{Section 4} What can be done?

Chapter 10
Boosting the capacity for employment in the UK workforce

Chapter summary

- Achieving the macroeconomic conditions for full employment is the most important thing that can be done to support living standards.
- The UK also needs to reduce the barriers to work faced by key groups of growing economic importance, particularly parents and older workers.
- Parents and second earners (overwhelmingly women) should be better supported by:

[i] Extending free childcare for pre-school children to 25 hours a week, 47 weeks a year, with extra hours charged at £1 an hour - the equivalent of three days a week of childcare for £10;

[ii] Better aligning cash support with work preferences by frontloading Child Tax Credit (and Universal Credit) on younger children; and

[iii] Allowing low paid second earners to keep more of their pay by adding a 'disregard' to Universal Credit.

- Capitalising on longer working lives requires more than just new obligations; the government needs to strike a new settlement giving people something in return.
- This should include support for social care and, because people are more responsive to incentives as they near retirement, lower employment taxes on over 55s.

Alongside efforts to boost wages in the bottom half there must be bolder action to boost employment and recover working hours. This is the second key ingredient of shared growth: high employment across society, where those who want to work, and who are able to work, are enabled to do so. A precondition for this will be ongoing efforts to achieve the macroeconomic conditions for full employment. But Britain also needs new efforts to support economically important groups like parents and older workers. The long-term goal is to ensure that employment is not only high but also broad, with no significant group blocked from working by weak financial incentives or other obstacles.

10a Tackling unemployment then broadening employment

Right now, tackling unemployment tops the agenda. As we saw in Chapter 3, the goal of full employment is even more important than ever, with real wage growth now more sensitive to unemployment.[1] The scarring effects of youth unemployment are well established and of immediate concern. Unemployment must now be reduced quickly, especially among the young, to avoid irreparable damage to living standards.

But, as in other areas, we focus on the longer-term, structural forces shaping living standards. While high employment is a prerequisite for shared growth, boosting incomes by raising the steady-state level of employment (or the employment to population ratio) is vital for future prosperity. This means working with the grain of societal trends, in particular the long-term rise of female employment and the decline of the male breadwinner model and, in the coming decades, with the growth of older workers. It means fully adapting to the UK's increasingly diverse workforce and to the new working patterns that arose in the late 20th century. In practical terms, it means developing pro-employment public services and a smarter tax and benefit system to support parents with dependent children, in particular mothers, as well as older workers.

[1] Machin and Gregg, What a Drag.

10b Parents and second earners

In the 20th century there was a transformation in female employment

As we saw in Section 2, in the late 20th century there was a transformation in the composition of the UK workforce and in working patterns. The biggest change was the rise of female employment, which grew from around 55 per cent in 1971 to 70 per cent in 2008, with women accounting for four-fifths of the increase in employment income for low to middle income households since 1968.[2] Linked to this were big changes in working patterns, in particular the decline of the "male breadwinner" model and the rise of households in which all adults are in work.[3] These changes underpinned a big shift in the nature of poverty, with single earner households now making up a bigger share of the poor. The result is that household earnings - and the route to prosperity for working households - are now far more dependent on second earners, as well as single parents, in both cases the vast majority of whom are women.[4]

The UK has only partially adapted to this change

Public policy has not yet fully adapted to these trends. While childcare provision has been substantially expanded, an overwhelming focus on child development means the system has underplayed parental employment. Tax credits have supported lower income families, helping to make sure that work pays to some degree, though support has recently been reduced. In any case the system is complex, creates crushingly high effective tax rates and offers little support to middle income families. Meanwhile, second earners look set to be disadvantaged by the upcoming Universal Credit. On all these fronts an era of squeezed living standards demands a much more concerted effort to support parents and second earners. Government should:

The first stage of expanded childcare support focused overwhelmingly on child development

- *Extend childcare provision to support parents of young children who want to work, building on the current free universal offer with a guarantee of highly affordable additional hours that make part-time work possible for all;*
- *Encourage flexible and part-time working options as the norm in high-quality jobs, rather than simply a characteristic of low-paid work, by extending the right to request flexible work to all employees;*
- *Revise the proposed Universal Credit system so that it better supports second earners; and*
- *Reform the tax and benefit system in response to parents' changing preferences for work, providing cash support when it is most needed.*

The next phase of development on childcare

Childcare must be front and centre of a new approach to supporting parents. As we have seen, the high cost of childcare in the UK is a major barrier to employment, hitting many low income parents as well as those on middle incomes who receive less tax credit support. Indeed many low income families are little or no better off from extra hours work due to childcare costs. With caring responsibilities still split very unequally by gender, these costs fall overwhelmingly on mothers, not only hitting living standards but also widening gender employment and pay gaps.

