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Childcare support and the hours trap: the Universal Credit

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Briefing

Gingerbread
Single parents, equal families

Resolution Foundation

Childcare support and the hours trap: the Universal Credit

Donald Hirsch

October 2011

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Introduction

The Government recently announced the terms under which childcare costs will be supported as part of Universal Credit from 2013. It has made an extra £300m available, compared to present spending levels. This briefing updates the earlier briefing *Childcare support and the hours trap*, published in May 2011, to show the impact of the government's final proposal for childcare support on work incentives for single parents and second earners.

In summary, the new system will extend help with childcare costs to parents working below 16 hours a week on the same terms as presently offered to those working more than 16 hours, i.e. coverage of 70 percent of childcare costs of up to £175 for one child and £300 for two or more children. However, this year, parents on low incomes are already paying 50% more towards childcare costs than they did previously, following the reduction in eligible childcare costs from 80 to 70 percent in April 2011. As a consequence, work incentives will be improved for single parents with "mini-jobs", but will be much worse than under the system prior to April 2011 for many single parents working at least two days a week and for second earners in couples on low incomes.

The change in childcare support and the cost to the Treasury

Table 1 below shows the system before it was changed in April 2011, the situation now and the recently announced plans under Universal Credit. It also shows, in the final column, what would be needed to restore the pre-2011 system which provided better work incentives.

- In 2011, the Government cut support within the present tax credit system from 80% to 70% of eligible childcare costs. This saved £335m in 2011-12[1]. However, it also meant that eligible families had to find 30% rather than 20% of childcare bills – a rise of 50%. With childcare costs rising fast, this has been a severe blow for many families[2].
- The plan to extend childcare support to people working under 16 hours from 2013 is estimated to cost an extra £300m compared to now.
- Originally, the DWP considered options that would have kept the cost to government the same as now (but less than last year) by offsetting the new costs of under 16 hours claimants with lower limits on eligible childcare payments. Reducing the limits from £175/£300 (for one or two children) to £125/£215 and retaining the 70% rate would have avoided additional costs, as would a reduction to £100/£170 and a return to the 80% rate. Both of these options would have caused a major disincentive to work more than part-time hours[3].
- Instead, the government has decided to put in an extra £300m to avoid a cut in the limits, while still extending eligibility to those working less than 16 hours a week. Compared with pre-2011, this means keeping the lower 70% rate of compensation for childcare costs[4].

[1] HMT, *Budget 2011*, Table 2.2

[2] See, for example, Save the Children/Daycare Trust, *Making work pay: The childcare trap,* Sept 2011

[3] Hirsch, D, *Childcare support and the hours trap*, May 2011

[4] In order to avoid the work disincentive that arises from the reduced 70% rate but still abolish the minimum hours rule, approximately a further £375m would be needed. This figure includes the £340 million that would be required to match pre-2011 terms for childcare support under Universal Credit as well as the additional £35 million that will be saved on childcare support under the proposed system compared to the pre-2011 system – see Table 1.

Table 1 – Changes in childcare credits for families on low incomes

	Pre 2011	2011	UC terms announced	*UC if restored with pre-2011*
Percentage of childcare covered	80%	70%	70%	*80%*
Limit of eligible childcare for one child	£175 for one child, £300 for two	£175 for one child, £300 for two	£175 for one child, £300 for two	*£175 for one child, £300 for two*
Hours rules	16 hour minimum	16 hour minimum	No minimum	*No minimum*
Spending compared to pre-2011 system (2011/12 prices)		-£335m	-35m	+£340m*

*Estimated as follows: As well as restoring the 80% rate for existing claimants, cancelling £335m in savings, the Government would have to pay newly entitled claimants, working fewer than 16 hours, at the 80% rate. The Government estimates the cost of paying them at the 70% rate as £300m; adding a seventh of this amount to pay 80% would raise the cost to around £340m.

