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# Wages, taxes and top-ups: the changing role of the state in helping working families ends meet

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### JRF Programme Paper Minimum Income Standards

## WAGES, TAXES AND TOP-UPS: THE CHANGING ROLE OF THE STATE IN HELPING WORKING FAMILIES MAKE ENDS MEET

#### Donald Hirsch and Laura Valadez

#### June 2014

This paper:

- looks at the changing influences of pay, benefits and taxes in allowing working families to reach minimum living standards from the late 1990s to the most recent recession;
- outlines and evaluates ways to help more low-earning families achieve an adequate income;
- assesses how the three main political parties' tax policies would affect families on lower incomes.

The Joseph Rowntree Foundation (JRF) commissioned this paper as part of its programme on minimum income standards, which aims to define an 'adequate' income and looks at what can be done to ensure more people achieve it.

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## **Executive summary**

In the past two decades, the growth of tax credits combined with only modest improvement in wages have changed the balance in working families' income sources. Many families on low earnings have had more help than before from inwork support, and this has become more important relative to wages for such families. For many families, disposable income rose substantially between 1998 and 2008, and for lone parents and dual earner couples with children in particular, the chance of reaching a minimum acceptable living standard increased substantially. Single-earner couples also became better off, but on low earnings they were still likely to have substantially less than they need.

These trends are identified in this paper by measuring the disposable income of typical low-earning families and comparing it to the Minimum Income Standard, a benchmark of income adequacy determined by members of the public. The paper shows the extent to which some of the earlier gains were reversed in the recession, as earnings fell relative to prices and some in-work benefits were cut. It finds that, having come to rely on state support, low-income working families have therefore suffered when the state has made cuts. Moreover, given that those depending on tax credits, and in future on Universal Credit, have these credits withdrawn sharply whenever their earnings increase, it can be extremely difficult to make up for any cuts to state support by earning more (for example, working more hours). Tax cuts have slightly but far from fully offset the effect of reductions on in-work support.

The paper looks at several future policy options that could potentially address this deterioration in the ability of low-earning families to meet the Minimum Income Standard, including the known tax proposals of the three main political parties. In the long term, strategies to increase wages will need to play a part, especially if reliance on state credits is to be reduced. However, even in light of the recovery, wages are unlikely to increase fast enough in the immediate future to improve net incomes without additional government help, which must therefore also have a role. Furthermore, if in-work support continues to be cut, the deterioration of living standards for those at the bottom will continue. The paper shows that increases in Universal Credit – or at the very least the avoidance of cuts to Universal Credit – will be several times more cost-effective in helping these families than tax cuts of any kind.

## 1. Introduction

This paper considers the extent to which wages provide enough for lower-earning families to live on, how much these families are taxed and the extent to which the state tops up their income to adequate levels. It shows how the interaction between these factors has changed over the past 15 years. The focus is on families with children because it is these households where state support to supplement wages from work has had by far the greatest impact.

Working parents with modest earnings often struggle to meet essential living costs. Bringing up a family at a standard that allows healthy living and a minimum level of social participation is far from cheap. A widening of pay inequalities has helped make the traditional model of a 'single male breadwinner' unrealistic for many couple parents (Lawton and Thompson, 2013), while lone parents face the combined pressures of providing care and income for their families. Moreover, even with two parents working, the escalating cost of childcare can greatly reduce disposable income, as it can for a working lone parent. All these pressures have become much greater in the past five years, as costs have risen sharply, but pay has not. Governments have tried to address this issue for families in recent years through policies to boost low working incomes and help 'make work pay'.

A sequence of means-tested top-ups – progressively more generous – were introduced by successive governments: Family Income Supplement (1971), Family Credit (1986), Working Families Tax Credit (1999), and Working Tax Credit/Child Tax Credit (2003). These top-ups evolved from providing a modest supplement to boost working incomes, to potentially paying half or more of all income to some families. Moreover, under the tax credit system since 1999, they have covered the majority of childcare costs up to certain limits, helping to tackle a particular work disincentive for lone parents and second earners with small children. Working families with the lowest incomes are also eligible for Housing Benefit (if renting) and for Child Benefit. Universal Credit will continue with the main features of tax credits and other in-work benefits, while better integrating these benefits with each other and with and out-of-work support.

Such support has helped to reduce family poverty. It has made work worthwhile for many families. It has also, however, made low-income working families much more reliant on in-work benefits than they have been previously. This has made them highly vulnerable to the effect of public sector cuts.

The overall level of cash transfers between the state and working families is also affected by direct taxation. Many families both pay money to the state in income tax and national insurance contributions and receive money back as benefits and tax credits. This happens in separate systems, with taxation assessed for the individual, and benefits and credits for families. However, it is the overall net transfer to or from the household that determines the relationship between earnings and final income, so it makes sense to consider the effect of what the state gives and what it takes away as part of the same overall picture. Recent increases in tax allowances have been presented as an effective way of helping families on modest working incomes. This paper therefore looks at the respective contributions of wages, taxes and benefits (including 'credits') in determining the disposable income of low-income working families between 1998 and 2013. This covers the period from the just before

tax credits were introduced, and includes the effects of the economic downturn after 2008. It considers how the mix of wages, taxes and benefits has contributed to the adequacy of families' disposable incomes, measured against the benchmark of the Minimum Income Standard, which is derived from what ordinary people consider to be needed for an acceptable living standard (see Box 1 overleaf). It does this by asking two types of question about working incomes:

- For different family types, with parents working on 'typical' below-average wages, how adequate are earnings in reaching a minimum income, and how do taxes and benefits affect this? (More precisely, this looks at families with one or two full-time workers on lower-quartile full-time earnings. The lower quartile is the mid-point of the bottom half of the distribution, and is therefore typical of below-median earnings. Lower-quartile earnings were £335 a week in 2013).
- How much do families need to earn in order to have a minimum disposable income, and how do taxes and benefits affect this?