In the past 15 years the UK childcare market has grown and matured at a remarkable rate, driven in large part by a big increase in public subsidies. There are a number of different elements to the current system. All three and four year olds are now entitled to 15 hours of free early education a week for 38 weeks a year. From September 2014 this provision will also cover most disadvantaged 40 per cent of the two year olds. In addition, financial support is provided for working parents on low and modest incomes through the childcare element of Working Tax Credits. Finally, the employer-supported childcare scheme ("childcare vouchers") allows employees to receive some help with childcare costs free of tax. Historically, these vouchers have been used mainly by higher earners.

The current system often leaves low-earning parents no better off in work

Yet despite this substantial expansion in support, which has overwhelmingly benefited mothers as the main providers of childcare, in the 2000s there was disappointing growth in female employment of only 1.4 percentage points (though this was an improvement on the 1990s). To understand why, it is important to note that the key plank of the expanded support, the free three- and four-year-old offer, was designed primarily with a focus on child development. This was undoubtedly right as a first priority given strong evidence for the widespread benefits of early education and the fact that the UK was starting from a very low base. Nonetheless, the fact that living standards and female employment were not the main focus of this first phase of expansion, and were not subsequently properly addressed, inevitably led to a number of shortfalls.

For one thing, a focus on child development determined the length of provision. Studies show that full-time childcare provides little or no additional benefit to children (but also no harm) compared with part-time childcare, suggesting that 15 hours of high-quality care was adequate.[5] In addition, parents were initially restricted in how they could use the free provision, and had to use three- or four-hour slots, which made it very hard for them to work. Flexibility is now being improved but it remains a major issue for many parents. Meanwhile the overall length of the free offer remains a barrier for parents trying to hold down a part-time job (the preferred form of work for many parents with young children), particularly once travelling time is factored in.

[2] Brewer and Wren-Lewis, Why Did Britain's Households Get Richer? [3] Ibid Single adult working households increased as a share of low to middle income households from 7 per cent in 1968 to 25 per cent in 2008-09. Among households with two or more adults, the proportion with two or more workers has increased from 48 per cent in 1968 to 57 per cent in 2008-09. [4] Ibid. [5] DfES, (2004), The Effective Provision of Pre-school Education (EPPE) Project: Final report, Department for Education and Skills, London.

The government has recently established a Commission on Childcare with an encouraging focus on "supporting families to move into sustained employment". It is important that this work, as well as future policy development on childcare, not only looks at detailed questions of market design and regulation but also grapples with the big question of how much the UK prioritises childcare as a country. Given the scale of the squeeze on living standards, the need to shift to employment income, the importance of female employment, and strong evidence that childcare costs are a major barrier to work – not to mention other recognised advantages of early education – there is a very strong case for increasing overall public investment in childcare while ensuring value for money.

> Under the proposal parents would receive the equivalent of three days a week of childcare for £10

The high costs of childcare in the UK are a particular barrier for parents of pre-school age children (aged under five). One short-term way of helping with costs would be to raise the portion of childcare costs met by the Working Tax Credit (and in the future the Universal Credit) back to 80 per cent (as it was until 2011). However, there is also a strong case for further investment outside the tax credit system. As we have seen, new research for the Resolution Foundation shows that families on modest incomes, who receive less help through tax credits, spend the most on childcare as a portion of their income (see In depth 5.1), making their work incentives extremely weak.[6]

Investment in a more universal, supply-side-funded offer also avoids exposing more people to high marginal tax rates, an inescapable downside of tax credits (and one that will remain under Universal Credit). There is also evidence that to date the UK's supply-side-funded offer – the 15-hour offer for three and four year olds – has encouraged the expansion of provision more effectively than the mixed market that operates through demand-side funding of tax credits.[7] Evidence also suggests that local childcare markets in low income areas have struggled to sustain themselves without some form of continuing supply-side subsidy.[8]

There is a compelling case for additional support to enable parents of young children to work

We believe that the best way to support parents' work aspirations is therefore to build on the current free entitlement. Government should extend the current 15-hour offer for three and four year olds and 40 per cent of two year olds to 25 hours a week. This should also be expanded from the current 38 weeks per year to 47 weeks a year to save parents from struggling to find cover for several weeks a year.[9] Rather than making additional hours free, we favour a highly subsidised and regulated fee of £1 an hour. This would reduce the cost to government and could help to ensure that the service is valued.[10] It would also help to target additional hours on working parents, in line with the principal objective of raising employment. (See In depth 10.1 for detail on the impact of our proposal on work incentives.) This approach of heavily subsidised, rather than free, supply-side funding works well in many continental European countries.

