, but not to stipulate

how that process happens, the Government has shown an admirable focus on the thing that matters most: helping people who can and want to work to get work.

Despite these changes, the Government's most significant achievement has been the drop in the claimant count (the number of people receiving the main unemployment benefit, which is currently Jobseeker's Allowance) to 785,000 in November 2007, one of its lowest levels ever.<sup>21</sup> This drop was significant for what it suggested: that Britain really could reduce its population of people on benefits and move many of the claimants who had been out of work for years into jobs.

Unfortunately, this is about as far as the evidence goes for real improvement. Despite the investment of so much political capital, there is little sense in which Labour has managed to change things in a manner which really has, in its words, meant "...work for those who can, security for those who cannot."<sup>22</sup>

To change this situation there are two things that need to happen. One, everyone who loses a job, asks the state for financial assistance and needs help to get back into work as quickly as possible should get that help as quickly as possible. For most people, time is of the essence when they lose a job – it gets harder to find new ones as time goes by and the consequent bill met by the exchequer grows much bigger. The Government used the strong labour market that existed between the mid-1990s and 2007 as a proxy for achieving this aim. Judging by the record low claimant count figure in 2007, it worked to an extent.

Two, claimants who have been unemployed for a long time and need help to familiarise themselves with work and the process of getting a job should get the practical assistance they need. If they get some work, and then maybe a permanent job and a career, they can start to live a life independent of state support. Many of the benefit claimants who have been out of work for years lost their jobs in past recessions and remained unemployed regardless of better economic circumstances.<sup>23</sup>

The financial incentives that benefit claimants get for gaining employment are central to achieving both of these aims. When there is a small difference between what someone receives on benefits compared to what they will get when working, it is implausible that they will have good reason to work for, say, 30 hours per week.

Unemployment benefits cut the depth of hardship into which claimants fall, but they also make the financial boost from being in work rather than out of it smaller. The government can provide lots of help through employment services, but if claimants do not want to work then getting them into work is a lot harder. This is not to say that the people affected are lazy. Small amounts of financial gain for working long hours would strike most people as an unreasonable deal.

Tax credits and the minimum wage were Labour's answer to this problem. Unfortunately, they have not made as much of a difference as they might have done. Before the Employment and Support Allowance was introduced in October 2008, there were nearly 2.4 million people claiming Incapacity Benefit (which is given to people who have been assessed as having a health impediment on their ability to work), a figure that has hardly changed since 1997.<sup>24</sup> This is a problem because many of the people on the benefit are thought to be capable of work (nobody knows how many) and 89% of the claimants who think of themselves as capable of work want to have a job.<sup>25</sup>

There are also lots of people who have been claiming Jobseeker's Allowance (which is given to people who are fully capable of work and are searching for it) for a long time. It is one of the government's biggest claims that "...over half of new Jobseeker's Allowance claimants leave benefits within three months of claiming and

20 The seven schemes were the New Deal for Young People (for claimants aged between 18 and 24 years), New Deal 25+ (for claimants over 25 years of age), New Deal for Lone Parents, New Deal for Disabled People, New Deal 50+ (for claimants over 50 years of age), New Deal for Partners (for people who had a partner claiming benefit for them on their behalf), and New Deal for Musicians (for musicians who needed help getting a job in the music industry). For more detail see Brewer M, *Welfare Reform in the UK: 1997-2007*, Institute for Fiscal Studies, 2007

21 The highest level according to this count was 3,407,729 in January 1986. Every one of the 100 lowest counts occurred after 2000. Data quoted for the United Kingdom from [www.nomisweb.co.uk](http://www.nomisweb.co.uk)

22 Department of Social Security, *New Ambitions for Our Country: A New Contract for Welfare*, The Stationery Office, 1998. Quoted by [www.cpag.org.uk](http://www.cpag.org.uk)

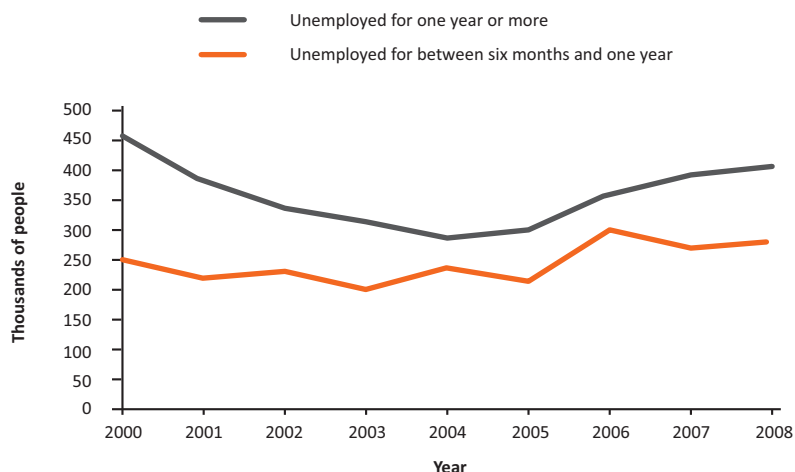
23 As of May 2009 there were around 1.2 million people on Incapacity Benefit who had been receiving the benefit for five years or more. See Department for Work and Pensions, *Tabulation Tool*

24 In November 2008 there were 2,343,250 people claiming Incapacity Benefit. In August 1999 there were 2,355,240 people claiming the benefit. Many people on Incapacity Benefit or the new Employment and Support Allowance also claim other support. In February 2009 there were 717,720 people in the United Kingdom solely claiming either benefit. See [www.nomisweb.co.uk](http://www.nomisweb.co.uk) for details

25 89% of Incapacity Benefit claimants in a recent survey who did not consider themselves to be permanently off work due to sickness or disability agree with the statement that "[h]aving a job is very important to me," Kemp PA and Davidson J, *Routes onto Incapacity Benefit: Findings from a follow-up Survey of Recent Claimants*, no 516, Department for Work and Pensions, 2008

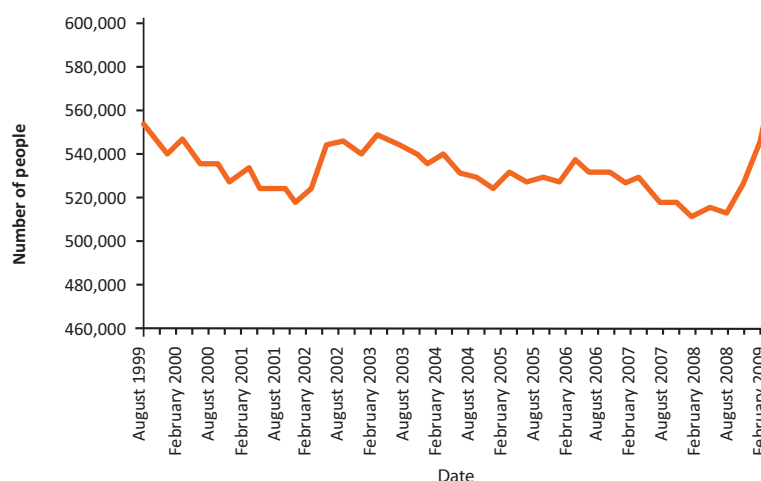
around three-quarters within six months.”<sup>26</sup> The problem is, “leaving” does not necessarily mean “leaving for a long-term job”. The majority of “new” Jobseeker’s Allowance claimants are actually repeat claimants.<sup>27</sup> Figure 1 shows how serious a problem long-term benefit claims are in Britain.

**Figure 1: Unemployment by duration, United Kingdom, 2000-2008<sup>28</sup>**



The failure of many of the people who have been claiming benefits to find work during the recent period of strong economic growth is what makes helping them do so more difficult now that the need to get people back to work quickly has re-emerged as a serious priority. In December 2009 there were just under 1.6 million people claiming Jobseeker’s Allowance – one of the highest levels since November 1989, when a similar number were on the main unemployment benefit.<sup>29</sup> Even though there were falls in the number of people on benefits during the middle of the last decade, over the whole decade the count hardly changed. See Figure 2 for details.

**Figure 2: Total number of people claiming out-of-work benefits, United Kingdom, 1999-2009<sup>30</sup>**



<sup>26</sup> Department for Work and Pensions, *Raising Expectations and Increasing Support: Reforming Welfare for the Future*, Department for Work and Pensions, 2008, pp 9

<sup>27</sup> Carpenter H, *Repeat Jobseeker’s Allowance Spells*, Department for Work and Pensions, 2006, pp 1

<sup>28</sup> OECD

<sup>29</sup> www.nomisweb.co.uk

<sup>30</sup> This data includes people claiming Carer’s Allowance, Disability Living Allowance, Incapacity Benefit, Employment and Support Allowance, Income Support, Jobseeker’s Allowance, Severe Disablement Allowance, and Widow’s Benefit. See www.nomisweb.co.uk for details

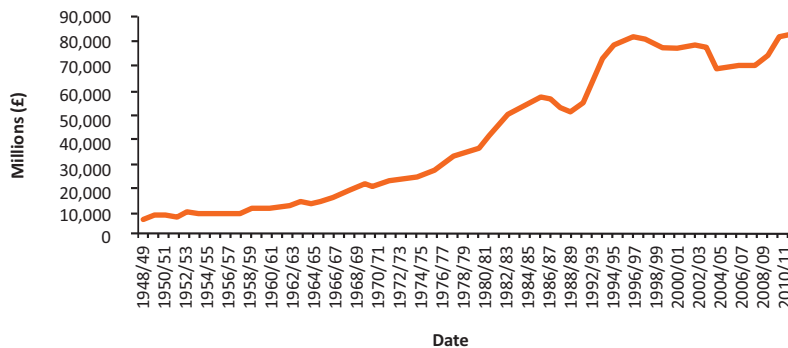
This failure has cost billions. Table 1 shows how spending on social security dwarfs all other areas of government activity when state pension spending is taken into account, and even exceeds spending on key areas when the state pension is ignored, as shown by Table 1.

**Table 1: Spending by area of government, 2009/2010 (£, billions)<sup>31</sup>**

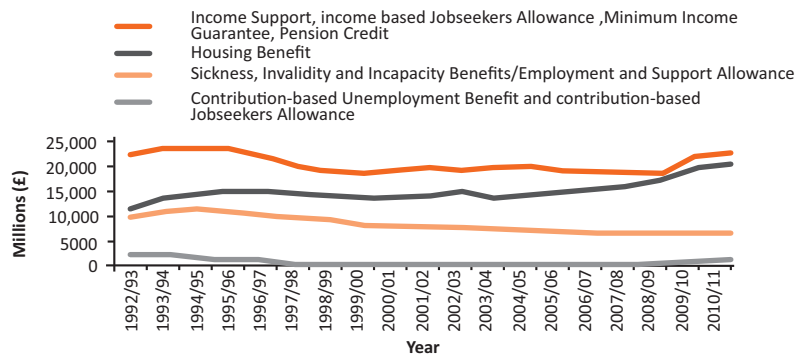
Area of government	
Social protection	189
Health	119
Education	88
<i>The benefits bill (DWP social security spending after excluding the cost of the State Pension)</i>	<i>81</i>
Defence	38
Public order and safety	35
Personal social services	31
Housing and environment	29
Debt interest	28
Transport	23
Industry, agriculture, employment and training	20

The following two figures show how this spending is distributed across the benefit system and how such spending has evolved over time.

**Figure 3: Spending on social security (everything excluding the state pension), United Kingdom, 1949-2009 (2009/10 prices)<sup>32</sup>**



**Figure 4: Spending by type of benefit, United Kingdom, 1992/93-2010/11 (2009/2010 prices)<sup>33</sup>**



31 HM Treasury, *Budget 2009 – Building Britain's Future*, The Stationery Office, 2009, pp 12; Department for Work and Pensions, *Benefit Expenditure Tables*

32 Department for Work and Pensions, *Benefit Expenditure Tables*

33 Department for Work and Pensions, *Benefit Expenditure Tables*

### Box 1: The logic behind tax credits

*Saunders P, Reforming the UK Family Tax and Benefits System, Policy Exchange, 2009*

[In the early 2000s] Britain's record on child poverty...compared poorly with most other EU countries. In France, child poverty was 7%; in Germany, 13%. The Scandinavian nations averaged only around 3%. Although the UK was not out of line with other 'Anglo' countries (the US figure in 2000 was 21.6%), it was around the bottom of the EU poverty league tables, and New Labour wanted to do something about it.<sup>34</sup> In March 1999, Tony Blair announced his target of halving child poverty by 2010, and eradicating it by 2020.

Tax credits were to be the main vehicle for achieving this, and they would do it in two ways. First, the child tax credit would boost family incomes directly, and because it was means tested, it would have most of its impact on those with the lowest incomes. Secondly, the working tax credit would increase the participation of low income parents (particularly sole parents) in paid work.

It was known that the main cause of poverty is joblessness – in 1999, half of all the children living in "poor" households in the UK were in families where nobody worked.<sup>35</sup> Poverty in non-employed sole parent households was particularly high, although unemployed couples with children ran a high risk of poverty. The OECD estimated that if Britain could reduce the number of jobless households to Swedish levels (Sweden was the third-best OECD performer), we would shave more than 3 percentage points off our poverty rate.

Here, then, was the logic behind introducing a tax credit linked to employment (the Working Families Tax Credit), and later the Working Tax Credit. The hope was that this would encourage more people to take up jobs and reduce poverty by raising earned incomes as well as benefits in the poorest families

<sup>34</sup> Hirsch D, *Ending Child Poverty in a Changing Economy*, Joseph Rowntree Foundation, 2009

<sup>35</sup> HM Treasury, *Supporting Children through the Tax and Benefit System*, HM Treasury, 1999, pp 10

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# 2

## The Real Cost of Welfare in Britain Today

Despite the size of the welfare bill, the most tragic aspect of the failure to reduce unemployment is the extent to which the unemployed suffer from being out of work. Having a job can give a person social status, a predictable structure around which to organise their life and an environment in which to develop skills. The millions of people who have spent a long time out of work have not just earned less money, but have also lost the chance to construct an independent existence and develop a better future. Employed people exist in an environment full of expectations that gives them access to information about the skills they need, the norms of work, and how they might progress to better pay and conditions.

These aspects of employment are captured in the psychology of work literature. In 1938, two sociologists, Philip Eisenberg and Paul Lazarsfeld, found that during the Great Depression in the United States the longer the period of unemployment, the more "...the individual's prestige is lost in his own eye, and as he imagines, in the eye of his fellow man. He develops feelings of inferiority, loses self-confidence, and in general, loses morale."<sup>36</sup> These effects of recession are being repeated right now.

There are two prominent theories in this body of work: those of Marie Jahoda and Peter Warr. Both look at what employees get as a whole from having a job, i.e. what the routine and expectations of employment do for them, and how workers accrue status and support.

Jahoda claims that jobs provide several hidden benefits: a day-to-day time structure; regular contact with peers; interaction with other people who hold similar goals; feelings of status and identity; and forced activity.<sup>37</sup> To her, the importance of these elements to mental health means that any job is better than none.

Welfare recipients do not get any such benefits. Many are not party to any time structure that demands particular activities every day, so they lose touch with the need to organise themselves. Often, contact with peers means time spent with other claimants, so social interaction does not involve transfers of information that help in the management of a working lifestyle. Being on benefits carries stigma, too.<sup>38</sup>

Warr viewed the benefits of employment as "vitamins" that work in similar ways to the physical nutrients that help the body. Without them, people suffer. To him, being employed meant exposure to nine positive things: opportunity for control; time to use skills; experience of goals set by others; clarity in day-to-day

36 Eisenberg P and Lazarsfeld P, "The psychological effects of unemployment," *Psychological Bulletin*, vol 35, pp 358-390, 1938. Quotes in Goldsmith AH, Veum JR, and Darity W "The impact of labor force history on self-esteem and its component parts, anxiety, alienation and depression," *Journal of Economic Psychology*, vol 17, pp 183-220, 1996, pp 184

37 Jahoda 1982; see Goldsmith AH, Veum JR, and Darity W "The impact of labor force history on self-esteem and its component parts, anxiety, alienation and depression," *Journal of Economic Psychology*, vol 17, pp 183-220, 1996

38 In an interview with the author one benefit claimant said that "I've had a few interviews, it's just I've been out of work two years, they look at the time you've been out of work and they think, 'Oh, what's he been doing?'"

life; the benefits of money; physical security; contact with others; and value from having a social position.<sup>39</sup>

The absence of these things constitutes the real loss of being unemployed. We can count the amount of people out of work, what the state pays to look after them, and how much they could be earning if they were in employment. But other, non-monetary, losses should be kept in mind when discussing welfare policy – the damage of unemployment is much greater than is immediately apparent.

It is particularly damaging to those out of work for a long time. They are more affected by the absence of the benefits of employment than those who are only temporarily without a job. Someone who has been claiming Incapacity Benefit for a few years is likely to have a weaker grasp of, say, the practices required in day-to-day work than a person who has only been receiving Jobseeker's Allowance for a few weeks. The loss of being unemployed is thus greater for the former individual – time exacerbates the damage of being unemployed.

Judging by studies from across the Western world, being unemployed damages the self-esteem held by the people affected, regardless of the country they are in. In a study of the effects of long-term unemployment on the Danish jobless population, Jørgen Goul Andersen, an academic, found that being without work can have a significant effect on the confidence of many people.<sup>40</sup> In 1999, when he asked a group of job-seekers to compare their general well-being to how they felt before they lost their jobs, 31% said that it had got “[m]uch or somewhat worse”, a response rate that increased when only those unemployed for nine years or more were asked. 49% replied that there had been no change, while 20% cited an improvement. When asked to make the same assessment about their self-confidence, only 13% said they felt better. 31% claimed things had got worse.<sup>41</sup>

These results are supported by findings from elsewhere. Three academics, Andrew E. Clark, Yannis Georgellis, and Peter Sanfey looked at data from surveys of employed and unemployed West Germans between 1984 and 1994. They found that the latter had lower life satisfaction than the former, but also that a history of unemployment is important: among male participants, those who were out of work most frequently over a three year period reported less contentment with life than those with less experience of being out of work over the same period.<sup>42</sup>

Low self-esteem can, then, be a problem for people out of work. But other measures suggest that unemployment can also worsen other parts of the psychological make-up of a person. 22% of the unemployed people in the same West German study cited an increase in loneliness (and only 7% claimed a decrease).<sup>43</sup> When asked to cite the biggest personal problem of being out of work, 22% of respondents said “fear of being outside mainstream society”, 28% the “feeling that somebody looks down at you”, 35% the “loss of daily contact with colleagues at the workplace”, and 37% “feeling that one is not the master of one's life.”<sup>44</sup>

Arthur H Goldsmith, Jonathan R Veum and William Darity Jr, three economists who have looked at the psychological effects of unemployment among the young find similar results. They expanded the issue of self-esteem to include other problems such as anxiety and depression and found that the former difficulty was most prevalent among those with the most intense experience of unemployment

39 Warr P, *Work, Unemployment and Mental Health*, Clarendon Press, 1987

40 Andersen JG, ‘Coping with long-term unemployment: Economic security, labour market integration and well-being,’ paper for the ESF/EURESCU conference ‘Labour Market Change, Unemployment and Citizenship in Europe,’ 2001

41 Andersen JG, ‘Coping with long-term unemployment: Economic security, labour market integration and well-being,’ paper for the ESF/EURESCU conference ‘Labour Market Change, Unemployment and Citizenship in Europe,’ 2001, pp 8

42 Clark AE, Georgellis Y, and Sanfey P, ‘Scarring: The psychological impact of past unemployment,’ *Economica*, vol 68, pp 221-241, 2001. Of the participants in their sample, they write “[i]ndividuals exposed to a completed spell of joblessness in the most recent sub period have a significantly lower level of self-esteem than comparable individuals throughout the sample period,” pp 206

43 Andersen JG, ‘Coping with long-term unemployment: Economic security, labour market integration and well-being,’ paper for the ESF/EURESCU conference ‘Labour Market Change, Unemployment and Citizenship in Europe,’ 2001, pp 8

44 Andersen JG, ‘Coping with long-term unemployment: Economic security, labour market integration and well-being,’ paper for the ESF/EURESCU conference ‘Labour Market Change, Unemployment and Citizenship in Europe,’ 2001, pp 13



but that, ultimately, "...the primary mechanism by which joblessness damages an individual's self-esteem is through its contribution to an individual's holding of feelings of depression."<sup>45</sup>

An especially tragic aspect of unemployment is its affect on suicide rates, which are particularly high among the jobless, especially jobless men.<sup>46</sup> A 20-year Edinburgh-based study found that 75% of all suicides involved people who had been out of work for six months or more, meaning the suicide rate was ten times greater among the unemployed than employed.<sup>47</sup>

A significant proportion of those on sickness-related benefits suffer mental-health problems, although this could partly reflect the fact that such conditions are very difficult to diagnose objectively.<sup>48</sup> As a result, the numbers may reflect a desire among some claimants to move onto Incapacity Benefit (now the Employment and Support Allowance for new claimants) in order to avoid the inconvenience of signing on or participating in training schemes. In some cases, however, a period of unemployment might bring on a psychological condition, which then makes the claimant eligible for Incapacity Benefit as well as reducing their overall job prospects.<sup>49</sup>

Despite these negative effects there are several reasons why claimants of Jobseeker's Allowance and Incapacity Benefit might be willing to tolerate such a loss in their overall welfare. Above all, a reasonable level of self-confidence is required if an unemployed person is going to get back into work – employment advisers often cite this as one of the most important determinants in whether someone will make the leap or not.<sup>50</sup> But having the confidence to re-enter the job market can, according to some findings, be strongly affected by the community that someone lives in.

Many claimants live in communities that do very little for their chances of getting employment, because they are surrounded by other unemployed people. In Blaenau Gwent, for example, 27% of the working age population is on benefits, as are 22.3% of the people in Hartlepool.<sup>51</sup> As so much of work is about meeting social norms and gaining non-financial rewards, unemployed people who live in these areas probably face a weaker expectation to seek employment than they would elsewhere.

Andrew Clark, an economist at the University of Chicago, analysed the answers to questions about work that were given by respondents to the British Household Panel Survey in the 1990s. He found that well-being among the 9,461 respondents aged between 16 and 65 in 5,500 households were lower if they lived in communities where lots of other people were unemployed. Ironically, this suggests that a resident of an area with high unemployment is likely to suffer a smaller loss of self-esteem upon unemployment.<sup>52</sup> But when he or she tries to find work, it will be even harder to succeed.

A report in 2000 by the Joseph Rowntree Foundation, *Communities in the Balance: The Reality of Social Exclusion on Housing Estates*, recounted the views of people on housing estates most likely to be excluded from society. Much of what they said supports the findings of Andrew Clark. One 21-year-old male said that "[w]e've been on the dole so long it's hard to get back into the swing of things, so you end up sleeping all day."