These relationships have changed significantly over the period reviewed. Overall, inwork benefits became substantially more generous between 1998 and 2008. This helped raise the incomes of many families with below average earnings to a more adequate level than previously. At the same time it made many working families, especially lone parents, very heavily dependent on state support. Between 2008 and 2013, falling real earnings meant that the shortfall between earnings and minimum requirements widened. However, the benefits system did not help to make up this gap, and since 2011, cuts in in-work support have widened it further.

Taxation has also played a changing role in this mix. For people on lower-quartile earnings, income tax has reduced significantly under the present government. However, this has not in general been enough to stop post-tax earnings from falling relative to needs. Cuts in in-work benefits are additional to this fall, widening further the gap between disposable income and the minimum required. Moreover, under Universal Credit, any further tax cuts will trigger reductions in in-work entitlements, and so will have only limited impact on the adequacy of disposable incomes. (This is not true of tax credits, which are assessed pre-tax. However, Housing Benefit and Council Tax Support, for which the least well-off working families are entitled, are already assessed post tax and so clawed back just as UC will be every time income taxes are reduced.)

As well as looking at changes in the balance between wages, taxes and benefits over the past 15 years in the following three chapters, the paper also considers, in Chapter 5, the cost of improving disposable incomes through different means in the future. This part of the paper analyses a range of policy options, including the known tax policies of the main political parties, in order to assess the most cost effective way of boosting incomes for low earners.

#### Box 1: The Minimum Income Standard (MIS)

MIS is the income that people need in order to reach a minimum socially-acceptable standard of living in the United Kingdom today, based on what members of the public think. It is calculated by specifying baskets of goods and services required by different types of household in order to meet these needs and to participate in society.

The research is funded by the Joseph Rowntree Foundation and carried out by the Centre for Research in Social Policy (CRSP) at Loughborough University, producing annual updates from 2008 onwards. MIS was originally developed in partnership with the Family Budget Unit at the University of York, bringing together expert-based and 'consensual' (based on what the public think) methods. The research entails a sequence of detailed deliberations by groups of members of the public, informed by expert knowledge where needed. The groups work to the following definition: *A minimum standard of living in the United Kingdom today includes, but is more than just, food, clothes and shelter. It is about having what you need in order to have the opportunities and choices necessary to participate in society.* 

MIS distinguishes between the needs of different family types. It applies to 'nuclear' families and to childless adults; that is, to households that comprise a single adult or a couple, with or without dependent children.

MIS is relevant to the discussion of poverty, but does not claim to be a poverty threshold. This is because participants in the research were not specifically asked to talk about what defines poverty. However, it is relevant to the poverty debate in that almost all households officially defined as being in income poverty (having below 60 per cent of median income) are also below MIS. Thus households classified as in relative income poverty are generally unable to reach an acceptable standard of living as defined by members of the public.

In using MIS as a benchmark, it is possible to calculate what earnings are needed to afford it. This requires a series of assumptions to be made, including:

- That housing costs are at a basic level (based on renting social housing of an appropriate size.

- That in order to work, people with small children require childcare at average childminder costs.

- That all households take up all in-work benefit to which they are entitled, and these contribute to meeting the required disposable income, with wages minus taxation making up the rest.

Further information and publications available at www.minimumincomestandard.org

## 2. Wages, taxes and top-ups for a lone parent

This section shows the changing roles of different income sources for a lone parent family. To illustrate this, we look at the case of a lone parent who works full time and has a small child (aged one), for whom childcare is needed.

This is just one version of the situation of lone parents, but illustrates the extent to which lone parents have an opportunity in practice to cover their families' income needs through work, given that this will also often require additional costs in childcare. Before the advent of the tax credit system in 1999, although some limited support for childcare was available by disregarding childcare costs in Family Credit and in Housing Benefit, this was capped at a relatively low level.

Tax credits have been particularly generous in reimbursing childcare costs, especially between 2006 and 2011 when up to 80 per cent of such costs were eligible for support. However, the reduction to 70 per cent eligibility in 2011 and a failure to uprate the limits in eligible costs in line with steeply rising charges since 2005 mean that families are having to find a far greater share of childcare costs from their wages than previously.

Figure 1a sets the context by looking first at the relationship between a lone parent's earnings and what they need to spend to reach a minimum living standard, taking account of all costs including childcare and rent. (For the years before MIS calculations were being made, this is estimated based on changes in prices and in general living standards.<sup>i</sup>)

In these graphs, 100 per cent represents this total MIS budget requirement. This shows that for a full-time worker on the lower-quartile wage, pay has until recently provided about three quarters of what a lone parent family needs to spend. However, as shown in Figure 1b, taxation reduces this to just under 60 per cent. Stagnant pay and rising costs, especially of childcare, have reduced the adequacy of gross wages from three-quarters to under two thirds of what is needed between 1998 and 2013. Income tax cuts have reduced the extent to which this has affected the adequacy of post-tax earnings, but nevertheless, about half of the reduction in wage adequacy (roughly five percentage points) remains after tax.

Figure 1c then shows how far the state goes in topping up the post-tax income of such a family, through help with housing costs, childcare costs and general costs. The first notable change over time is that the tax credit system has done so more generously than its predecessor (Family Credit), as shown in 1998. Indeed, by 2003, a lone parent on a modest wage was able in this example to bring up a child at a minimum acceptable standard of living, rather than falling about 20 per cent short. By 2008, with childcare and other elements having been made more generous still, income adequacy improved still further. But in the following five years, disposable income fell from about 6 per cent above the minimum to 5 per cent below (or 7 per cent under Universal Credit, which is slightly less generous in this case). This 11-13 percentage point fall in income adequacy reflects a combination of factors:

• Less adequate wages (making incomes about 10 per cent less adequate).

- Less adequate benefits and tax credits (making final incomes 6 to 8 per cent less adequate).
- Higher tax allowances (making final incomes 5 per cent more adequate).

Thus in the case in question, the tax allowance effect offset the negative impact of lower wages and benefits, but only by about a third.



Figure 1a Lone parent's gross income on a low wage<sup>1</sup>



Figure 1b. Lone parent's income after tax



<sup>&</sup>lt;sup>1</sup> Figures 1a, 1b and 1c refer to full-time earner at lower quartile wage. Budget is for lone parent plus one infant, including rent and childcare.