Extending the entitlement to year round cover of 25 hours per week, and charging £1 per hour for any hours above 15 hours a week would cost in the region of £2.3 billion. Because many of the families who would benefit from this are already claiming the childcare element of Working Tax Credit (which will broadly remain the case under Universal Credit), the government would save around £200 million in tax credit spend, reducing the net cost to around £2.1 billion.[11] (See Annex E for more detail).[12] This does not account for *any* of the additional tax revenue that would be expected as more parents entered work. It is therefore a worst case scenario and it is highly likely that this figure considerably overstates the true net cost the Treasury would face.

[6] Alakeson, V. and Hurrell, A., (forthcoming), "Modelling Childcare Costs in the UK", Resolution Foundation, London. [7] For a full summary of evidence on early years policy see Waldfogel, J., (2004), Social Mobility, Life Chances, and the Early Years, CASE Paper 88, London. [8] NNI Research Team, (2007), National Evaluation of the Neighbourhood Nurseries Initiative: Integrated Report, Department for Education and Skills, London. [9] We define year round as 47 weeks per year, allowing for five weeks' statutory leave. [10] The true cost of this £1 an hour childcare would be lower for claimants of Working Tax Credit (and its future Universal Credit variant), who would be entitled to claim back 70 per cent of childcare costs. [11] These numbers are rounded to the nearest £100 million, from £2.28 billion and £2.12 billion respectively. Tax credit savings are based on a couple in which the main earner works full-time earning £18.82 per hour (a salary of £705 per week or £36,7000 per year) and the second earner earns £9.41 per hour and enters full-time work at 35 hours a week. Assumes the second earner currently claims the full 15 hour free offer and any subsequent eligibility for tax credits and under the new offer claims the full 25 hour offer at £1 an hour. [12] It would be important to ensure that the per unit funding of any extended offer was adequate, not least because a longer public offer reduces providers' ability to cross-subsidise from private provision, as many currently claim to do.

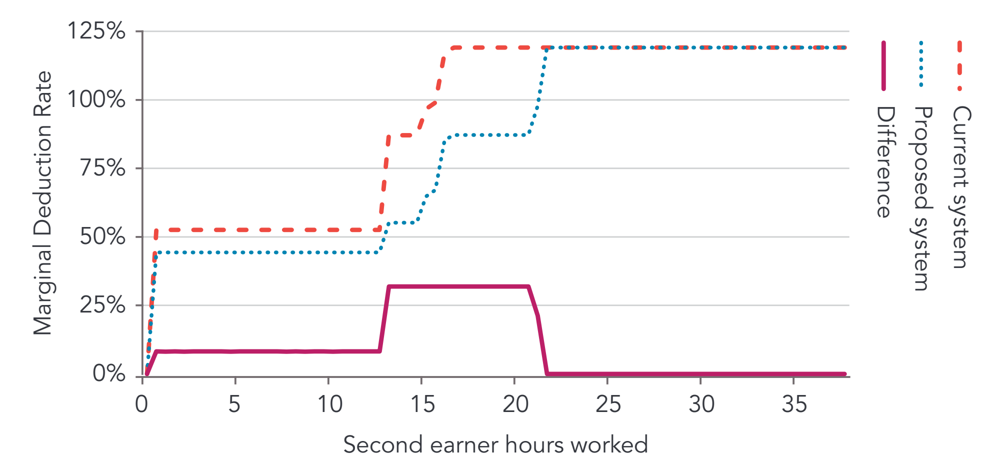
In depth 10.1: Before and after improved childcare support

Reducing childcare costs as we propose would significantly enhance work incentives for second earners. As we saw in Chapter 5 (In depth 5.1), work simply doesn't pay for many second earning parents (overwhelmingly mothers). The income of a typical middle income family with two children rises by just £1,060 a year after the second earner moves into full-time work. Under our proposed system, this £1,060 a year rises to £2,980, a 282 per cent increase in annual take home pay after childcare costs.

