

# LOW INCOMES TAX REFORM GROUP – WRITTEN EVIDENCE (EUC0010)

## The economics of Universal Credit

### 1 Introduction

1.1 LITRG's websites (which last year received over 5.5 million visitors) provide guidance for people on low incomes, many of whom claim welfare benefits.<sup>1</sup> Our experience of the tax and benefits systems, and evidence from website enquiries from members of the public, have informed our answers below. We focus on areas related to our particular expertise, i.e. where tax and benefits interact.

### 2 How well has UC met its original objectives?

2.1 We understand the objectives of UC were broadly: simplification/streamlining the system, to make work pay, to reduce fraud and error rates, and to combat worklessness and poverty.<sup>2</sup>

#### 2.2 ***Streamlining systems: using data for simplification and fraud/error reduction***

2.2.1 For employees, the key to streamlining UC claims was to build the system around HMRC's PAYE 'real-time information' (RTI) data. This idea broadly makes sense, and has the potential to alleviate burdens from claimants by capitalising on opportunities created by the digital age. However, mismatches in the definition of earned income for UC<sup>3</sup> and the data supplied by HMRC via RTI create problems.

##### *Timing of earnings*

2.2.2 UC is calculated monthly based on the claimants' circumstances, but claimants' pay dates do not always match neatly to their UC monthly assessment period. For example, those paid four-weekly will have one UC assessment period a year into which two lots of pay fall. Even those paid monthly can face this double-pay problem, e.g. if they are paid early due to the usual payday being a non-banking day, or a holiday such as Christmas<sup>4</sup>.

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<sup>1</sup> [www.litr.org.uk](http://www.litr.org.uk), [www.revenuebenefits.org.uk](http://www.revenuebenefits.org.uk), [www.taxguideforstudents.org.uk](http://www.taxguideforstudents.org.uk) and [www.disabilitytaxguide.org.uk](http://www.disabilitytaxguide.org.uk)

<sup>2</sup> From the original white paper: <https://www.gov.uk/government/publications/universal-credit-welfare-that-works>

<sup>3</sup> UC Regulations 2013, SI 2013/376, Part 6, Chapter 2

<sup>4</sup> HMRC guidance to employers states that they should use the contractual pay date on their submission to HMRC where they pay early (due to the usual pay falling on a weekend or over Christmas). However, we are contacted regularly by claimants whose employers (including some large employers) do not follow this guidance. Many of the two pays in one assessment period problems would be alleviated if the guidance was followed.

- 2.2.3 One might assume that the claimant should not be any worse off overall because although they will receive a lower UC payment in one assessment period, where two pays are taken into account, they will correspondingly receive a higher UC payment in the next, where there is no reported pay information. However, the claimant could lose out due to: losing out on the work allowance<sup>5</sup> in the months where the RTI indicates no earnings; hardship caused by an unexpected missed payment of UC; extra pay might end the UC claim, meaning that the claimant will have to claim again; potentially triggering the benefit cap and surplus earnings rules. If an objective of UC was to combat poverty by improving claimants' ability to manage their money, in such cases precisely the opposite effect has been seen.
- 2.2.4 This issue came before the courts in *R (oao Johnson and others) v Secretary of State for Work and Pensions* [2019] EWHX 23 (Admin).<sup>6</sup> The High Court concluded that the DWP should adjust the earned income figure when it is clear that the actual amounts reported as received in an assessment period do not reflect the earned income payable in respect of that period. DWP are currently appealing this decision. HMRC have issued guidance<sup>7</sup> to employers which goes some way to help with the data aspects. However, these 'easements' are not the complete answer and our understanding is that they are non-statutory, and therefore not enforceable by the employee or HMRC.<sup>8</sup> As more people come across to UC, this issue is likely to become significant.