Figure 1c Lone parent's disposable income, after tax and benefits

This pattern shows that while benefits and tax credits continue to provide a more adequate top-up than in 1998, a lone parent with substantial childcare costs has thereby become much more dependent on fiscal transfers than they were at that time, and hence more exposed to their cuts. (About a third of net income in the above example come from net fiscal transfers, compared to less than a tenth in 1998.) Between 2008 and 2013, income tax cuts and tax credit/benefit cuts roughly cancelled each other out in this case. However, since 2010 there has been an overall deterioration: tax credits continued to rise in value from 2008-2010, whereas in the past three years, tax credit and benefit cuts have had a larger effect than income tax cuts.

In the years ahead, three key factors are likely to be relevant for this family:

Reductions in the adequacy of basic benefits and tax credits are likely to continue much longer than reductions in the adequacy of wages. Real wages are forecast to grow by 0.6 per cent in 2014, rising steadily to 1.8 per cent in 2018 (OBR, 2014). However, benefits and tax credits have been capped to a 1 per cent cash rise a year, a real-terms fall. Furthermore, a freezing in the amount of income disregarded when calculating entitlements will cause the amount received in tax credits or Universal Credit to fall, as families' wages rise by inflation or more. The fact that, as shown in Figure 1b, a working lone parent can now have at least 40 per cent of income dependent on state transfers, compared to about a quarter for the same family in 1998, means that it is much more vulnerable to fiscal retrenchment.

- Even if the government continues to raise the tax allowance substantially, as it has done since 2011, this will have a reduced effect on disposable incomes of such families. This is because under Universal Credit, unlike under tax credits, entitlements are based on post-tax income, so some of the tax cut will be clawed back by lowering UC payments. The smaller tax take shown in Figure 1b would continue, but this would be offset by a smaller top-up shown in Figure 1c. To be more specific, the reduction in tax take between 2008 and 2013 improved income adequacy by moving the household 4.5 per cent nearer to achieving the minimum income standard as agreed by the public. But under Universal Credit this net gain would only have been 1.5 per cent, as the remaining 3 per cent would have been lost in a reduced Universal Credit payment as a result of higher post-tax income.
- The rate at which childcare is reimbursed will have a large effect. Much of the decline in generosity of the system to date is, for this family, attributable to the decrease in support for eligible childcare costs from 80 to 70 per cent. A plan to increase support to 85 per cent in 2016 will have a substantial effect in the opposite direction. However, a caveat to this must be that such improvements will be compromised if the cap on eligible childcare costs continues to be frozen. At present, the family shown in this example pays childcare fees of £164 a week, based on the cost of a full-time childminder at average rates. Childcare prices have increased rapidly in recent years. If they continue to increase at a similar rate, the average cost of a childminder will exceed the limit of eligible childcare costs by 2015. This limit has not been raised since 2005. The consequence is that families will have to pay 100 per cent of every increase in childcare fees, rather than 30 per cent. This is already true for those with above-average fees, including those living in parts of the country where childcare is relatively expensive. Moreover, for large families, even with modest childcare costs, the limits create severe work disincentives.

Up to this point, the analysis has looked at these changes in terms of how close a particular low-earning family is able to get to an adequate income. A different question is how much a lone parent working full time would need to earn to meet this minimum standard. This has changed sharply for lone parents, as shown in Figure 2.





Cash illustrations for Figure 2:

# Earnings required for MIS, compared to low-wage earnings (lower quartile), for lone parent working full time, were:

In 1998, £275 for MIS, compared to £208 low wage In 2003, £195 for MIS, compared to £254 low wage In 2008, £191 for MIS, compared to £300 low wage In 2013 £388 for MIS, compared to £335 low wage

Fuller figures in Appendix 1

The green bars in Figure 2 show that, before the present tax credit system was introduced, a lone parent would need to earn far more than someone on a low (lower-quartile) wage to cover the minimum costs of their family and the additional childcare costs associated with working full time. In fact, the wage needed was above the median wage. The introduction of tax credits reduced this substantially, by paying more towards both childcare and living costs, compounded by the fact that the lower earnings that were therefore needed meant that less was taken away in tax and the tax credit taper (as well as in tapering of Housing Benefit) than would have been the case on higher earnings. By 2008, even a lone parent earning substantially *below* the lower-quartile wage would have enough.

Conversely, the recent cuts noted above have increased earnings requirements, by an amount compounded by the extra tax and lower tax credits and benefits that are triggered by higher earnings. The high overall 'withdrawal rate' that the tax credit system creates for additional earnings received by its beneficiaries thus makes it especially hard to make up for any cuts by increasing one's earnings. As shown in the graph, this has meant that the period in which lone parents with relatively low wages could make ends meet has proved to be transitory. It is also worth noting that, despite the raising of the income tax allowance referred to above, a lone parent earning enough for a minimum income paid over twice as much tax in 2013 than in 2008. This is because in order to reach this level of disposable income, earnings needed to be substantially higher, by a much greater amount than the increase in tax-free income. In this case, therefore, the burden of tax on a family achieving an equivalent minimum standard of living is greater today, after the tax cuts, than in 2008.

# 3. Wages, taxes and top-ups for a single-earner couple with children

This section shows the changing roles of different income sources for a family with children with one member of a couple working. To illustrate this, we look at the case of a couple with children aged three and seven, where one parent works full time and the other does not work. This family is assumed not to require paid childcare.

As mentioned earlier, the 'single male breadwinner' family model has become less viable for people on modest earnings: a full-time below-average wage tends to fall well short of meeting the minimum needs of couples with children. This raises a difficult issue for government, separate from that arising from lone parents. Should it aim to ensure that families have an adequate income with just one person working, or should it rely rather on encouraging and helping the second parent to work? In practice, policy has steered between these two choices: support for single earners has increased, but the lowest-paid single-earner couples with children remain on very low incomes relative to their needs.

