Capping Welfare

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One bill two caps

Britain already has one cap on benefits but between now and 2015 it is likely the discussion will focus on an additional cap to be in place to attempt to manage welfare spending.

The first of these caps is relatively straight forward. The "Benefit Cap" was introduced from April 2013 and is one of the Coalition government's most controversial but most popular policies. It limits the value of benefits that any household can get to a level judged to be consistent with the average take-home pay of working families. For those with children, the level has been set at £500 a week and for those without children, the level is £350 a week.[1]

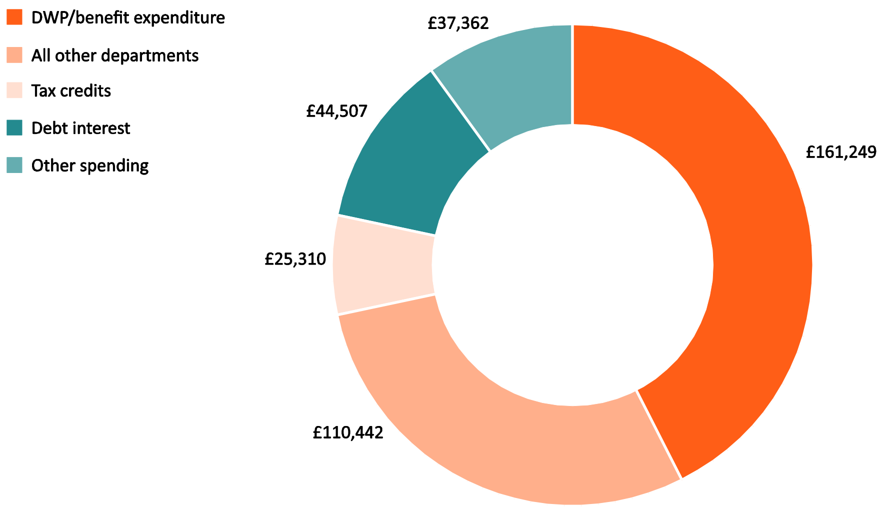
The second cap is much more complex. First proposed by the Coalition in 2011, re-announced in Budget 2013[2] and subsequently supported (in principle) by the Leader of the Opposition,[3] this proposes to cap Annual Managed Expenditure (AME). The proposal has left Westminster wonks scratching their heads and arguing over the potential aims, merits and practicalities.[4]

In simple terms, Government spending can be split into two categories. Departmental Expenditure Limits (DELs) are set as part of the Spending Review process and budgets the amount that each department plans to spend over a three year period. They amount to around 49.2% of total government expenditure; some £367 billion.[5]

[1] https://www.gov.uk/benefit-cap
[2] Budget 2013, p. 26.
[3] http://www.newstatesman.com/2011/06/responsibility-society-pay
[4] For example, see http://opinion.publicfinance.co.uk/2013/06/an-ame-cap-we-already-have-one/#more-11206
[5] DELs as % of TME, 2013/4 forecast, 2011/12 prices.

AME takes up the remaining 50.8% of government expenditure; £379 billion for 2013/14. Figure 1 shows that the main components are benefits (working age and pensioner), tax credits and debt interest payments.

Figure 1: Components of AME spend, 2013/14



Source: Public Sector Finance Databank, April 2013, Public Expenditure Statistical Analyses (forecast, 2011/12 prices).

This composition means that, in contrast to DEL, it is the part of government expenditure that is harder to predict because it is determined by a number of factors outside of any department's direct control. For instance, the Department for Work and Pensions can set benefit rates and rules, but it is not directly in control of the number of unemployed people who claim benefits.[6]

The Treasury's Consolidated Budgeting Guidance makes this clear by defining AME as spending that is:

> "...not only demand led but also exceptionally volatile in a way that could not be controlled by the department, and where the programmes are so large that departments could not be expected to absorb the effect of volatility in their DELs."[7]

[6] http://www.smf.co.uk/files/4713/6537/6131/20130407_AME_analysis.pdf

[7] https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/207689/consolidated_budgeting_guidance_201314.pdf, p. 8

In this respect, it is analogous to taxation, where receipts vary across the economic cycle and cannot be predicted with certainty.