David Page, the author of the report, found a strong attachment to work among unemployed young people from families with a history of employment, but

45 Goldsmith AH, Veum JR, and Darity Jr W, 'The impact of labor force history on self-esteem and its component parts, anxiety, alienation and depression,' *Journal of Economic Psychology*, vol 17, pp 183-220, 1996

46 Waddell G and Burton AK, *Is Work Good for your Health and Well-Being?*, TSO, 2006

47 Owen K and Watson N, 'Unemployment and mental health', *Journal of Psychiatric and Mental Health Nursing*, 2, 2, pp 63-71, 1995

48 Kemp P A and Davidson J, *Routes onto Incapacity Benefit: Findings from a Survey of Recent Claimants*, Department for Work and Pensions, 2007

49 Brenninkmeijer V, Houtman I and Blonk R, 'Depressed and absent from work: predicting prolonged depressive symptomatology among employees', *Occupational Medicine*, 58, 4, pp 295-301, June 2008

50 In a conversation with the author, a New Deal adviser at a Jobcentre Plus office said that "If someone does want to look for work then it is a lot easier. We don't get every customer that's going to sit there and [be] willing to participate...it's quite fifty/fifty with some customers. Some customers come to you and they are motivated and for some reason they get thrown off track and...they're not motivated any longer. It can depend ...they could be going for interviews and not being successful and they're wondering where they're going wrong. A lot of the youngsters are set in their ways but you can actually turn them around, and as you build their confidence and you get to know them you can actually work well with them." This is an opinion that welfare-to-work advisers from both the public and private sectors have regularly expressed in conversations with the author

51 [www.nomisweb.co.uk](http://www.nomisweb.co.uk)

52 Clark AE, 'Unemployment as a social norm: Psychological evidence from panel data', *Journal of Labor Economics*, vol 21 no 2, pp 323-351, 2003



53 Page D, *Communities in the Balance: The Reality of Social Exclusion on Housing Estates*, Joseph Rowntree Foundation, 2000, pp 26

54 Page D, *Communities in the Balance: The Reality of Social Exclusion on Housing Estates*, Joseph Rowntree Foundation, 2000, pp 28

55 Waddell G and Burton AK, *Is Work Good for your Health and Well-Being?*, The Stationery Office, 2006

56 The direction of causation from unemployment to illness has been shown to be greater than the inverse. The most exhaustive review of the health and work literature can be found in Waddell G and Burton AK, *Is Work Good for your Health and Well-Being?*. The authors found that the quality of a job and the level of incapacity matter to the experience of employment borne by a person, but for the vast majority of those studied in research work across the UK and US, the value of work was quite clear. They concluded that “...work is better than unemployment for physical and mental health and well-being.” They also found that employment is generally the most important means of obtaining adequate economic resources, which are essential for material well-being and full participation in society; that work meets important psychosocial needs in societies where employment is the norm; that work is central to individual identity, social roles and status; and that employment and socio-economic status are the main drivers of social gradients in physical and mental health and mortality. They also found that unemployment induces higher mortality; poorer general health and long-standing illness; poorer mental health, psychological distress, minor psychological/psychiatric morbidity; and higher levels of medical consultation, consumption of medication and hospital admission rates

57 McClean C et al, *Worklessness and Health – What do We Know about the Causal Relationship?* Evidence Review, NICE, 2005

58 Reinhardt Pedersen C and Madsen M, ‘Parents’ labour market participation as a predictor of children’s health and well-being: a comparative study in five Nordic countries’, *Journal of Epidemiology and Community Health*, 56, pp 861-867, 2002

59 Office for National Statistics, *The Health of Children and Young People*, Office for National Statistics, 2001

worried about the effects of the estate’s culture on them. He wrote that “...these young people with a more positive attitude to work were not helped by the estate culture, which is clearly not conducive to seeking work. Most of them had friends ‘in the same boat’ who appeared content to live on benefit.”<sup>53</sup>

He also found that an estate’s culture had an effect on the perceived acceptability of illegally working while on benefits. In one area with a particularly high number of claimants on Incapacity Benefit there was evidence of people who claimed to be incapable of work actually doing jobs to boost their income. It seemed that doing so did not contradict the general attitude of the estate community or, as one person put it, “[y]es, I’m guilty, on the fiddle. It’s disgusting, but everybody does it.”<sup>54</sup>

Unemployment also significantly affects the health of the people involved. Those of working age not in either work or training are far more likely to suffer ill health than those in employment, even after the figures have been age-adjusted.<sup>55</sup> And while the picture is complex and causation works in both directions (i.e. poor health and/or damaging behaviour can harm employment prospects), it is clear that greater economic participation could greatly improve the lives of a significant proportion of those currently inactive.<sup>56</sup>

Children in jobless households also suffer from relatively poor health. Those born to unemployed fathers have a lower birth weight than average, visit their GP more frequently and are admitted to hospital more often.<sup>57</sup> There is also strong evidence that children in families where neither parent has worked for the previous six months have a higher prevalence of chronic health conditions and lower well-being.<sup>58</sup> The incidence of psychological illness among children whose parents have never worked is nearly twice that of children with parents in low-skilled jobs and about five times higher than children with parents in professional occupations.<sup>59</sup>

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# 3

## The New Priorities for Welfare Reform

The Government may well have not achieved as much as it could have because it did not properly consider the basic questions of welfare reform before it took office. The Institute for Fiscal Studies has written of Labour's approach:

*In opposition and into its first days in Government, new Labour seemed to believe that a radically 'modernised' view of social security was needed...[b]ut aside from a consistent emphasis on encouraging entry into paid work, there seemed little clear idea of what this might mean. Certainly, answers to the most obvious questions in social security policy – How much redistribution is desirable? Should benefits be organised through income-testing, social insurance or some other principle? How can the operation of benefits be improved? – were not forthcoming.*

Because welfare claimants often receive a package of benefits paid in different ways (via means-testing or because of a record of contributions, for example) and from several sources – Jobseeker's Allowance from a Jobcentre Plus, Housing Benefit from their local council and then, when in work, tax credits from Her Majesty's Revenue and Customs (HMRC) – a clear idea of how the interactions between benefit should be managed and on what principles reform should take place are vital.

Without a consistent approach to the way that Britain's social security system should be run, it is difficult to see how the users of it – the benefit claimants – are meant to understand it, nor how reforms that are driven by a particular philosophy (demands on claimants to get jobs, say) can have the maximum effect when they are offset by programmes elsewhere that take a different approach.<sup>60</sup>

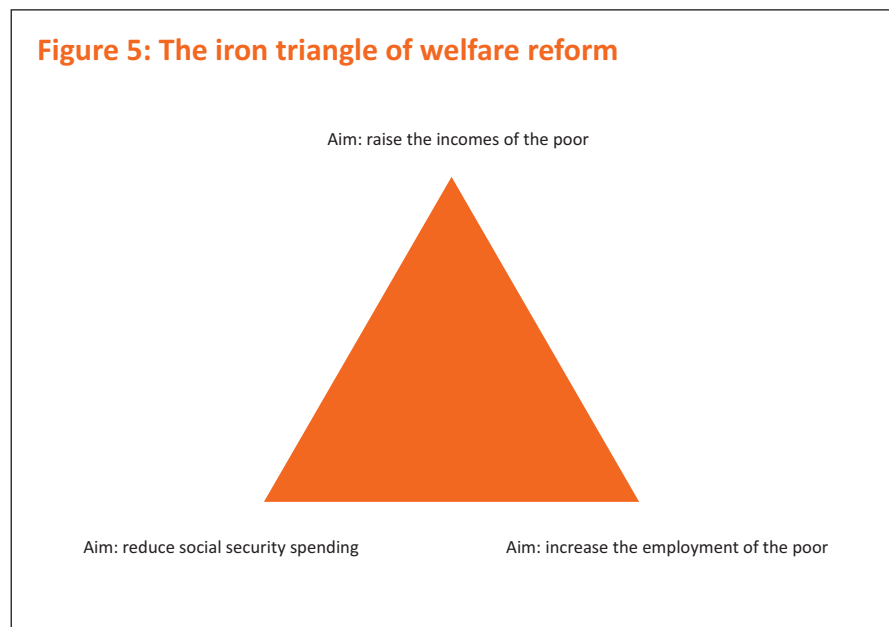
A holistic plan for how reform should proceed is clearly necessary. This report is a first step in developing Policy Exchange's vision of what Britain's social security system should look to achieve and how it should be organised. By looking at financial incentives to work first, this plan can be developed out of one of the basic questions in welfare reform, i.e. whether the money on offer to claimants in a potential transition from welfare to work is enough to encourage work. Given that Britain's levels of unemployment are now so serious, the need for change is even more pressing, regardless of which party is in power. It would be a shame to waste another generation of potentially fruitful development.

Any holistic vision of change to the social security system needs to start by considering what is called the "iron triangle" of welfare reform. Articulated most fully by Richard Blundell of the Institute for Fiscal Studies, it defines the most common objectives – raising the incomes of the poor, reducing social

60 Between 1999 and 2006 alone there were seven changes to the tax and benefits' system for poor families with children. See Brewer M and Browne J, "The Effect of the Working Families' Tax Credit on Labour Market Participation," Institute for Fiscal Studies, briefing note no 69, 2006

security spending and increasing the employment of the poor – welfare reformers have had and shows the constraints on what future reformers might want to achieve.<sup>61</sup> Ultimately, welfare reform is about finding the best balance between these aims.

**Figure 5: The iron triangle of welfare reform**



It is, on the whole, only possible to achieve two of these aims at once, not all three. In a simple sense, giving more money to the poor will give them a better standard of living but cut the amount of extra money that they will gain once in work, thus reducing the likelihood of them looking for it while also increasing the burden on the Exchequer. Alternatively, reducing financial payments to the poor will lower public spending and increase the likely gain from being employed, but will worsen poverty.

Actual reforms can, of course, be a lot more complicated. Labour's introduction of tax credits was a good example of a change that looked to satisfy two sides of the iron triangle. By giving money to people on low wages Labour looked to raise their incomes, but by linking payments, for the most part, to actually having a job and working a certain number of hours, it also tried to encourage recipients to get a job or stay in work. This achieved two objectives but failed on the third, cutting the burden of welfare spending on the state finances – in 2009/10 spending on tax credits is expected to be £29.3 billion.<sup>62</sup>

The three priorities in the iron triangle might not, of course, all be similarly pressing at the same time, although policy-makers are ultimately faced with the need to balance all three. Throughout most of its years in government Labour has been able to emphasise aims other than cutting the fiscal cost of welfare because it has had high tax revenues to spend. Given the likely state of the public finances over the next parliament – the period in which holistic reforms to the welfare system need to start – which parts of the iron triangle are most urgent right now?

61 Blundell R, "Welfare-to-Work: Which Policies and Why?", *Proceedings of the British Academy*, vol 117, pp 477-524, 2002, p 477

62 This is the sum of the "income tax credits" and "tax credit" lines (£6.5 billion plus £22.8 billion respectively) in HM Treasury, *Securing the Recovery: Growth and Opportunity, Pre-Budget Report* December 2009, HM Treasury, 2009

## Raising the incomes of the unemployed poor

Given that many people would undoubtedly be in severe poverty upon becoming unemployed were it not for social security, it is clearly necessary that their incomes be raised above such a level. But by how much should they be raised?

In 2009, Policy Exchange looked at the consequences of using a relative measure of poverty to raise the incomes of the families with children in *Poverty of Ambition: Why we Need a New Approach to Tackling Child Poverty*. We concluded that the relative measure that the government uses is not a sufficient guide to the depth of the poverty that these families face, and that this approach has led to an insufficient focus on the factors that cause poverty. In short, it would be better if the government used absolute measures of deprivation.

The Joseph Rowntree Foundation recently produced a hybrid between these relative and absolute measures by using focus groups to find out the level of income thought necessary for different family types to have enough money to meet their basic material needs and to fully participate in society. For people on benefits, they estimated that the following differences between what claimants get and what they need apply (see Table 2).

**Table 2: A minimum income standard compared to out-of-work benefit income<sup>63</sup>**

	Single working-age person	Pensioner couple	Couple with two children	Lone parent with one child
Minimum income standard (£)	144.51	183.72	349.32	194.76
Difference per week between benefits income and the minimum income standard (£)	-84.01	9.47	-124.52	-61.92

However, a person can, of course, be poor while in work and out of it. On a relative measure of poverty (which is judged by whether someone's income is less than 60% of the median income in the UK) 13.5 million people in Britain were in poverty in 2007/08, the last year of available data.<sup>64</sup> Here, only the "unemployed poor" are analysed because being completely out of work is, as shown by the consequences of unemployment outlined in chapter 2, a particularly pressing concern for welfare reform.

But what objective should we take from the knowledge that British benefits are, for the most part, low? Simply, that cutting poverty relief for the unemployed poor should be avoided unless there are very compelling reasons to do so.

### Objective 1: to not make the unemployed poor financially worse off.

#### Controlling public spending

A significant tightening of the public finances will be necessary over the next few years. A recent Policy Exchange paper, *Controlling Public Spending: The Scale of the Challenge*, estimated that 16% of spending would have to be cut from the budgets of all departments in 2010/11 other than health, education and welfare if the deficit were to be reduced by just £50 billion.<sup>65</sup>

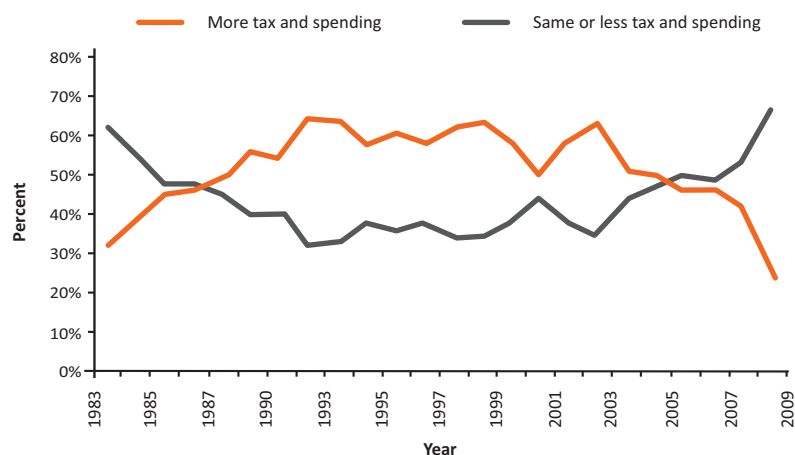
63 Bradshaw J, Middleton S, Davis A, Oldfield N, Smith N, Cusworth L and Williams J, *A Minimum Income Standard for Britain: What People Think*, Joseph Rowntree Foundation, 2009, pp 36

64 [www.poverty.org.uk](http://www.poverty.org.uk)

65 Lilico A, O'Brien N, Atashzai A, *Controlling Public Spending: The Scale of the Challenge*, Policy Exchange, 2009

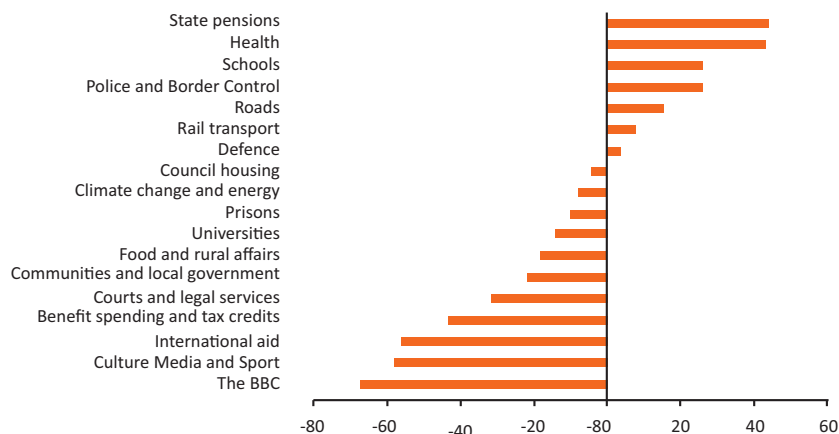
There is significant support for these cuts. When YouGov, on behalf of Policy Exchange, asked 3,215 people in August 2009 what they thought should happen to public spending, there was net support of 41 points for cutting public spending over raising it. If we look at how attitudes to public spending have changed over the years, there has been a marked recent drop in support for extra spending (see Figure 6 below).

**Figure 6: Suppose the government had to choose between reducing taxation and spending, keeping taxation and spending at the same level or increasing taxation and spending, what would you choose?**



When YouGov asked the same people to prioritise areas of government for more or less spending, the benefits bill was cited as a prime candidate for cuts (see Figure 7 below).

**Figure 7: For each of the following areas of spending, say whether you think it should be a priority for more spending, less spending, or that it should stay about the same**



If welfare spending were to be reduced then Britain would be following an approach to fiscal consolidation that has been pursued both here and abroad in the past. Two countries among many that have cut welfare spending during fiscal crises have been Canada between 1994 and 1998 (a now exalted example of how to cut the size of state spending), which shrank its welfare bill by 2.5% as a percentage of total expenditure.<sup>66</sup> Finland did the same thing, but by 4.2% between 1995 and 1998 instead.<sup>67</sup>

Britain has also done similar things during its own fiscal crises. During the fiscal squeeze between 1981 and 1983 the government cut welfare spending in real terms (at 2003 prices) from £73.8 billion to £72.3 billion, or by 0.7% of its total budget.<sup>68</sup>

Despite the relatively low level of income that welfare benefits provide to claimants, the public spending figures, opinion of voters and experience of fiscal consolidations around the world suggest that the social security budget will be a major candidate for spending cuts over the next few years. It is thus clear that the fiscal prudence side of the iron triangle will be much more of a priority for reforms over the next parliament than it has been over the past decade.

## Objective 2: to cut the social security bill.

### Increasing the employment of the unemployed poor

The third side of the iron triangle of welfare reform is essentially about increasing the labour supply, i.e. getting people on benefits into work. Because of the historically low numbers of people claiming Jobseeker's Allowance before the recession, claimants of Income Support (particularly lone parents) and Incapacity Benefit have been the focus of much of this effort since 1997.

To encourage lone parents to work, the government will require them (from 2010) to look for jobs (and thus receive Jobseeker's Allowance rather than Income Support) once their child is 7. In 2008 they were only required to do so once their child was 12.<sup>69</sup> By doing so the government hopes that the parents affected will, by getting work earlier in their child's life, avoid the consequences of effectively being unemployed for years. The New Deal for Lone Parents was also part of this effort.

Pathways to Work, a scheme which aims to give claimants of Incapacity Benefit practical help to find work, has been one of the government's main programmes for encouraging a population of people that have mostly been out of work for years to take steps back into employment.<sup>70</sup> Because the Government suspected, rightly, that many people were getting on to the benefit even though they had a condition which did not render them completely incapable of work, it introduced the Employment and Support Allowance in October 2009.<sup>71</sup>

Now that there are around 5.8 million people claiming benefits and just over 1.6 million of them on Jobseeker's Allowance, this focus will change over the next few years.<sup>72</sup> The government has responded to the growth of unemployment with short-term measures such as the Young Person's Guarantee, which provides anyone between 18 and 24 who has been claiming Jobseeker's Allowance for 12 months with a job, training or place on a community development scheme.<sup>73</sup> But the party that wins the next election will still be faced with having to try and get many people who are very capable of work back into employment too.<sup>74</sup>

66 White M, "Taking an Axe to Public Spending the Canadian Way," *The Guardian*, 8 July 2009

67 Lilico A, Holmes E and Sameen H, *Controlling Spending and Government Deficits: Lessons from History and International Experience*, Policy Exchange, 2009

68 Lilico A, Holmes E and Sameen H, *Controlling Spending and Government Deficits*, Policy Exchange, 2009

69 From November 2008 lone parents were required to look for work once their youngest child reached 12 years of age. Since October 2009 lone parents have had to do the same thing once their youngest child reached 10 years of age. From October 2010 lone parents will be required to look for work once their youngest child is 7 years of age. See [www.jobcentreplus.gov.uk](http://www.jobcentreplus.gov.uk) for details

70 Nice K, Irvine A and Sainsbury R, *Pathways to Work from Incapacity Benefits: A Study of Experience and use of the Job Preparation Premium*, Department for Work and Pensions, 2009 for more details

71 See Disability Alliance, *ESA: Employment and Support Allowance, 2008-2009*, Disability Alliance, 2008 for more details

72 [www.nomisweb.co.uk](http://www.nomisweb.co.uk)

73 See <http://research.dwp.gov.uk/campaigns/futurejobsfund/youngpersons.asp> for further details

74 The Young Person's Guarantee is meant to give all 18 to 24-year-olds who have been on Jobseeker's Allowance for 12 months or more, work-focused training, or a place in a community work scheme. One of, but not the least, of the costs of this scheme is that it replicates spending that is already going to companies providing the Flexible New Deal. See <http://research.dwp.gov.uk/campaigns/futurejobsfund/youngpersons.asp> for details

Resources will determine how this shift plays out, but it is obvious that getting people back into work will be the utmost priority for any government. Doing so will not just mean lower social spending bills, but also fewer people suffering from the ill-effects of unemployment.

**Objective 3: to increase employment among the unemployed poor.**

**Financial incentives and the new priorities for welfare reform**

Alleviating the poverty of those who become unemployed should remain a priority for welfare reform over the next few years. However, because of the recent surge in unemployment and the known ill-effects of being out of work for a long time the government should focus on making work pay. Furthermore, because of the inevitable cuts in state spending, this should happen while making no more demands on the public purse.

Recently, the Centre for Social Justice produced a report, *Dynamic Benefits*, that looked at the incentives for people on benefits to work. It concluded that Britain's social security system should be changed so that claimants have their benefits withdrawn, after tax, at a rate of 55%. This conclusion is a very useful addition to the discussion of what to do about work incentives, and the thoroughness of the report a benchmark for how to look at what welfare reform should be about.<sup>75</sup>

This report will identify the most pressing financial problems that claimants face when considering work, show how savings can be made to deal with these problems, and make recommendations that can be implemented now to both deal with the new priorities of welfare reform and make the holistic change of the next decade possible.

75 Centre for Social Justice, *Dynamic Benefits: Towards Welfare that Works*, Centre for Social Justice, 2009

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# 4

## Financial Incentives to Work in Britain's Welfare System

### Using case studies to reveal the financial decisions faced by claimants

As the Government has shown with its use of Pathways to Work and the Flexible New Deal to try and get benefit claimants back to work, there are different ways of satisfying the aims of the welfare reform iron triangle, but there is only one issue that sits at its heart: how much claimants receive in benefits and what the difference between that amount and what they might earn in a job does for their likelihood of seeking work.

There are several different techniques that are often used to analyse the incentives to work that benefit claimants face. Each one is explained below, but they are all essentially a delineation of the most important question that people on welfare ask: “How much more money will I get if I take a job rather than stay on benefits?”

To see how this question plays out across the actual range of people who claim welfare, it would be necessary to look at the incomes on social security of lots of different people and then compare such figures to what the same people might earn in work. It would be very difficult to undertake such an endeavour, so this report uses the next best thing: approximations of what most benefit claimants receive.

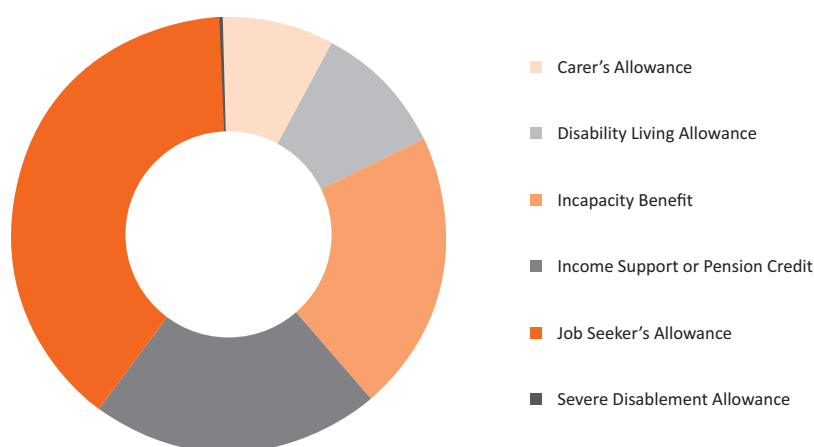
The 5.8 million people in total who claim out-of-work benefits is a count of everyone, including those who receive more than one type of support – for example, people who get Incapacity Benefit and Disability Living Allowance. But most claimants in Britain's social security system receive a standard set of benefits. The easiest way to assess this is by looking at the number of people who claim just one of the main benefits.

A count of the people who just claim one main benefit gives a breakdown as shown by Figure 8. 81.5% of claimants receive one of Jobseeker's Allowance, Incapacity Benefit or Income Support and its related payment, Pension Credit. By looking at just these three schemes it is possible to gain meaningful insight into the work incentives faced by the majority of people on benefits.

“There are different ways of satisfying the aims of the welfare reform iron triangle, but there is only one issue that sits at its heart: how much claimants receive in benefits and what the difference between that amount and what they might earn in a job does for their likelihood of seeking work”



**Figure 8: Working-age claimants of one main benefit only, United Kingdom, May 2009<sup>76</sup>**



This report thus looks at people claiming Jobseeker's Allowance, Income Support and a combination of Incapacity Benefit and the Employment and Support Allowance. The other benefits, such as Disability Living Allowance, are ignored because the health issues involved in claiming them are much too complicated for an analysis of financial work incentives to explain very much.

These core benefits also give licence to claim two other forms of help, Council Tax Benefit and Housing Benefit. Payments from these two schemes are thus included in each of the case studies.

In each of the case studies the claimants in question receive the headline, income-based rate of the benefit, as advertised on the government websites such as [www.direct.gov.uk](http://www.direct.gov.uk).<sup>77</sup> People on Jobseeker's Allowance and Incapacity Benefit/the Employment and Support Allowance can receive money according to their record of being in work and making National Insurance contributions, but income-based calculations are used for the sake of simplicity. All of Britain's in-work and out-of-work benefits are explained in Box 2.

"Claimants" are not single people with no children and all of a similar age. In order to capture the incentives faced by a young mum on Income Support, for example, there is a relevant case study that includes the benefits for her children that she will receive such as Child Benefit and Child Tax Credit. All of the other case studies are varied by the requirements for the different rates in each benefit. So, for example, there is a case study for someone under 25 who is only eligible for the youth rate of Jobseeker's Allowance (£50.95), another that shows the work incentives faced by couples making a joint claim for benefits, and a further one that looks at the situation faced by someone on what was Incapacity Benefit and is now the Employment and Support Allowance.

The trickiest part of showing the rates of payment that typical claimants get is not actually in identifying the benefits they qualify for, but in deciding how much they receive from the two payments most volatile to regional circum-

<sup>76</sup> [www.nomisweb.co.uk](http://www.nomisweb.co.uk)

<sup>77</sup> As of February 2009, there were under 10,000 Jobseeker's Allowance claimants receiving £20 per week; 17,940 receiving between £20 and £40; 392,010 receiving between £40 and £60; 751,210 receiving between £60 and £80; 106,200 receiving between £80 and £100; 12,610 receiving between £100 and £150; 4,220 receiving over £150; 98,140 receiving nothing at all; and 29,420 receiving an unknown payment. In the same month there were 138,420 Income Support claimants receiving under £20; £199,070 receiving between £20 and £40; 179,490 receiving between £40 and £60; 611,140 receiving between £60 and £80; 481,650 receiving between £80 and £100; 263,760 receiving between £100 and £150; 169,690 receiving over £150 and a few thousand receiving an unknown payment. See Department for Work and Pensions, *Tabulation Tool*

stances, Housing Benefit and Council Tax Benefit. Rates of Housing Benefit paid across the country can vary substantially by where a claimant lives and what they need from their home.<sup>78</sup>

To make the case studies as demonstrative as possible of what claimants receive, each one is given the minimum Housing Benefit and Council Tax Benefit rates available (if they got more there would be even greater adverse effects on incentives to work). For Housing Benefit the rates paid are those in the middle of the range and are from an area, Birmingham, where claims for these benefits are running at some of the highest rates in the country.

**Table 3: Top ten local authorities by expenditure on Housing Benefit, 2007/08 (£, thousands)<sup>79</sup>**

Birmingham	338.3
Glasgow City	282.2
Newham	253.0
Haringey	216.6
Brent	201.0
Hackney	190.4
Liverpool	190.0
Westminster	188.8
Lambeth	183.7
Tower Hamlets	180.2

For the calculation of Council Tax Benefit, the case studies are assumed to be living in a band A listed property (i.e. to be in the cheapest type of housing as per its market value) and to be receiving all applicable discounts. So, a single person over the age of 25 who is living in a bedsit in Birmingham would be allowed a 25% discount on the normal rate applied to the property of £728.60.<sup>80</sup> Across all the case studies the claimants are assumed to be taking, in full, all the benefits available to them (including tax credits, where applicable).