Figure 10.1 shows how the current system and our proposed system affect work incentives for a second earner in a typical middle income family with two children. It shows the effective tax rate faced by the second earner as they move towards full-time work, capturing the percentage of earned income lost through a combination of taxes, withdrawn benefits and childcare costs.

Under our proposal, work incentives would improve from the first hour of work because childcare coverage would increase from 38 to 47 weeks. The biggest beneficiaries of the change are second earners who want to work between 12 and 22 hours a week.[13] Under the current system, optimum hours of work for a second earner are 15.5 hours a week, with effective tax rates after this point rising past 100 per cent so that every extra hour of work loses the household money. Under our proposed system this optimum point rises to 21 hours (when the second earner would be taking home £4,620 after taxes and childcare costs).

Figure 10.1: Marginal effective tax rate after childcare costs for a second earner in a typical middle income household in the UK with two children aged one and four



Source: RF analysis, Resolution Foundation childcare costs model, Family Resources Survey

[13] This does not align with 15 and 25 hours because the figures are averaged over a year and because travel time is factored in.

While we believe that a universal and highly affordable childcare offer is the correct way to proceed, this must be implemented in a way that works for childcare providers. Childcare providers have expressed concerns that funding for the current free three- and four-year-old offer does not cover their costs, leaving them to cross-subsidise from other provision. Any expanded entitlements must be funded in a sustainable way and implemented at a pace that allows the sector to adjust, not least given existing plans to expand the two-year-old offer. It should also be introduced carefully so as to promote the expansion of care outside term-time, which is currently lacking. Finally, it must be designed to minimise complexity for providers. None of these challenges are insurmountable.

In addition, government should prioritise efforts to address gaps in holiday care

While parents of pre-school children face the highest costs, we saw in Chapter 3 that it is among mothers of school age children that the UK falls furthest behind OECD average employment rates. This sits uncomfortably with the fact that preferences for work and longer hours are high among mothers of older children. Parent surveys suggest that the biggest barrier for this group is inadequate holiday provision rather than the overall cost of childcare.[14] Recent evidence shows that just one-third of local authorities are providing adequate holiday childcare, with two-thirds judged to be failing in their legal duty to do so.[15]

> Under Universal Credit, most households will start to have their support withdrawn from the moment a second earner enters work

The government should urgently address the low availability of holiday childcare provision. When one considers the low unit cost of additional school age care and preferences for work, there are few more productive, pro-work investments the government could make in a constrained spending environment. We urge the government to hold local authorities to account on their statutory duty to ensure sufficient childcare provision, and to work with them to identify and address the barriers that are holding them back in providing holiday childcare. Given existing problems with availability, there may be a case for targeted supply-side subsidies to support a wider range of providers.

Encouraging quality part-time and flexible work

More affordable childcare will help parents to better balance work and caring responsibilities. But it is also vital that good jobs are available for those who want to work flexibly or part-time. While there is clear demand for flexible working patterns, employers need to do more to respond. Despite a large increase in the quantity of flexible (mainly part-time) jobs in the UK, part-time work remains disproportionately low paid and the UK has one of the highest part-time pay penalties in the European Union. This is particularly important for women, with 39 per cent of all employed women in the UK working part-time (the third highest rate in the OECD).

The part-time pay penalty largely reflects the occupational segregation between full- and part-time work, with relatively few flexible high-quality, high-paying jobs being offered. The result is that new mothers who go part-time often have to downshift into lower skilled and lower paid jobs and then struggle to progress as their situation changes. As many as half of part-time working mothers in low to middle income households have downshifted in this way.[16] If the part-time pay gap remains as wide as it is today, any move towards shorter hours roles, which will be promoted under Universal Credit, will be likely to move more women into low-paid work.

The part-time pay gap is likely to reflect inertia from employers

More positively, recent evidence suggests that the part-time pay gap, though persistent, may be changing. New mothers who are able to stay with the same employer and reduce their hours now experience a much lower part-time pay penalty, while those who move employers – and this proportion is still large – still face a sustained hit to their earnings potential.[17] Survey data also suggests that employers are persuaded of the business case for flexible work: 96 per cent now offer some form of flexible working, although this is overwhelmingly in the form of part-time work, and nearly three-quarters feel that this has boosted staff retention, motivation and engagement.[18] Other forms of flexible working such as flexi-time or term-time working are still far less common.