This uncertainty has been a key foundation of the scepticism that surrounds the, as yet unspecified, policy. Taken in its broadest sense, a plain cap on the in-year level of AME spend would be practically difficult. For example, had such a cap between in place in 2008, it seems unlikely that the government could have offset the additional costs associated with rising unemployment with savings in other parts of AME, particularly when debt interest was also rising strongly.[8] Such an approach would also be unwelcome as rising AME can act as an automatic stabiliser in times of economic difficulty.

This means that any move to implement this policy will require far greater nuance. A multi-year cap based on the non-cyclical elements of AME, seems more likely.[9] This approach has the advantage of allowing automatic stabilisers to work in a downturn, while providing a limit to broader AME rises and allowing government time to respond to any projected increases. However, it does raise a number of questions. These include the level at which the cap should be set; which elements of AME should be put "inside" the cap; and the length of time over which the cap is set. Rehearsing the arguments for the need for such a cap can provide useful insight into the potential answers for these questions.

Why doing something is important

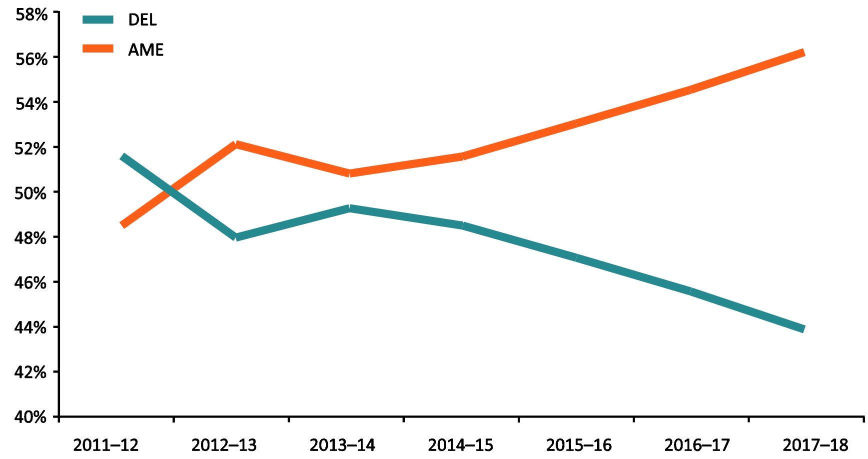
As the Chancellor laid out in the 2013 Budget, around half of all government spending is accounted for by AME. Figure 2 shows that this proportion is forecast to rise in coming years, reaching some 56% by 2017/18. This has important consequences. Money spent through AME is not available for spending on wider public services – mostly funded through DELs. This means that, all else equal, rising AME would present difficult choices. For instance, if overall government spending stays at a fixed proportion of GDP, but AME costs rise, this will necessarily mean cuts in areas like health, education and defence funded through DEL. This makes it unsurprising that, since coming to power, the Coalition have been trying to tackle the welfare bill in order to protect public services. But they are facing an uphill battle.

Of course, there are also broader considerations. The most obvious is the state of the public finances overall. Achieving a balanced budget is something that governments over the last 50 years have

[8] http://www.smf.co.uk/files/4713/6537/6131/20130407_AME_analysis.pdf
[9] http://labourlist.org/2013/06/full-text-ed-miliband-speech-a-one-nation-plan-for-social-security-reform/