**Table 4: Top ten local authorities by expenditure on Council Tax Benefit, 2007/08 (£, thousands)<sup>81</sup>**

Birmingham	87.9
Glasgow City	73.8
Liverpool	53.2
Leeds	43.1
Manchester	41.4
Sheffield	40.7
Haringey	34.9
Bristol, City of	33.3
Bradford	32.3
Hackney	31.4

78 In September 2009, according to the Valuation Office Agency, "Local Reference Rents", from which entitlement to Housing Benefit is taken, range from £160 in central London for one room with shared facilities to £63 in Rotherham for the same conditions. The average rate across the country is £66.55. See <http://www.voa.gov.uk/publications/LocalRefRents/Irr-090930.htm> for details

79 Department for Work and Pensions, *Benefit Expenditure Tables*

80 [www.birmingham.gov.uk](http://www.birmingham.gov.uk)

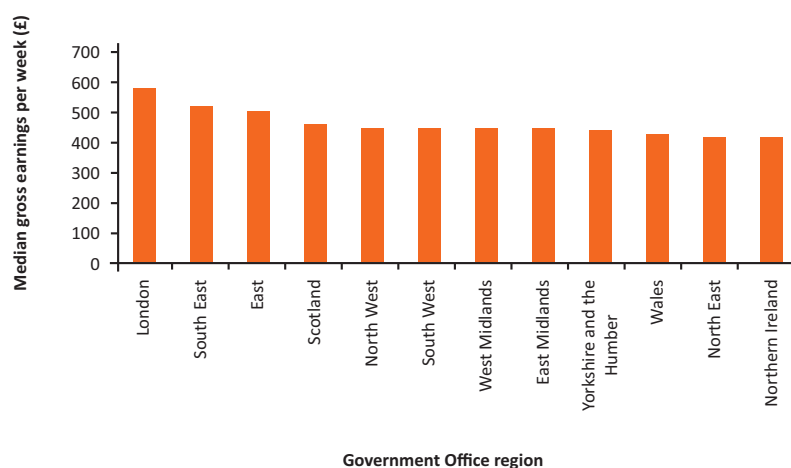
81 Department for Work and Pensions, *Benefit Expenditure Tables*

In total, there are nine case studies:

1. A single person under 25 years of age claiming Jobseeker's Allowance.
2. A single person over 25 years of age claiming Jobseeker's Allowance.
3. A couple over 25 years of age claiming Jobseeker's Allowance.
4. A couple over 25 years of age, with one child under 7 years of age, claiming Jobseeker's Allowance.
5. A couple over 25 years of age, with two children under 7 years of age, claiming Jobseeker's Allowance.
6. A single person over 25 years of age, with one child under 7 years of age, claiming Income Support.
7. A single person over 25 years of age, with two children under 7 years of age, claiming Income Support.
8. A single person over 25 years of age claiming the Employment Support Allowance and in the Work-Related Activity Group.
9. A single person over 25 years of age claiming the Employment Support Allowance and in the Support Group.

The flip-side to how much income someone receives out of work is, of course, the amount of money they receive in work. When they leave benefits and find a job some former claimants will enjoy good rates of pay. However, many will be competing for low-skilled, and thus low-paid, work, particularly those who have been on Incapacity Benefit for many years.<sup>82</sup> Figure 9 and Figure 10 highlight how wages can vary substantially across the country, as can the number of jobs available.

**Figure 9: Gross weekly pay by region, 2008<sup>83</sup>**



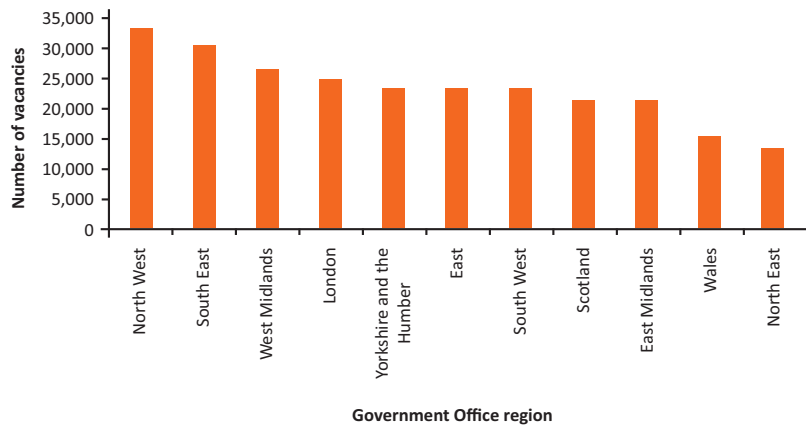
<sup>82</sup> In a survey of people who had made at least one previous claim for Jobseeker's Allowance, 40% of the people who had recently left benefits were in jobs paying less than £5 per hour. The average wage for the group was £6.36. See Carpenter H, *Repeat Jobseeker's Allowance Spells*, Department for Work and Pensions, 2007, pp 40. At the time people aged 22 and over were entitled to a minimum wage of around £5

<sup>83</sup> [www.nomisweb.co.uk](http://www.nomisweb.co.uk)

<sup>84</sup> The current rates of the National Minimum Wage are £3.57 for all workers under 18 years of age, £4.83 for all workers between 18 and 21 years of age, and £5.80 for all workers over 22 years of age. See <http://www.hmrc.gov.uk/nmw/> for further details

The minimum wage makes a comparison between what claimants get when out of work and what they will get as a minimum in work straightforward. Each case study thus has unemployment income compared to work income over a normal range of working hours, 0-40 per week, at the minimum wage.<sup>84</sup>

**Figure 10: Number of Jobcentre Plus vacancies by region, September 2009<sup>85</sup>**



However, there are two important caveats to using the minimum wage for comparison: many people who should be receiving it are actually getting wages below the legal rate, and people on benefits can earn money from the black market, something which would lessen their financial gain from working in a legal job.<sup>86</sup> In 2008 the National Audit Office calculated that £1.5 billion was being lost in tax revenue through people across the economy, i.e. including those not on any benefits, either declaring no income or only some of it.<sup>87</sup>

The illegal wage phenomenon has been analysed by Mike Brewer of the Institute for Fiscal Studies.<sup>88</sup> In 2007 he estimated that between 230,000 and 340,000 people were being paid wages below the minimum wage. This must be kept in mind in the analyses below, as must the question of undeclared wages (an issue which is much more difficult to measure, for obvious reasons).

All the calculations of how much someone is receiving in and out of work have been undertaken using the Lisson Grove Benefits Program, a benefits calculator used by professional welfare advisers at organisations such as the Citizens Advice Bureau to show claimants how their circumstances will change if they take work.

## How to analyse the work incentives faced by benefit claimants

The answer to the claimant's question of "How much will I earn if I get a job?" obviously depends on how much the job pays and how many hours the claimant works per week. But the rates at which the benefits being received are withdrawn and taxes are levied against basic earnings also matter. The sum of this equation is called the "budget constraint". Each one of the case studies has been subjected to this measure for zero to 40 hours of work per week. In the case studies, the results are shown against gross income so that it is easy to see the difference between what someone is being nominally paid and what they actually receive.

<sup>85</sup> [www.nomisweb.co.uk](http://www.nomisweb.co.uk)

<sup>86</sup> Much of the time this is referred to as "benefit fraud" which, to some extent, it clearly is. However, one might also take the view that Britain's social security system is so complex that people doing normally legitimate work might be encouraged to declare it if they trusted the system more. This is the view taken by the *Need not Greed* campaign (<http://www.neednotgreed.org.uk/>) and others

<sup>87</sup> National Audit Office, HM Revenue and Customs: Tackling the Hidden Economy, National Audit Office, 2008

<sup>88</sup> Brewer M, Welfare Reform in the UK: 1997-2007, Institute for Fiscal Studies, 2007

For the purposes of analysing financial work incentives, the budget constraint actually gives only a crude analysis. To know much more about what claimants face, it is necessary to delineate the answer to the claimant's basic question into two other questions, which are "How much will I get if I work for a certain number of hours per week, compared to the benefits I get now?"

“If someone receives £100 per week in benefits, then finds a job that pays £200 a week, but ends up with only £150 of final income, they have paid a tax rate on their earnings of 75%. Clearly, the higher the rate the lower the financial incentive to work”

and "How much will I get if I decide to work a few more hours after that?". These two questions are the basis of analysing the financial incentives to work and are the incentive to work at all and the incentive to work more.<sup>89</sup>

A concept called the "participation tax rate" helps with the analysis of what incentive claimants have to work at all.<sup>90</sup>

This compares the total income that a claimant receives when out of work with the total income that they receive in work at a certain number of hours. Crucially, it also takes into account the total income that the person receives when employed before they have paid any taxes or relinquished any benefits. This means that if someone receives £100 per week in benefits, then finds a job that pays £200 a week, but ends up with only £150 of final income, they have paid a tax rate on their earnings of 75%. Clearly, the higher the rate the lower the financial incentive to work.

If the same person decides to take the job, which requires 20 hours of work from them a week, but is then offered more hours by their employer, they again need to know how much they will earn. However, this time, having taken the original decision to work they are now interested in a marginal change – how much an extra hour or extra few hours will pay. They are considering the financial incentive to work more, which is analysed by the "marginal effective tax rate."<sup>91</sup>

Like the participation tax rate, the marginal effective tax rate compares total income at a given number of hours (20, in this example) with total income when working for another hour (21 hours) and works out how much of the basic pay earned by the person has been lost to the withdrawal of benefits and levying of taxes. Again, the higher the rate the lower the incentive to work. Clearly, in both methods of analysis, tax credits will lessen the rate at which a percentage of income is being lost.

The financial costs of work are also factored into each case study. In its attempt to establish what a minimum income should be, the Joseph Rowntree Foundation calculated estimates for the travel and clothing budget that a person would need in order to achieve a certain basic standard of living. As the consideration of this budget included up-to-date calculations of the costs borne by working, the figures are used to take money away from the wages earned from a job as a way of showing how much work really costs and thus how much someone on benefits would have to earn before they make a real financial gain.

The first hour worked incurs all of the costs. In the absence of good data showing how people on low pay approach their work costs, this is probably the most realistic way to calculate how they do so. A bus pass, for example, needs to be paid

89 See Adam S. Brewer M and Shephard A, *Financial Work Incentives in Britain: Comparisons over Time and Between Family Types*, Institute for Fiscal Studies, 2006 for a recent in-depth discussion of these concepts

90 Formula:  $1 - ((\text{net income in work} - \text{net income out of work}) / \text{gross earnings})$

91 Formula:  $1 - (\text{change in total income} / \text{change in gross income})$

for at the beginning of a work week. It is also likely that work clothing will be bought at around the same time. Both of these costs are, in a sense, fixed.

This method of calculating work costs shows a plausible way of how claimants might behave, but the downside to it is that it only reflects the situations faced by people who are intending to work for more than a few hours – about 10, say. It is implausible that someone only working for a few hours per week would approach their work costs in the same way as a person with plans to work more. *The work cost calculations in the case studies thus only approximate the scenarios faced by people who want to work for more than a few hours a week and bear similar costs whether they work for, say, 10 hours or 40.*

In all of the Income Support, i.e. lone parent, case studies the people in question are assumed to either not be paying for childcare or to have all of their childcare costs defrayed by the Childcare Element of the Working Tax Credit. This is because in some cases grandparents and other family members may take care of the children for free, but also because the grant of help for the costs of looking after children are then spent on those costs, thus making the sense of “withdrawal” meaningless. Table 6 shows the range of childcare costs across the population.

**Table 5: Amounts paid by families for childcare, per hour, by type of care<sup>92</sup>**

Provider type	Median (£)	Mean (£)
All	1.50	2.18
Nursery school	1.95	2.63
Nursery class	0.29	1.81
Day nursery	3.71	4.09
Playgroup or pre-school	1.74	2.04
Childminder	3.81	4.78
Nanny or au pair	5.00	6.62
Babysitter who visits home	2.88	3.59
Breakfast or after-school club on school site	2.40	3.61
Breakfast or after-school club not on school site	2.77	4.73
Grandparent	1.30	3.04
Friend or neighbour	3.01	3.91

## Box 2: Britain's benefit system

### *Jobseeker's Allowance<sup>93</sup>*

Anyone under the state pension age who is unemployed or working for less than 16 hours per week is, as long as they are capable of work and looking for it, eligible for Jobseeker's Allowance. It is paid in two ways, through a “contribution-based” method and an “income-based” calculation. The rates paid by the two systems are, for many claimants, nearly identical, but someone becomes eligible for the former by having paid a sufficient amount of National Insurance Contributions in the years before a claim, while they qualify for the latter by not having sufficient income to support themselves. Unemployed 16 and 17-year-olds can also receive the benefit via the income-based stream if they have been

92 Speight S, Smith R, La Valle I, Schneider V, Perry J, Coshall C and Tipping S, *Childcare and Early Years Survey of Parents 2008*, Department for Children Schools and Families, report no RR136, 2009, pp 71

93 See the relevant pages of the Jobcentre Plus website for details: [http://www.jobcentreplus.gov.uk/JCP/Customers/WorkingAgeBenefits/Dev\\_015272.xml.html](http://www.jobcentreplus.gov.uk/JCP/Customers/WorkingAgeBenefits/Dev_015272.xml.html)

forced to live away from home, do not have enough money to look after themselves, or are part of a couple looking after a child. The payment rates are as follows:

In the contribution-based payment system:

- For claimants aged between 16 and 24: £50.95 per week.
- For claimants aged 25 or over: £64.30 per week.

In the income-based payment system:

- For single claimants aged between 16 and 24: £50.95 per week.
- For single claimants aged 25 or over: £64.30 per week.
- For claims by people in a partnership who are both aged 18 or over: £100.95 per week.
- For claims by lone parents who are younger than 18: £50.95 per week.
- For claims by lone parents who are 18 or older: £64.30 per week.

An income-based claimant does not qualify for anything if they have savings over £16,000. Furthermore, if a claimant's partner works for more than 24 hours per week on average, they will not be able to claim. If their partner works for less than 24 hours, the amount they receive may also be affected. None of these three stipulations apply to the contributions-based method of paying Jobseeker's Allowance.

For someone moving from welfare to work, the first £5 of earnings for both types of Jobseeker's Allowance is disregarded (for a couple making a claim £10 is disregarded). After this any money earned is withdrawn from the benefit claim. *Thus, on everything but the first £5 of earnings, claimants face a 100% withdrawal rate on the benefit on their earnings.*

#### *Income Support<sup>94</sup>*

People who have low incomes but are not thought of as appropriate claimants of Jobseeker's Allowance (because they are sick or disabled; a lone parent with a child under 7 (according to the new rules); a carer; or are blind) can claim Income Support. They must also be between 16 and 59 years old, not in full-time study, not have savings in excess of £16,000, and not be working for more than 16 hours per week. It is essentially paid at the following rates:

- For single people between the ages of 16 and 17: £50.95 per week.
- For single people between the ages of 18 and 24: £50.95 per week.
- For single people aged 25 or over: £64.30 per week.

For couples where both people are aged 18 or over: £100.95 per week. Where one or both claimants is under 18, the rate is calculated according to their personal circumstances.

- For lone parents between the ages of 16 and 17: £50.95 per week.

Like Jobseeker's Allowance, anything earned after the earnings disregard of £20 will be deducted from the benefit. *The withdrawal rate for this benefit for people moving into work is thus, for most hours worked, 100%.*

<sup>94</sup> For further details, see [http://www.jobcentreplus.gov.uk/JCP/Customers/WorkingAgeBenefits/Dev\\_015271.xml.html](http://www.jobcentreplus.gov.uk/JCP/Customers/WorkingAgeBenefits/Dev_015271.xml.html)

*Incapacity Benefit*<sup>95</sup>

Before the October 2008 change which stipulated that all new Incapacity Benefit claimants must apply for the Employment and Support Allowance instead, the health requirements for receiving Incapacity Benefit were as follows:

- That the claimant had been paying National Insurance Contributions before the claim.
- That the claimant was unable to work due to illness for more than four days in a row.
- That the claimant was unable to work for two or more days out of seven consecutive days.
- That the claimant was receiving medical treatment.

If the claimant did not qualify by these measures, then they could retain eligibility by meeting the following criteria:

- That they had been too ill to work for at least 28 weeks.
- That they were too ill to work before they turned 20 (or 25 if they had been in training or education for three months before their twentieth birthday).

Incapacity Benefit is paid at the following rates:

- A short-term (low) rate for people under the State Pension age, paid for the first 28 weeks of a claim: £67.75 per week.
- A short-term (low) rate for people over the State Pension age, paid for the first 28 weeks of a claim: £86.20 per week.
- A short-term (high) rate for people under the State Pension age, paid from weeks 29 to 52 of a claim: £80.15 per week.
- A short-term (high) rate for people over the State Pension age, paid from weeks 29 to 52 of a claim: £89.80 per week.
- A long-term "basic" rate for all claimants under the State Pension age, paid after week 53 of a claim: £89.80 per week. People over the State Pension age are not eligible for any part of this rate.

There are also "age-additions" for certain types of claimant. People who are on the long-term rate of the benefit and were under 35 on the first day of their claim may receive an extra £15.65 per week. People between 35 and 44 on the first day of their claim may receive an extra £6.55 per week.

Furthermore, if a claimant is entitled to the long-term rate of Incapacity Benefit and was under the age of 35 on their first day of claiming, they may receive an Age-Related Addition of £16.50 per week. If they were under the age of 45 on their first day of claiming, then they may receive an Age-Related Addition of £8.25 per week.

As with Jobseeker's Allowance and Income Support, people receiving Incapacity Benefit are, for the most part, only allowed to work for 16 hours (there are regulations called the "permitted work rules" that allow claimants to earn a generous amount

<sup>95</sup> Descriptions and figures taken from the government's main website for information about benefits and services, [www.direct.gov.uk](http://www.direct.gov.uk). For details on IB, see [http://www.direct.gov.uk/en/DisabledPeople/FinancialSupport/DG\\_10016082](http://www.direct.gov.uk/en/DisabledPeople/FinancialSupport/DG_10016082)



before losing their benefit, but these do not apply to the whole population of claimants). However, whereas payments of the other two benefits are small enough to be exhausted by a pound-for-pound withdrawal rate before the 16 hours threshold applies, payments from Incapacity Benefit are too big to be exhausted by the same rate. Thus, when a claimant gets to 16 hours of work, they lose a final tranche of money. *This means that after the initial earnings disregard of £20 or more (depending on circumstances), most claimants of Incapacity Benefit face a withdrawal rate that is 100% or higher.*

#### *Employment and Support Allowance<sup>96</sup>*

The Employment and Support Allowance was introduced in October 2008 for all new claimants of Incapacity Benefit, i.e. anyone who wanted to start claiming Incapacity Benefit after that date would go on to the Employment and Support Allowance instead. In order to get the benefit, claimants must first go through a 13-week “assessment phase” during which their ability to work is analysed. After this period they are either put into the “Work-Related Activity Group”, which means they are capable of work but need help with a health problem, or the “Support Group”, which means they have no capacity for employment. Everyone in the former group must attend six work-focused interviews. The rates of payment in the benefit are as follows:

#### Assessment phase:

- For people under 25: £47.95 per week.
- For people over 25: £60.50 per week (on the contributions-based half of the benefit)

#### Main phase:

- Work-related activity addition: £24 per week.
- Support addition: £29 per week.

On top of these basic parts of the benefit there are also a plethora of add-ons available for being severely disabled or of a particular age.

As with Incapacity Benefit there are regulations called the “permitted work rules” that allow claimants to earn a generous amount before 100% of extra earnings are withdrawn. *The withdrawal rate is thus 100%.*

#### *Housing Benefit<sup>97</sup>*

Like the qualifications for Council Tax Benefit, Housing Benefit is paid to people on low incomes who do not have capital of more than £16,000 (although those that violate this stipulation but receive the “guarantee credit” part of the Pension Credit are eligible). Students, asylum-seekers, and those who live in the home of a close relative are disqualified from claiming. Only one person in a couple can claim, and people under-25 can only claim for the Local Housing Allowance single room rate regardless of the property they are in.

<sup>96</sup> Disability Alliance, *ESA: Employment and Support Allowance, 2008-2009*, Disability Alliance, 2008,

<sup>97</sup> Descriptions and figures taken from the government’s main website for information about benefits and services, [www.direct.gov.uk](http://www.direct.gov.uk). For details on HB, see [http://www.direct.gov.uk/en/MoneyTaxAndBenefits/BenefitsTaxCreditsAndOtherSupport/On\\_a\\_low\\_income/DG\\_10018926](http://www.direct.gov.uk/en/MoneyTaxAndBenefits/BenefitsTaxCreditsAndOtherSupport/On_a_low_income/DG_10018926)

The amount someone receives in Housing Benefit is calculated according to their “eligible rent”, which means the rent they are paying for their accommodation, plus any services, such as lift or communal area charges, that go with it. Utility bills are not paid for. The amount received also depends on the income and savings of the person and their partner, as well as their family circumstances, such as whether there is a person at home who can help with the housing costs. A council will also consider whether the rent is reasonable for the size of the home, the size of the family, and the area.

Since April 2008, the government has been using a new scheme to pay Housing Benefit to new claimants and anyone on the benefit that moves from one place to another: the Local Housing Allowance. It is paid according to a set rate in the area where a claimant lives, plus how large the person's household is and how many people live in the accommodation being claimed for. It is only paid for accommodation rented from the private sector.

Rates of Local Housing Allowance are set according to the median rent levels in “Broad Market Rental Areas” every month. In late April 2009, for example, the benefit available for a one bedroom home with shared facilities was £68.00 per week in Sheffield and £78.46 in Exeter.<sup>98</sup> Claimants are allowed to keep up to £15 of any rent amount that is lower than these rates, but must pay any excess if they find more expensive accommodation.

Housing Benefit is withdrawn, post-tax, at a rate of 65p for every £1 earned. *Claimants of Housing Benefit thus face a 65% withdrawal rate on the benefit.*

#### *Council Tax Benefit<sup>99</sup>*

Council Tax Benefit can be claimed by people on low incomes who have savings and investments that are worth less than £16,000, although recipients of the “guarantee credit” part of the Pension Credit are exempt from these stipulations. The benefit is paid as a reduction on the full bill that a person would normally have to pay. Cuts of up to 100%, which are most likely when someone is receiving Income Support, income-based Jobseeker's Allowance and the aforementioned Pension Credit, are possible.

In assessing eligibility for the benefit, a local council will consider the income and savings of a claimant and their partner, and take into account the family circumstances behind the claim, such as the ages of any children and whether there is another person in the household who can help with housing costs.

A person who is sharing a home with the claimant, but is not their partner, can ask for the Second Adult Rebate, which is a set percentage reduction levied according to circumstances. The person is eligible for the rebate if they are aged 18 or over; not paying rent to the claimant; not paying Council Tax; and are on a low income. It is set at the following rates:

- For people on Income Support, income-based Jobseeker's Allowance, or Pension Credit: 25% reduction.
- If the person's gross weekly income is less than £175.00: 15% reduction.
- If the person's gross weekly income is between £175.00 and £227.99: 7.5% reduction.

Council Tax Benefit is withdrawn, post-tax, at a rate of 20p for every £1 earned. *Claimants of Council Tax Benefit thus face a 20% withdrawal rate on the benefit.*

<sup>98</sup> Figures correct as of 28 April 2009. See <https://lha-direct.therentservice.gov.uk/Secure/Default.aspx> for details

<sup>99</sup> Descriptions and figures taken from the government's main website for information about benefits and services, [www.direct.gov.uk](http://www.direct.gov.uk). For details on CTB, see [http://www.direct.gov.uk/en/MoneyTaxAndBenefits/BenefitsTaxCreditsAndOtherSupport/On\\_a\\_low\\_income/DG\\_10018923](http://www.direct.gov.uk/en/MoneyTaxAndBenefits/BenefitsTaxCreditsAndOtherSupport/On_a_low_income/DG_10018923)

### Child Benefit

Child Benefit is paid to all families with children. "Child" can mean either someone under 16, or 17 if they are in certain types of work or training. No tax is levied against the benefit.

£20 per week is paid to families for their eldest child, and £13.20 for each other child. *Because the benefit is paid at a flat rate and there are no restrictions on who can receive it, it is not withdrawn as claimants earn money.*

### Working Tax Credit and Child Tax Credit<sup>100</sup>

The calculation of an entitlement to tax credits is very complicated. At base, the level of payment is related to the amount of income someone has and the different parts of the scheme that they are entitled to. The final amount of a claim will constitute an amalgam of the following elements:

#### Child Tax Credit (per year)

Family element: £545

Child element: £2,235

Disability element: £2,670

Severe disability element: £1,075

#### Working Tax Credit (per year)

Basic element: £1,890

Couples and lone parent element: £1,860

30-hour element: £775

Disability element: £2,530

Severe disability element: £1,075

Return-to-work payment for the over 50s: £1,935

Childcare element: £175 maximum for one child, £300 maximum for two children

Tax credits are, for the most part, withdrawn at a rate of 39p for every pound earned. *Claimants of tax credits thus face a withdrawal rate of 39%.*

## The case studies

Case study 1: A single person under 25 years of age claiming Jobseeker's Allowance.

