Social Security and In-work Poverty – call for evidence
Response from the Low Incomes Tax Reform Group (LITRG)

1 Executive Summary

1.1 We welcome the opportunity to submit a response to the Social Security Committee of the Scottish Parliament's inquiry into Social Security and In-work Poverty. We do so as tax specialists with interest and expertise in the tax and related welfare problems of those on low incomes, particularly the self-employed. We have only responded to those questions where we think we can add value.

2 About Us

2.1 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.

2.2 LITRG works extensively with HM Revenue & Customs (HMRC) 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.

2.3 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.

3 Introduction

3.1 LITRG is particularly interested in self-employment, use of Real Time Information (RTI) for Pay As You Earn (PAYE) data, wider interactions with the tax system and the digital aspects of the system, along with the transition of legacy benefit claimants to universal credit (UC).

3.2 LITRG has recently provided evidence to the Work and Pensions Committee (WPC) of the UK Parliament on the rollout of UC.[1] This follows the publication of our report *Self-employed claimants of universal credit – lifting the burdens* in October 2017, in which we summarised the main shortcomings of the current UC system in respect of the self-employed and proposed what we believe to be a workable alternative.[2] The submission and report drew on evidence from enquiries to the various LITRG websites.[3]

4 What impact will Universal Credit have on in-work poverty in Scotland?

4.1 As claimant numbers increase, we are concerned that work coaches, who are central to the success of UC, may not be able to manage.

4.2 We have a major concern that the structure of UC creates particular problems for the self-employed, and that if major changes are not made there is a risk that those who are already self-employed will be forced to give up their businesses in order to access adequate state support. We also think that the structure of UC may deter people from starting self-employment.

4.3 In part, this is due to the Minimum Income Floor (MIF), which, in our view, fails to strike the right balance between protecting public funds on the one hand and supporting self-

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[1] https://www.litrg.org.uk/sites/default/files/files/180109-LITRG-response-WPC-UC-rollout-inquiry-FINAL.pdf

[2] https://www.litrg.org.uk/latest-news/reports/171030-self-employed-claimants-universal-credit-%E2%80%93-lifting-burdens

[3] LITRG has responsibility for four websites: https://www.litrg.org.uk/; https://www.taxguideforstudents.org.uk/; https://www.disabilitytaxguide.org.uk/; https://revenuebenefits.org.uk/

employed businesses on the other.[4] Moreover, those in self-employment have to report their earnings on a monthly basis, but this, along with the MIF, does not work well for those with fluctuating earning patterns, irregularly occurring large expenses or receipts or periods in which losses are made. Often, if their earnings were viewed over an annual period, these claimants would earn more than the National Minimum Wage (NMW). However, as things stand they can be penalised, as in some months they may earn less than the NMW, and the recently introduced rules on surplus earnings and self-employed losses do nothing to mitigate the effects of this design.[5] Due to the way in which UC is paid (in arrears), a claimant with fluctuating earnings is likely to find it particularly difficult to budget.[6] This is because higher earnings in month 1 will result in a lower UC entitlement, and a lower payment in month 2; but if in month 2 the claimant also has lower earnings, they have lower income from both their self-employment and UC simultaneously (see Appendix).

5 What is the experience so far in full-service areas in Scotland for those who are in work who are moving or have moved on to Universal Credit?

5.1 We do not have evidence relating specifically to Scotland in respect of experiences in full-service areas. We are aware of a number of issues with UC, which apply generally throughout the UK.

5.2 We referred to current issues for the self-employed in section 3 of the evidence we submitted to the WPC inquiry on the rollout of UC.[7] However, the relatively small number of self-employed people claiming UC to date means that the full impact is difficult to assess at this stage.

5.3 The online application process for UC is in itself too long and appears to carry weaknesses; difficulties arise due to the inability of claimants to fully complete the application in one sitting and confusion as to whether and how they can save a partially completed application (particularly when they are accessing the claim system from a public computer), fulfilling the online identity verification, obtaining access to a JobcentrePlus office and facing the need to wait for a code. There have also been payment delays and errors in payment calculations.