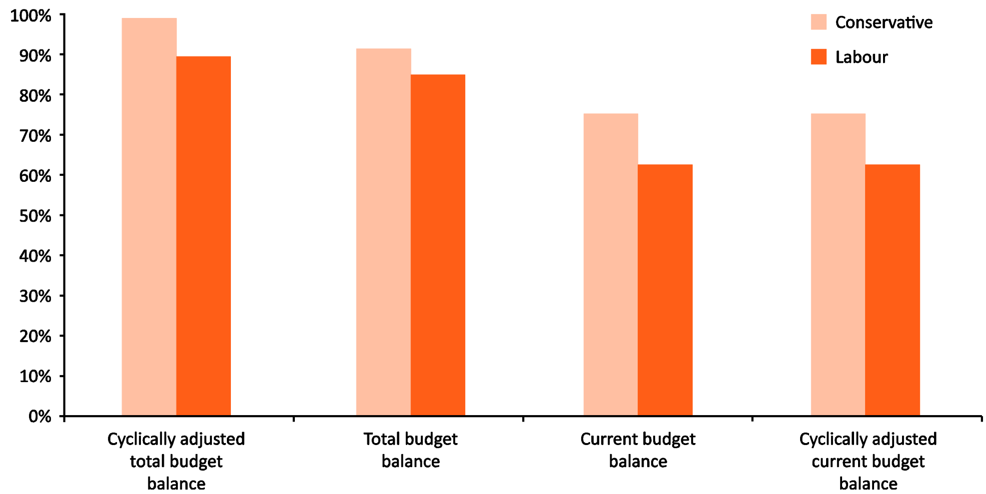
struggled with. Both of the main political parties have consistently run deficits in both their current and total budgets, even after taking a cyclical adjustment. For instance, Figure 3 shows that the cyclically adjusted total budget balance (in other words, the total amount of government borrowing or surplus adjusted for the economic cycle) has been in deficit for over 80% of the time both the Conservative and Labour parties have been in power since 1965.

Figure 2: DEL and AME as a proportion of Total Managed Expenditure



Source: HM Treasury

Figure 3: Proportion of time budget in deficit while in power, 1965-2013[10]

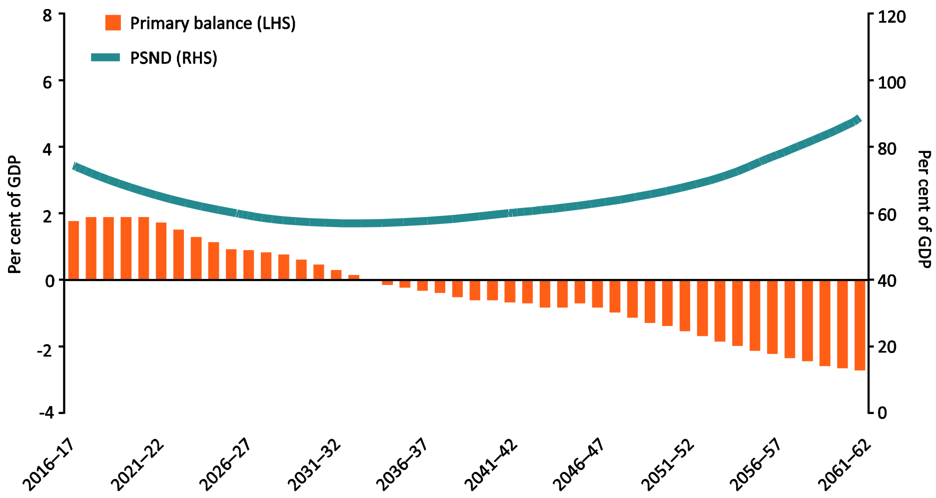


Source: Authors' calculations and Public Finance Databank May 2013 aggregates.

[10] Defined by which party was in office for the majority of that fiscal year, including when the main party in a coalition.

In a general sense, rectifying this situation and reducing the size of public debt will present a distinct challenge for policy makers and government as, based on existing policy, it is likely that this situation will continue well into the future. Analysis from the Office for Budget Responsibility's assessment of long-term fiscal sustainability suggests that total non-interest public spending could rise to 40.8% of GDP by 2061/2062 compared to 35.6% in 2016/17: an increase of some £80 billion (or the equivalent of around three-quarters of the NHS' budget in today's prices). In terms of budgetary balance and debt, Figure 4 demonstrates the OBR's projections of the primary balance (public sector net borrowing excluding net debt interest payments) and shows the public sector net debt rising to a level approaching 90% of GDP in the long-term.