### Income Breakdown

Jobseeker's Allowance: £50.95

Housing Benefit: £61.00

Council Tax Benefit: £10.47

Total out-of-work social security income: £122.42

- Total income when working 16 hours per week: £132.95 (total change against benefit income: £10.53). Total income when working 16 hours per week (after work costs): £109.35 (total change against benefit income: -£13.07).

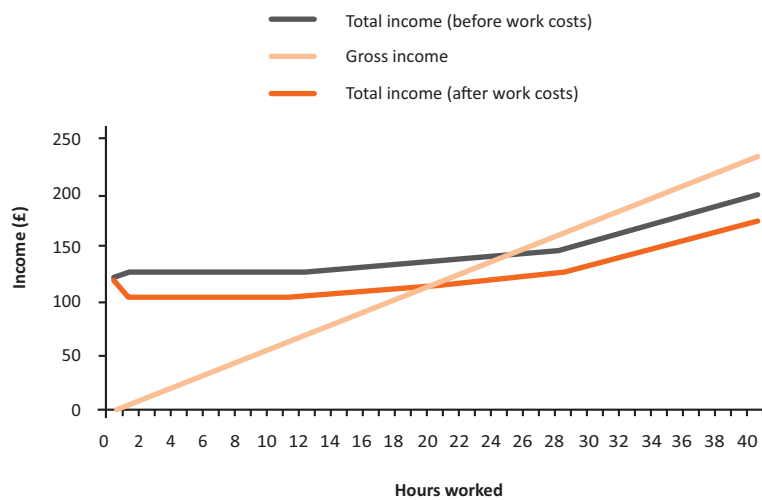
100 HMRC, see <http://www.hmrc.gov.uk/taxcredits/payments-entitlement/entitlement/how-worked-out.htm>

- Total income when working 30 hours per week: £157.00 (total change against benefit income: £34.58). Total income when working 30 hours per week (after work costs): £133.40 (total change against benefit income: £10.98).
- Total income when working 40 hours per week: £197.02 (total change against benefit income: £74.60). Total income when working 40 hours per week (after work costs): £173.42 (total change against benefit income: £51).

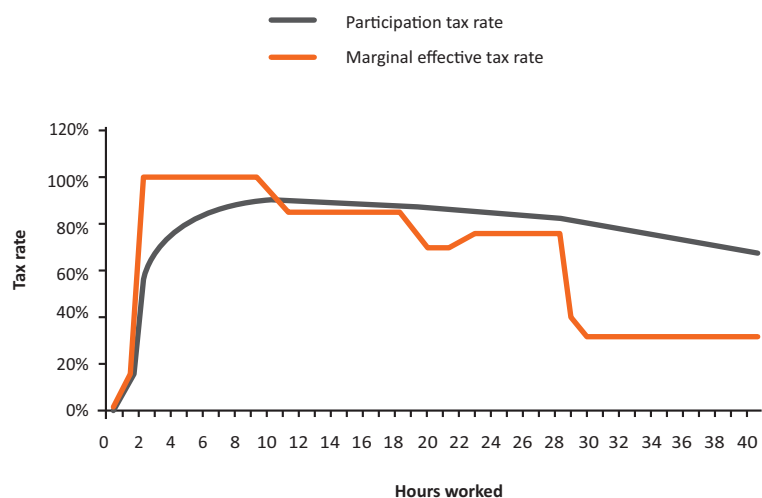
Average hourly wage after 40 hours of work (before work costs): £1.87

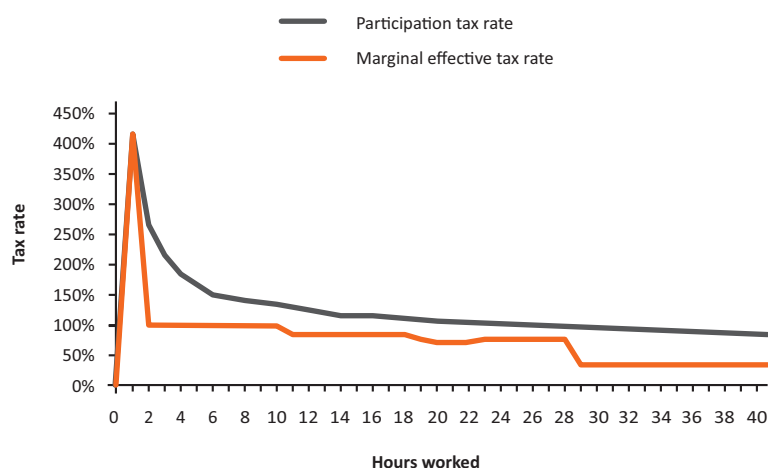
Average hourly wage after 40 hours of work (after work costs): £1.28

**Figure 11: Budget constraint**



**Figure 12: Taxes before work costs**



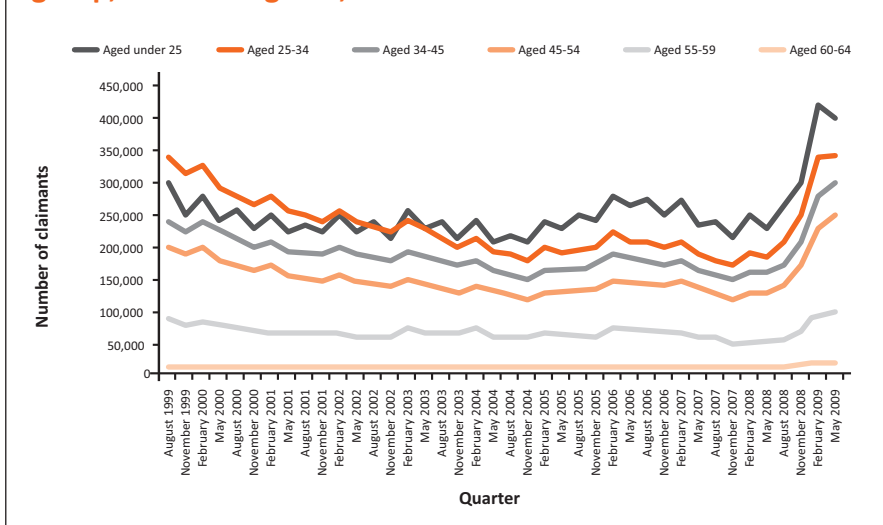
**Figure 13: Taxes after work costs****Figure 14: Financial gain per hour**

*Financial issues faced before work costs are taken into account*

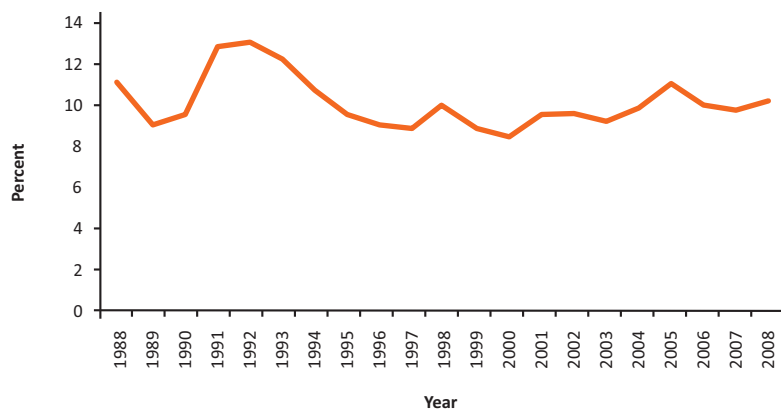
This case study captures an important cohort in Britain's population of welfare claimants: people who are too young to either receive anything more than the basic rate of support on offer or to get tax credits. Claimants in this situation are not given money for anything more than a room in accommodation with shared facilities.

As of May 2009 this group, i.e. those under 25, constituted 28% of the number of people solely claiming Jobseeker's Allowance.<sup>101</sup> As shown by Figure 15, this cohort has consistently been the largest within this population since the early 2000s. Since May 2007 it has grown from around 230,000 to around 410,000, a 73% increase.

101 [www.nomisweb.co.uk](http://www.nomisweb.co.uk)

**Figure 15: Number of Jobseeker's Allowance claimants by age group, United Kingdom, 1999-2009<sup>102</sup>**

Unemployment is particularly bad for young people because, while others also suffer from being out of work, there is strong evidence to show that, as a result of being out of work when young, these people will suffer from poorer careers, more unemployment and lower pay later in life – in other words, they will lose some of their potential.<sup>103</sup> This is one of the main concerns that have driven the concentration in recent years on reducing the number of young people (16-18 year-olds) not in employment, education or training (NEETs). The Department for Children, Schools and Families has a target to reduce the proportion of NEETs as a percentage of the 16-18 year-olds age group by 2 percentage points from its 2004 level of 9.6% by 2010, i.e. to 7.6%. As shown by Figure 16, the count was more than high enough in 2008 (the latest available data) to suspect that the target will not be met this year.

**Figure 16: Proportion of 16-18 year-olds not in employment, education or training, England, 1988-2008<sup>104</sup>**

102 [www.nomisweb.co.uk](http://www.nomisweb.co.uk)

103 See Gregg P and Tominey E, 'The wage scar from youth unemployment', CMPO Working Paper Series No 04/097, 2004 for more details

104 Department for Children, Schools and Families, "NEET Statistics – Quarterly Brief," Department for Children, Schools and Families, 2009

Because this type of claimant is not given the most generous benefits, but is old enough to be paid the adult rate of the minimum wage (£5.80 from October 2009), their gain from working is, compared to other types of claimant, quite high. Figure 11 shows how this person would enjoy a relatively steep gain from working. After 40 hours of work, the claimant would be £74.60 per week better off.

However, this does not mean that the claimant avoids high taxes (a combination of actual taxes plus the removal of benefits) on total income. If the claimant were to decide to take a job that requires anything from three to 22 hours per week, they would always lose more than 80% of the extra income earned, and sometimes 90%, as shown by the participation tax rate. Only by getting a job with full-time hours would the claimant start to keep close to a quarter of the income being earned compared to what was being received on benefits.

The incentive for the claimant to work more (determined by the marginal effective tax rate) is very low at low hours of employment and, compared to other types of claimant, very high at high hours of employment. In between – from hour 9, where Jobseeker's Allowance has been exhausted, to hour 28, where Housing Benefit has been exhausted – for each extra hour worked the claimant will only ever keep a maximum of £1.80 (from per hour wages of £5.80). Only once the claimant starts to work for more than 30 hours does the marginal effective tax rate start to fall on the earnings made to a normal level, between 30% and 40%, albeit at the rate of Income Tax that the highest earners in Britain paid for many years.

#### *Financial issues faced after work costs are taken into account*

As with all the case studies below, this claimant will have to give serious consideration to how much they might need to pay out in getting transport and buying clothing once they take a job. Because of the £23.60 bill that these costs might amount to, people with similar benefits to the ones outlined here will actually be £13.07 worse off after working for 16 hours. This same burden cuts their total gain from working for 30 hours to £10.98, a figure which is not the result of any tax credit payment, and the gain from working for 40 hours to £51.

The imposition of the costs of work also push up the tax rates faced by the claimant. Because they are levied on the first hour in the methodology used here, the marginal effective tax rate faced by the claimant at this point is pushed up to over 400%. However, it is the effect on the participation tax rate that has the most impact. On this measure, the claimant will lose money from deciding to enter work for anything less than 27 hours. However, even this would only mean a profit of £2.10.

#### Case study 2: A single person over 25 years of age claiming Jobseeker's Allowance.

##### **Income Breakdown**

Jobseeker's Allowance: £64.30

Housing Benefit: £77.00

Council Tax Benefit: £10.47

Total out-of-work social security income: £151.77

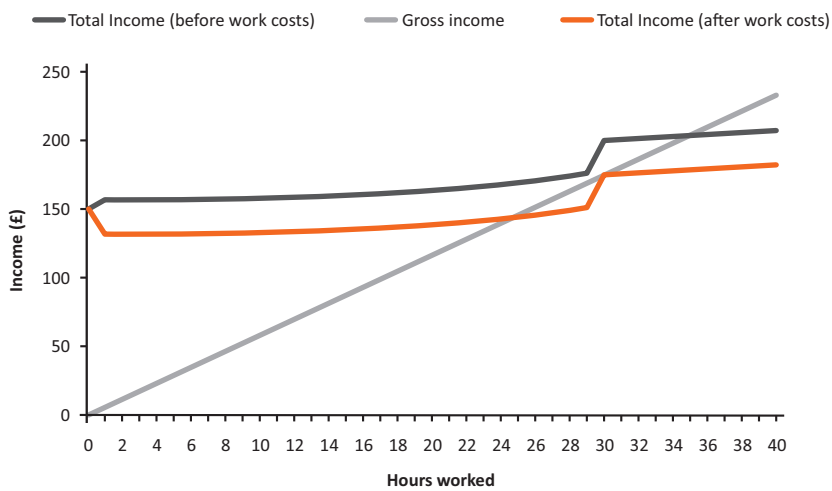
- Total income when working 16 hours per week: £160.30 (total change against benefit income: £8.53). Total income when working 16 hours per week (after work costs): £136.70 (total change against benefit income: -£15.07).

- Total income when working 30 hours per week: £198.92 (total change against benefit income: £47.15). Total income when working 30 hours per week (after work costs): £175.32 (total change against benefit income: £23.55).
- Total income when working 40 hours per week: £205.73 (total change against benefit income: £53.96). Total income when working 40 hours per week (after work costs): £182.13 (total change against benefit income: £30.36).

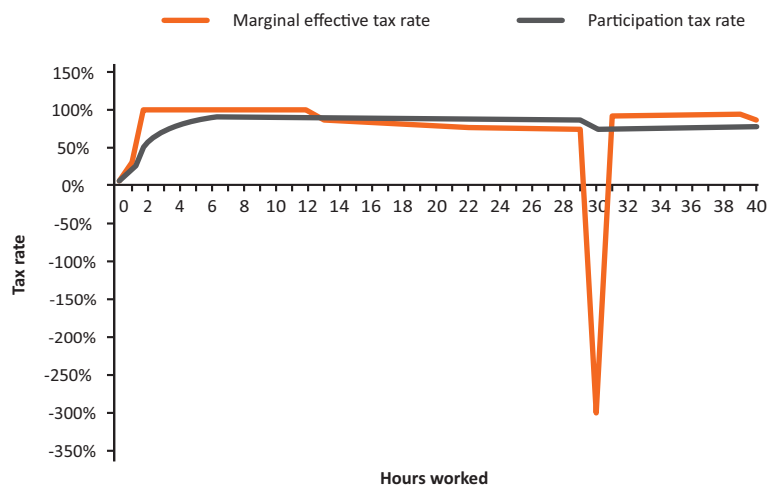
Average hourly wage after 40 hours of work (before work costs): £1.35

Average hourly wage after 40 hours of work (after work costs): 0.76p

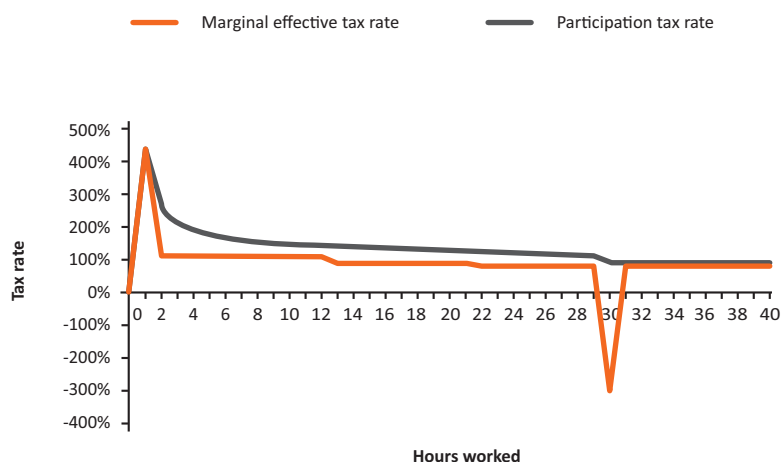
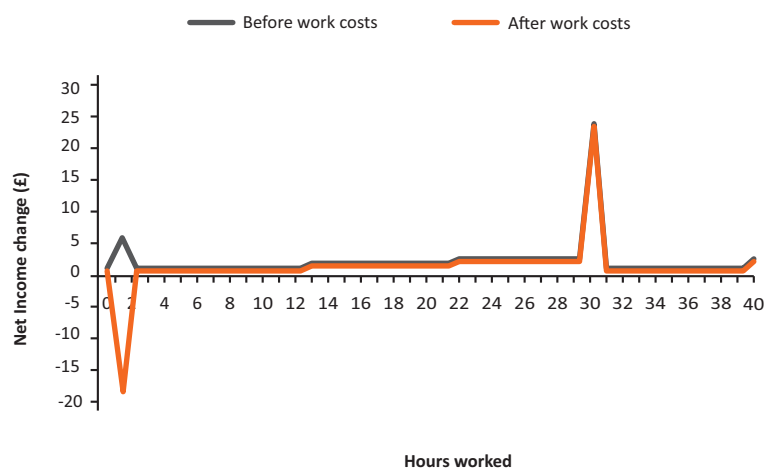
**Figure 17: Budget constraint**



**Figure 18: Taxes before work costs**





**Figure 19: Taxes after work costs****Figure 20: Financial gain per hour**

*Financial issues faced before work costs are taken into account*

This case study covers anyone over 25 who is simply unemployed and claiming Jobseeker's Allowance plus Housing Benefit and Council Tax Benefit. As shown by Figure 15, people between 25 and 54 seem to have fared worse in the recession than their older counterparts. This may, of course, be because older claimants (those between 55 and retirement) have been more inclined to rely on their savings while out of work.

Unlike the person under 25 in the first case study, people represented here are eligible both for a higher rate of Jobseeker's Allowance (£64.30) and tax credits, albeit only once they work for 30 hours per week (claimants with children get the Working Tax Credit after 16 hours of work, and then an uplift after 30 hours of work). They also

receive more in Housing Benefit because they are eligible for payments that allow them to live in a self-contained bedsit rather than somewhere where they must share washing and cooking facilities. This cohort of Jobseeker's Allowance claimants is just under 70% of the total number of people on the benefit.<sup>105</sup>

After working for 40 hours per week, this type of claimant would be £53.96 better off, a sum that is in line with many of the case studies below but much lower than the £74.60 gain that a person akin to case study one would make. As shown in Figure 17, much of this jump is constituted by the payment of tax credits after 30 hours of work. Up until then, the gain is quite small – only £23.83 per week.

If this claimant wanted to take a job, then they would face the loss of around 90% of their earnings above what they got on benefits. This level of participation tax only falls once tax credits are given to the claimant, but they then start to be withdrawn too, thus returning the loss to a level close to 90%.

The marginal gain from working is low for a very small amount of hours as the claimant benefits from the earnings disregard of £5 applied to Jobseeker's Allowance. The benefit is then removed pound-for-pound. This nearly always means that the claimant can only hope to keep around 10% of the extra money earned for working an hour more. This changes, of course, when they work for 30 hours and receive tax credits, but the claimant is then stung again by the removal of them. The gains from working for more than 30 hours per week are tiny.

#### *Financial issues faced after work costs are taken into account*

Like case study 1, this claimant's income from working is made very insignificant by having to pay out for travel and clothing. Only by persevering through 29 hours of work will they have made any money, 23p. This is then boosted to £23.55 by the payment of tax credits at 30 hours.

Having to pay for everything at the start of the first work week does, of course, push up the marginal effective tax rate faced by the claimant at that hour by a lot, to 421%. It then falls to the same level as it would without work costs but the participation tax rate has been permanently heightened. It is above 100%, i.e. the person loses from working, until the payment of £31.33 in tax credits once 30 hours have been worked. After this the rate is only just below 90%.

#### **Case study 3: A couple over 25 years of age claiming Jobseeker's Allowance.**

##### **Income Breakdown**

Jobseeker's Allowance: £100.95

Housing Benefit: £77.00

Council Tax Benefit: £13.97

Total out of work social security income: £191.92

- Total income when working 16 hours per week: £183.77 (total change against benefit income: -£8.15). Total income when working 16 hours per week (after work costs): £160.17 (total change against benefit income: -£31.75).

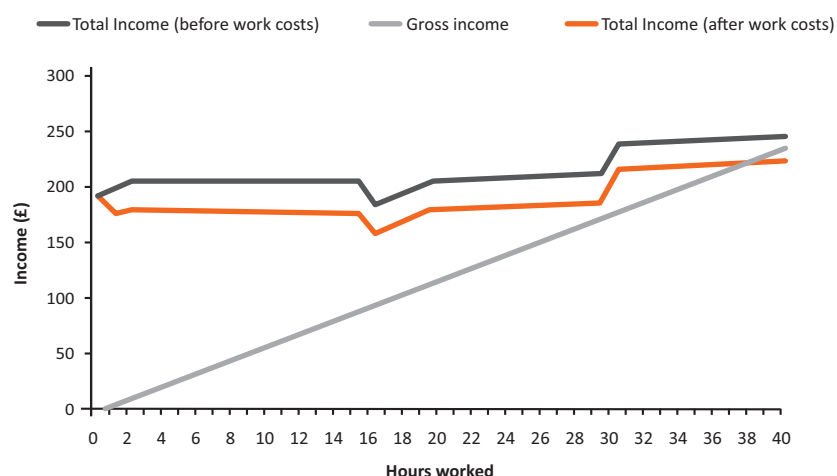
105 Department for Work and Pensions, *Tabulation Tool*

- Total income when working 30 hours per week: £238.49 (total change against benefit income: £46.57). Total income when working 30 hours per week (after work costs): £214.89 (total change against benefit income: £22.97).
- Total income when working 40 hours per week: £244.58 (total change against benefit income: £52.66). Total income when working 40 hours per week (after work costs): £220.98 (total change against benefit income: £29.06).

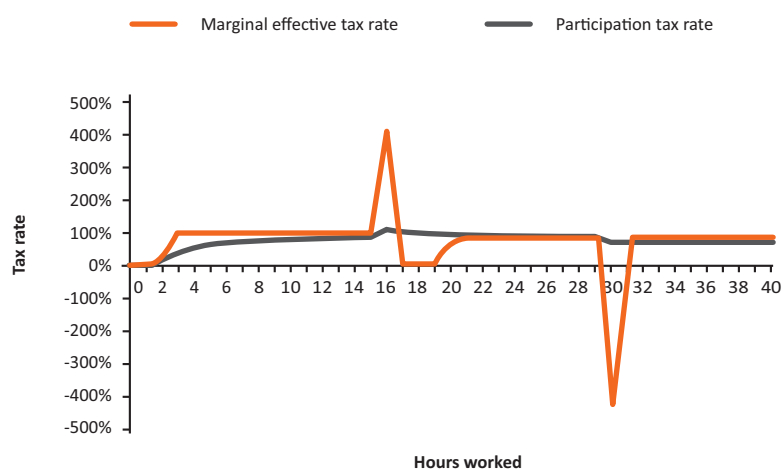
Average hourly wage after 40 hours of work (before work costs): £1.32

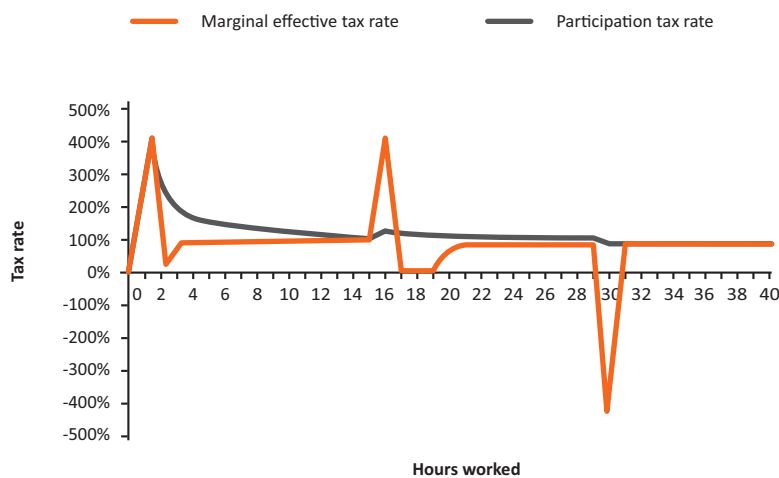
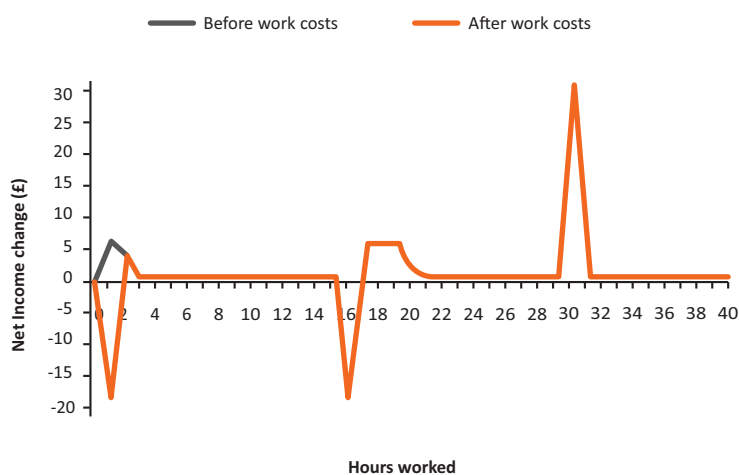
Average hourly wage after 40 hours of work (after work costs): 0.73p

**Figure 21: Budget constraint**



**Figure 22: Taxes before work costs**



**Figure 23: Taxes after work costs****Figure 24: Financial gain per hour**

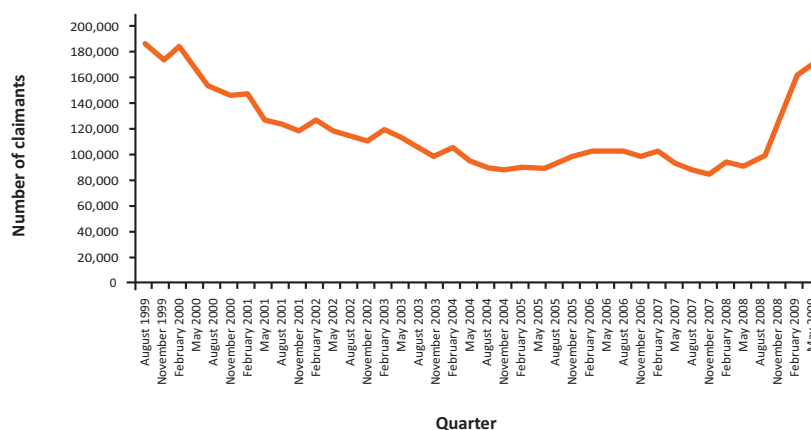
#### *Financial issues faced before work costs are taken into account*

As of May 2009 there were 168,700 claims for the couple's rate of Jobseeker's Allowance. As with the total claimant count, this is one of the highest levels since the early 2000s, as shown by Figure 25. The rate received by these people and this case study is, at £100.95, less than each person would receive were they to be on the youth rate of the benefit (case study 1). Figure 26 shows how over three-quarters of claims for this type of Jobseeker's Allowance are made by men.