#### *Incomplete data*

- 2.2.5 RTI data does not give the complete picture of employed earnings for UC, e.g. claimants might be able to deduct expenses that they have necessarily incurred and that their employer has not reimbursed.<sup>9</sup> These details are not included in the PAYE data. To date, this is not mentioned on GOV.UK, nor in the UC claim process, so is reliant on claimants or their work coach knowing about it. Even where claimants are aware, it may be difficult to get DWP to agree that they can deduct expenses. See Appendix 1, case study 1.
- 2.2.6 Somewhat surprisingly, even the net-of-tax income figure that the DWP receives through RTI may not reflect the claimant's true net income for UC. The regulations state that, from the earnings figure, income tax and primary class 1 contributions **in respect of the employment** are to be deducted. This is rather odd, because HMRC do not calculate tax separately on individual sources of

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<sup>5</sup> UC Regulations SI 2013/376, Reg 22

<sup>6</sup> <https://www.bailii.org/ew/cases/EWHC/Admin/2019/23.html>

<sup>7</sup> <https://www.gov.uk/government/publications/cwg2-further-guide-to-payee-and-national-insurance-contributions>, para 1.8

<sup>8</sup> See our two articles on this issue for further details: <https://www.litrg.org.uk/latest-news/news/190225-universal-credit-payment-problems---could-hmrc-hold-key> and <https://www.litrg.org.uk/latest-news/news/190710-uc-two-payments-one-assessment-period-problem---what-next>

<sup>9</sup> UC Regulations SI 2013/376, Reg 55(3)(a)

income. Instead, the data received by DWP from HMRC may show tax deducted that isn't necessarily in respect of the employment. So why might the RTI feed be misleading?

2.2.7 First, the claimant's PAYE code might include other tax debt which is 'coded out' for ease of tax collection. It appears the legislation does not allow for such tax to be deducted when calculating net earned income, but in practice it is – meaning that if HMRC adjust a tax code to recover a tax debt, the UC award will increase as result.

2.2.8 Second, the PAYE code might be incorrect, so the claimant is paying too much or too little tax. If paying too much, a later tax refund can (if certain conditions are met) be treated as earned income for UC when it is received from HMRC.<sup>10</sup> If paying too little, the claimant should be able to have the tax underpayment in respect of the employment deducted from UC earnings in a later assessment period if they settle it with HMRC direct (or it would be automatically taken into account if 'coded out' and they still claim UC when that PAYE code is operated).<sup>11</sup> However, HMRC do not notify DWP of PAYE tax refunds (nor, we assume, PAYE underpayments).<sup>12</sup> The claimant should declare them to DWP, to be factored into their UC award. It is not clear to us how the claimant would know to do this. Furthermore, the claimant will probably not know to what the tax refund relates as HMRC do not give a breakdown of refunds in their P800, Simple Assessment or Self Assessment tax calculations. Therefore, although one reason for using RTI was to 'design out' opportunities for claimant error, hidden errors may remain. To help resolve this, PAYE coding and how it fits with UC claims needs further examination so that appropriate adjustments can be made in the UC calculation, preferably without the claimant having to notify the DWP of their PAYE code breakdown or tax overpayments or underpayments.

## 2.3 **Making work pay**

2.3.1 We think that the government needs to give more rounded consideration to policy making – across the tax, national insurance, minimum wage and welfare benefits systems. 'Making work pay' cannot be considered in isolation: although under UC, people should keep 37p for each pound they earn (and thus on first glance it appears to make work pay), this does not take account of council tax reduction (a further 20% in some cases), nor loss of passported benefits or travel to work costs.

2.3.2 Further, it has been a policy of successive governments to substantially increase the income tax personal allowance. The present government also plans to increase the starting point at which people pay national insurance contributions.<sup>13</sup>

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<sup>10</sup> UC Regulations SI 2013/376, Reg 55(4A)

<sup>11</sup> UC Regulations SI 2013/376, Reg 55(5)(b)

<sup>12</sup> See Parliament, written question 237574, answered 1 April 2019:

<https://www.parliament.uk/business/publications/written-questions-answers-statements/written-question/Commons/2019-03-27/237574/>

These measures provide less benefit than sometimes implied to those on the lowest incomes. Those already earning under the personal allowance (or NIC threshold) – an increasing number – gain nothing from an increase. Also, UC claimants see much of any gain clawed back, because UC is based on income net of tax and NIC. Due to the UC taper, most claimants therefore only gain 37% of any tax or NIC saving resulting from an increase in the personal allowance or NIC threshold. To help those on very low incomes, increasing UC work allowances and, indeed, restoring work allowances for all would be more beneficial and could provide an additional work incentive.

- 2.4 Similarly, National Minimum Wage (NMW) rates have continued to rise. If the UC work allowances do not at least keep in step with NMW increases, those in low-paid work may not see the benefit when the NMW increase is taken in the round with their UC award.