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[4] Under the MIF, any month in which the self-employed claimant's profits fall below the MIF, the claimant's UC award is assessed as if they had profits at least equal to the MIF.

[5] http://www.legislation.gov.uk/uksi/2018/65/contents/made

[6] It should be noted that the employed can also be affected by this issue in respect of fluctuating earnings, for example, those on zero hours contracts.

[7] https://www.litrg.org.uk/sites/default/files/files/180109-LITRG-response-WPC-UC-rollout-inquiry-FINAL.pdf

5.4 In addition, issues arise in the interaction of the UC system with RTI for PAYE. UC has been developed on the basis that HMRC will send RTI data to the DWP in order to enable it to automatically calculate and adjust UC awards. However, UC claimants can be disadvantaged, as the income figure provided through RTI may not be the correct figure for the calculation of their UC award. For example, RTI data does not include details about unreimbursed expenses, but these are allowable deductions for UC. Moreover, at this stage there is no online guidance available,[8] and we understand that DWP does not always ask the appropriate questions or provide consistent information about expenses to enable the proper determination of a claim. UC claimants also face alterations to or cessation of their awards if employers submit RTI information to HMRC late or submit incorrect data.

5.5 The rationale underpinning UC is that work always pays. Despite that often being strictly true when only the UC taper rate is taken into account, the rationale is eroded when additional (and important) factors are taken into account, such as loss of support with Council Tax, travel costs, loss of passported benefits and the topping up of childcare, to name but a few.

5.6 Currently, those who are newly self-employed may not be subject to the MIF (see 4.2 above) as it is not applied during the first 12 months of the business – the start-up period.[9] However, research by the RSA shows that on average it takes three years for a self-employed person to be earning the equivalent of the NMW from their business. This suggests that the 12-month start-up period is too short and may mean that some individuals have to cease self-employment, even though their businesses might have the potential to become strong and profitable over time.[10]

6 What can or should the Scottish Government do to mitigate any detrimental impact?

6.1 We appreciate that the action that the Scottish Government can take to mitigate any detrimental impact depends on the powers that are devolved to Scotland.

6.2 Our October 2017 report *Self-employed claimants of universal credit: lifting the burdens* sets out a model that could be used to address the current areas of concern within the UC

[8] We understand that there are plans to remedy this by the placing of guidance on GOV.UK.

[9] Unless the claimant has previously benefitted from the 12-month start-up period in the previous five years.

[10] RSA – *Boosting the Living Standards of self-employed people* (2015): https://www.thersa.org/discover/publications-and-articles/reports/boosting-the-living-standards-of-the-self-employed

system.[11] Our response to the Social Security Advisory Committee (SSAC) consultation on passported benefits[12] set out three key principles for the reform of passported benefits.

6.3 A coherent passporting strategy in Scotland (and indeed across the UK) would be welcome. There are a number of passported benefits linked to UC that have different thresholds and in some cases the same benefits with different thresholds in each part of the UK. This creates a complex landscape which is difficult to understand for claimants and those who seek to advise them. Some complexity is inevitable, but the burden of dealing with this should fall on those responsible for delivering the benefit, rather than those receiving it.

6.4 Fixed thresholds, such as that for free school meals,[13] create a cliff-edge and do not take account of the number of children in a family.[14] Thresholds can also affect work incentives.

6.5 In Scotland, UC claimants can be eligible for a number of benefits, managed and paid for by the Scottish Government, including legal aid, free NHS dental treatment, education maintenance allowance and early learning and childcare entitlement. Although these are all passported benefits, the eligibility criteria vary from benefit to benefit, creating complexity. So, for example, while a UC claimant must have monthly earned income of £610 or less to gain eligibility for free school meals, in order to be entitled to free NHS dental treatment, the UC claimant must have earned income of £435 or less (or £935 or less if the award includes elements for a child and/or limited capability for work or work related activity).