Public authorities should use what levers they have available to make flexible work the norm

These changes may have been encouraged by the introduction in 2003 of a right to request flexible working for parents with a child aged under six, since extended to those with children under 17 and to some carers. The Coalition government has consulted on proposals to extend this right to all employees but, as yet, no firm plans have emerged.[19] We would strongly support this move as an important step towards making flexible working the norm, rather than a feature of low-paid employment. The big challenge in the long run will be to encourage employers to advertise new vacancies as part-time-friendly roles rather than simply offering flexibility as a retention tool.[20]

Another key aspect of mainstreaming flexible work is the distribution of part-time work between genders. Our part-time workforce is overwhelmingly female, in part because women carry out the bulk of caring responsibilities. This means it is important to encourage a more even split of caring responsibilities for living standards as well as gender equality reasons. There are practical ways government could encourage this in the UK, for example, mothers enjoy one of the longest maternity leave periods in the OECD (52 weeks, albeit at very low pay), while paternity leave is just two weeks, encouraging a highly unequal division of childcare. Again, the current government has stated its intention to make this system more flexible and we would strongly encourage it to follow through as a priority, while taking care not to reduce existing entitlements.

[14] DfE, (2010), Childcare and Early Years Survey of Parents 2009, Department for Education, London. [15] Daycare Trust, (2012), Holiday Childcare Costs 2012. [16]Alakeson, V., (2012), The Price of Motherhood: Women and part-time work, Resolution Foundation, London; Plunkett, The Missing Million. [17] Neuberger, J. et al., (2011), Part-time Working and Pay Amongst Millennium Cohort Mothers, CLS Cohort Studies, Working Paper 2011/12, London. [18] CBI/Harvey Nash, (2011), "Employment Trends Survey 2011", CBI, London. [19] HM Government, (2011), Consultation on Modern Workplaces. [20] Stewart, E., (2012), Building a Sustainable Quality Part-time Recruitment Market, Joseph Rowntree Foundation, York; CIPD, (2012), Flexible Working Provision and Uptake, Chartered Institute of Personnel and Development, London.

10c The importance of second earners

In addition to these general steps to support parents, more needs to be done to reduce specific barriers faced by second earners, a major source of rising prosperity, providing a growing share of household income over time.[21] As we have seen, second earners, overwhelmingly women, face particular barriers to work because of their position in the household. For those with children, childcare costs need to be weighed up against any income earned through work – costs the first earner in a couple doesn't have to take into account. This makes affordable childcare essential. But the design of taxes and benefits also matters greatly. As things stand, the Universal Credit is set to weaken work incentives for low-paid second earners.

The tax and benefit system has a major impact on second earners' work incentives

The tax and benefit system always affects the way that work is divided within households but these effects have been strengthened by tax credits, which have weakened work incentives for low wage second earners. For example, a low income household may become entitled to Working Tax Credits when a first earner moves into full-time work but then gradually lose their entitlement as the second earner moves into work. For this reason, tax credits have increased employment among parents whose partners do not work but have reduced employment among parents whose partners do work.[22]

Universal Credit threatens to undermine second earners' incentives

As things stand, the overall effect of Universal Credit will be to further increase incentives for couples to have one person in work but to worsen the incentive for second earners. In simple terms, this is because couples will be allowed to earn between £1,920 and £3,000 between them (depending on circumstances) before support begins to be withdrawn. This is analogous to the personal allowance in the income tax system, which sets how much you can earn before paying tax, except that it is shared between both members of the couple.

In practice, most households receiving Universal Credit that have one person in work will already earn above this threshold. The result is that most households will start to have their support withdrawn from the moment a second earner enters work. The second earner (overwhelmingly women) will, in effect, face a tax rate of 76 per cent from the first pound they earn, assuming they pay tax. This discourages work and we believe it is a move in the wrong direction. (See In depth 10.2 for more detail.)

In depth 10.2: Is the Universal Credit a single (male) breadwinner system?

The introduction of Universal Credit from 2013 will bring together existing means-tested benefits and tax credits into a single system. While Universal Credit will generally strengthen the incentive to take up work, particularly for low-earning single people and primary earners in couples, (potential) second earners will face weaker work incentives. This is mainly because, under Universal Credit, support will be withdrawn more quickly as incomes rise. Specifically, the "taper rate" will rise from 41 per cent of gross income for tax credits, to 65 per cent of net income. Second earners who do not pay NICs or income tax will face an overall marginal effective tax rate of 65 per cent compared with 41 per cent at present. For those liable to pay the basic rate of income tax and National Insurance, marginal effective tax rates will rise from 73 per cent under the current system to 76.2 per cent under Universal Credit.