Figures 3a to 3c show the situation of a single earner in a couple earning a full-time wage equal to the lower quartile of full-time earnings, in the same terms as shown for the lone parent in the previous section. The overall pattern is the same, with a fall in the adequacy of earnings after 2008 partially offset by a fall in taxation, and with inwork support rising relative to need between 1998 and 2008 but falling thereafter. However, compared to the lone parent, there are several important differences.

Most importantly, while gross earnings have been 25-40 per cent below what a family needs for both lone parents and for single-earner couples, the source of this shortfall is different in the two cases. For a couple with two children, it is entirely due to the fact that one person's low earnings are not enough to pay for the living costs of four people. For a lone parent with one child, on the other hand, gross pay would roughly cover living costs, but in order to work, the parent must also incur large childcare costs. The tax credit system has improved both the topping up of living costs and the reimbursement of childcare costs to low income families. As a consequence, by 2003 it had entirely closed the gap between disposable income and household needs for a lone parent on a lower quartile wage, who had benefited from both these policies (figure 1c above). On the other hand it had closed only half the gap for a single-earner couple, who had benefitted only from the additional living costs coverage (figure 3c).

The other side of this coin is that the extent of dependency on state transfers remains somewhat less for the single-earner couple than for the lone parent, making the former less vulnerable to cuts. In particular, single-earner couples were not affected by the sharp cut in childcare support in 2011. As a consequence, the overall cut in benefits and tax credits reduced income for this family type by only half as much as for the lone parent (relative to need) between 2008 and 2013. Moreover, as a result of the government's efforts to favour 'traditional' families, couples will end up doing relatively well in the switch to Universal Credit, and in the case of the single earner shown here, the result will be to make the family no worse off overall than in

2008: a significant boost, although still some way short of enough to afford what the public think is a minimum acceptable living standard.









<sup>&</sup>lt;sup>2</sup> Figures 3a, 3b and 3c refer to full-time earner at lower quartile wage. Budget is for couple with two children aged three and seven, including rent (but no childcare).



Figure 3c Single-earner couple's income, after tax and benefits

In the years ahead, the adequacy of this family's income will, like that of the lone parent, be reduced by plans to uprate credits and benefits by less than the rate of inflation, but improved by any tax cuts – although again to a lesser extent under the Universal Credit than under tax credits. Unlike for the lone parent family, however, it will not gain from more generous subsidies for childcare.

Figure 4 looks at what a single earner needs to earn to support a family at the MIS level. It shows that while the amount needed for a single earner to reach a minimum acceptable living standard fell relative to median earnings during the period under review, it remained far above the amount earned on the lower quartile wage. This is because even an average earner bringing up a family must not only pay a substantial amount of tax but also gets a very small amount of benefits, and so did not have enough to cover the minimum needed even at the most favourable point of the tax credits story. At that point (2008), a single-earner couple earning enough for MIS would get child benefit, the common family element of the Child Tax Credit and a small amount of the child element. By 2013, means-testing of tax credits had been tightened, and earnings requirements to reach MIS had risen, to such an extent that the family earning enough for MIS with a single earner would only be entitled to child benefit, and no tax credits. They would also be paying more tax than the family earning enough to meet MIS in 2008, despite the increase in the tax allowance. Under Universal Credit, this situation improves slightly: a disposable income sufficient for an acceptable living standard can be achieved with the help of a small credit, and hence lower earnings than required in the present tax system, but this improvement is small relative to the deterioration since 2008, and still requires the family to pay more tax than at that time.





Cash illustrations for Figure 4:

Earnings required for MIS, compared to low-wage earnings (lower quartile), for couple with one working full time, were:

In 1998, £404 for MIS, compared to £208 low wage In 2003, £458 for MIS, compared to £254 low wage In 2008, £515 for MIS, compared to £300 low wage In 2013 £691 for MIS, compared to £335 low wage

Fuller figures in Appendix 1

# 4. Wages, taxes and top-ups for a couple with children, with both parents working full time

This section shows the changing roles of different income sources for a working couple with children. To illustrate this, we look at the case of a couple with children aged three and seven, where both parents work full time. This family is assumed to require paid childcare, for the older child when not at school, and full time for the younger child – but with 15 hours a week now free under the government's early years entitlement.

Few children with two parents in full-time work are classified as being in poverty, but according to the Minimum Income Standard, such families may still not have enough for an acceptable standard of living if both parents are in low-paid jobs and children are young enough to need childcare. However, before the advent of the tax credit system, help for dual earner families, even those facing high childcare costs, was mainly restricted to child benefit.

Figures 5a to 5c show how this situation has evolved. Two earners on the lower quartile wage typically earns almost enough, gross, to support a family at a minimum level and pay for childcare (5a), but after tax this reduces to below 80 per cent of what is needed (5b). Under the Family Credit system up to 1998, this family's earnings were too high to make them eligible for the credit, but the more generous treatment of childcare under tax credits boosted incomes to around the minimum needed (5c).









<sup>&</sup>lt;sup>3</sup> Figures 5a, 5b and 5c refer to relative to minimum family budget; full-time earners at lower quartile wage. Budget is for couple plus children aged three and seven, including rent and childcare.



#### Figure 5c Dual earners' income, after tax and benefits

As in the other examples, the overall adequacy of this family's income has reduced since 2008, but the pattern has been slightly different. This particular case includes a three-year-old receiving childcare, whose family now benefits from the early years entitlement to 15 hours of free childcare. This reduces total costs and therefore explains why Figure 5a shows gross wages almost keeping up with overall costs, and post-tax earnings growing slightly faster than costs, helped by tax cuts.

On the other hand, the top-ups for this family under the tax credit system (and in this case unchanged under Universal Credit) fell by a third (Figure 5c). This was due both to a cut in childcare tax credits (counteracting the benefit of some free childcare) and to an increase in the tax credit withdrawal rate, which affects a particularly large tranche of income for a dual earner couple. The result is that disposable income fell below the Minimum Income Standard, although by much less than other household types show in this paper.

Looking ahead, this family will be particularly affected by the generosity or otherwise of childcare support. It is only because of childcare that it has an entitlement to tax credits or Universal Credit, although real-terms cuts in UC rates will also reduce its overall entitlement. And as long as it has some UC entitlement, the clawing back of tax cuts through UC will also limit the benefit of these cuts to the dual-earner family.