Figure 4: Central projection of the primary balance and PSND



Source: Authors' calculations and Public Finance Databank May 2013 aggregates.

The analysis led the OBR to summarise that:

> *"...on current policy we would expect the budget deficit to widen sufficiently over the long-term to put public sector net debt on a continuously rising trajectory as a share of national income. This is clearly unsustainable."*

The scale of this challenge going forward should not be underestimated. Ensuring sustainability of UK public spending will require significant reform going forward and, in particular, a more transparent and democratically accountable framework for spending control. This is something that Policy Exchange will publish on later this year.

Seen in this light, the need to bring a more formal process into place in order to limit AME spending becomes obvious. This is made even more important when the OBR analysis shows that a large factor driving this rise in spending is the ageing population, with state pension costs alone rising from 5.6% of GDP in 2016/2017 to 8.3% in 2061/2062. In short, with a rising proportion of total spending coming from AME and the need to rein-in spending to reduce public debt, not tackling AME will put increasing pressure on DEL budgets and this could lead to the need to cut public services to a degree which is neither politically nor economically desirable.

For this reason, we support the principle that an AME cap should be introduced in order to restrict growth in public spending in the short-term and reduce it in the medium-term. To facilitate this, it would make sense that the cap on AME should be set at a given proportion of GDP, so that within any given size of the state, AME does not become a greater proportion of overall spending.

Once the principle that increases in AME are going to have to be moderated in the future is accepted, putting forward the prospect of a cap on AME has two distinct advantages. Firstly, it provides the opportunity for a transparent public debate over how reductions could be delivered if the cap were to be breached. Secondly, it allows us to reconsider the structure of public expenditure and the control frameworks that are in place to ensure value for money and quality of service.

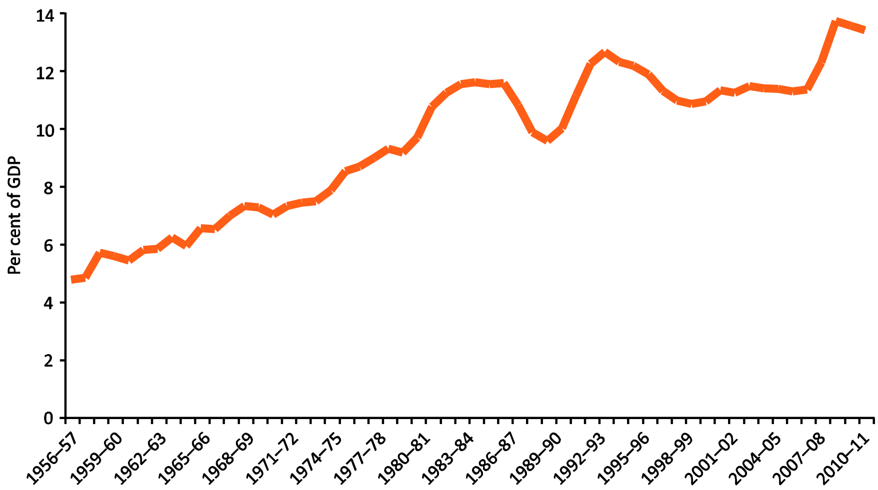
How savings are delivered

As we have shown, forecasts of increased expenditure within an unchanged system ultimately mean that difficult decisions will need to be made over what elements could be included inside a possible cap and where savings will come from in the future. The most likely area for government attention to focus will be on the welfare elements of the AME bill, given that they account for some 52% of the total.