According to government estimates, 900,000 non-working individuals in households where the partner is already in work (potential second earners) will face higher participation tax rates under Universal Credit. This is the effective tax rate paid when moving into work, reducing their incentive to enter work (on average this will increase from 35 per cent to 65 per cent). The participation tax rate for 1.5 million second earners who are currently already in work will rise from 30 per cent to 45 per cent on average.[23]

A disregard for second earners would make a tangible difference to work incentives

Reducing the incentive for second earners to work runs counter to the government's policy to raise the personal allowance to enable low earners to keep more of their pay.[24] We would also argue that it is important, both in principle and practice, that Universal Credit goes with the grain of the long-term rise of second earners and women's work, rather than reinforcing an outdated "male breadwinner" model.

There should be additional investment in Universal Credit to improve its impact on second earners. This would best be done by introducing a "second earner disregard", allowing the second earner to earn a certain amount before their Universal Credit is withdrawn. While the exact size of the disregard is, to some extent, arbitrary, our preferred option would be to introduce a disregard for the second earner of the same value as the existing minimum disregard for a couple with no children (£1,920). This would cost in the region of £700 million and would increase Universal Credit entitlement by around £1,200 for a second earner earning more than £1,920.[25]

[21] 57 per cent of households with two or more adults had two or more workers in 2008-09, up from 48 per cent in 1968. [22] Brewer, M., (2007), "Supporting Couples with Children Through the Tax System", in IFS, The IFS Green Budget 2007, Institute for Fiscal Studies, London; Mirrlees, J. et al., (2011), Reforming the Taxation of Earnings in the UK, Institute for Fiscal Studies, London. [23] Brewer, M. et al., (2012), "Universal Credit: A preliminary analysis of its impact on incomes and work incentives", Fiscal Studies, 33 (1); DWP, (2011), Second Earners, Universal Credit Policy Briefing Note 5, Department for Work and Pensions, London. It is worth noting that these calculations do not include the impact of childcare costs. Universal Credit will retain the basic structure and levels of the existing childcare element of Working Tax Credits, but extend this to those working fewer than 16 hours per week. Compared with the results set out above, this would slightly improve work incentives for those working fewer than 16 hours per week. See DWP, (2011), Childcare, Universal Credit Policy Briefing Note 10, Department for Work and Pensions, London. [24] DWP, Second Earners. [25] See www.publications.parliament.uk/pa/ld201011/ldhansrd/text/111103-gc0001.htm. It is important to note that this would increase the relative generosity of tax credits towards couples as opposed to single people. There is a wider debate about the relationship between single and couple disregards, and we do not seek to enter into this debate here. Rather, our intention is simply to highlight the most promising way of increasing work incentives for second earners.

In depth 10.3: What impact would a second earner disregard have?

Questions about the design and size of so-called "disregards" may sound technical but they make a significant difference to people's decisions about work. If we consider a couple with two children and one earner on a salary of £20,000 a year, under the government's current plans for Universal Credit, if the second earner entered work at 20 hours a week earning £7 an hour she would keep only one-third (35 per cent) of her pay – taking home just £2,500 a year. In a system with a second earner disregard of £1,920, she would instead keep half of her pay (52 per cent).[26]

Any such reform involves inescapable trade-offs. While a second earner disregard improves incentives to enter work, it would also lead to more people receiving Universal Credit and being subject to means-testing. We think this trade-off is worthwhile. There are also implications for the balance between couples and single people from a second earner disregard, which we don't go into here. The bigger argument is that the goal should be to continue the move away from a system – through taxes and benefits and childcare costs – that is premised on a single (mostly male) breadwinner to one that recognises the high and growing economic importance of (mostly female) second earners.

Giving parents support that fits their preferences

Finally, we believe there is a case for better aligning the tax credit system with what is known about parents' preferences for work. This is based on the principle that policymakers should worry more about work incentives when people are more likely to respond to them. Some groups are unlikely to work even with much stronger financial incentives – whether through personal choice or inability – whereas others are more likely or able to respond to financial incentives.

This particularly applies to mothers before and after their children start school. Surveys show that financial incentives typically play less of a role for mothers of very young children who in general prefer a more even balance between work and parenting.[27] Support should be designed to reflect these preferences, ensuring that help is provided in the right form and when it is needed most. This would mean giving relatively more cash support before children start school and relatively less after children start school, when preferences shift towards working more.