The effect on the hours trap

The Government has emphasised that it wants to improve work incentives by ensuring that people keep more of what they earn. Today, the simultaneous reduction of benefits and tax credits combines with income tax to mean that people can lose over 90 pence of each extra pound in their pay packet.

For families with small children, working additional hours in order to boost family income can be frustrated by the combination of several factors. For each extra pound earned, income tax and national insurance contributions can rise, tax credits and benefits can fall and the cost of childcare to the family (even after help with tax credits) can go up. The ***"withdrawal rate"*** associated with an "hours trap" can be defined as the percentage of earnings that a family loses through all of these factors combined. It is different from the way in which the withdrawal rate is sometimes expressed, because it includes the cost of extra childcare.

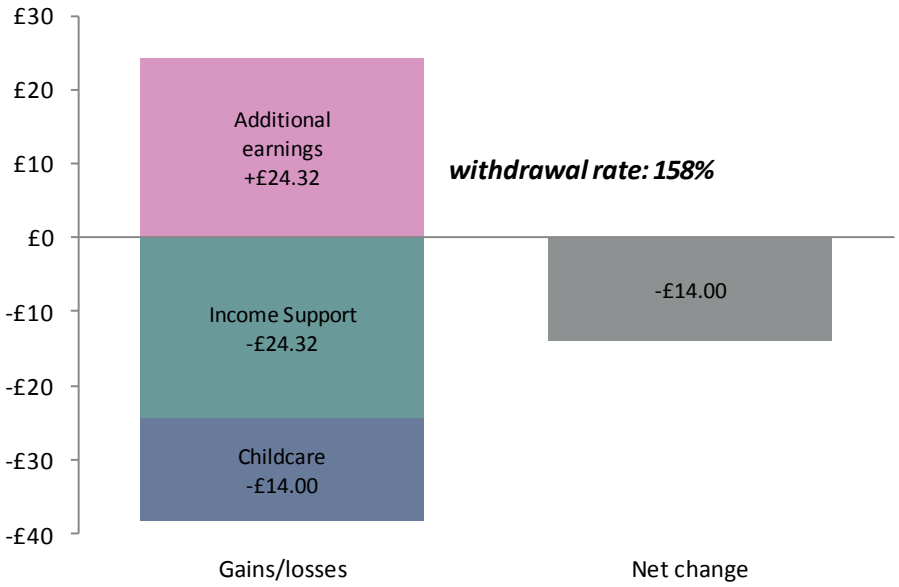
The changes from the pre-2011 to the post-2013 system affect this hours trap in a number of ways. Some of these changes are already in place; others will occur with the shift to Universal Credit. In particular:

a) For families ***where nobody works more than 16 hours***, the withdrawal rate will reduce. At present, such families typically lose benefits pound for pound, and get no help with childcare costs. This means they will often be worse off working. Under Universal Credit, payments from the state will be reduced more slowly, and such families will be eligible for childcare credits, so work will generally pay, although not always very much.

EXAMPLE 1: a single parent on £6.08 an hour (current minimum wage) increases working hours from 8 to 12 a week[5].

