Manchester Metropolitan University

Work incentives in the tax and benefit system

Research policy briefing

Dr Becky Milne, Professor Ashwin Kumar
December 2024

1. Key findings

Despite the intended simplification of work incentives, once Universal Credit (UC) is fully rolled-out, work incentives in the tax and benefit system will remain immensely complex.

The majority of UC recipients will also be paying Income Tax and National Insurance (NI) or be in receipt of Council Tax Reduction, creating overlaps between taper rates from different parts of the tax and benefit system.

As a result, fewer than a quarter of UC recipients will face a marginal deduction rate (MDR) equal to the UC taper rate of 55% and two-fifths will face a rate higher than this.

These findings have implications for a number of areas of policy. Efforts to encourage low-paid workers on UC to increase their hours of work should recognise that many are likely to see little additional income from any such change.

For most UC recipients, the effects of any changes to the UC taper rate are dampened by interactions with other parts of the tax and benefit system.

Despite reductions in the real level of benefits over several years, marginal deduction rates remain very high for large numbers of people: under UC, one in eight working age adults will face an MDR of 64% or higher.

Some people – e.g. higher-earners in receipt of Child Benefit and people making student loan repayments – will continue to face very high marginal deduction rates.

There will also remain some circumstances that give rise to cliff-edges – points where an increase in earnings will result in a drop in income.

Given the complexity of incentives in the tax and benefit system, it is inconceivable that most people will understand the actual incentives that they face but it is highly likely that these will be different from the headline of 55% used frequently in public discussion.

Finally, the extent to which people actually respond to the complex incentives they face with changes to their hours of work remains a topic that requires substantial research.

PERU Policy Evaluation & Research Unit

abrdn Financial Fairness Trust

2. Broader recommendations about the tax and benefit system

Policy design relating to the UC taper should consider explicitly the implications for people who face interactions between the UC taper, Council Tax Reduction, NI Contributions and Income Tax.

Policy discussion relating to the level of support provided to people in need should recognise that reducing that level of support cannot eliminate high MDRs.

Active Labour Market Policies to support in-work progression should prioritise enabling low earners to increase their hourly rate of pay, not simply the number of hours of work.

Policy discussion on reducing the UC taper rate should acknowledge that the effect of doing so is dampened for most UC claimants by interaction with other parts of the tax and benefit system.

The Scottish Child Payment should be redesigned as an increase in the UC Maximum Amount. The Scottish Government should receive from the Department for Work and Pensions (DWP) an appropriate data feed of UC Maximum Amounts and receipt so that the Scottish Government can calculate and pay the relevant amount.

The tax system for higher rate taxpayers should be redesigned so that families with children do not pay higher MDRs than others and so that the highest paid face the highest MDRs.

3. Recommendations about specific tax and benefit rules

Compulsory student loan repayments should be deducted from the income figure used to assess entitlement to UC.

The DWP should estimate and publish the cost of removing the rule that any earnings render a family ineligible for support for service charges.

To avoid the current cliff-edge, the DWP should explore tapering away the size of loan payments when income rises just above the level at which entitlement to UC ceases.

The maximum amount of childcare that can be supported in UC should be increased to where it would have been had it tracked increases in childcare costs over the last 15 years and the maximum should be increased each year in line with the annual Childcare Survey.

The Employment and Support Allowance Permitted Work rules should be changed from an earnings threshold to an hours threshold.

4. Research methods

Datasets consisting of millions of synthetic families were constructed to encompass a wide range of possible combinations of circumstances. These synthetic families were run through the calculation engine of the IPPR Tax-Benefit Model to generate net income for each family, and net income if each adult’s earnings were one pound higher. This allowed calculation of MDRs for each adult. The analysis uses the tax and benefit system as of April 2024 and assumes all claimants are subject to UC rather than legacy benefits.