One way of doing this would be to rebalance Child Tax Credit (and its equivalent under Universal Credit) to focus support on pre-school children. This could be done in a cost neutral way by raising Child Tax Credit (or Universal Credit) for the under fives, offset by an equivalent reduction for school age children. If resources could be found from elsewhere, money could instead be added to the system. This change could be introduced gradually to stop parents of older children from facing big cash losses.

Note 10.1: Refocusing Child Tax Credit in line with parents' work preferences

Our proposed reform would refocus spending on parents with younger children. If carried out in a cost neutral way, it would mainly take the form of redistribution over the life cycle: families would gain when their children are young and nominally lose when their children are older. In addition to these employment effects, there are other good reasons to give more cash support to younger children, since we know that the early years of life are the most important for child development and because poverty when children are very young is particularly problematic. Most would receive broadly the same support as they do now over the life course[28] (if additional resources were identified there would be no losers at all), but the net impact could also be to raise overall employment.[29]

To give a sense of the practicalities, we have looked at a revenue neutral version of the reform modelled by the IFS.[30] This would increase the child element of Child Tax Credit from £2,235 to £3,100 where the youngest child in a family was under five, while reducing it by half to £1,550, where the youngest child was five or older. The IFS estimates that more than three times as many parents of older children would enter work than parents of younger children would stop work, creating a net boost to employment. Aggregate earnings (including employer NICs) would increase by £0.8 billion, of which about £0.5 billion would accrue to households and £0.3 billion to the Exchequer. These are not insignificant sums for a revenue neutral change that moves in line with parental preferences.[31]

[26] On the basis of latest government assumptions about Universal Credit design and disregards. The family's initial Universal Credit entitlement with one earner would amount to £7,080 a year, producing a total net income of £23,220. On entering 20 hours of work at £7 an hour the second earner would earn £7,280, but would face a withdrawal rate of 65 per cent, therefore increasing the household's net income by £2,500. Under the proposed disregard system household net income would instead rise by £3,800, or 52 per cent of the second earners' gross earnings. [27] Johnson, P., (2012), Fairer by Design: Efficient tax reform for those on low to middle incomes, Resolution Foundation, London. [28] The distributional impact is not quite so simple. For example, some families might have too much income to qualify for tax credits when their children are older, but not when their children are younger. [29] As parents of older children enter work, while a smaller number of parents of younger children leave work. [30] Modelled in the Mirrlees review, on the basis of the 2009-10 tax credits system, and assuming no behavioural change. [31] Mirrlees, Reforming the Taxation of Earnings in the UK, pp. 112–113.

10d Older workers

The ageing workforce will be the key employment trend of the early 21st century

The second major opportunity to boost employment in the coming decades will be among older workers. We have seen that, despite recent improvements, the UK remains a middling performer among the over 50s with large gaps compared to the best performers, particularly among older men. For example among men in the 60–64-year-old age group, the UK lags the employment rate among better performing countries by nearly 8 percentage points. People over 50 already head one in four low to middle income households and their share of employment income is only set to rise over time, making this group increasingly central to living standards.

There is a longstanding debate about how best to respond to increasing life expectancy. Alongside positive moves such as the abolition of the default retirement age, the centrepiece of policy to date has been raising the state pension age. This means that many workers will have no choice but to work for longer (or spend longer on out of work benefits). The UK is yet to develop a fuller settlement with our older population that brings together this new obligation with a more positive offer of support.

The UK hasn't developed a fuller settlement with our older population that balances new obligations with something in return

There is a strong case for a more positive and proactive approach

We have seen in this report that older workers face many barriers to employment, from the role the over 50s (particularly women) play in caring for grandchildren, sick spouses and elderly relatives, to widespread evidence of age discrimination and inadequate back-to-work support.[32] There are particularly high rates of economic inactivity in later years, with ill health accounting for over one-third of inactivity among men and women just before they reach the state pension age. Ill health is an even greater barrier to work among those in skilled trades occupations, where many people on low to middle incomes work.

Tackle barriers to employment – social care and financial incentives

The most obvious barrier for those who are able to work – and the one most urgently in need of reform – is social care. Independent of concerns about employment income, current funding arrangements are unfair and, as a result of a strict means-test, many low and middle income people miss out on support. We must add to these reasons for reform the growing need to reduce barriers to employment among older people.