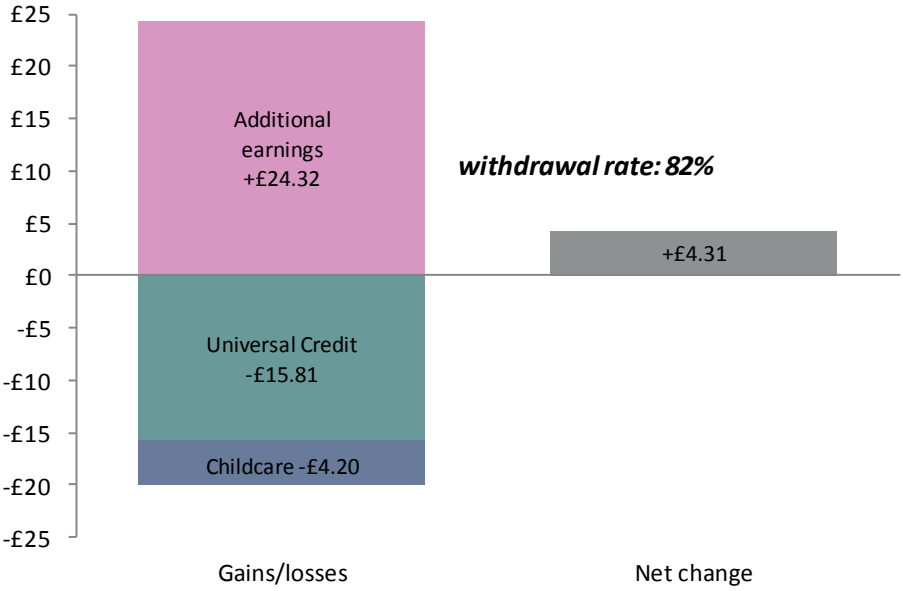
At present, increasing from 8 to 12 hours work per week, they get no help and end up worse off. The additional £24.32 they earn is lost through the withdrawal of income support. Paying £14 for childcare to cover their extra hours, leaves them £14 worse off.

Gains/losses for single parent increasing from 8 to 12 hours work under current and previous system



Under Universal Credit, increasing from 8 to 12 hours work per week, they will get help with childcare and be slightly better off. From the £24.32 extra they earn, they will lose £15.81 in withdrawn support. But they will only pay £4.20 towards the additional hours of childcare they need, leaving them £4.31 better off from working 4 extra hours.

Gains/losses for single parent increasing from 8 to 12 hours work under Universal Credit (2013)



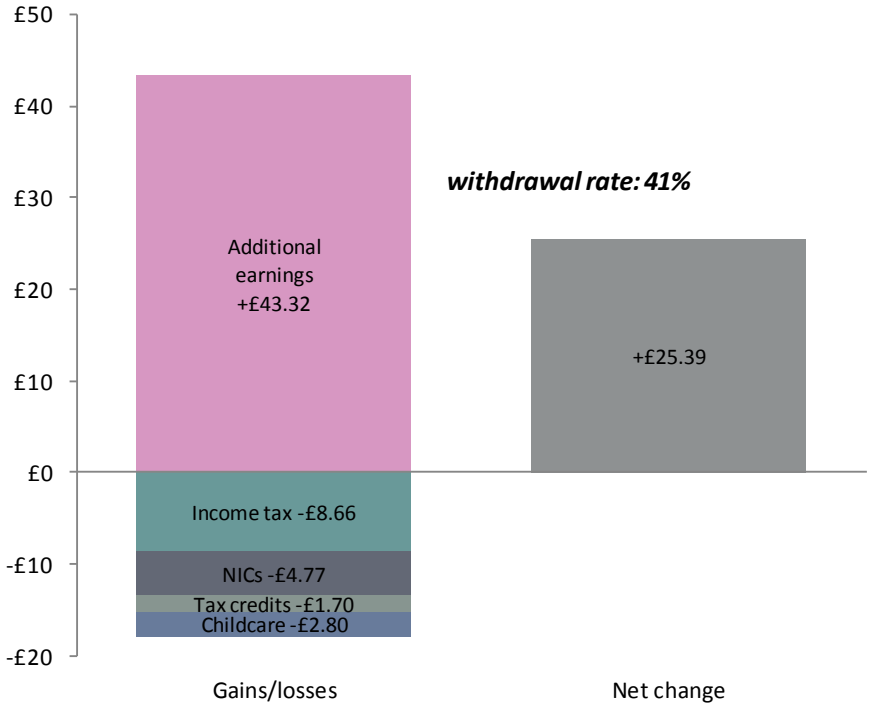
[5] All the examples used here assume that for each extra hour worked, the parent incurs the average childminder hourly fee of £3.50 for one small child.

b) For many ***single parents working more than 16 hours a week*** and requiring childcare, the cut from 80% to 70% reimbursement of childcare costs has already significantly worsened the hours trap. This effect will persist under Universal Credit. At the same time, the rate at which tax credits are withdrawn as income rises has been increased, and it will rise further under Universal Credit. The "30 hour bonus" encouraging near-full time work will also be abolished. All these factors will combine to worsen the hours trap for many single parents.