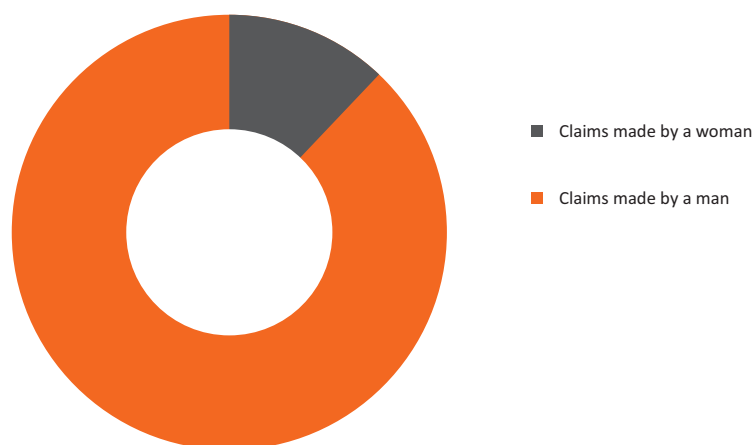
In this case study the couple receive the same amount of Housing Benefit as the single person in case study 2 because, like that person, they are only entitled to one room. All of the calculations in this case study also only relate to one person in the couple seeking work. This is done for reasons of simplicity and the fact that

the chances of one half of the couple getting work are, obviously, higher than both. All changes to their income thus refer to the combined effects on the couple.

**Figure 25: Number of couple-based claims for Jobseeker's Allowance, United Kingdom, 1999-2009<sup>106</sup>**



**Figure 26: Claims made for Jobseeker's Allowance on the basis of being a couple, United Kingdom, May 2009<sup>107</sup>**



Like the single person in case study 1, the couple in this case study would only be around £52.66 better off, compared to their income when both of them are unemployed, if one of them got a job at the minimum wage for 40 hours. This is, of course, from a higher starting income (£191.92) and higher final income (£244.58). Unlike the previous two case studies, however, they actually face a point in their budget constraint – in the movement from 15 to 16 hours – where their income falls, as can be seen in Figure 21.

<sup>106</sup> Department for Work and Pensions, *Tabulation Tool*

<sup>107</sup> Department for Work and Pensions, *Tabulation Tool*

This is more clearly shown by the marginal tax rate that the couple face across the choice of hours that one of them has to work. It is very high after 15 hours as they leave receipt of Jobseeker's Allowance (at this point, the final £23.95 is removed in one go). Then, because little tax is being paid and neither Housing Benefit nor Council Tax Benefit is being withdrawn, the loss of earnings on each hour worked falls to zero, i.e. between hours 16 and 20 the one half of the couple working brings home nearly exactly what their employer is paying them in wages.

An even higher rate of wage removal kicks in after 22 hours have been worked, and then continues at around 90% until 30 hours, when a tax credit payment of £67.03 begins. After this the marginal effective tax rate increases to a level where the couple never benefit by more than 61p for each extra hour worked by one of them at a minimum wage of £5.80 per hour.

The participation tax rate faced by the couple follows this trend. It is at its lowest for only a few hours of work, then turns prohibitively high once the couple's entitlement to Jobseeker's Allowance ceases. Here, at 16 and 17 hours of work, the couple is worse off than when neither of them was doing any work at all. Only with 18 hours of work (where their income reaches £195.37) are they richer than the £191.92 income derived from social security that they were receiving when completely unemployed.

#### *Financial issues faced after work costs are taken into account*

The burden of the costs of getting a job just make the loss that the couple faces over the 16 hours that one of them has worked even bigger, i.e. £31.75 rather than £8.15. Unlike the previous two case studies, where there is some financial gain from working before any tax credit payments have been received, this couple only make money once they have received £67.03 in tax credits at 30 hours of work. After this their total gain from working grows gently to £29.06 after 40 hours work.

The work costs as levied here substantially push up the bill from working the first hour, i.e. the marginal effective tax rate is very high. After this the participation tax rate remains above 100% until that payment of tax credits at 30 hours. However, this result is also dependent on the withdrawal of £23.95 in Jobseeker's Allowance after 16 hours of work.

**Case study 4: A couple over 25 years of age, with one child under 7 years of age, claiming Jobseeker's Allowance.**

#### **Income Breakdown**

Jobseeker's Allowance: £100.95

Housing Benefit: £101.54

Council Tax Benefit: £13.97

Child Benefit: £20.00

Child Tax Credit: £53.41

Total out of work social security income: £289.87

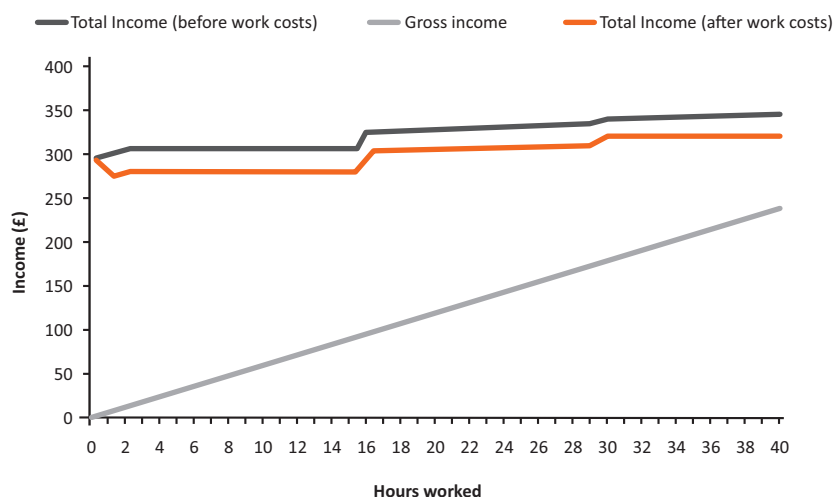
- Total income when working 16 hours per week: £322.27 (total change against benefit income: £32.40). Total income when working 16 hours per week (after work costs): £298.67 (total change against benefit income: £8.80).

- Total income when working 30 hours per week: £336.44 (total change against benefit income: £46.57). Total income when working 30 hours per week (after work costs): £312.84 (total change against benefit income: £22.97).
- Total income when working 40 hours per week: £342.53 (total change against benefit income: £52.66). Total income when working 40 hours per week (after work costs): £318.93 (total change against benefit income: £29.06)

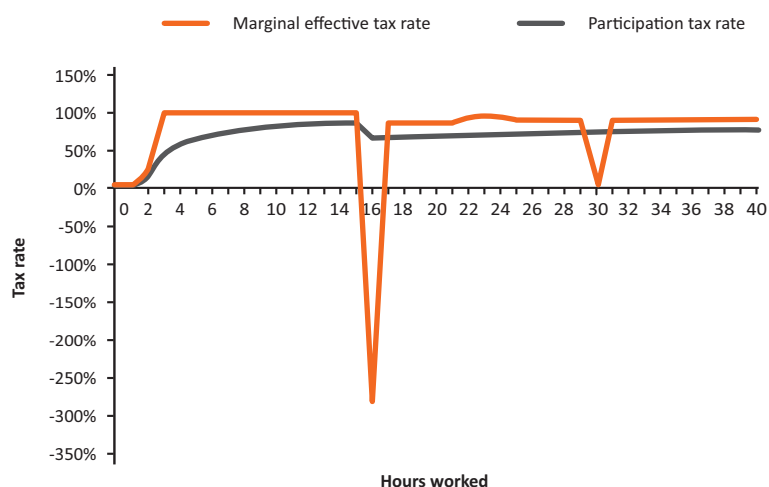
Average hourly wage after 40 hours of work (before work costs): £1.32

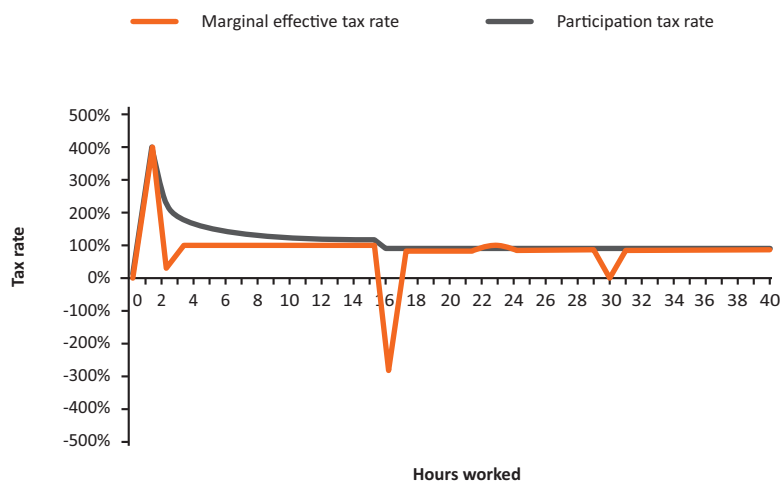
Average hourly wage after 40 hours of work (after work costs): 0.73p

**Figure 27: Budget constraint**



**Figure 28: Taxes before work costs**



**Figure 29: Taxes after work costs****Figure 30: Financial gain per hour**

#### *Financial issues faced before work costs are taken into account*

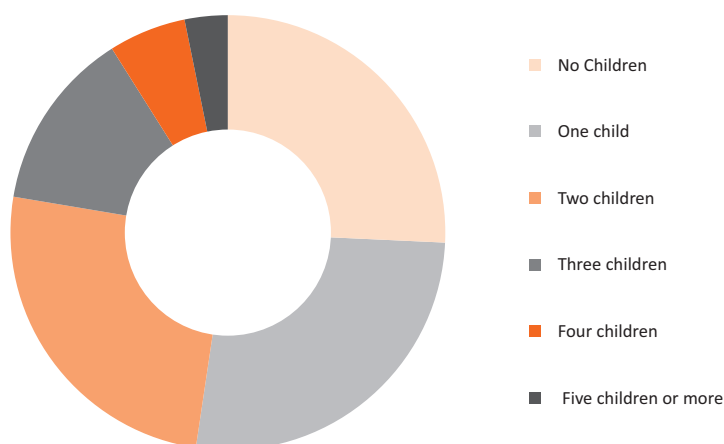
This couple gets nearly the same benefits as the couple in case study 3, but gain from three differences: one, they get Child Tax Credit of £53.41 because they have a child; two, they get Child Benefit for that child of £20; three, they get more Housing Benefit (£101.54 rather than £77.00) because their child entitles them to have two rooms rather than just one. This raises their income when completely out of work to £289.87 rather than £191.92.

The fact that Child Tax Credit is paid when both halves of the couple are unemployed shows how it is, for the most part, just an addition to Child Benefit rather than a “tax credit”, i.e. a portion of tax that is returned because the recipient has been working.

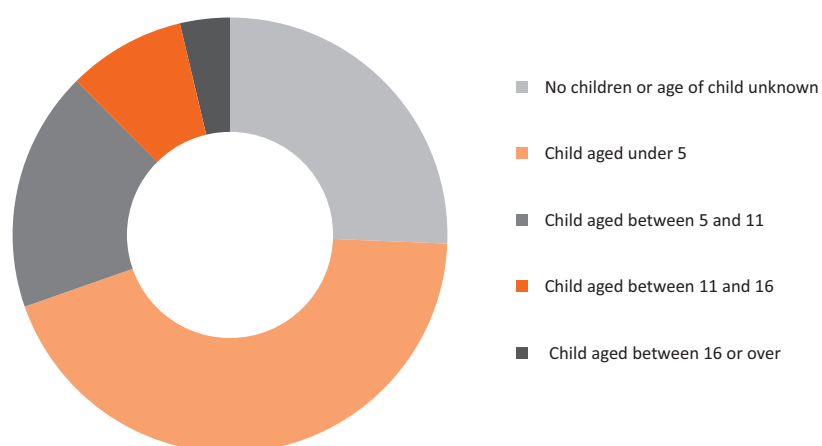


75% of couples making a claim for Jobseeker's Allowance have a child.<sup>108</sup> As shown by Figure 31, around half of this group have one or two children. In comparison, the vast majority of people making a single person's claim for Jobseeker's Allowance do not have any children, or at least not according to government statistics – see Figure 33. Figure 32 shows how many people making a couple-based claim for Jobseeker's Allowance have young children – 44% of the total claimant pool have a child under 5.

**Figure 31: Distribution of children among people making a couple-based claim for Jobseeker's Allowance, United Kingdom, May 2009<sup>109</sup>**



**Figure 32: Age distribution of the youngest child among people making a couple-based claim for Jobseeker's Allowance, United Kingdom, May 2009<sup>110</sup>**



<sup>108</sup> Department for Work and Pensions, *Tabulation Tool*

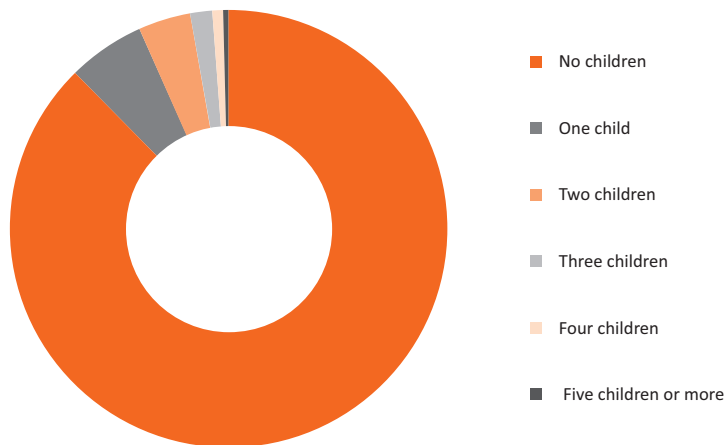
<sup>109</sup> Department for Work and Pensions, *Tabulation Tool*

<sup>110</sup> Department for Work and Pensions, *Tabulation Tool*

This couple starts with a higher income and ends with a higher income than their contemporaries in the previous case study who do not have children, but they still end up with a similar gain, £52.66, from one of them working for 40

hours per week. Because of their receipt of a jump in tax credits once one of them works for 16 hours, and then again when one of them works for 30 hours, there are two points at which the half of the couple that is working could decide to not increase their earnings as, financially, it is not worth it. The overall effects on their income of working are shown in Figure 27.

**Figure 33: Distribution of children among the total Jobseeker's Allowance population, United Kingdom, May 2009<sup>111</sup>**



One of these points, 16 hours of work, is reflected in the participation tax rate that the couple faces. From only a few hours work to fifteen hours work, the rate increases steadily to nearly 100%. At hour 16, the couple gets to keep nearly 35% of the money that they have earned. This loss of around 60% only gently rises after that, as can be seen in Figure 28.

The receipt of tax credits is what makes the effective marginal tax rate faced by the couple so different around 16 hours of work than the situation faced by the couple in case study 3 with no children. Here, rather than lose money by working for 16 hours rather than 15, the couple gain because the loss of the final £23.95 of Jobseeker's Allowance is compensated by the £71.96 they gain in tax credits. It is this that means working for that extra hour is so profitable.

Again, however, the marginal rate of tax that the couple face shoots up again to close to 100% for nearly all the extra hours one of them may choose to work, bar the cut to a zero percent rate once the person who is working does so for 30 hours. As the final parts of their Council Tax Benefit are being withdrawn between around 20 and 24 hours, the increase in the marginal tax on working an extra hour (see Figure 28) gets close to 100%.

#### *Financial issues faced after work costs are taken into account*

The payment of £71.96 in tax credits after 16 hours is what gives this couple an incentive for one of them to work for a far greater range of hours than the other case studies analysed here. It leaves them with £8.80 after those with 16 hours of work and, with the extra payment of £12.64 at 30 hours, £29.06 after a full 40-hour week has been worked.

111 Department for Work and Pensions, *Tabulation Tool*

It is, of course, these tax credit payments which keep the taxes on the work being done by this couple below 100% after 16 hours. Between hours 16 and 29 the participation tax rate they face is 90%, and then 87% between hours 30 and 40. The marginal effective tax rate across these hours only once falls below 89%.

Case study 5: A couple over 25 years of age, with two children under 7 years of age, claiming Jobseeker's Allowance.

#### Income Breakdown

Jobseeker's Allowance: £100.95

Housing Benefit: £101.54

Council Tax Benefit: £13.97

Child Benefit: £33.20

Child Tax Credit: £96.32

Total out of work social security income: £345.98

- Total income when working 16 hours per week: £378.38 (total gain against benefit income: £32.40). Total income when working 16 hours per week (after work costs): £354.78 (total gain against benefit income: £8.80).
- Total income when working 30 hours per week: £392.55 (total gain against benefit income: £46.57). Total income when working 30 hours per week (after work costs): £368.95 (total gain against benefit income: £22.97).
- Total income when working 40 hours per week: £398.64 (total gain against benefit income: £52.66). Total income when working 40 hours per week (after work costs): £375.04 (total gain against benefit income: £29.06).

Average hourly wage after 40 hours of work (before work costs): £1.32

Average hourly wage after 40 hours of work (after work costs): 0.73p

Figure 34: Budget constraint

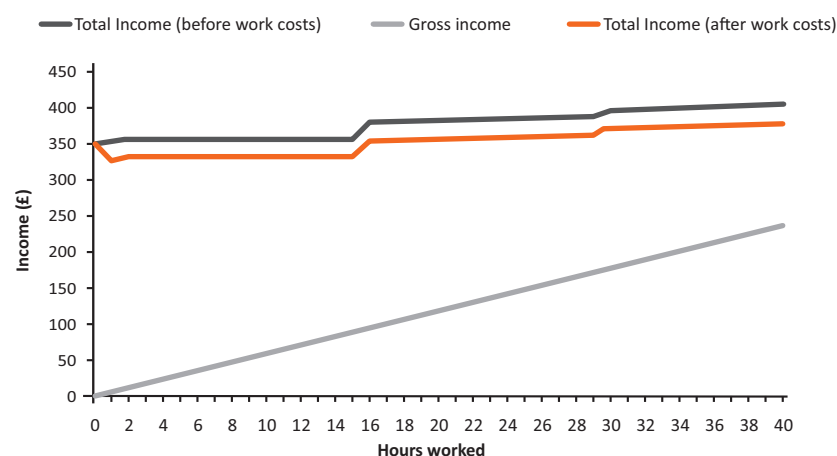


Figure 35: Taxes before work costs

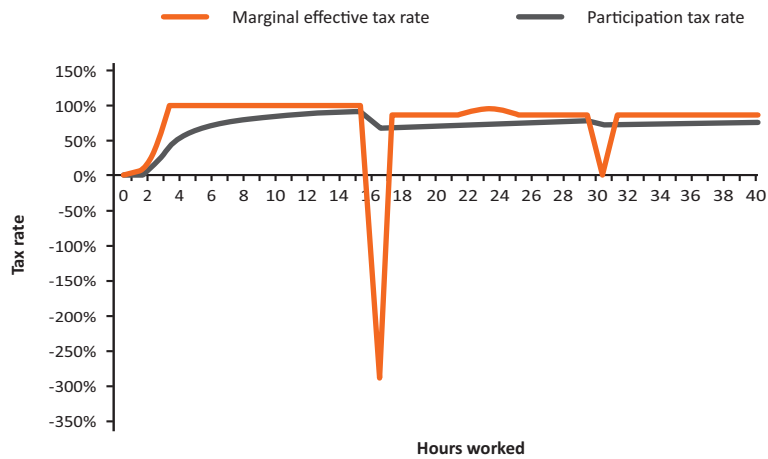


Figure 36: Taxes after work costs

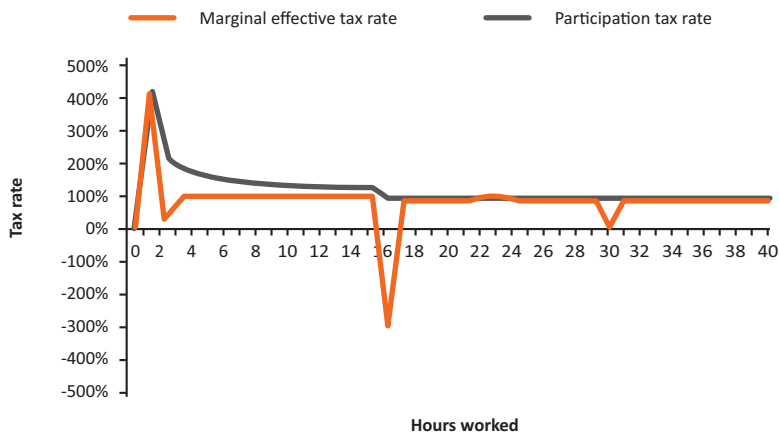


Figure 37: Financial gain per hour



*Financial issues faced before work costs are taken into account*

Because two children are included, this case study captures the basic situation faced by around a quarter of the people making a couple-based claim for Jobseeker's Allowance, as shown by Figure 31. Many have very young children, as shown by Figure 32. Even though they receive the most in benefits of any case study in this report, they would still only be £52.66 better off from one of them working for 40 hours per week rather than both of them staying completely on benefits.

As with the previous case study, the income difference between not working and working goes through two jumps over the 40-hour range: once an extra £71.96 is given in tax credits when one half of the couple works for 16 rather than 15 hours, and £12.64 once that person works for 30 hours rather than 29.

Interestingly, the generosity of tax credits means that the couple are still receiving £140.73 from the scheme once one of them is working for 40 hours per week. The couple's budget constraint is shown in Figure 34. The participation tax rate is close to 75% for most of the time, a level which is very high but actually lower than most of the other case studies.

The marginal effective tax rate faced by the couple is nearly always 100% for the first 15 hours of work as Jobseeker's Allowance is withdrawn, and only falls to anything below 70% once the extra payments of tax credits are made. Unlike most of the other case studies, the rate actually returns to 100% or close to it at two points: from working hours 24 to 30, where the last of the Council Tax Benefit is being withdrawn, and immediately after 30 hours. These changes are shown by Figure 35.

*Financial issues faced after work costs are taken into account*

Because of the presence of children this couple get a much earlier financial boost from working, and thus get to make a financial gain after their costs of work have been taken into account, than many of the other case studies. This means that their income is £8.80 higher after 16 hours of work than when on a full unemployment income, and £29.06 higher after 40 hours of work.

After the 400% marginal effective tax on the first hour of work, this couple then enjoy the reverse, a 400% marginal gain once one of them has worked for 16 hours. This, of course, is a result of their first tax credits payment. They also get to keep all of their earnings between hours 29 and 30 for the same reason. As with the other case studies with children, this means an unusual thing: a participation tax rate that is below 100% for any stretch of time – in this case at every hour after work hour 16.

**Case study 6: A single person over 25 years of age, with one child under 7 years of age, claiming Income Support.**

**Income Breakdown**

Income Support: £64.30

Housing Benefit: £101.54

Council Tax Benefit: £10.47

Child Tax Credit: £53.41

Child Benefit: £20.00

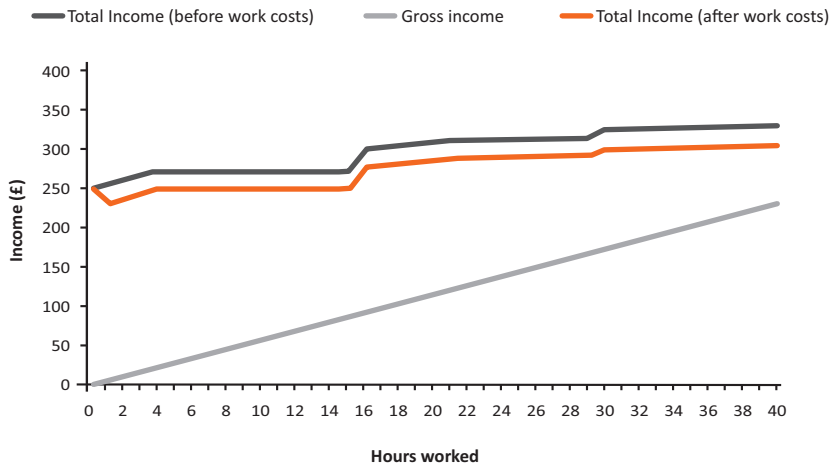
Total out of work social security income: £249.72

- Total income when working 16 hours per week: £301.62 (total gain against benefit income: £51.90). Total income when working 16 hours per week (after work costs): £278.02 (total gain against benefit income: £28.30).
- Total income when working 30 hours per week: £322.36 (total gain against benefit income: £72.64). Total income when working 30 hours per week (after work costs): £298.76 (total gain against benefit income: £49.04).
- Total income when working 40 hours per week: £328.45 (total gain against benefit income: £78.73). Total income when working 40 hours per week (after work costs): £304.85 (total gain against benefit income: £55.13).