Figure 6 shows that, unlike lone parents and single-earner couples, dual earner couples can support a family at a minimum level earning not much more than a lower quartile wage. However this is still much more than the National Minimum Wage.

And due largely to the rising cost of childcare and decreased generosity of the tax credit system in helping to pay for it, the earnings requirement is now higher relative to the lower quartile than at any other time in the period under review. As with the previous two examples, a family with a minimum income will pay slightly more tax now than before the raising of the tax allowance, due to the additional earnings needed to reach this level.



#### Figure 6 Dual earners' requirement, to reach MIS

Cash illustrations for Figure 6:

Earnings required for MIS, compared to low-wage earnings (lower quartile), for couple with both working full time (combined earnings), were:

In 1998, £544 for MIS, compared to £416 low wage In 2003, £530 for MIS, compared to £508 low wage In 2008, £528 for MIS, compared to £600 low wage In 2013 £743 for MIS, compared to £670 low wage Fuller figures in Appendix 1

## **5. Future policies and impact**

Many different policies and economic trends could affect low income families' ability to afford a minimum acceptable standard of living in the years ahead. In the context of the trends identified above, we can distinguish the contributions made by three kinds of policy/trend:

- improvements in earnings, relative to the minimum cost of living (whether because of market forces or helped by policies that improve people's earnings power or promote higher pay, such as the Living Wage);
- cuts in taxation;
- improved in-work benefits coming mainly in the form of the Universal Credit once it has been fully implemented.

Any one policy in each of these categories would have a range of effects on different kinds of household according to composition, work and childcare patterns and wage levels. It is beyond the scope of this paper to survey such projected outcomes in detail. Instead, as a simplified way of illustrating the different effects and costeffectiveness of various measures, this section considers one particular case. It asks what it would take to ensure that a working couple could support themselves plus two children despite having relatively low earnings. In terms of the above analysis, this requires the family shown in Figure 5 to make up the shortfall of £20 a week in disposable income compared to the Minimum Income Standard. This would be a very modest improvement, and much smaller than is needed in some of the examples in this paper, but is a way of asking 'what policies could start to improve income adequacy of working families, reversing the recent deterioration?' It also seems eminently reasonable that a family supported by two full-time working parents on medium-low earnings (significantly above the minimum wage) should be able to reach an adequate living standard. Other family types would need greater adjustments, but the overall pattern described below would be similar, particularly in terms of the relative cost-effectiveness of different fiscal measure.

In the following policy examples, the costings are approximate, but show clearly the wide differences between how much it would cost to close the gap with MIS using different policies. The main conclusions about the relative effectiveness of different measures align closely to those of the Institute for Fiscal Studies (2014). However, the present analysis is framed in a different form – looking at cost-effectiveness of policies in boosting the disposable income of low-wage households, and moving them towards MIS – rather than at the overall profile of winners and losers.

First, the required *earnings increase* to close the £20-a-week gap for the dual-earner couple with two children would be about 11 per cent, as noted in Figure 5 above. A 'typical' full-time low-paid worker (on the lower quartile) earns £17,500 a year. Earnings of both parents would need to increase to £19,400 to reach MIS in 2013. Note that this means that between them, the family would then be earning about

£3,800 a year more, but would only keep just over £1,000 of it – the rest would disappear in additional taxes and reduced tax credits. Nevertheless, this example shows what kind of pay increase, potentially spread over several years, could make a tangible difference in a family's ability to make ends meet.

Second, in terms of *tax cuts*, the objective would be to ensure that the net tax bill of the two parents combined was reduced by £20 a week. There are several different ways of doing this through direct taxation, each of which would have similar effects on income distribution, and similar costs:

- By raising the personal tax allowance.
- By raising the National Insurance threshold.
- By introducing a new starting rate of tax, lower than 20 per cent.
- By designing a married tax allowance capable of helping such a family.

The size and cost of the cut required to put an extra £20 a week in a low-income family's pocket would depend crucially on whether it took place under the present tax credit system, under the new Universal Credit system as it is currently being introduced or under a modified version of that system. This is because people on Universal Credit who get a cut in income tax or national insurance contributions also experience a reduction in their Universal Credit entitlement, by 65 per cent of the amount by which the tax cut raises their post-tax income (see Hirsch, 2013). This 'clawback' does not take place under the tax credit system, and could potentially be largely avoided under the UC system if the government increased the amount of post-tax income that it disregards when determining UC entitlements to mirror any tax cuts. For example, raising the income tax allowance by £1,000 matched by a £200 increase in the Work Allowance (for the amount that can be earned before UC starts to be withdrawn) would give a single-earning family on UC £200 more post-tax income without changing the amount that is subject to the UC 'taper', thereby producing a net gain of £200. They would then get the same amount of gain from this policy as a non-UC working household. To avoid a clawback for dual-earning couples, both paying tax, the system would need to double the increase in Work Allowance for this group.

Without the clawback, one of the following policies would be sufficient to increase a family's net income by £20 a week (where two people work full time and therefore earn enough to pay tax):

A £2,600 increase in the income tax threshold, which would reduce each parent's tax bill by £520 a year or £10 a week. This is similar to the Liberal Democrat's aim to raise the income tax allowance to £12,500 over the next parliament (but in fact more ambitious, since the increase would need to be net of inflation, and the policy goal is in cash terms). This would benefit 24 million basic rate taxpayers, most of them not on low incomes, and cost at least £11.5 billion<sup>ii</sup>.