6.6 It is essential that guidance and communications concerning passported benefits is up-to-date and accurate, in order that claimants can understand not only the passported benefit itself, but also how that passported benefit entitlement is linked to income and the impact that changes will have on the person's overall financial situation. As of August 2018, the document relating to NHS patient travel costs to which the UC (Scottish choices) webpage links does not refer to UC, even though this is listed on that page as being a passported benefit for UC claimants.[15] It would be particularly helpful for Scottish UC claimants to be able to visit one website and easily see all the passported benefits that might be relevant or

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[11] https://www.litrg.org.uk/sites/default/files/Self%20Employment%20report%20FINAL%20for%20release.pdf

[12] https://www.litrg.org.uk/sites/default/files/110722-LITRG-SSAC-passported-benefits-FINAL.pdf

[13] In Scotland, a UC claimant's child can get free school lunches up until the age of 16, provided monthly earned income of the UC claimant is not more than £610: https://www.mygov.scot/school-meals/

[14] Section 4: https://www.litrg.org.uk/sites/default/files/files/180109-LITRG-response-WPC-UC-rollout-inquiry-FINAL.pdf

[15] The webpage https://beta.gov.scot/policies/social-security/universal-credit/ links to http://www.gov.scot/Resource/0039/00393022.pdf

available to them. Currently, the Scottish Government website lists only those passported benefits that are actually managed and paid by it, while GOV.UK provides a list that may be comprehensive for an English UC claimant, but creates problems for the Scottish UC claimant:[16] it is necessary to visit a further page for each benefit to double-check whether or not each item on the list applies to a Scottish UC claimant; moreover, it does not include all of the passported benefits that are available to Scottish UC claimants. While we accept that there may be a reluctance to list benefits which are either reserved or devolved (respectively), in the interests of claimants, we think both the Scottish websites and GOV.UK should provide comprehensive information, accompanied by appropriate signposting.[17]

6.7 Since UC is received in arrears, UC claimants with children may face difficulties paying for childcare. Costs for childcare are often charged in advance and this can cause acute difficulties for the UC claimant waiting for their UC payments. In this regard, we note the work Scottish Government is carrying out in relation to developing a flexible and high-quality Early Learning and Childcare (ELC) system, including an increase in free entitlement to ELC.[18] This may also assist in mitigating the problem of educational attainment gaps between children in richer and poorer areas. It would also be helpful to mitigate the effects of arrears payments for UC claimants with out-of-school childcare costs for school-age children.

6.8 A number of tax powers have been devolved to Scotland. In respect of income tax, the Scottish Parliament has the power to set rates and bands for income tax on the non-savings, non-dividend income of Scottish taxpayers.[19] We would caution the use of these tax powers to mitigate the detrimental impact of in-work poverty in Scotland however, due to the complex interactions between the tax and benefits systems. In particular, we note that the current personal allowance is £11,850 (for tax year 2018/19), meaning that those on very low incomes may have taxable income that falls well within this allowance anyway.[20] In relation to this, we understand that there are around 2 million (out of 4.5 million total) adults in Scotland who have income below the personal allowance.[21]

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[16] https://beta.gov.scot/policies/social-security/universal-credit/ and https://www.gov.uk/universal-credit/other-financial-support

[17] Thought could also be given to including information about passported benefits on https://www.mygov.scot/

[18] https://beta.gov.scot/policies/early-education-and-care/early-learning-and-childcare/

[19] Non-savings non-dividend income consists of employment income, profits from self-employment, pension income and rental profits.

[20] The setting of the personal allowance is reserved to the UK Parliament.