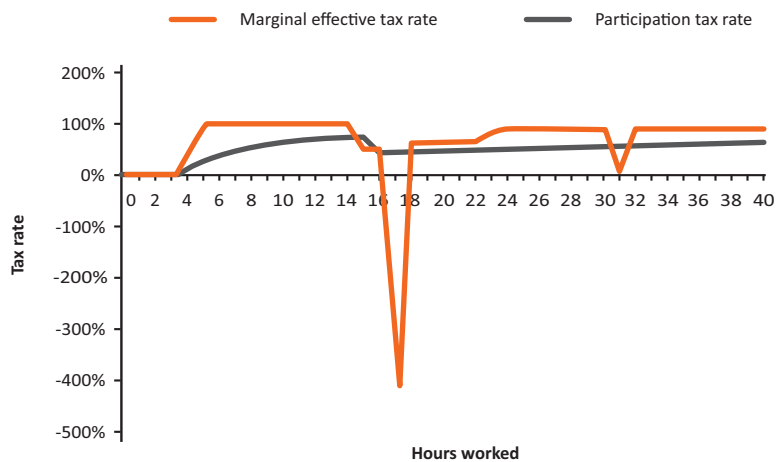
Average hourly wage after 40 hours of work (before work costs): £1.97

Average hourly wage after 40 hours of work (after work costs): £1.38

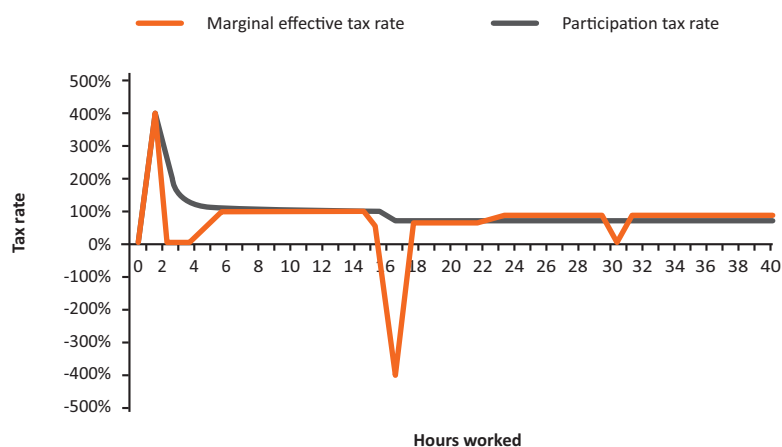
**Figure 38: Budget constraint**



**Figure 39: Taxes before work costs**



**Figure 40: Taxes after work costs**



**Figure 41: Financial gain per hour**



*Financial issues faced before work costs are taken into account*

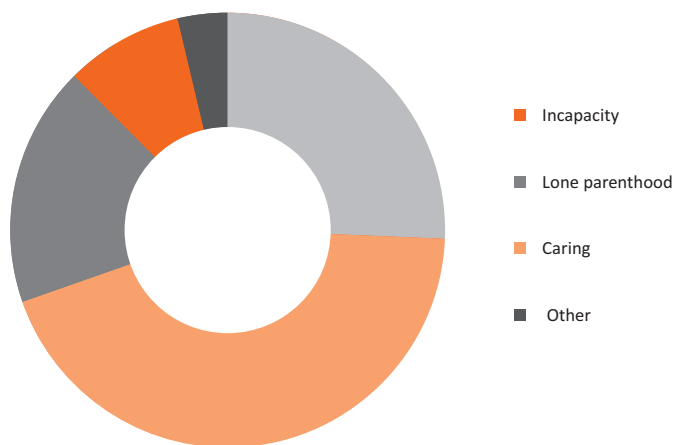
This case study reflects the financial situation faced by many lone parents on Income Support. The money from the benefit that this parent is receiving is identical to the rate for a person of the same age on Jobseeker's Allowance (case study 2), but this person is receiving Income Support because they have been determined as needing extra income in order to look after their child rather than because they are unemployed and looking for work (the qualification for Jobseeker's Allowance). The child is also young enough to mean that the claimant is allowed to stay at home as a carer and is not required to look for employment.

Figure 42 shows how claims for "income support", i.e. income top-ups given to people deemed to be unable to work and not in receipt of enough money per week to live on, actually incorporates many more people than those claiming just

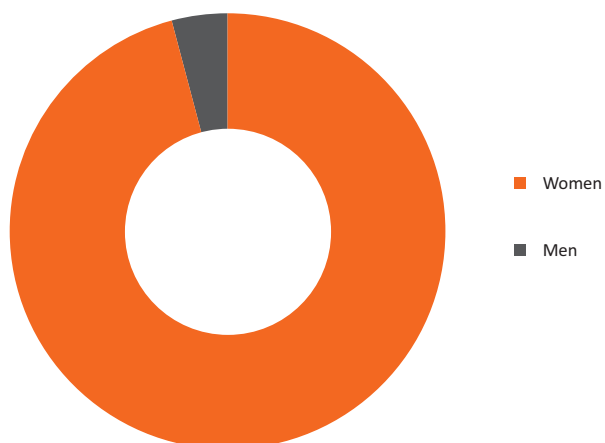
for being a lone parent. However, people claiming income support on grounds of incapacity actually come under the Incapacity Benefit and Employment and Support Allowance scheme, hence the reason for the common assertion that the Income Support cohort is dominated by lone parents. For these lone parents, Figure 43 shows how most of them are lone mothers.

As is to be expected, these lone mothers fall, more often than not, into the most common age ranges for child-rearing. Figure 44 and Figure 45 show how the most populated of these ranges is the 25-34 years old one. Both figures also show how lone parents with one or two children far outnumber those with any more kids. Furthermore, these children are nearly always under 11 years old, which is unsurprising given recent pressure on lone parents with older children to join Jobseeker's Allowance.

**Figure 42: Distribution of reasons for claiming Income Support, United Kingdom, May 2009<sup>112</sup>**



**Figure 43: Distribution of Income Support claims for lone parenthood by sex, United Kingdom, May 2009<sup>113</sup>**

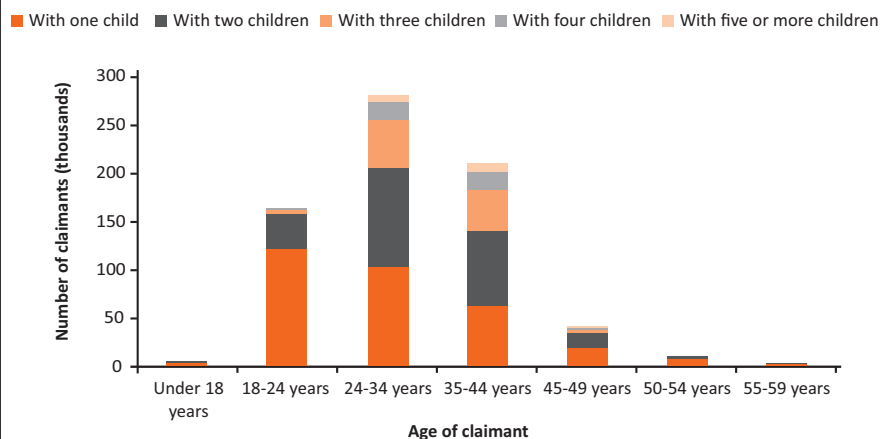


112 Department for Work and Pensions, *Tabulation Tool*

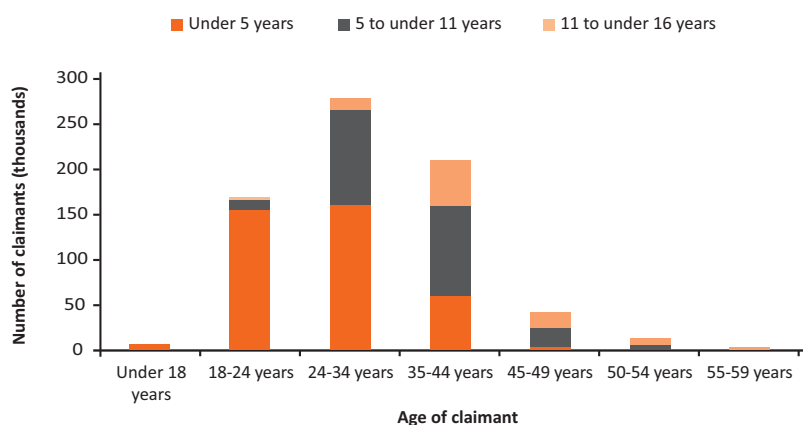
113 Department for Work and Pensions, *Tabulation Tool*



**Figure 44: Number of children among each age group of women claiming Income Support on grounds of lone parenthood, United Kingdom, May 2009<sup>114</sup>**



**Figure 45: Age of youngest child among each age group of women claiming Income Support on grounds of lone parenthood, United Kingdom, May 2009<sup>115</sup>**



The extra benefits given to the claimant as a result of being a lone parent push their out of work income up by £97.95 (£249.72 against £151.77) net per week. The claimant also receives Child Benefit, Child Tax Credit and entitlement to extra Housing Benefit that will pay for another room.

This lone parent enjoys one of the highest potential gains from working a full time job among all of the case studies analysed here. Over 40 hours of work at the minimum wage this claimant would gain £78.73. This is much greater than the potential rewards of working faced by many of the case studies which only face a jump of £50. Because of the earnings disregard on Income Support for the first £20 of wages earned, and then the payment of extra tax credits after 16 and 30 hours of work, the progression to the top work income of £328.45 takes place in three jumps, as shown by Figure 38.

The relative generosity of the benefits that this lone parent receives means that tax credits (£97.82) and Housing Benefit (£13.61) are still being paid after 40

<sup>114</sup> Department for Work and Pensions, *Tabulation Tool*

<sup>115</sup> Department for Work and Pensions, *Tabulation Tool*

hours of work. This fits the pattern of other claimants with children shown in the other case studies. People on social security without children are much less likely, as shown by the first few case studies, to be still receiving welfare when they have a full-time job.

Like with the double payment of tax credits for working in the other case studies, this claimant faces a similar levying of participation and effective marginal tax rates. The former is particularly high for hours 10 to 15, meaning that the reward from working within

these hours (something that might suit a lone parent most) is low. By working for 15 hours, they would be bringing in an extra £22.70, which gives a tax rate on choosing to take employment of 74%. This then falls to 43% if the claimant chooses to work for 16 hours, before gently rising as benefits continue to be withdrawn across the potential 40 hours of work.

The double payment of tax credits for working is, after the withdrawal of Income Support during the first 16 hours of work (which pushes the claimant's marginal tax rate up to 100%), what causes both the two significant drops in the rate (to a negative 410% after 16 hours and a negative 2% at 30 hours, i.e. the claimant is gaining more money than they are losing) and the high withdrawal rates on each extra hour of work afterwards. This type of claimant faces a high participation tax rate on the decision to get a part-time job of less than 16 hours per week, and then high marginal tax rates to make that job a full-time one. All of this is shown in Figure 39.

“ This type of claimant faces a high participation tax rate on the decision to get a part-time job of less than 16 hours per week, and then high marginal tax rates to make that job a full-time one ”

#### *Financial issues faced after work costs are taken into account*

As with the other case studies with children, this claimant's participation tax rate is kept below 100% after 16 hours have been worked. Before then, the payment of work costs mean that a person in this situation would have to pay to work if they could only work for 15 hours or less per week. If this lone parent was in the same situation they would lose 90p after working for 15 hours.

**Case study 7: A single person over 25 years of age, with two children under 7 years of age, claiming Income Support.**

#### **Income Breakdown**

Income Support: £64.30

Housing Benefit: £101.54

Council Tax Benefit: £10.47

Child Benefit: £33.20

Child Tax Credit: £96.32

Total out of work social security income: £305.83

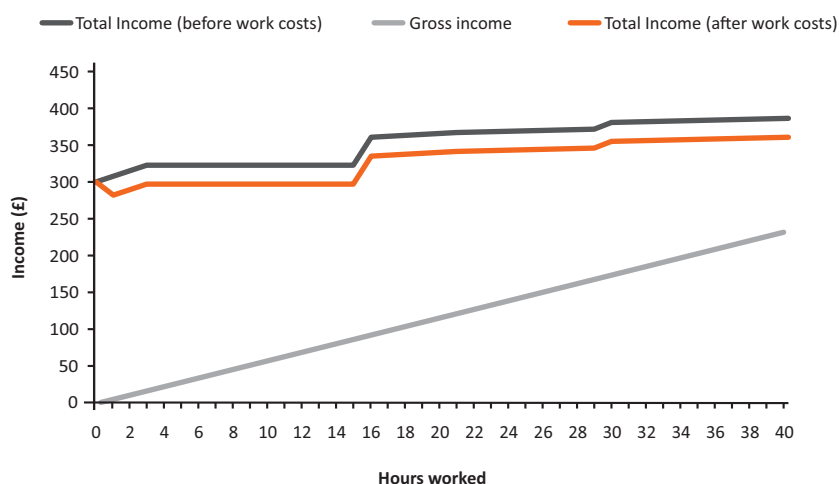
- Total income when working 16 hours per week: £357.73 (total gain against benefit income: £51.90). Total income when working 16 hours per week (after work costs): £334.13 (total gain against benefit income: £28.30).

- Total income when working 30 hours per week: £378.47 (total gain against benefit income: £72.64). Total income when working 30 hours per week (after work costs): £354.87 (total gain against benefit income: £49.04).
- Total income when working 40 hours per week: £384.56 (total gain against benefit income: £78.73). Total income when working 40 hours per week (after work costs): £360.96 (total gain against benefit income: £55.13).

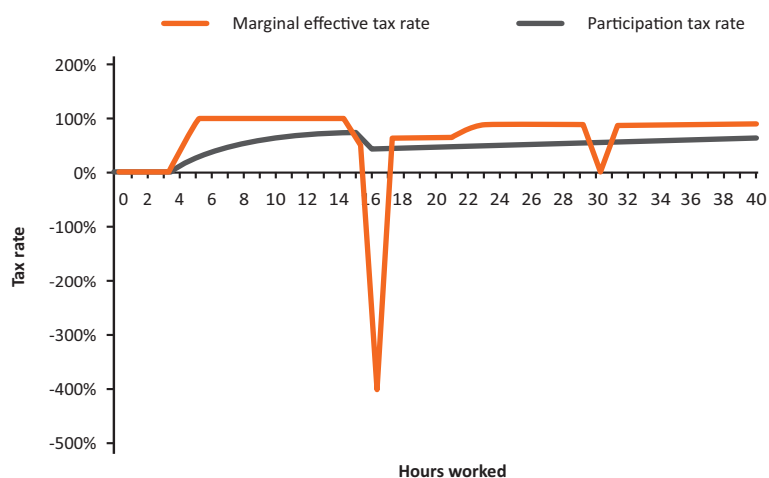
Average hourly wage after 40 hours of work (before work costs): £1.97

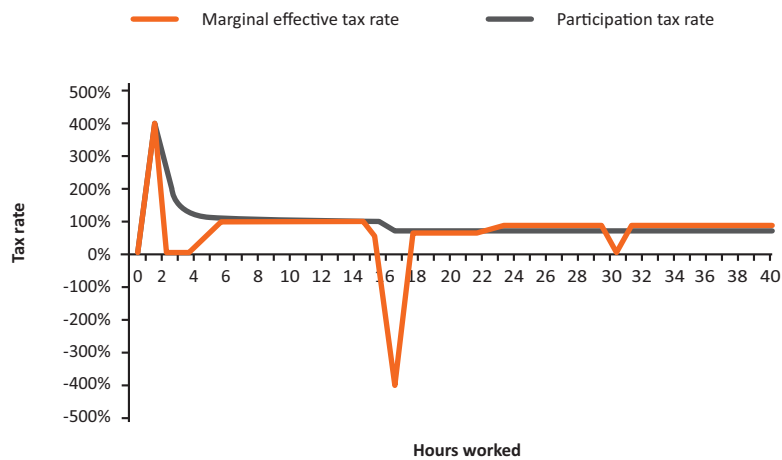
Average hourly wage after 40 hours of work (after work costs): £1.38

**Figure 46: Budget constraint**



**Figure 47: Taxes before work costs**



**Figure 48: Taxes after work costs****Figure 49: Financial gain per hour**

#### *Financial issues faced before work costs are taken into account*

This lone parent, with two children rather than one, faces a similar incentive to get a full-time job, a £78.73 gain in income, as the previous case study. Like the previous claimant, this progression occurs in three stages (the initial earnings disregard, followed by two tranches of tax credits), as shown by Figure 46. The gain from getting a part-time job that only requires 16 hours of work a week is also similar to the previous case study, at £51.90.

As with the claimant on Income Support with only one child, this case study also faces a high tax on earnings upon entering work for anything less than 16 hours per week. At 15 hours it is 74%, but then falls with the payment of extra tax credits at hour 16 to 43%. It then gently increases after that to one of its

highest levels, 66%, at 40 hours work, if the claimant gets a job that demands a jump from working zero hours a week to 40. As with the previous case study, after the tranche of tax credits that is received at 16 hours, the replacement rate faced by this claimant is relatively more profitable than the other case studies enjoy.

This claimant thus faces very similar incentives to work as the lone parent with one child, albeit from a higher income level. There are also drops in marginal tax for this case study as tax credits for working are paid at 16 and 30 hours of work, but near 100% rates afterwards, as shown by Figure 47.

#### *Financial issues faced after work costs are taken into account*

This lone parent, like all the parents analysed here, will only make any money from working if they work for 16 hours or more. The gain from working for 16 hours, £28.30, starts a consistent rise in financial profitability, albeit in only very small steps.

These small steps are reflected in the fact that this claimant faces a marginal effective tax rate that is just under 90% for every hour worked after hour 22, i.e. for every pound earned only around 10p is taken home. This, of course, keeps the participation tax rate high. However, at between 69% and 76% between 17 hours of work and 40, it is actually much lower than what the other case studies face.

#### **Case study 8: A single person over 25 years of age claiming the Employment Support Allowance and in the Work-Related Activity Group.<sup>116</sup>**

##### **Income Breakdown**

Employment and Support Allowance: £89.80

Housing Benefit: £77.00

Council Tax Benefit: £10.47

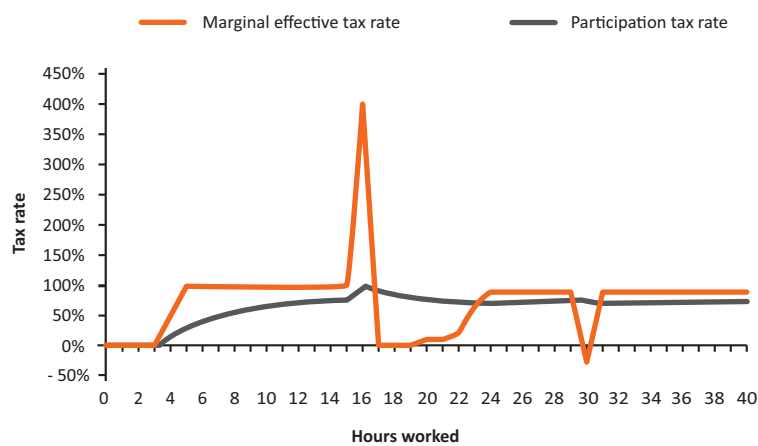
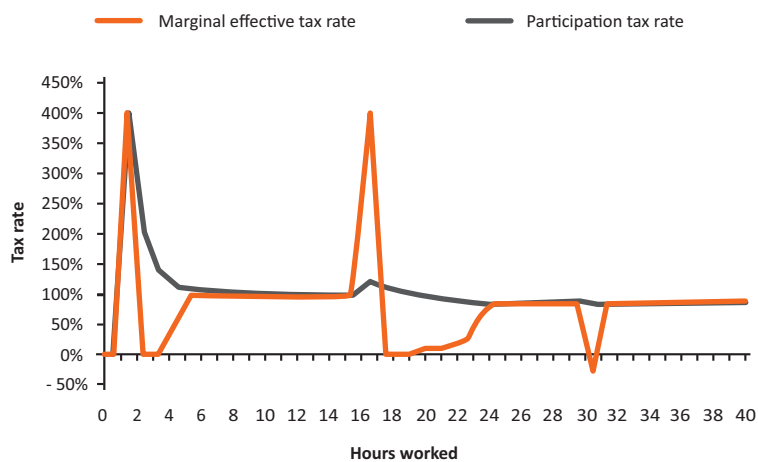
Total out of work social security income: £177.27

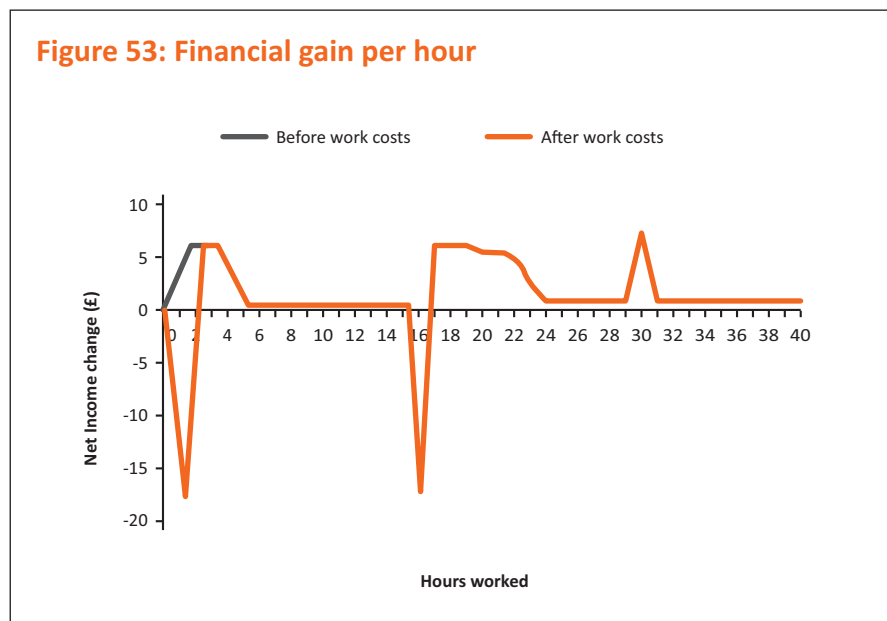
- Total income when working 16 hours per week: £180.27 (total gain against benefit income: £3). Total income when working 16 hours per week (after work costs): £156.67 (total gain against benefit income: -£20.60).
- Total income when working 30 hours per week: £225.24 (total gain against benefit income: £47.97). Total income when working 30 hours per week (after work costs): £201.64 (total gain against benefit income: £24.37).
- Total income when working 40 hours per week: £231.31 (total gain against benefit income: £54.04). Total income when working 40 hours per week (after work costs): £207.73 (total gain against benefit income: £30.46).

Average hourly wage after 40 hours of work (before work costs): £1.35

Average hourly wage after 40 hours of work (after work costs): 0.76p

<sup>116</sup> People over 50 who have been on benefits for a long time and are returning to work qualify for extra tax credit payments once they work for 16 and 30 hours. This would be most likely to apply to Incapacity Benefit and Employment and Support Allowance claimants

**Figure 50: Budget constraint****Figure 51: Taxes before work costs****Figure 52: Taxes after work costs**

**Figure 53: Financial gain per hour**

Financial issues faced before work costs are taken into account

This case study looks at the first of the two hypothetical claimants on the Employment and Support Allowance. The benefit was introduced as a replacement for Incapacity Benefit because the binary nature of Incapacity Benefit (a person is either too ill to work and thus qualifies for the programme, or is healthy enough and

does not) was thought to be too inflexible to what claimants with health-related problems could actually do.<sup>117</sup> As a result, the Employment and Support Allowance splits people who qualify for it into two groups: those who are completely incapable of working because of their condition, and those who have a condition that means that they are only temporarily unfit for work, or could

only manage small amounts of it. The claimants in the latter group receive a lower amount of benefit and get intermittent help to ease them through the process of moving into employment. The person in this case study is in the latter group.

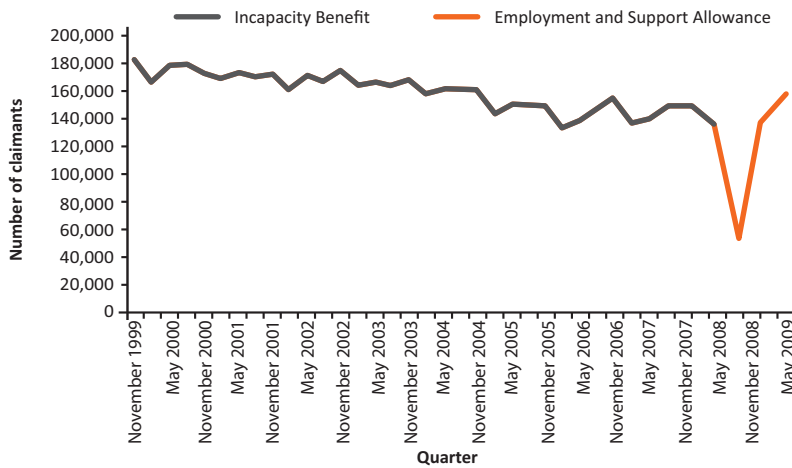
It is Incapacity Benefit and Employment and Support Allowance claimants who are most likely to suffer from the personal and social costs of unemployment outlined in chapter 2. They are more likely to spend a long time out of work, and to face greater problems when trying to get back into it, than claimants who are on more work-focused benefits.