- The Labour Party has floated the idea of introducing a 10 per cent starting rate of tax. If there was a *starting rate tax band* of £5,200, taxed at 10 per cent rather than 20 per cent it would have very similar results, both in costs and benefits, to the increase in the tax allowance by half that amount. The overall cost would be about £0.5 billion less, but still at least £11 billion<sup>iii</sup>.
- An increase in the threshold above which employees start *paying national insurance contributions*, by £4,330, which at a rate of 12 per cent would again produce a £10 a week gain for each parent. Again, this would have similar costs and effects to the raising of the tax threshold. The main difference is that, whereas about 2 million additional people between the present tax and national insurance thresholds would gain, pensioners would not since they do not pay contributions. Compared to raising the tax allowance, this would reduce the number of beneficiaries by 4 million and the cost by about £2 billion, but the cost would still be above £9 billion.
- A big increase and a redesign of the *married tax allowance*. Note that in its present form (being introduced in April 2015), this Conservative Party policy will take the form of a transferrable allowance of up to £1,000 in cases where only one partner uses their allowance, will not help the two-earner family being considered here. (It does help the singe-earner family whose case is described in Figure 3 above, but note that of the £113 a week that this family falls short, the allowance will make up only £4. If the whole tax allowance became transferrable, at ten times the cost and value of the present allowance, it would still only make up £40.) For dual-earner married couples to benefit, on the other hand, a higher allowance, similar to the one that existed in the past, would need to be given to one member of a married couple regardless of whether their spouse used their own allowance. This would need to be worth £5,200 to generate the £20 a week net income by which the two-earner couple falls short of MIS. Giving one member of each married couple a £15,000 rather than £10,000 tax allowance would cost over ten times as much as the estimated £800 million allocated to the announced transferrable tax allowance, costing roughly £8 billion a year<sup>V</sup>.

The above policies are expensive ways of creating modest increases in disposable income for low-income families because they benefit all taxpayers – whether or not supporting families and whether or not on low incomes – by the same amount. Note however that even these large costs do not take account of the clawback of direct tax cuts for families receiving Universal Credit. Roughly speaking, taking the clawback into account, all the above numbers need to be multiplied by about three. For example, in order to be £20 a week better off, a two-earner couple on UC would need a tax allowance increase not of £2,600 but of over £7,400. The cost would be somewhat less than three times the £11 billion required with no clawback, because

more people would be taken out of tax, but the cost would still be approaching £30 billion a year<sup>v</sup>.

An alternative to cutting direct taxes would be to *cut VAT*. This would reduce families' spending requirements, and since it would not therefore require any increase in income (either pre- or post-tax), would involve no clawback through reductions in benefits or credits. However, it is interesting to note that, even though many lowincome families pay high proportions of income in indirect taxes, especially if they are smokers, the indirect tax in a MIS budget is relatively modest. In terms of duties, this budget includes only moderate spending on alcohol and (in the case of families with children) on petrol, and none on tobacco, whose consumption is not considered part of an essential minimum. In the case of VAT, non-VATable items such as food and children's clothes are substantial in the budget. A calculation made for this paper shows that about 14 per cent of the MIS budget for a couple with two children (excluding rent, childcare, and council tax) is paid in indirect taxes, less than the average of just over 20 per cent estimated for a median family (Snowden, 2013). About three guarters of this is VAT – adding up to around £50 a week for a MIS budget. For the family to gain £20 a week from a reduction in VAT, the main rate would therefore need to reduce by two fifths - from its present rate of 20 per cent to just 12 per cent. This would cost over £40 billion<sup>vi</sup>, disregarding any change in spending patterns caused by the tax cut. Hence, reducing VAT is an even more expensive "blunt instrument" for helping low-income families than reducing direct taxes. (Conversely, using the same calculation, the last increase in VAT, from 17.5 to 20 per cent, raised the family's spending requirement by only a modest £5 or around 1 per cent.)

A third way of helping to raise disposable incomes to the amount required to reach MIS is to *improve in-work benefits*. This is a much more focused fiscal measure than cutting taxes, since gains are concentrated on low-income families. The following are examples of how entitlements under the Universal Credit could be raised for a dualearner couple with two children to produce an additional £20 a week of disposable income:

- By increasing the value of tax credits/Universal Credit. One of the main reasons for the declining adequacy of in-work incomes at present is that tax credits and UC are not rising as fast as inflation (increases are fixed at just 1 per cent per year). To reverse that the government could, for example, give an additional £10 a week for each of the 7.7 million children in families currently claiming tax credits (which will be similar for UC). This would cost about £3.8 billion year<sup>vii</sup>.
- By raising the amount of earnings disregarded for tax credit/UC purposes among working families. For example, under the UC system, where net income is withdrawn at 65p in the pound, disregarding an additional £31 a week for a couple would mean that the credit would be reduced by £20 a

week less against earnings, so disposable income would rise by this amount. About four million parents are in working families with children that will be entitled to Universal Credit. If disregards were increased to raise family disposable income by £10 a week for each such parent, the annual cost would be £520 x 4 million, or just over £2 billion a year<sup>viii</sup>.

- By *lowering the taper rate* defining the withdrawal of UC or tax credits as earnings rise. This would be of particular benefit to a two-earner couple with children, who in the case being described have just over £30,000 of combined gross income subjected to this taper. Thus reducing the taper by three percentage points of gross income would increase the family's disposable income by around £1,000 a year or £20 a week. This would cost about £1.1 billion a year<sup>ix</sup>. This is the cheapest way reviewed so far of producing the £20 increase in net income for a two-earner family working full time on low wages, although benefits for families with fewer working hours would be much less.
- By raising the tax credit/UC subsidy to childcare costs. At present this is 70 ٠ per cent of childcare costs, which are £162 in the MIS example for a couple and two young children. To improve disposable income by £20 a week would require the subsidy to be raised by 12 percentage points to 82 per cent – in fact, about halfway between the 80 per cent that it was until 2011 and the 85 per cent that it will be raised to in 2016. Increasing it to 82 per cent would cost about £450 million<sup>x</sup>. This is even more cost-effective than the previous measure above, in relation to meeting the needs of low-earning families with high costs: its effects are concentrated on the minority of families claiming tax credits who claim the childcare element, and the benefits are particularly concentrated on those facing relatively high childcare costs because they require full-time childcare. It is the one public policy in the present list that is actually due to be implemented (in 2016). However, its effects will be offset by other policies, including further cuts in the real value of tax credits/UC due between now and 2016. Moreover, for some families with high childcare costs, these are increasingly likely to rise above the limits supported by tax credits and Universal Credit, unless these limits are raised. This will offset and in some cases wipe out the gain from the higher reimbursement rate.