EXAMPLE 2: a single parent on a modest wage (£10.80, representing an entry-level midwife) increases hours from 28 to 32 a week.

Pre April 2011, before the childcare tax credit rate was reduced and helped by the "30 hours bonus", this single parent would have kept most of their additional earnings. From an extra £43.32, they would have lost only £17.93 through tax, National Insurance contributions, withdrawn tax credit support and payments for childcare. This would leave them £25.39 better off from working an additional 4 hours.

Gains/losses for single parent increasing from 28 to 32 hours work under previous system (pre April 2011)



Under Universal Credit, with less generous childcare support and no 30 hours rule, most of the additional earnings will be lost. From the additional £43.32 they earn, £8.66 will be paid in income tax and £5.20 in National Insurance contributions. £19.15 will be lost in withdrawn benefits and £4.20 will be paid towards childcare costs. This will leave them only £6.11 better off from working an additional 4 hours.

Gains/losses for single parent increasing from 28 to 32 hours work under Universal Credit (2013)



Note on Housing Benefit: In Example 2 above, the family is assumed to have too high an income to qualify for Housing Benefit. For some single parents working more than 16 hours but still on very low incomes, an entitlement to Housing Benefit as well as tax credits presently creates a very high headline withdrawal rate of around 90%, not counting childcare. Universal Credit is designed to abolish such high rates. However, when the effect of higher childcare costs is taken into account, the overall withdrawal rate will be similar for many such families under Universal Credit. This is because the withdrawal of Housing Benefit with rising income is presently mitigated by taking account of childcare costs in the withdrawal rules. This concession is being withdrawn under Universal Credit.

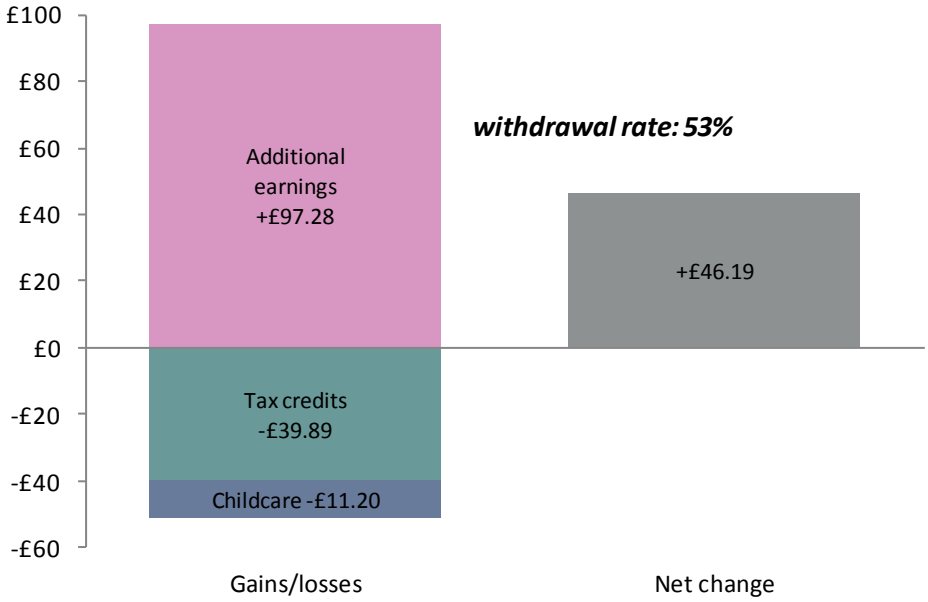
c) For second earners working part time in families with low overall income, a new basis for withdrawing support as family income rises will greatly reduce the amount of pay that is retained below the income tax threshold. At present, the first £139 a week of earnings of the partner of someone receiving tax credits is free of tax and national insurance, but causes tax credits to fall by 41p for every £1 earned. This has risen from 39p in 2010, and will jump to 65p under Universal Credit. For a second earner working under 16 hours a week, this loss will offset the gain from becoming eligible for childcare support. Someone on the minimum wage will only be about £1 better off for each hour worked.