Unfortunately, the latest figures for the Employment and Support Allowance show that the numbers of people starting a new claim each quarter are just as high as those under Incapacity Benefit (see Figure 54 and Figure 55). It is too early to say whether the change has been a failure, but the figures so far suggest that Britain may be creating more long-term, health-related unemployment in the current recession.

“Unfortunately, the latest figures for the Employment and Support Allowance show that the numbers of people starting a new claim each quarter are just as high as those under Incapacity Benefit”

<sup>117</sup> The Work Capability Assessment, introduced to act as a gateway to the new Employment and Support Allowance, was intended to “...assess entitlement to benefit based on what people can do, not what they cannot.” Department for Work and Pensions, *No One Written Off: Reforming Welfare to Reward Responsibility*, Public Consultation, Department for Work and Pensions, 2008

**Figure 54: Number of people joining Incapacity Benefit or the Employment and Support Allowance, United Kingdom, 1999-2009<sup>118</sup>**



**Figure 55: Number of people receiving Incapacity Benefit or the Employment and Support Allowance, United Kingdom, 2006-2009<sup>119</sup>**

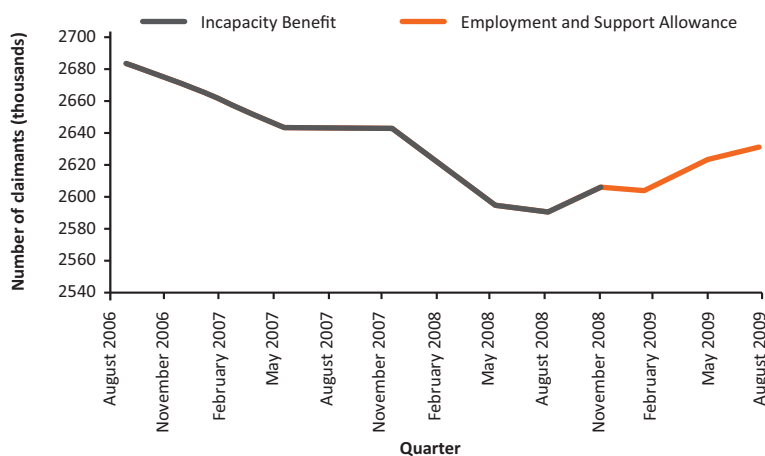


Figure 56 shows why Incapacity Benefit was thought of as ripe for reform for so long. Of all the people on the support at the last count in August 2008, i.e. before new claimants were pushed towards the Employment and Support Allowance, the majority had claimed for 5 years or more. In other words, once someone joined the benefit they were unlikely to leave.

The places with the highest proportions of Incapacity Benefit claimants among their population are shown in Table 6. All of them have suffered from industrial decline over the past few decades and started to generate high numbers of claims when it became hard for skilled local people who had been in jobs to adapt to demand for different skills or, of course, for no workers at all.

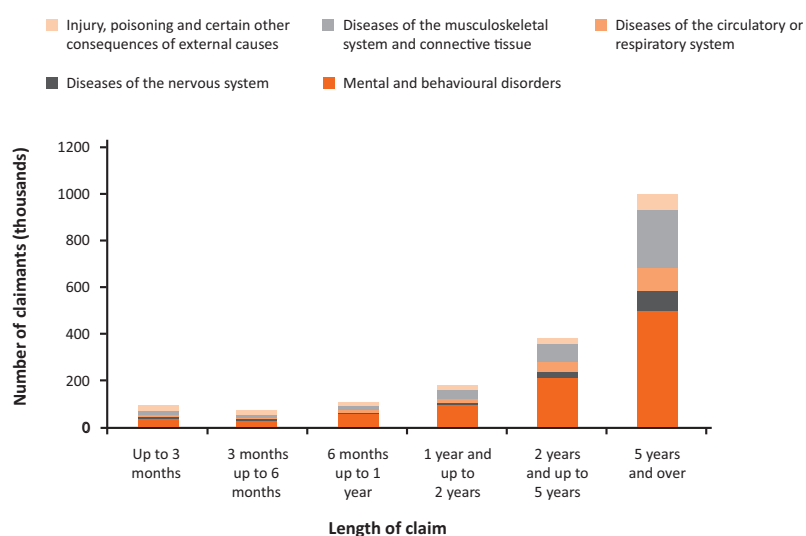
<sup>118</sup> Department for Work and Pensions, *Tabulation Tool*

<sup>119</sup> Office for National Statistics, "DWP Monthly Statistical Summary," 16th December 2009

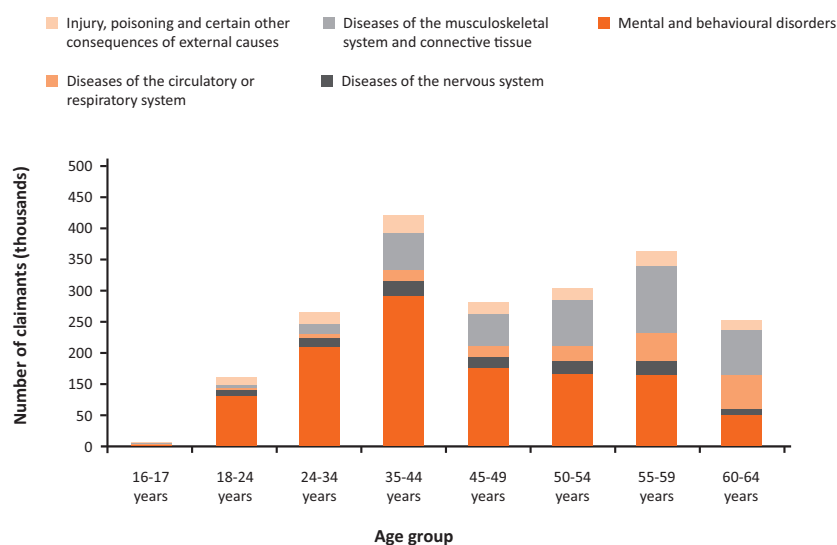


Figure 56 and Figure 57 show how the health problems faced by people on Incapacity Benefit are not particularly related to their age or length of claim. “Mental and behavioural disorders” are by far the most common, with “diseases of the musculoskeletal system and connective tissue” also afflicting many of the people on the benefit.

**Figure 56: Distribution of health disorders among Incapacity Benefit claimants by length of claim, United Kingdom, August 2008<sup>120</sup>**



**Figure 57: Distribution of health disorders among Incapacity Benefit claimants by age of claimant, United Kingdom, August 2008<sup>121</sup>**



120 Department for Work and Pensions, *Tabulation Tool*

121 Department for Work and Pensions, *Tabulation Tool*

**Table 6: Top ten local authorities by proportion of people claiming Incapacity Benefit or the Employment and Support Allowance only, May 2009<sup>122</sup>**

Local authority	Number of people claiming Incapacity Benefit or the Employment and Support Allowance	Number of claimants as a proportion of the local working age population
Blaenau Gwent	2,290	5.5
Merthyr Tydfil	1,780	5.3
Rhondda, Cynon, Taff	7,450	5.2
Neath Port Talbot	3,790	4.6
Caerphilly	4,640	4.4
Bridgend	3,420	4.2
Burnley	2,190	4.1
Carmarthenshire	4,290	4.1
Stoke-on-Trent	5,920	4.0
Hartlepool	2,180	3.9

At £89.80 per week, this case study receives less than people in the other half of the Employment and Support Allowance (£108.55) but the same amount as some people on Incapacity Benefit receive. The comparison between this claimant's income and income from work thus holds for many of the people on Incapacity Benefit.

Like the other case studies of single people over 25 with no children, this claimant receives £77 in Housing Benefit and £10.47 in Council Tax Benefit. Also like these people, the claimant faces a similar gain from working a full time job compared to only taking benefits (£54.06). Without the entitlement to tax credits enjoyed by the claimants with children, this case study faces, like nearly all the people without children, a sharp drop in income of £17 (from £197.27 to £180.27) once entitlement to the main benefit, Employment and Support Allowance, finishes suddenly once 16 hours have been worked. As shown by the budget constraint in Figure 50, there is then a subsequent boost to the claimant's income as tax credits are paid after 30 hours of work.

This cut in income at 16 hours of work means that, on top of a participation tax rate that gets ever higher as more hours are worked, the rate reaches 97% at 16 hours. It then remains above 72% for the remainder of the potential work spectrum. This, of course, is reflected in the replacement rate that the claimant faces, which never gets above 130% of unemployment income.

The marginal tax rates on working an extra hour are volatile because of this. They are really high at two points (hours 16 and then for most of the hours 23 to 40) but also really low (zero) at two points (hours 17 to 19 and at hour 30). These changes, combined with the participation tax rates in force, are particularly important for this claimant because of their likely health background. For someone who has been out of work for many years (in the case of Incapacity Benefit) or has a work-limiting condition, part-time work may be most appropriate. The incentives to take it, though, are quite low, as shown by Figure 51.

#### *Financial issues faced after work costs are taken into account*

Given their often lesser familiarity with work than other benefit claimants, people on long-term health-related benefits such as the Employment and Support Allowance are more likely than others to face particularly high work costs. It must be likely, although impossible

122 [www.nomisweb.co.uk](http://www.nomisweb.co.uk)

to know, that they have fewer work resources to draw on, such as old suits, that might help them defray the initial costs of getting a job. This is why, even though this case study benefits from an earnings disregard that allows them to take home every penny from their first three hours of work, they still end-up £20.60 down after 16 hours of work.

The addition of work costs means that this claimant faces around a 400% marginal effective tax rate at two points, on the first hour of work and then at 16 hours of work as the final tranche of the Employment and Support Allowance is withdrawn. This, of course, keeps the participation tax rate above 100% until 20 hours have been worked.

#### Case study 9: A single person over 25 years of age claiming the Employment Support Allowance and in the Support Group.

##### Income Breakdown

Employment and Support Allowance: £108.55

Housing Benefit: £77.00

Council Tax Benefit: £10.47

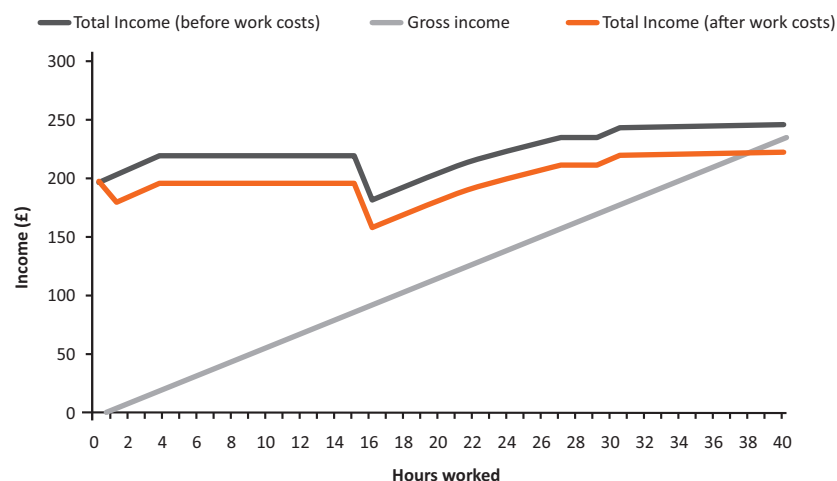
Total out of work social security income: £196.02

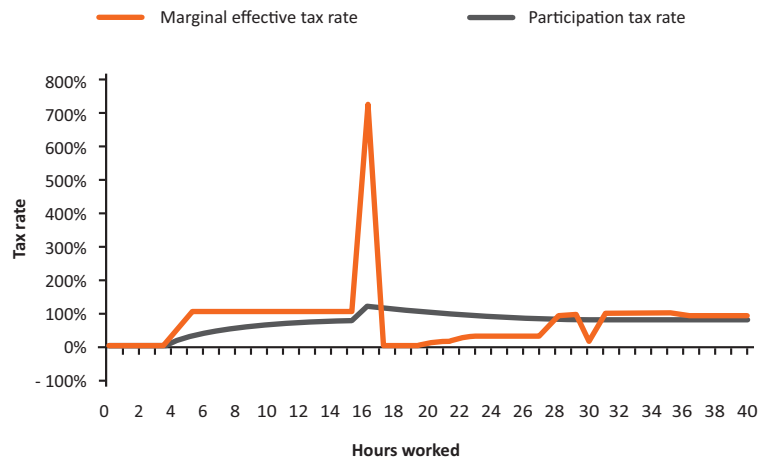
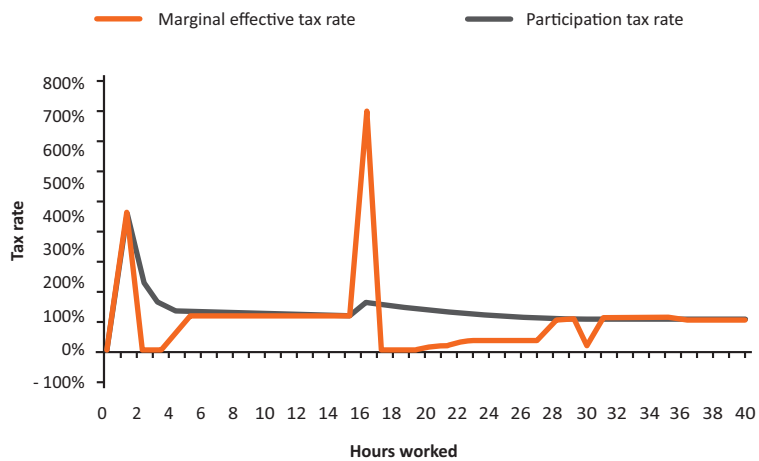
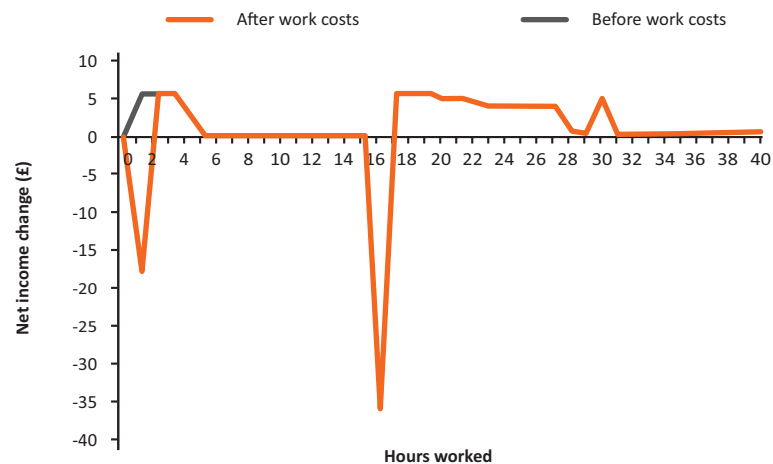
- Total income when working 16 hours per week: £180.27 (total gain against benefit income: £15.75). Total income when working 16 hours per week (after work costs): £156.67 (total gain against benefit income: -£39.35).
- Total income when working 30 hours per week: £239.32 (total gain against benefit income: £43.30). Total income when working 30 hours per week (after work costs): £215.72 (total gain against benefit income: £19.70).
- Total income when working 40 hours per week: £243.52 (total gain against benefit income: £47.50). Total income when working 40 hours per week (after work costs): £219.92 (total gain against benefit income: £23.90).

Average hourly wage after 40 hours of work (before work costs): £1.19

Average hourly wage after 40 hours of work (after work costs): 0.60p

**Figure 58: Budget constraint**



**Figure 59: Taxes before work costs****Figure 60: Taxes after work costs****Figure 61: Financial gain per hour**

*Financial issues faced before work costs are taken into account*

The claimant in this case study gets the same amounts of Housing Benefit and Council Tax Benefit as the person in the previous case study, but gets a higher amount from the Employment and Support Allowance while not being subject to any demands to work. This claimant's income is, therefore, different in one important respect to that given to the other case studies: it is for being out of work because the claimant is incapable of it rather than because they cannot find work. This person faces a lower cost of being out of work because they do not have to endure any conditionality measures imposed by Jobcentre Plus.

In the unlikely circumstance that this claimant were to get a full-time job of 40 hours per week, they would gain £47.50 in extra income, an amount similar to the gains elsewhere. However, because of the greater amount of Employment and Support Allowance received, the drop in income from being on benefits when taking a part-time job of 16 hours per week is much greater. Only the couple on Jobseeker's Allowance in case study 3 is similarly worse off from taking a part-time job than not working at all, as shown by the dip in the budget constraint at hour 16, shown in Figure 58. Between the working hours of 15 and 16, £35.75 is lost. Past this point, only by working for 19 hours will the claimant make a net gain from being employed. Figure 59 shows how these changes force the participation tax rate up to a negative level at 16 hours, after which it carries on at over 75% for the rest of the potential working schedule.

The marginal tax rates faced by the claimant are similarly volatile. Up until 18 hours have been worked they are mainly over 100% or, briefly at 16 hours of work, extremely high at 724%. They then fall to relatively low levels until increasing quickly again before the introduction of tax credits at 30 hours.

As with the previous case study, this type of claimant is most likely to want, and get, part-time work that does not inflame their condition too severely. With the tax rates so high on part-time work and the absolute losses from working a certain number of hours, the choice of doing this does not look rational.

*Financial issues faced after work costs are taken into account*

It is simply a difference in magnitude between the after work costs faced by this claimant and the previous one. Like that case study, this one also faces two spikes in taxes: once one and 16 hours have been worked. This means a person in a situation similar to this one would be £39.35 worse off after working for 16 hours than doing nothing.

Given that this type of claimant is unlikely to get a full-time job very easily, the participation tax rate of above 100% on working for anything less than 24 hours is particularly serious.

## Financial incentives to work in the British benefit system

There are many different situations faced by the typical claimants' profiles in the case studies, but they all have one thing in common: the social security system is messy and oppressive for each one of them. It is baffling to think how any claimant could hope to work out how their income will change once they get a job. The income taken home from an hour of work can vary by so much that only with professional help could someone fathom what is going to happen. For a welfare system that is meant to help people get back to work and be independent, this is perverse.

The changes in what someone might take home are dictated by withdrawal rates on incomes that can exceed 100%, as shown by case studies 3, 8 and 9. Nearly every claimant that has circumstances similar to these case studies faces an effective tax on working of over 80%, and often over 90% for a long stretch of hours. This is a counter-productive approach to encouraging work.

Eligibility for tax credits changes this situation markedly once claimants work for a certain number of hours. But, as a result, the benefit system gives money on one hand, then takes it away very quickly after that, thus restoring high withdrawal rates.

Some claimants fare much better than others. Anyone who has a child gets two tranches of cash from the system, at 16 and 30 hours, as shown by case studies 4, 5, 6 and 7. Because parents get Child Benefit and Child Tax Credit on top of other benefits, they start with a comparatively high income and end with a comparatively high income after enjoying the same increase between the two as nearly anyone else.

The addition of work costs to the calculations makes this advantage even more stark. Only those case studies that have children make any money from working for 16 hours. All the others suffer from a financial penalty that ranges from £13.07 to £39.35. Interestingly, the much smaller benefit payments received by case study 1, i.e. the £50.95 youth rate on Jobseeker's Allowance, makes the claimant's gain from working for 40 hours, both before and after work costs, very similar to the gains enjoyed by the claimants with children.

**Table 7: Summary work incentives table for all the case studies (£)**

	Case study 1	Case study 2	Case study 3	Case study 4	Case study 5	Case study 6	Case study 7	Case study 8	Case study 9
Total out-of-work income	122.42	151.77	191.92	289.87	345.98	249.72	305.83	177.27	196.02
Total change in income after 16 hours of work	10.53	8.53	-8.15	32.4	32.4	51.9	51.9	3	-15.72
Total change in income after 16 hours of work with work costs included	-13.07	-15.07	-31.75	8.8	8.8	28.3	28.3	-20.6	-39.35
Total change in income after 30 hours of work	34.58	47.15	46.57	46.57	46.57	72.64	72.64	47.97	43.3
Total change in income after 30 hours of work with work costs included	10.98	23.55	22.97	22.97	22.97	49.04	49.04	24.37	19.7
Total change in income after 40 hours of work	74.6	53.96	52.66	52.66	52.66	78.73	78.73	54.06	47.5
Total change in income after 40 hours of work with work costs included	51	30.36	29.06	29.06	29.06	55.13	55.13	30.46	23.9
Average per hour wage after 40 hours of work	1.87	1.35	1.32	1.32	1.32	1.97	1.97	1.35	1.19
Average per hour wage after 40 hours of work with work costs included	1.28	0.76	0.73	0.73	0.73	1.38	1.38	0.76	0.60

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# 5

## Recommendations on How to Save Money and Improve Incentives

The current state of the government's finances means that money spent on improving incentives must come from savings, not debt or additional taxation. This is, of course, a simple movement of money from one pot to another. In many of the recommendations below this means an emphasis on just one of the objectives in the iron triangle: reducing social security spending.

By making these changes the recommendation further on for increasing the work incentives for people on welfare can then be paid for. Given the low rewards from getting work highlighted by the case studies above, it is vital that these incentives be raised.

In total, the package of recommendations meets the three objectives stated above. It does not make the unemployed poor financially worse off but cuts the social security bill and, through increasing the incentives to work, seeks to raise the labour supply.

### **Recommendation 1: claw back the 3% increase in the value of some benefits in 2009-2010 by reducing expected rises in their value in the next few years.**

The Secretary of State for the Department for Work and Pensions is required by the Social Security Administration Act 1992 to ensure that benefits maintain their values relative to the level of prices. Because of this link to prices rather than earnings, many benefits have slipped in value against the wages earned across the working population, but have maintained their purchasing power. The main unemployment benefit has done this, as shown by Figure 62 and Figure 63.

In the 2009 Pre-budget Report the Chancellor broke this tradition and, in the face of a 1.4% decline in RPI to September 2009 (the RPI count that would normally be the basis for the increases in benefits linked to RPI in April 2010), decided to increase the value of all such benefits by 1.5%, thus giving the people affected a real 2.9% rise in the value of their income. Given the state of the public finances, there is no logical reason for this.<sup>123</sup>

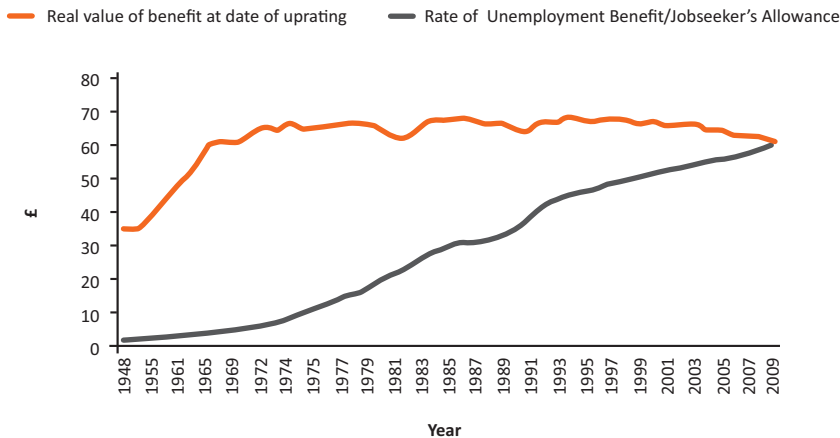
If the government were to reverse this change over the next few years then it could reclaim the £700 million that the Treasury expects this change to cost. This could be done by reducing the increases in the value of affected benefits by a sufficient percentage each year until the money is recouped.<sup>124</sup>

**Projected saving: £700 million.**

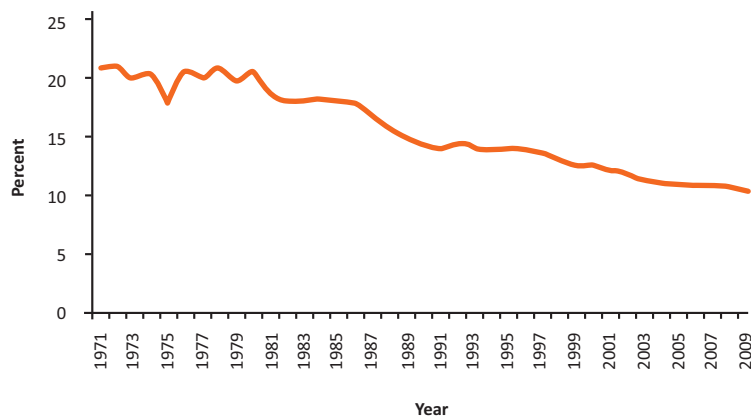
123 HM Treasury, *Pre-Budget Report*, HM Treasury, 2009, pp 79

124 HM Treasury, *Pre-Budget Report*, HM Treasury, 2009, pp 11

**Figure 62: Value of the main unemployment benefit relative to prices, 1948-2009 (£ per week, April 2008 prices)<sup>125</sup>**



**Figure 63: Value of the main unemployment benefit as a percentage of average earnings, 1971-2009 (2008 prices)<sup>126</sup>**



**Recommendation 2: taper away the Family Element of the Child Tax Credit and Child Benefit at 39% once the Child Element of the Child Tax Credit has been exhausted.**

The Institute for Fiscal Studies recently suggested this change as something the government might do were it to want to divert spending towards poor families and away from richer ones. The Family Element of the change would save £1.3 billion a year alone, while applying the same approach to Child Benefit would save a further £4.5 billion a year.