As Figure 5 shows, we have also seen a steady rise in social security (working and pensioner age benefits plus state pensions) spending, over the last 60 years. At less than 5% of GDP in 1956 and 10% of GDP in 1990 it now represents some 13.5% of GDP. Far from being simply the result of the recession, IFS analysis shows that the average real terms increase has only been below 3% in three five year periods since 1956.[11]

With these factors in mind, we agree that the main focus of an AME cap should be on welfare spending.[12] Delivering savings here will require changes to eligibility or, in short, for some people to get less. This is politically difficult, but not impossible. It is important here to remember that a significant number of reforms have been introduced to make AME savings since 2010. Some £18 billion of savings were pencilled in through reforms in the 2010 Emergency Budget and Spending

Figure 5: Social security expenditure as a percentage of GDP, 1956–57 to 2011–12



Source: IFS

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[11] http://www.ifs.org.uk/bns/bn13.pdf

[12] Meaning that debt interest, net transfers to the EU, accounting adjustments and financial interventions should be excluded.

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been, on the whole, supported by a population becoming tougher on welfare. There is also ongoing debate on a number of areas of potential reform.

One area to make further savings could be through tax credits. Since introduction on a large scale after Labour came to power in 1997, this has been the major growth area in welfare spending. They were a key component of the drive to tackle relative low income among households with children, but have begun to be criticised for subsidising low-productivity, low-pay employment. Indeed, Policy Exchange will publish a paper later in the year showing that up to half of the value of tax credits has been passed through into lower wages of those who were eligible. However, with reforms to limit the generosity and scope of in-work tax credits since 2010, without major reform of the system, potential savings are likely to be small.

A more fruitful area of savings could come through limiting the generosity of Child Benefit and child tax credit. There are two obvious ways that this might work: fully means testing Child Benefit by incorporating it inside Universal Credit; or limiting the number of children per household that are eligible for state support (for instance capping Child Benefit at two children). The evidence suggests that such policies might also be supported by the public. Polling of 2,400 people conducted for a previous Policy Exchange report, *Just Deserts*, revealed that:

- By a margin of 55%-36% people disagreed with the idea that "People with children should be given higher benefits to compensate for the costs of bringing them up."
- By more than two to one (66%-27%) people agreed that "People who have more than three children should not get extra child benefit if they have a fourth".

This is also an area of potentially large savings. The most recent statistics from DWP show that some 325,000 families receiving Child Benefit have four or more children.[14] HMRC data show that around 290,000 families claiming tax credits have four or more children. Less than half of these families have anyone in work. With such large numbers involved the estimates of potential savings from capping Child Benefit and child tax credit at two children have been as high as £4.5 billion a year.[15]

However, in practice, the likelihood of cuts of this size is low. The politics would certainly be difficult with the Child Poverty Act still putting pressure on government to maintain benefits for children and existing cuts already expected to move 200,000 children below the relative low-income poverty line.

[14] http://www.hmrc.gov.uk/statistics/child-geog-stats/chb-geog-aug12.pdf
[15] Estimate by The Children's Society.

This potential difficulty in delivering further cuts reflects a more general problem going forward. That is that the majority of the relatively easy and popular choices have already been made. Since they have focussed predominantly on working-age welfare, they have also been focussed predominantly on a relatively small part of welfare-related AME.

Figure 6 outlines the composition of DWP's expectations of AME in 2013/14. It shows that, excluding benefits for disability or ill-health, working age benefits account for 28% of welfare-related AME, whereas the State Pension, Pension Credit and other pension-age related benefits account for 53.8% of welfare-related AME. Benefits related to ill health or disability account for 18.2%.