[21] Section 3.2, The Scottish income tax base, in *The Role of Income Tax in Scotland's Budget* (2017): http://www.gov.scot/Publications/2017/11/5307

6.9 As noted above, many individuals have taxable income too low to allow them to benefit from any increase in the personal allowance or creation of a 0% rate band for Scottish income tax. Moreover, as pointed out in our response to the Scottish Government's discussion paper *The Role of Income Tax in Scotland's Budget* UC claimants would not see all the benefit from a decrease in their tax liability.[22] This is because the basic position for UC is that entitlement depends on net earned income, that is, after tax income; therefore a decrease in tax liability (due to an increase in the personal allowance or the creation of a 0% rate band, for example) results in an increase in net earned income and a subsequent reduction in UC entitlement. This reduction follows the 63% taper rate, meaning a UC claimant only sees 37% of any change to their net earned income.[23]

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[22] See section 6: https://www.litrg.org.uk/latest-news/submissions/171124-scottish-government-discussion-paper-role-income-tax-scotland%E2%80%99s

[23] We note that unearned income, such as pensions, is taken into account on a gross basis, and therefore reduces a UC award £ for £.

Appendix

Examples from our response to The Work and Pensions Committee inquiry into Self-employment and the gig economy.[24] The examples were submitted in early 2017 using 2016/17 tax year figures.

Example 1 – Fiona and Gregory[25]

Fiona is a single parent with three children and runs a self-employed business with fluctuating profits across the year. Gregory is a single parent with three children who works 35 hours a week and earns £7.20 an hour as an employee.

Over 12 months, from April 2016 to March 2017 Fiona's self-employed income for UC purposes is £12,077 and Gregory's employment income for UC purposes is also £12,077.

Fiona will receive a total of £5,333.43 in UC payments over those 12 months while Gregory will receive £7,944.96. Gregory receives £2,611.53 more UC than Fiona because of the variable pattern of earnings that Fiona has in her business even though over the year both earn the same amount.

If the proposed surplus earnings rules applied to Fiona, she would receive £455 less UC than the figures above show. She would then be even worse off when compared to Gregory by £3,066.53.

The following table shows Fiona's actual self-employed earnings for each monthly assessment period, her treated earnings and the amount of UC received. It also shows Gregory's net earnings from self-employment and his monthly UC figure.

[24] http://www.litrg.org.uk/sites/default/files/files/170116-LITRG-response-WPC-self-employment-FINAL.pdf – note that the examples use 2016/17 rates.

[25] Assumptions used in the example – Fiona is out of her 12 month start-up period and has no special circumstances that reduce the number of hours she is required to work. Children are all over the age of 13. Fiona's business pays out the majority of expenses between September and March.

Month	Fiona's actual self-employed earnings[26] £	Fiona's income for UC calculation [27] £	Fiona's UC payment[28] £	Gregory's net employment earnings[29] £	Gregory's UC payment[30] £
April 16	3,000	3,000	0	1,006.49	662.08
May 16	1,500	1,500	341.29	1,006.49	662.08
June 16	2,000	2,000	16.29	1,006.49	662.08
July 16	2,500	2,500	0	1,006.49	662.08
August 16	1,500	1,500	341.29	1,006.49	662.08
September 16	200	1,006.49	662.08	1,006.49	662.08
October 16	300	1,006.49	662.08	1,006.49	662.08
November 16	500	1,006.49	662.08	1,006.49	662.08
December 16	Nil	1,006.49	662.08	1,006.49	662.08
January 17	Nil	1,006.49	662.08	1,006.49	662.08
February 17	577	1,006.49	662.08	1,006.49	662.08
March 17	Nil	1,006.49	662.08	1,006.49	404.02
TOTAL	12,077	17,545.43	5,333.43	12,077.88	7,944.96

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[26] Calculated as (receipts – allowable expenses) – actual tax, National Insurance and pension contributions.

[27] Applying a MIF of £1,006.49 which is 35 hours x £7.20 less notional tax and National Insurance of £85.51 each month.

[28] Calculated with standard rate (£317.82) and 3 child elements (£277.08+£231.67+£231.67) making a maximum UC amount of £1,058.24. The work allowance (£397) is deducted from the earned income for that month and the taper of 65% is applied to the resulting figure. This is then deducted from the maximum amount figure to determine the monthly entitlement for UC.