Reform the tax system to improve work incentives for low earners

As a Commission we have not sought to add to the crowded and complex debate about social care funding but broadly speaking we support the fundamentals of the Dilnot Commission's proposals and urge the government to act quickly to implement this reform.[33]

One aspect of a new settlement that is less widely discussed is a smarter approach to the taxation of older workers, to encourage work in the later years, which we know are so crucial to living standards in retirement. We have seen that the UK is a mid-level performer in its employment of older workers, lagging considerably behind leading countries. We also know that decisions about work become much more responsive to financial incentives as people approach retirement (especially from 55 to 70).

As we have argued, tax and benefit rates should better reflect people's preferences for work. We therefore propose raising the threshold at which those aged 55+ pay employee NICs from £7,592 to £10,000. This would boost the incomes of low and middle-earning older workers, who would be able to earn more before paying tax, in a similar fashion to the government policy of raising the income tax personal allowance. Coupled with greater access to flexible working, which we endorse elsewhere in this report, this would encourage more older people into employment. If necessary, the benefits of this reform could be more tightly focused on lower earners if accompanied by an off-setting increase in the rate at which NICs are paid by the over 55s.[34] Any change in the NICs rate would need to be weighed against the significant disadvantages of increased complexity in the tax system.

The need for new investment: raising revenue by means-testing universal non-pension benefits

A substantial new settlement with older people will require significant new investment, and therefore additional revenue. There is a growing public debate about the way our tax and benefit system supports older generations, which many argue is outdated. Universal non-pension benefits may make less sense as our pensioner population becomes increasingly diverse, containing great inequalities in income and wealth. Similarly, employee NICs still end at state pension age, in part because there used to be a very sharp decline in employment at this age. Despite all the talk about an ageing society there is still a tendency to think of being 65+ (or 60+ for women) as a proxy for being out of work.

In the case of universal non-pension benefits, the UK government currently spends around £2.7 billion per year on Winter Fuel Allowances and free TV licences. Free bus passes and free prescriptions take total expenditure on universal pensioner benefits to well over £4 billion. With such strong pressure on resources, it has been argued that such spending, which supports all pensioners regardless of income, can no longer be justified. Means-testing Winter Fuel Allowance and free TV licences (by restricting them to Pension Credit recipients) would raise approximately £1.4 billion.[35]

[32] Cory, G., (2012), Unfinished Business: Barriers and opportunities for older workers, Resolution Foundation, London. [33] Commission on Funding of Care and Support, (2011), "Fairer Care Funding: The report of the commission on funding of care and support", Department of Health, London. [34] An increase of 1.6 percentage points would make the reform revenue neutral. [35] In the long term, Pension Credit is to be phased out with the introduction of the single tier state pension, requiring a different method of means testing.

Too often the public debate about universal non-pension benefits has underplayed the difficulties of raising money in this way. Although the poorest pensioners would not lose out and the richest would not be adversely affected, those in the middle of the income distribution, who may be just too rich to qualify, would lose the most as a percentage of their income. For these reasons, as commissioners, our individual instincts on this issue differ sharply and some would instead opt for a different balance of revenues, raising a greater amount via a more restrictive approach to Pension Tax Relief.

The government should quickly implement the Dilnot reforms

However, in the context of improvements to the pension system – for example, the introduction of auto-enrolment and the restoration of the link between the basic state pension and earnings, and as a package alongside the other recommendations contained in this report – the clear prevailing view of the Commission is that the government should means-test universal non-pension benefits, as part of a mix of revenues to fund new support for living standards.

There is also a case for reforming National Insurance

Another potentially outdated aspect of our tax and benefit system is the way that emplyee NICs stop at the State Pension Age (SPA). At present those working beyond SPA do not pay employee or self-employed NICs. Imposing these now would raise about £800 million per year (falling to about £400 million per year once the State Pension Age is 65 for men and women). Only pensioners in paid work would lose out from this reform, a group which tends to have higher incomes. Indeed, only the richest quintile of pensioner families would be significantly affected. This is a difficult trade-off, but one which we feel would be worthwhile given the importance of raising revenue to help improve work incentives for those between 55 and 65 when workers are likely to respond and continue in employment.

In total, these reforms would raise in the region of £2.2 billion, some of which could be invested productively in a positive deal to boost employment among older workers. These positive proposals form just some of the elements of a necessary settlement with older people that recognises the complexity of the group and the opportunity and challenge afforded by extended working lives. Although the aim of these reforms would be to increase employment, predicting the size of any change is extremely difficult. Again, we take a conservative approach, making no assumption in our costings of any increase in tax revenues from these measures. This is almost certainly too pessimistic.