Overall, then, there is a yawning gulf between the fiscal cost of using taxation and inwork credits to enhance the disposable incomes of low-earning families. Even to achieve a modest effect putting £20 a week into the pockets of a working couple with two children on low pay, tax cuts would need to be implausibly high – of the order of £30 billion a year with a Universal Credit clawback, or of the order of £10 billion without. Of course, a smaller cut would at least make a contribution in this direction, but the effects would be proportionately smaller. In contrast, more targeted increases in in-work benefits could achieve the same effect for a much smaller cost, with the examples looked at here costing between  $\pounds$ <sup>1</sup>/<sub>2</sub> billon and  $\pounds$ 4 billion a year. The cheaper of these policies are more selective in terms of which low-income families are helped and by how much, while the  $\pounds$ 4 billion policy would give a boost to all low-income families with children.

## 6. Conclusions

Many families on low incomes have fragile incomes. Low pay, short-term or sporadic employment in jobs that may have varying hours – and in some cases with zero-hours contracts – interact with other changes in life, such as relationship break-up, repartnering and the arrival of a new child, that affect households' ability to maintain an adequate living standard. Rising costs of essential items, especially childcare, have added to this mix in recent years.

The growth of in-work support for low-earning families was intended to help improve the stability of their incomes, rising steeply as income fell to provide a better safety net, and in particular making work worthwhile even on relatively low income for people with heavy childcare responsibilities. Now, however, this support, which has played an important role in contributing to such families' overall income, has itself become unstable, adding to their vulnerability. Budget cuts continue at pace; there are no guarantees that any one working-age benefit will maintain its value.

The overall effects of these changes vary according to household type, but as shown in the three family examples in this paper, the overall pattern has been similar. For a lone-parent family or dual-earner couple on a typical low wage, the introduction of tax credits raised disposable income substantially, and in the examples shown here had brought it above the Minimum Income Standard by the 2008. But since then it has dropped back below this standard. A single-earner couple with children was also helped by tax credits, but continued to fall well short of MIS – although this family will not be worse off relative to this benchmark under UC than before the recession.

This is not to suggest that working families should look only to the government to maintain their living standards. The failure of wages to keep up with the cost of living has been the primary cause of falling living standards in the past few years. Improvements in pay, including a rising minimum wage and greater take-up of the Living Wage, could make a significant contribution to living standards. However, it must also be acknowledged that for low-income working families, who typically lose over 70 per cent of any pay increase through higher taxes and lower credits, pay can only be part of the mix. If the value of income top-ups continues to decline, this can easily wipe out the gains from improved pay. This is illustrated by the graphs in this paper, which show how volatile the earnings needed for a minimum income can be, especially under changing fiscal conditions. High income withdrawal rates associated with increased earnings mean that for each pound taken away through a welfare cut, a family typically needs to improve earnings by around £4 to compensate.

Tax cuts have helped, but in no case illustrated here have they been sufficient to fully offset the factors that have reduced living standards. Under Universal Credit, their impact, relative to the planned erosion of the credit's value, will be particularly small, because two-thirds of any gain will be clawed back through the tapering of post-tax income. However, as shown in the policy projections in the previous section, even without the clawback it is far more expensive to use tax cuts to boost low earners' incomes than to use in-work benefits and credits, since the effects of the latter are focused on low income families.

Moreover, the above examples have looked only at the case of people working full time, all of whom pay income tax and therefore benefit from tax cuts as well as losing from benefit and tax credit cuts. For many part-time workers, only the latter is the case, since their earnings do not come above the tax threshold, and therefore they gain nothing from raising it further. The Resolution Foundation (2013) has estimated that two thirds of working families receiving Universal Credit have at least one adult not paying income tax.

Looking ahead, the following three aspects of policy will help determine how many low-earning families achieve adequate incomes in the future:

- The uprating of tax credits, Universal Credit and the amount of earnings that are disregard before being reduced as earnings increase. At present the level of the credits (both tax credits and universal credit) is rising by only 1 per cent, and the disregards are frozen. This means that families relying on credits are bound to get worse off, as even if they do get healthy pay rises, two thirds of their extra income will be lost (under UC) through tapering. The policy issue for government is whether it intends eventually to restore inflation-based upratings, or whether this is part of a continuous pruning of welfare support.
- The level of support for childcare through Universal Credit. From 2016, families on Universal Credit will get up to 85 per cent of costs covered, rather than 70 per cent as at present, under government plans. This will provide a big boost to eligible families' incomes. However, an important issue is whether the limits on eligible childcare costs will be permanently frozen: childcare costs have already risen by over 50 per cent since the limit was last set, in 2005, and by 2015, even people with average childcare costs (full time) will exceed the limit. For anyone either with average to high childcare costs or with more than two children requiring childcare, large disincentives to work could return unless the limits are increased. Furthermore, the government has said the estimated £400 million needed for the extra support must be paid for out of savings elsewhere in the social security and UC budgets. It remains to be seen how this will be paid for, but the result could be less funding for other elements of in- or out-of-work support.
- Whether any measure is taken to enable low-income families to gain fully from future tax cuts. The simplest way of doing this would be to increase the Work Allowance automatically by the same amount as any increase in tax allowances, which would prevent post-tax income from being clawed back through UC (Hirsch 2013).

Better government support for low-income families is clearly not the only factor determining whether they are able to bring their children up at a minimum acceptable living standard. General improvements in pay combined with better protection through the minimum wage also play a crucial role. However, for those working families who now depend on state help to top up their wages and enable them to afford childcare, even generous pay increases will not improve living standards if the level of this support continues to deteriorate.