### **3 Were the original objectives and assumptions the right ones? How should they change?**

- 3.1 We think that UC should have an objective of being 'equitable'. It should treat people in similar financial situations equitably, e.g. looking at how UC treats the self-employed as compared to the employed. It does not seem equitable that two UC claimants with similar levels of income overall, one who might be employed in a steady job and the other who might be in self-employment with variable earnings across a year, should end up with different levels of state financial support. The minimum income floor means that the self-employed are treated quite differently to employees. While we understand there is a need to get the balance right between supporting entrepreneurship and not subsidising long term, unprofitable self-employment, we are concerned that this balance has not been achieved. People may be dissuaded from becoming self-employed or will give up self-employment unnecessarily in cases where they are caught by the minimum income floor even though, over an annual period, they are earning above it. This policy feels especially uncomfortable given that some people have been encouraged into self-employment by DWP staff, and others may have been forced to accept 'false' self-employment terms to secure any work at all. See appendix 1, case study 2.
- 3.2 Also within equitable treatment is an anomaly we think exists in respect of pension contributions. The regulations<sup>14</sup> allow deduction of 'relievable' pension contributions when calculating net earned income for UC. 'Relievable contributions' has the same meaning as s188 FA 2004, i.e. the gross amount. There are two ways of giving effect to tax relief. The first is out of after-tax pay ('relief at source'), where the individual pays into their pension the net of basic rate tax amount, so a gross contribution of £10 has effectively cost them £8.

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<sup>13</sup> See Conservative and Unionist Party manifesto 2019, <https://vote.conservatives.com/our-plan> and <http://www.legislation.gov.uk/ukdsi/2020/9780111192580>

<sup>14</sup> Universal Credit Regulations 2013, SI 2013/376, reg 55

The other way of giving relief ('net pay arrangements') is for the gross amount of the pension contribution to be deducted from gross pay, with tax then calculated on the balance.

3.3 We do not think it is appropriate to work out the claimant's net income for UC purposes by deducting the gross pension contribution for those in relief at source schemes. The purpose of calculating benefits entitlement on a net basis is to identify how much income a person has left after all deductions have been made. For someone in a relief at source pension scheme, the regulations effectively allow a deduction for the tax relief on their contribution, which is not a cost they have directly suffered, therefore not giving a true representation of the net income in their pocket. We suspect that for UC claimants contributing to relief at source schemes, the DWP is deducting only the net – i.e. paid – amount. This would seemingly give the equitable result, but it does not match the regulations. We have raised this issue with DWP but have yet to receive a substantive response.

**4 What have been the positive and negative economic effects of UC?** – No comment here.

**5 What effect has fiscal retrenchment had on the ability of UC to successfully deliver its objectives?**

5.1 It is possible (though we are not certain of the cause) that austerity measures, and consequent pressure on resources, have inhibited DWP's ability to be open with external stakeholders in relation to UC. By contrast for example, we found HMRC more willing to engage in the early days of tax credits, which helped to overcome some of the challenges of implementing that system.

**6 Which claimants have benefited most from the UC reforms and which have lost out?**

6.1 We believe that UC as it stands works best for those with single job, steady income and stable personal circumstances. However, in our experience, such 'idealised' circumstances are not typical.

6.2 Though by no means perfect, tax credits produced better results for some lower income households, e.g. those with income peaks and troughs over a year. Take, for instance, the recent Parliamentary debate and press coverage of Greggs employees losing a large chunk of their £300 bonus due to the interaction of tax and benefits.<sup>15</sup> Such a bonus would not have had an immediate effect on tax credits awards, provided the award was based on prior year income, because the income disregard would have protected them. Such a bonus might have affected the award for the following tax year, but claimants would not easily have connected the two. Under UC, the effect is immediate.

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<sup>15</sup> See for example <https://www.bbc.co.uk/news/uk-politics-51208542>

Although logically this is the 'right' result in that UC aims to match support to immediate needs, it could make people think that work does not pay.

6.3 What is interesting is that benefits in kind are not currently treated as earnings for UC, so anyone receiving benefits in kind may gain under UC as compared to tax credits.<sup>16</sup> And had Greggs, in the above example, provided a benefit in kind rather than cash bonus, their UC claimant employees would have realised the full benefit of their bonuses. It is unclear whether the government intends to re-visit this.

6.4 Probably the most significant concern is that self-employed claimants with fluctuating cash flow will be amongst the biggest losers under UC. To date, we understand there are relatively few self-employed claimants, so we have yet to see some of our concerns in this area play out. We discuss this further below.