But the real change will be to the incentive to take a part time job of 16 hours or more, where now someone on the minimum wage can gain about £50 a week or more from doing so. Under Universal Credit, the same second earner takes home less than £20 in some cases.

EXAMPLE 3: A parent whose partner is working on low pay takes a £6.08 an hour job for 16 hours a week to supplement family income.

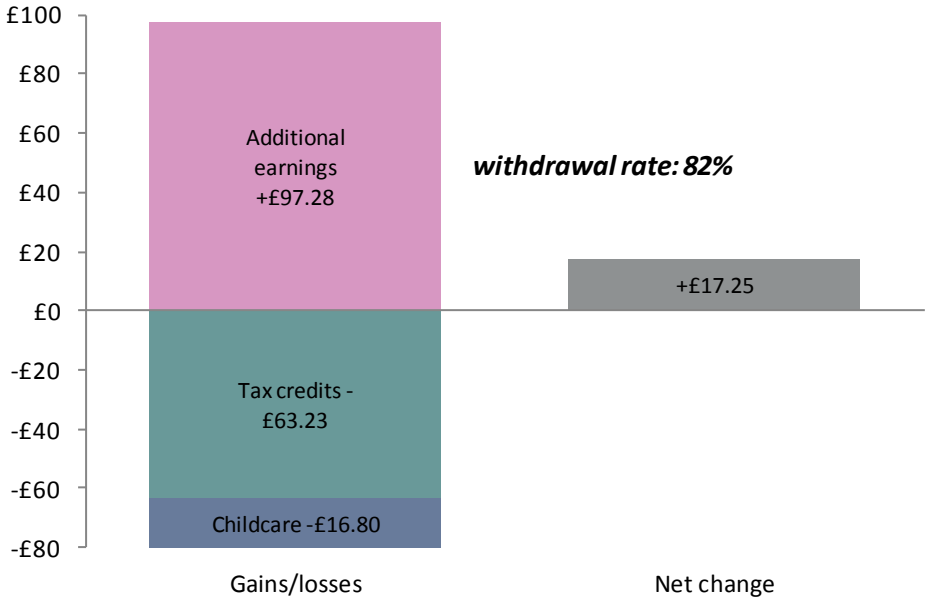
Pre April 2011, before the cut in childcare support and under the old system of income withdrawal, about half of the additional earnings were retained. Of the additional £97.28 earned, £39.89 is lost in withdrawn tax credits and £11.20 is paid towards the additional costs of childcare. This leaves a second earner £46.19 better off from taking up a job for 16 hours a week.

Gains/losses for a second earner working 16 hours a week under previous system (pre April 2011)



Under UC, much faster withdrawal of support for second earners below the tax threshold will combine with the recent cut in childcare support so most extra income will be lost. Of the extra £97.28 earned, £63.23 will be lost in withdrawn tax credits and £16.80 will be paid towards childcare costs. This leaves only £17.25 from the total earned from a second earner taking up a job for 16 hours a week.

Gains/losses for a second earner working 16 hours a week under Universal Credit (2013)



Conclusion

The government will spend approximately the same amount supporting childcare under Universal Credit as it did under the pre April 2011 system. It will put extra resources into enabling people to work short hours by helping them with their childcare costs, as well as making them eligible for other parts of Universal Credit. To pay for this, support for everyone has been reduced. This will particularly affect work incentives for people on modest but not very low wages, people working enough hours not to have any entitlement to Housing Benefit and second earners. Overall, it will mean that while Universal Credit helps some of the poorer families on benefits to become a bit better off, it will limit the potential for families on modest means to rise above a minimum living standard. For such families, it will put a lid on aspiration.

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