[29] Calculated as 35 x £7.20 (NLW for his age) x 52/12 = £1,092 minus tax, NI of £85.51. We have assumed no pension contributions have been made by either Fiona or Gregory.

[30] Calculated in the same way as Fiona.

Example 2

This is based on the example used by the DWP in their explanatory memorandum[31] to the Social Security Advisory Committee during the consultation on the surplus earnings and losses proposal.

The example DWP used showed Paul and Barry, two employees who over a 12 month period, earn the same amount. It demonstrated 'the potential for unfairness and possible incentive for households to manipulate their patterns of pay to increase their UC entitlement'. By altering his pattern of payments so that he received just two payments over the year, Paul gained an extra £5,259 in UC compared to Barry over the 12 month period. The surplus earnings and losses policy was designed to combat this potential manipulation.

However, if the example was changed slightly so that Paul was self-employed the result is very different as the following example shows. This is primarily because the MIF already disincentives self-employed people from manipulating income to the extent shown in the DWP example.

We have used similar figures to the DWP paper, however we have included the increased net earnings due to the increase of the NMW, increased the disregard of £300 which was announced after the consultation and we have removed the work allowance.

The following table shows Barry and Paul, both employed and both earning the same net amount over 12 months. Barry receives the same earnings each month, Paul receives all of his earnings in just two payments. The figures show their UC payments under the current rules (before the surplus earnings policy is applied). As this table shows, Paul receives significantly more UC than Barry.

MONTH	Barry's net earnings	Barry's UC payment[32]	Paul's net earnings	Paul's UC payment
1	1006.49	101.73	6038.94	0
2	1006.49	101.73	0	755.95
3	1006.49	101.73	0	755.95
4	1006.49	101.73	0	755.95

[31] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/364573/uc-earnings-Explanatory_Memorandum.pdf

[32] This UC payment is calculated based on maximum UC of 755.95 which was calculated based on the figures used in the DWP paper showing a NIL UC point of 1163. 755.95 x 100/65 = 1163.

5	1006.49	101.73	0	755.95
6	1006.49	101.73	0	755.95
7	1006.49	101.73	6038.94	0
8	1006.49	101.73	0	755.95
9	1006.49	101.73	0	755.95
10	1006.49	101.73	0	755.95
11	1006.49	101.73	0	755.95
12	1006.49	101.73	0	755.95
TOTAL	12,077.88	1220.76	12,077.88	7559.50

The following table shows what Paul would receive if he were self-employed rather than employed. This shows that actually Paul would be worse off than his employed counterpart Barry and therefore, under the existing rules, the same manipulation is not possible if Paul is self-employed rather than employed. This is due to the impact of the MIF.

MONTH	Paul's actual earnings	Paul's earnings used in the UC calculation	Paul's UC payment
1	6038.94	6038.94	0
2	0	1006.49	101.73
3	0	1006.49	101.73
4	0	1006.49	101.73
5	0	1006.49	101.73
6	0	1006.49	101.73
7	6038.94	6038.94	0
8	0	1006.49	101.73
9	0	1006.49	101.73
10	0	1006.49	101.73

11	0	1006.49	101.73
12	0	1006.49	101.73
TOTAL	12,077.88	22,142.78	1017.30

This second table shows the operation of the surplus earnings policy on self-employed Paul. It shows that Paul would lose over £600 of UC compared to his position under the existing rules and would be over £800 worse off than Barry.[33]

MONTH	Paul's actual earnings	Paul's surplus amounts	Amount treated as earned income if he claims UC in each month	Paul's UC payment
1	6038.94	4575.94	6038.94	0
2	0	3112.94	4575.94	0
3	0	1649.94	3112.94	0
4	0	186.94	1649.94	0
5	0	0	1006.49	101.73
6	0	0	1006.49	101.73
7	6038.94	4575.94	6038.94	0
8	0	3112.94	4575.94	0
9	0	1649.94	3112.94	0
10	0	186.94	1649.94	0
11	0	0	1006.49	101.73
12	0	0	1006.49	101.73
TOTAL	12,077.88			406.92

[33] The Regulations (SI 345/2015) as originally enacted are not entirely clear about how the MIF works when calculating the surplus amount. We have therefore not included the MIF as Paul's actual income when calculating his surplus amounts. If the MIF was to be included Paul would receive no UC in months 5,6,11 and 12.