## **7 How has the world of work changed since the introduction of UC? Does UC's design adequately reflect the reality of low-paid work?**

### **7.1 *Self-employment and 'gig' work***

7.1.1 Two significant changes are the increasing numbers of people in self-employment, and the continued rise of the gig economy (with people being in self-employment but perhaps not having set out to be so and therefore daunted by the consequent administration).

7.1.2 Linked to this, the 'trading allowance' has been introduced, meaning that self-employed income up to £1,000 per year is not taxable. Yet for welfare benefits, these amounts are still assessed as income. This mismatch has the potential to cause confusion, as people could easily believe that they need not report amounts up to £1,000 to government at all.

### **7.2 *Zero-hours contracts***

7.2.1 It appears that UC claimants are not required to accept zero-hours contracts, but only if the contract requires exclusivity.<sup>17</sup> This seems to be too limited a concession considering the reality of zero-hours contracts. A UC claimant who refuses a non-exclusive zero-hours contract job can be sanctioned. However, if they accept such a zero-hours contract and apply for other jobs, the claimant risks being 'zeroed down' (i.e. given no hours of work) by their employer.

## **8 If UC does not adequately reflect the lived experiences of low-paid workers, how should it be reformed?**

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<sup>16</sup> UC Regulations 2013, SI 2013/376, reg 55

<sup>17</sup> <https://www.gov.uk/government/publications/universal-credit-and-employers-frequently-asked-questions/universal-credit-and-employers-frequently-asked-questions#what-is-the-current-rule-on-zero-hour-contracts>

- 8.1 We explored ideas for reform of UC for the self-employed in a 2017 report.<sup>18</sup> We suggest:
- allowing averaging of self-employment income for UC;
  - extending the start-up period to 24 months (currently 12 months);
  - removing the complex surplus earning rules (for both employees and the self-employed), instead having a general anti-abuse provision to tackle cases where income is manipulated;
  - aligning various definitions, such as: ensuring a person is consistently treated as self-employed for tax and UC purposes; and aligning the UC and tax cash bases of accounting.
- 8.2 We believe that the two pay packets in one assessment period issue (explained earlier) needs a combined response between HMRC and DWP, delivering a statutory solution. There also needs to be some thought given to the mismatches that exist between the legislation and the data feed that comes from HMRC, and more done by DWP to ensure that awards take into account allowable deductions (that, as above, are currently not communicated to claimants). Otherwise, problems will only grow as more people claim UC. This will impact not only claimants, but also will result in administrative costs to DWP, HMRC and employers due to handling claimants' queries.

*24 February 2020*

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<sup>18</sup> [www.litrg.org.uk/latest-news/reports/171030-self-employed-claimants-universal-credit---lifting-burdens](http://www.litrg.org.uk/latest-news/reports/171030-self-employed-claimants-universal-credit---lifting-burdens)

## **Appendix 1 – Example case studies**

### **Case study 1: LITRG website enquiry – failure to deduct employment expenses in UC claim**

'I am a community care worker... the UC staff need more training. They are unaware that your mileage is not taken into account and they are having to look into this.'

### **Case study 2: LITRG website enquiry – employee being treated as self-employed**

'My job is as a leaflet distributor. I was initially PAYE, but my employer has informed me that I am now self-employed. I have undiagnosed learning disabilities and require step by step help with what to do in order to pay tax and National Insurance that is due...'

## **Appendix 2 – About us**

The Low Incomes Tax Reform Group (LITRG) is an initiative of the Chartered Institute of Taxation (CIOT) to give a voice to the unrepresented. Since 1998, LITRG has been working to improve the policy and processes of the tax, tax credits and associated welfare systems for the benefit of those on low incomes. Everything we do is aimed at improving the tax and benefits experience of low-income workers, pensioners, migrants, students, disabled people and carers.

LITRG works extensively with HM Revenue & Customs and other government departments, commenting on proposals and putting forward our own ideas for improving the system. Too often the tax and related welfare laws and administrative systems are not designed with the low-income user in mind and this often makes life difficult for those we try to help.

The CIOT is a charity and the leading professional body in the United Kingdom concerned solely with taxation. The CIOT's primary purpose is to promote education and study of the administration and practice of taxation. One of the key aims is to achieve a better, more efficient, tax system for all affected by it – taxpayers, advisers and the authorities.