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## Appendix

Minimum Income Standard requirements and income adequacy

					2013
1. Lone parent one child aged 0-1	1998	2003	2008	2013	(UC)
MIS budget requirement*	£286.73	£342.24	£409.62	£524.59	£524.59
Adequacy of income at lower quartile wage					
Gross earnings	£208.00	£254.00	£300.00	£335.00	£335.00
Earnings after tax	£166.74	£202.63	£240.05	£281.89	£281.90
Disposable income after tax, benefits and credits	£230.72	£345.54	£430.92	£497.81	£488.63
As % of budget requirement	80.5%	101.0%	105.2%	94.9%	93.1%
Difference between disposable income and budget					
requirement	-£56.01	£3.30	£21.30	-£26.78	-£35.96
Income required to meet budget requirement exactly					
Gross earnings	£370	£243	£229	£490.72	
Earnings after tax	£275.28	£195.26	£191.06	£387.79	
Disposable income after tax, benefits and credits (=MIS					
budget)	£286.73	£342.24	£409.62	£524.59	
2. Couple with two children (pre-school and	4000	0000	0000	0040	2013
primary), single earner	1998	2003	2008	2013	(UC)
MIS budget requirement	£318.81	£376.56	£439.92	£558.10	£558.10
Adequacy of income at lower quartile wage					
Gross earnings	£208.00	£254.00	£300.00	£335.00	£335.00
Earnings after tax	£166.74	£202.63	£240.05	£281.89	£281.89
Disposable income after tax, benefits and credits	£210.37	£307.14	£375.42	£444.90	£479.78
As % of budget requirement	66.0%	81.6%	85.3%	79.7%	86.0%
Difference between disposable income and budget	-			-	
requirement	£108.44	-£69.42	-£64.50	£113.20	-£78.32
Income required to meet budget requirement exactly					
Gross earnings	£404.00	£458.00	£515.00	£691.60	
Earnings after tax	£298.06	£339.31	£388.40	£524.40	
Disposable income after tax, benefits and credits (=IVIIS	0240.04	C076 E6	C420.02	CEE0 40	
budget)	2310.01	2370.00	1439.92	2000.10	
Couple with two children (pre-school and primary)					2013
dual earner	1998	2003	2008	2013	(UC)
MIS budget requirement*	£444.06	£528.80	£626.45	£714.68	£714.68
Adequacy of income at lower quartile wage					
Gross earnings	£416.00	£508.00	£600.00	£670.00	£670.00
Earnings after tax	£337 55	£405 27	£480 10	£563 78	£563 78
Disposable income after tax benefits and credits	£358.30	£522.20	£648.05	£694 84	£695.20
As % of hudget requirement	2000.00 80 7%	Q8 8%	103.4%	Q7 2%	Q7 3%
Difference between disposable income and budget	00.7 /0	50.070	100.470	51.270	57.570
requirement	-£85.76	-£6.60	£21.60	-£19.84	-£19.48
Income required to meet budget requirement exactly					
Gross earnings	£544	£530	£528	£743.36	
Earnings after tax	£423.31	£420.01	£430.42	£613.68	
Disposable income after tax, benefits and credits (=MIS					
budget)	£444.06	£528.80	£626.45	£714.68	

\* Budgets before 2008 estimated using method described in endnote 1.

<sup>ii</sup> This assumes that 22 million out of 24 million basic rate taxpayers gain by the full £520, that the approximately 2 million of them between the old and the new thresholds gain by on average half this amount and that the higher rate threshold is adjusted to prevent higher-rate taxpayers from gaining at all. Pensioner taxpayers are included in the policy, even though they have not been included previously, since the government has indicated that once the pensioner threshold of £10,500 is reached, the thresholds for all ages will be merged.

<sup>iii</sup> About four million rather than two million would be above the existing threshold but below the top of the new band, and would therefore on average experience only half the gain: an additional two million people getting £250 less, making £0.5 billion.

<sup>iv</sup> There are nearly nine million married couples with someone in work. Not all of these have someone earning over £15,000 a year, which would allow them to benefit fully from a tax allowance at that level. On the other hand there are in addition married pensioner couples who do not gain from the existing married tax allowance available to those born before 1935, and whose income is high enough to benefit partially or fully from an additional married couples allowance. Assuming that the latter effect is at least great enough to balance out the former, the cost of a £5,000 allowance would be at least £9 billion, over £1 billion more than the new transferrable allowance. These are rough approximations.

<sup>v</sup> About 18 million basic-rate taxpayers above the new threshold would mainly gain the full benefit of a  $\pounds$ 7,400 tax cut,  $\pounds$ 1,480, while six million between the old and new thresholds would mainly gain half this,  $\pounds$ 720, making a total of  $\pounds$ 31 billion, reduced by the clawback affecting about 2.8 million taxpayers in UC households by up to  $\pounds$ 1,000 each ie <  $\pounds$ 2.8 billion.

<sup>vi</sup> Increasing VAT by 2.5 percentage points in 2011 was estimated to increase revenues by £13.5 billion a year by 2014 <u>http://www.parliament.uk/briefing-papers/sn05620.pdf /</u>. Pro rata, an 8 percentage point difference costs £13.5bn x 8/2.5 =£43.2 billion.

<sup>vii</sup> This is based on giving an additional £10 to all those presently getting the credit, but the actual cost would be slightly higher by making more people eligible, whose income is presently just too high to get UC.

<sup>viii</sup> As above, the actual cost would be slightly more because more people would become eligible.

<sup>ix</sup> Based on £730m projected saving in 2013/14 from the 2011 increase in taper rate by two points. For UC, to get the same effect, the taper on net income would have to be higher to achieve the same gain, but this would have a similar effect both on who gains and how much it costs.

<sup>x</sup> Based a projected saving of £370m for 2013/14 from the cut from 80 to 70 per cent, times 1.2.

<sup>&</sup>lt;sup>i</sup> Specifically, it is estimated as an average of the present basket's cost adjusted on the one hand for estimated changes in the cost of this basket and on the by the percentage change in average income. This assumes that a minimum basket rises over time by something between the inflation rate and changes in general living standards. In practice, average incomes grew by an average of about 1 per cent a year faster than the cost of a minimum basket in the 15 years between 1998 and 2013, meaning that the figure used for 1998 is about 7 per cent lower than if the minimum were based only on price changes, and 7 per cent higher than if it rose with general income.