Example 3 – Alyssa

This example shows a self-employed claimant who runs a wedding photography business. Alyssa has a large insurance premium to pay which is £1,200 for the year (covering her public liability, indemnity and equipment insurance). Due to her previous credit rating she is unable to take advantage of a monthly payment plan.

Alyssa's UC for a 12 month period will be £12,769.89. If she was able to pay her premium monthly instead, she would receive nearly £600 more in UC over the year.

This is because when she pays her premium of £1,200 in month 5, her income in that month is reduced to £100. The MIF then applies and she is treated as earning £1,006.49 that month and so most of the expense of the premium is in effect disallowed for UC.

The proposed surplus earnings rules from April 2018 will not help someone in Alyssa's situation and this shows that the MIF impacts on people who have large expenses to pay even though over a year they are earning well above the MIF.

MONTH	Actual self-employed earnings (annual insurance premium paid Month 5)[34]	Earned income for UC purposes[35]	Monthly UC payment[36]	Actual self-employed earnings (monthly insurance premium)[37]	Monthly UC payment[38]
1	1,200	1,200	1078.05	1,100	1143.05
2	1,250	1,250	1045.55	1,150	1110.55
3	1,250	1,250	1045.55	1,150	1110.55

[34] Calculated as (receipts – allowable expenses) – actual tax, National Insurance and pension contributions. Assuming that the insurance premium of £1,200 is paid in Month 5.

[35] The MIF is applied in Month 5 because earned income is below £1,006.49 – the level of the MIF.

[36] For the purposes of the calculation we have assumed that Alyssa's maximum UC amount is £1,600 due to children, housing costs and childcare costs. Her work allowance is £397.

[37] Calculated as (receipts – allowable expenses) – actual tax, National Insurance and pension contributions. Assuming that the insurance premium is paid £100 a month for 12 months.

[38] Again we have assumed that the maximum UC amount is £1,600.

4	1,275	1,275	1029.30	1,175	1094.30
5	100	1,006.49	1203.84	1,200	1078.05
6	1,300	1,300	1013.05	1,200	1078.05
7	1,200	1,200	1078.05	1,100	1143.05
8	1,250	1,250	1045.55	1,150	1110.55
9	1,200	1,200	1078.05	1,100	1143.05
10	1,300	1,300	1013.05	1,200	1078.05
11	1,200	1,200	1078.05	1,100	1143.05
12	1,225	1,225	1061.80	1,125	1126.80
TOTAL	13,750	14,656.49	12769.89	13,750	13359.10

Example 4 – Aaron and Derek

Aaron is a self-employed builder – his self-employed income for January 2017 is £1,092. His notional tax and National Insurance will be £85.51.

Derek works in a call centre for 35 hours a week earning the NLW (currently £7.20). His monthly income is also £1,092 and he has deductions of tax and National Insurance of £85.51 in that assessment period.

Aaron and Derek will both receive the same amount of UC in January 2017, assuming their circumstances are both the same.

In February 2017, Aaron and Derek both decide to pay £75 a month into a private pension. Derek will have his UC calculated on his new net income of £931.49 (£1,092 gross less tax and NI of £85.51 and pension contributions £75) whereas Aaron will have his UC calculated on £1,006.49. This is because Aaron's actual income of £931.49 is lower than the MIF of £1,006.49.

This means that Derek will receive nearly £50 a month more UC than Aaron despite them having the same earnings each month and making the same pension contributions. Aaron is therefore not given any recognition for his pension contributions.