People with circumstances similar to the ones in the case studies analysed here would not be affected by these changes, but those on higher incomes would. Following this recommendation would mean that the Government would not be able to pursue some of the childcare financing suggestions

<sup>125</sup> Office for National Statistics, *The Abstract of Statistics and Benefits, National Insurance Contributions, and Indices of Prices and Earnings: 2008 Edition*, Department for Work and Pensions, 2009, pp 55. Please note that the year and month of recording has changed several times in the data series

<sup>126</sup> Office for National Statistics, *The Abstract of Statistics and Benefits, National Insurance Contributions, and Indices of Prices and Earnings: 2008 Edition*, Department for Work and Pensions, 2009, pp 55



made in a previous Policy Exchange report, *Reforming the UK Family Tax and Benefit System*.

Furthermore, readers must note that this recommendation, in combination with recommendation three, will change the work incentives of some people receiving tax credits. The savings made here thus show how much money can be taken out of the tax credits system, but any plan for reform would need to consider the structure of the system as a whole. This is a question that Policy Exchange will return to in later work.

### **Projected saving: £5.8 billion**

**These savings amount to around £6.5 billion.** A future government of any stripe could use them to improve the incentives to work faced by millions of people on benefits.

These savings are derived from what an economist would call a “static” view of the world, i.e. that spending is reduced without any effects on behaviour elsewhere. This means that these calculations do not take account of the benefit savings and extra tax revenue that might be generated by having more welfare claimants in work. These calculations can be taken as they are, and the following recommendations for improving incentives paid for, without any need for anything else to happen.

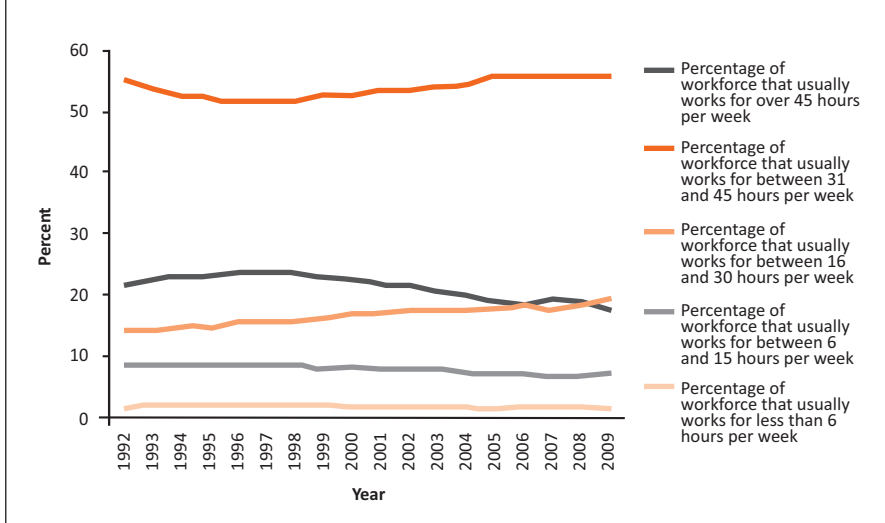
The alternative way of calculating the saving from having more people in work is by using a “dynamic” view of the world. This approach, by making a judgement about how many benefit claimants will be in work if the incentives to do so improve, is a very useful way of looking at the changes that could be achieved through certain welfare reforms. Given the pressure on the public finances at the moment, however, it is probably better to be as certain as possible about how improvements in incentives can be paid for.

The case studies showed three things about the work incentives faced by typical benefit claimants: that they can be weak across the income spectrum (when all benefits have been combined, not just through the high withdrawal rates of one benefit or another), that they can be very volatile and, in particular, that they can be too insignificant for people who want to work part-time. All three of these issues need to be dealt with by reformers, but the recommendations here only address the last one as the problem of how to increase the financial incentives to do part-time work is the most pressing one right now.

The definition of “part-time” used here is work done for 16 hours or less per week. As shown by Figure 64, 8.1% of the labour force normally works within this band of hours. This definition does not, of course, capture all the jobs that are normally thought of as being part-time. For example, a good proportion of people working for between 16 and 30 hours per week would normally be thought of as working part-time. However, this definition is used here for the sake of simplicity.

Quite simply, it is not clear why anyone on benefits would consider taking a job that requires working for less than 16 hours work a week. The participation tax rate, which measures the amount of money that a claimant would gain from deciding to work for a given wage and number of hours, rises quickly to around 80% for every single person analysed here. For each one this means that, after their earnings disregard has been exhausted, they will not keep any more of what they earn. 80% of their earnings at a given number of hours will be lost.

**Figure 64: Hours worked across the labour force, United Kingdom, 1992-2009<sup>127</sup>**



Once in a job, the answer to the second most important question “What will I get if I work a few more hours?” is even worse. Case studies 1, 2, 6 and 7 all face the complete loss of earnings if they decide to work an extra hour after they have exhausted their earnings disregard. Case studies 3, 4, 8 and 9, because they have higher initial awards, face the same situation but must, once they have worked for 16 hours, give up a whole tranche of their benefit. Clearly, there is not much reason for someone on benefits to either consider work for less than 16 hours a week, or try to get more hours if they do work for less than 16 hours a week.

The difficulty of this situation is compounded by the costs of work that benefit claimants must consider. For each case study the financial gains per hour from work are tiny once the burden of paying for work clothing and travel is taken into account. The way that these costs have been levied in the analysis is only meant to show how some people may face this problem, not how everyone does. But if someone on benefits must start paying out money for new things once they have a job, the reason to work may well be depressed considerably.

Clearly, the holistic change that Britain’s social security system needs should mean that working is not a difficult choice for anybody who receives benefits. The extent of this aim depends on a whole host of factors but, in principle, high tax rates on poor unemployed people are not likely to encourage them to find employment.

This means that welfare reform must concentrate on what matters most for the next few years: getting as many people at least some work. The tax credits system may be flawed, but its bias towards two groups of people, those who work for 30 hours per week or have children, means that Britain’s social security system is already trying to incentivise work among these groups. In 2006, a survey of people who had claimed Jobseeker’s Allowance or other benefits more than once in the few years prior to them being questioned found that 66% of the people who had left the benefit had done so for a job that required more than 16 hours of work per week. But even in times of strong economic growth that left everyone else unemployed, i.e. the other 44%.<sup>128</sup>

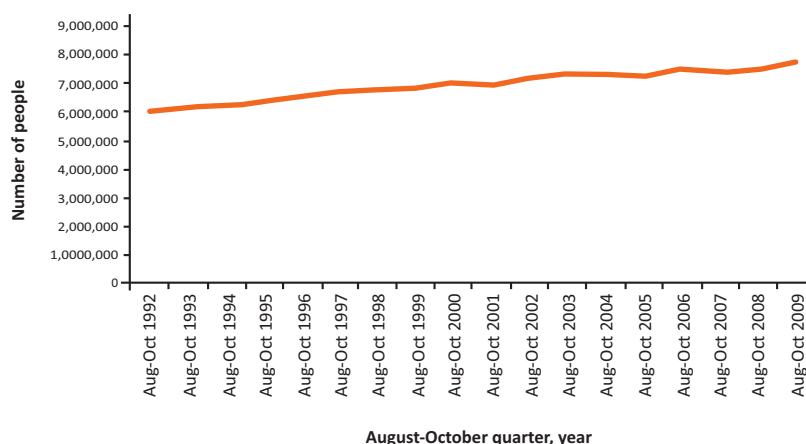
127 Office for National Statistics, *Labour Force Survey*. Data are the three-month rolling averages of the survey as at October of each year

128 Carpenter H, *Repeat Jobseeker’s Allowance Spells*, Department for Work and Pensions, 2007, pp 34

Financial incentives do matter to whether someone on benefits will take work or not. In April 1992 the rules for Family Credit (a forerunner to the Working Tax Credit) were changed so that a claimant had only to work for 16 hours per week rather than 24 in order to get the financial support. In the years after this change, the number of hours worked by recipients changed substantially. From 1993, the number of people working for between either eight and 15 hours or 24 and 29 hours started to decline, while there were substantial increases in the amount of people working for around 16 hours.<sup>129</sup> This would suggest that a change in the incentives offered by the social security system would affect the amount of work done by people on benefits.

Improving the incentives to work part-time could affect many different types of claimant. Since 1992 the number of part-time jobs in the economy has risen by around 1.2 million (see Figure 65).<sup>130</sup> Many more jobs require shift work or people to work unusual hours. In principle, if the labour market needs more people to fit part-time hours then any reform that looked to increase the supply of people prepared to do that work could help to meet that demand. This would, logically, help more people not working any hours and on benefits to get at least some work.

**Figure 65: Number of people in part-time work, United Kingdom, 1992-2009<sup>131</sup>**



In one survey the average number of hours worked per week by people who had left Jobseeker's Allowance was 36. However, 26% of the respondents were working part-time (less than 30 hours per week), a phenomenon that was far more common among women than men (40% rather than 23%) and claimants who had been on other benefits or had literacy and skills problems.<sup>132</sup>

While helping everyone on benefits to have more flexibility, increasing the financial gains from part-time jobs should also help particular groups of benefit claimants. A report for the Department for Work and Pensions in 2006 argued that part-time work is particularly helpful for people who want to balance work and caring; who have health problems; who are in education or training; are close to retirement and want to reduce their hours of work; who want to volunteer; and anybody who needs a "stepping stone" into the labour market.

<sup>129</sup> Bell K, Brewer M and Phillips D, *Lone Parents and 'Mini-Jobs'*, Joseph Rowntree Foundation, 2007, pp 70

<sup>130</sup> Office for National Statistics, *Labour Force Survey 2009*, 2009

<sup>131</sup> Office for National Statistics, *Labour Force Survey 2009*, 2009

<sup>132</sup> Carpenter H, *Repeat Jobseeker's Allowance Spells*, Department for Work and Pensions, 2007, pp 39

In short, of the three types of claimants that welfare reform often looks to help – people who are simply unemployed, carers (particularly lone mothers) and those with health problems – reform of the incentives to work part-time could be beneficial. The two latter groups actually state in surveys that part-time work would suit them best. Back in 1996, one survey found that among people on disability benefits looking for work, 30% of them were looking for a part-time job.<sup>133</sup> Other studies have both found that lone parents want part-time work so that they can look after their children at the same time and take gradual steps into the labour market, and that many women in this situation are good at holding on to their jobs despite the difficulties they may face over caring and, sometimes, poor qualifications.<sup>134</sup>

However, despite the welfare state needing to incentivise work whether it is part- or full-time, stating this still leaves some questions unanswered. Should reformers be content with people just remaining in a hybrid situation where they get some income from the government and some from work? Given that having no connection with work can have such serious personal consequences, this is a significant step forward if it is all that someone can achieve.

In fact, given that so much of the concern about modern social problems in Britain is linked to unemployment, as shown by chapter 2, it is important that the welfare reformers of the next decade ponder the question of whether encouraging some work among a broader range of people might help to lessen some of these problems. Breaking the cycle of long-term unemployment and its effects might only come through short steps into work.

Some of the evidence from how people treat part-time jobs actually suggests that this type of work can help claimants move to full-time work. Several surveys have found that part-time work can act as a stepping-stone into full-time work. One found an association between working for less than 16 hours per week one year and more the next, with the association being stronger with the more hours initially being worked.<sup>135</sup> Another found that people on benefits working part-time were more likely to have left benefit eight months later.<sup>136</sup> People with disabilities have also been found to be more likely to leave benefits if they initially start taking some work.<sup>137</sup>

Interestingly, this transition may take place in many different jumps. One study of the work experiences of lone mothers leaving Income Support found that both temporary jobs and job changes were common during the first 12-18 months of making the transition to tax credit-supported part-time work. This may suggest that the benefit system needs to both incentivise this type of work and tolerate gradual adaptation to it.<sup>138</sup>

But how should the incentives to take part-time work be increased? There are essentially two ways in which people on benefits or low wages can be encouraged to work or work more: by giving them extra income for working or by allowing them to keep more of what they earn. The latter is achieved by lowering (effective) tax rates while the former can be met by tax credit schemes and suchlike. Britain's minimum wage is a hybrid between these two approaches.

There are many different suggestions for how either approach might be pursued. One scheme in the 1990s, called the "Back to Work Bonus", tried to award people on benefits for working in a similar way to what the government is now trying to achieve with tax credits. If someone was on Jobseeker's Allowance or Income Support

133 Rowlingson K and Berthoud R, *Disability, Benefits and Employment*, Department of Social Security, research report 54, 1996

134 Bell A, Finch N, La Valle I, Sainsbury R and Skinner S, *A Question of Balance: Lone Parents, Childcare and Work*, Department for Work and Pensions, research report no 230, 2005; Rafferty A, "The Characteristics of Lone and Coupled Mothers Working Fewer than 16 hours per week," Department for Work and Pensions, in-house report no 125, 2003

135 Iacovou M and Berthoud R, *Parents and Employment*, Department for Work and Pensions, research report no 107, 2000

136 Ashworth K and Youngs R, *Prospects of Part-Time Work: The Impact of the Back to Work Bonus*, Department of Social Security, research report no 115, 2000

137 Dewson S, Davis S and Loukas G, *A Stepping Stone to Employment? An Evaluation of the Permitted Work Rules*, Department for Work and Pensions, research report no W214, 2004

138 Millar J, "Better-off in Work? Work, Security and Welfare for Lone Mothers," in Glendinning C and Kemp P (eds), *Cash and Care*, The Policy Press, 2006

and started work, then they would accrue an entitlement to a bonus payment of 50% of all the money they earned above the earnings disregard, but would only get the money once they had completely left either benefit. Philosophically, it attempted to encourage claimants to make the steps to leaving the main unemployment benefit completely. One report that analysed the effects of the scheme found that the most consistent insight to take from it was that the greater awareness of part-time work being allowed under the two benefits attracted many more people to take it up.<sup>139</sup>

The government's new scheme, "Better Off in Work Credit", is along these lines. In a recent white paper it announced that anyone who has been on benefits for six months or more and then finds a job will enjoy a guarantee of being £40 a week better off.<sup>140</sup>

“If reformers want to allow claimants to keep more of the money they earn when in work, they can change the benefit system in two ways: by raising the amount of money that someone is allowed to earn before they start losing benefits, or by lowering the rate at which those benefits are taken away once they start working”

If reformers want to allow claimants to keep more of the money they earn when in work, then they can change the benefit system in two ways: by raising the amount of money that someone is allowed to earn before they start losing benefits (the earnings disregard), or by lowering the rate at which those benefits are taken away once they start working. Both changes would be an attempt to lower the participation tax rate that a claimant will face, but by

only concentrating on the initial tranche of wages, earnings disregard policies do not seek to change marginal effective taxes on the income earned above that level.

Most suggestions for reform attempt to combine both of these methods. *Dynamic Benefits*, the report from the Centre for Social Justice, seeks to raise the earnings disregards (according to the type of household making a claim) and then withdraw all the benefits that are being paid at a universal rate, 55% of post-tax earnings. Entitlement to housing support would also affect the level of disregard that a person is entitled to. For some claimants this would mean only a small increase in the disregard they are entitled to now, but an increase in the earnings they are allowed to keep because of the imposition of a lower withdrawal rate.

Many recommendations for changing earnings disregards suggest a different combination of the two methods, i.e. a flat increase in the disregard followed by different withdrawal rates according to how much a claimant was being given in their original benefit award. Suggestions for how big the increase in the disregard should be range from around £50 to a level equivalent to what someone would earn after working for 16 hours on the minimum wage.<sup>141</sup> This is a line of reform that has been advocated by campaigns such as *Need not Greed* from Community Links, a community services organisation based in East London.

In the simplest sense, these two suggestions for change offer a choice between alternative ways of trying to achieve both simplicity and an increase in work incentives. The Centre for Social Justice proposal offers the imposition of different disregards but the same withdrawal rate, while other reformers argue for the same disregard, and then different withdrawal rates.

Because both of these proposals seek to allow people to keep more of their money rather than giving them more state funding, they appeal to what should

139 Ashworth K and Youngs R, *Prospects of Part-Time Work: The Impact of the Back to Work Bonus*, Department of Social Security, research report no 115, 2000, pp 56

140 Department for Work and Pensions, *Building Britain's Recovery: Achieving Full Employment*, The Stationery Office, 2010, pp 14

141 There is an extensive literature on the arguments for and against raising earnings disregards in the benefit system. See Barbour A, "Work Incentives in the Benefits System: Increasing Levels of Earnings Disregards," Community Links evidence paper no 12, 2008; Bell K, Brewer M and Phillips D, *Lone Parents Working Under 16 hours per week ('mini-jobs')*, Joseph Rowntree Foundation, 2007; Brewer M, Saez E and Shephard A, *Means Testing and Tax Rates on Earnings*, Institute for Fiscal Studies, 2008; and House of Commons, *The Best Start in Life? Alleviating Deprivation, Improving Social Mobility and Eradicating Child Poverty*, vol 1, The Stationery Office, 2008

be an important principle in the welfare system: that living independently is probably the best state of affairs for most people. In other words, a pound earned is worth more than a pound given. It is for this reason that reformers should favour the disregard and withdrawal rate approach over the tax credits one of handing out more money.

But how can the best bits of these two (disregard and withdrawal rate) approaches be moulded into a change that affects all of the claimants analysed here, and can be applied quickly enough for work incentives to be dramatically improved for the coming few years? By taking the immediate benefits of a higher earnings disregard – which can be applied now – and extending them to all claimants on income-based benefits, as the argument for a universal taper rate would have reformers do. One universal disregard across the system would dramatically improve the incentives to work part-time jobs, and simplify things for claimants.

However, this recommendation should not be seen in isolation. Evidence from the United States suggests that increasing an earnings disregard and improving the incentives to work should be combined with a package of other measures, such as good employment services and strong expectations on claimants to look for jobs.<sup>142</sup> Given that the government is paying attention to the need for expectations on claimants (through the Gregg Review) and is implementing better employment services for some claimants through the Flexible New Deal programme, how, and by how much, should disregards be raised?

**The disregard should be raised to £92.80 for all benefits, meaning that anyone on the minimum wage who works for 16 hours keeps everything that they earn.** The case studies showed that the incentives to work fewer than 16 hours are very poor. By raising them to a level that any claimant on any benefit could take advantage of, Britain's social security system might start to change this situation. This change would immediately give a big financial reason to leave unemployment or work more for 2.8 million people, or anyone who is making an income-based claim for welfare.<sup>143</sup>

Because the high participation and marginal effective tax rates are often an amalgam of several different benefits being withdrawn at once, this disregard would apply to every one of them. This would mean that a claimant would keep all of their main benefit (Jobseeker's Allowance, Income Support and Incapacity Benefit/the Employment and Support Allowance), plus all of their Housing Benefit, Council Tax Benefit and any other add-ons until they earned £92.80.

By having one disregard, the system would also have a greater semblance of simplicity. Every time a person on benefits asked a welfare adviser "How much will I be better off by if I take that job next week?" the answer will always be "By at least £92.80". It would be reasonable to expect that this statement would be more powerful than the current ones that claimants have.

But why £92.80? Because the tax credits system is currently set-up to operate along the hours rules currently in place (this change would implicitly change those rules, as the normal tapering of benefits would still apply after the disregard). The only way to achieve reform within the current system, i.e. without having to tear-up the tax credits system as well, is to try and change things within the current structure.

It would also mean more people would be drawn into the benefit system. This is an inevitable consequence of trying to lower the amount by which benefits are withdrawn at the low end of the income and hours spectrum. This is a trade-off

142 Blank RM and Matsudaira JD, "The Impact of Earnings Disregards on the Behaviour of Low Income Families," NBER working paper series, no 14038, 2008

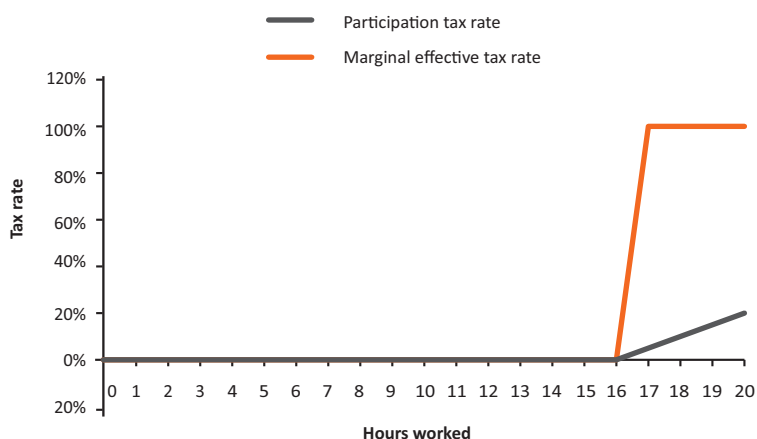
143 Department for Work and Pensions, *Tabulation Tool*

worth making, given the amount of people now out of work and experiencing the poverty trap. Solutions to it include restricting benefits to anyone above a certain level of earnings or having a sharper taper rate.

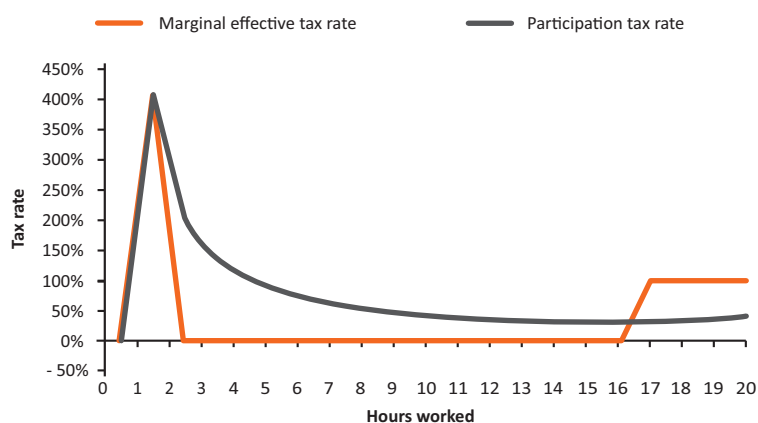
After increasing the disregard to £92.80, the tax rates faced by someone over 25 years of age on a typical Jobseeker's Allowance claim would change to the ones shown by Figure 66 and Figure 67. Over the first 20 hours of work the participation tax rate before work costs would fall to a maximum of 20%, while after work costs it would fall much more quickly to under 50%. After 16 hours of work this would leave the claimant £92.80 better off before work costs, and £69.20 better off after them.

**Recommendation 3: raise the earnings disregard for all means-tested benefits to £92.80, or the minimum wage for adults times 16 hours.<sup>144</sup>**

**Figure 66: Taxes on the first 20 hours of work faced by a Jobseeker's Allowance claimant over 25 years of age, before work costs and with a £92.80 disregard**



**Figure 67: Taxes on the first 20 hours of work faced by a Jobseeker's Allowance claimant over 25 years of age, after work costs and with a £92.80 disregard**



144 Since the Institute for Fiscal Studies estimated how much a change such as this would cost, there have been increases to some disregards (to the levels discussed in this report). This means that the actual cost of having a universal disregard of £92.80 is likely to be less than the £5.1 billion outline here



## How much the change would cost

Any effort to improve work incentives without increasing the overall fiscal burden of the welfare state implicitly works on the principle that priorities in the benefit system should be changed. The recommendations here are no different. By taking away money from people with sufficient income to support themselves, as the fiscal measures above propose, and then giving the money saved to poorer welfare claimants, the recommendations here should shift some of the balance in Britain's social security system.

Thankfully, a shifting of this balance leaves enough money to pay for change. When the Institute for Fiscal Studies worked out the cost of its own proposals, it found that raising the earnings disregard for Housing Benefit and Council Tax Benefit by the minimum wage times 16 hours would cost £4.5 billion, while raising it for Jobseeker's Allowance and Income Support would cost just over £600 million (this latter change would also now encompass some of the Employment and Support Allowance). Combined, this would cost £5.1 billion.<sup>145</sup>

These figures only refer, of course, to income-based benefits. The contributions-based parts of Jobseeker's Allowance, Incapacity Benefit and the Employment and Support Allowance should also be included in this change, but doing so would require a lot more thought about how Britain's social security system works for people who receive benefits because they are entitled to them, and not necessarily because they are poor.

By starting with all income-based benefits, reformers can start to move towards the imposition of a universal incentive to work. Over the long-term, contributions-based benefits can be brought into the fold. As a whole, this change would increase the financial reason to work for lots of people who need to avoid the personal costs of not doing so.

**Projected cost : £5.1 billion**

**Total projected financial gain from the three recommendations: £1.4 billion.**

<sup>145</sup> If the government wanted to make a cheaper, and less dramatic, change to the earnings disregard applied to means-tested benefits then it could choose to increase the disregard to £50 rather than £92.80. The Institute for Fiscal Studies estimated the total cost of this measure to be just over £2 billion (in 2009/2010 prices). See Brewer M, Saez E and Shephard A, *Means Testing and Tax Rates on Earnings*, Institute for Fiscal Studies, 2008, pp 51. The figures used here have been increased from their original 2007/2008 levels using the Treasury's GDP deflator tool





Britain has a serious problem with unemployment. Even when economic growth was strong in the mid-2000s there were still around 2.3 million people who had been on benefits for over 5 years. Now that many more people have started to take welfare, this problem is only going to get worse.

Being unemployed is bad for the health and confidence of the people affected, but it also damages communities. It is exacerbated, however, by the depth of the poverty trap in the social security system. This report shows how, through losing so much of their benefits and then paying tax, someone on welfare has very little financial incentive to seek work – over a normal working week the average wage rate can be as low as 60p.

This report also shows how this problem can be solved. By cutting money out of the tax credits bill, people who want to leave welfare can be allowed to keep their benefits for longer and thus see that there is a really good financial reason to work. This way, many of the 5.8 million people on benefits in Britain can be helped to improve their lives by taking at least a small step into the labour market.

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