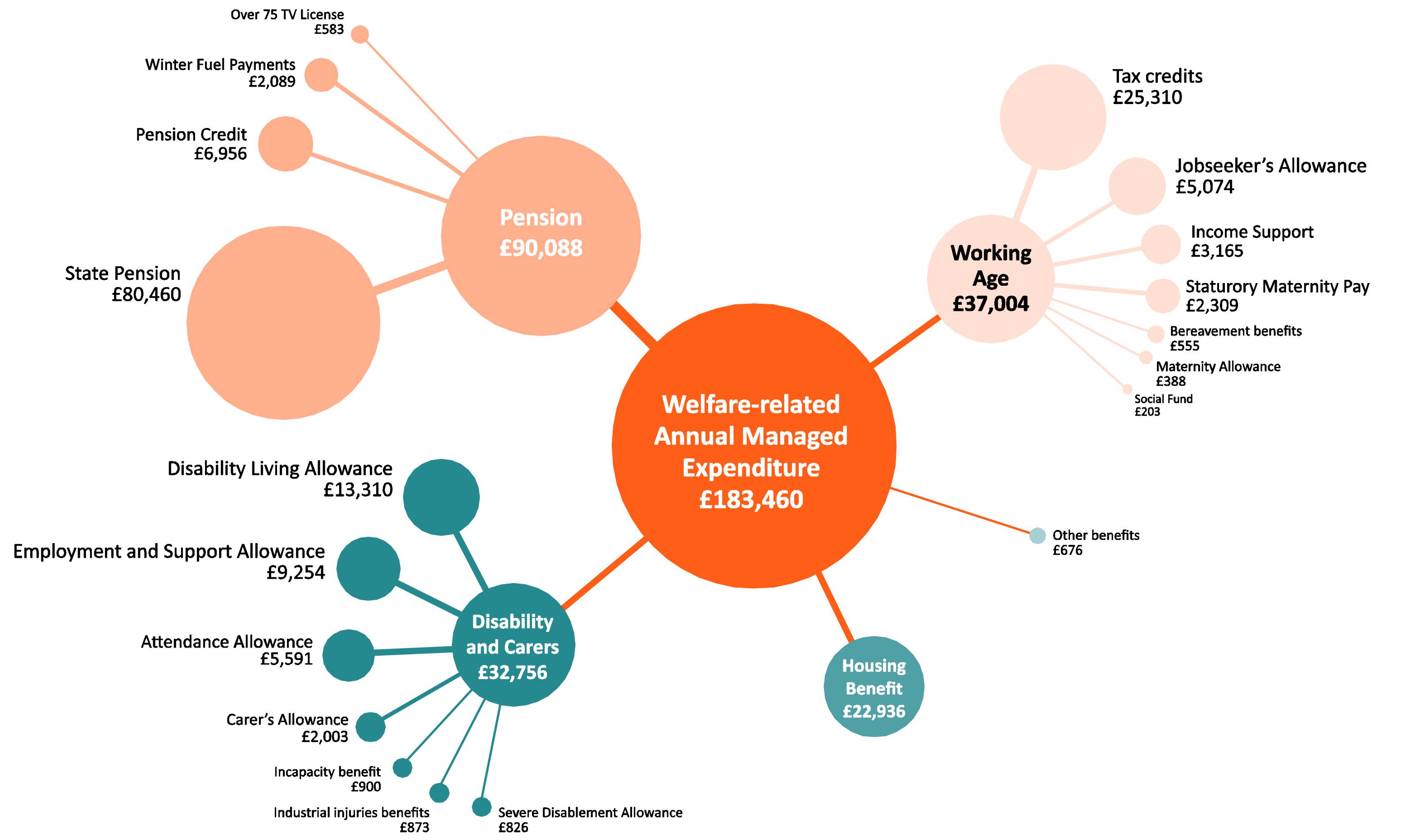
The OBR analysis also shows that this balance is likely to change over time because of the proportion of the population aged 65 and above rising from 17% in 2012 to roughly 26% in 2061. This leaves pension costs rising to some 8.3% of GDP by 2061/2062 whereas, in contrast, working age benefits remain at 3.1% of GDP from 2016/2017 to 2061/2062. The rise in state pension costs are equivalent to some £40 billion in today's prices.

This fact underlines the need for future decisions over reforms to limit AME to consider where growth in expenditure is coming from and to make decisions over how they are managed in order for the AME cap to be met. This could involve taking action to stem the rise at its root, or to offset it with reductions in spend elsewhere. The important thing is that both of those options are on the table when decisions are made. This means that, while politically challenging, it is a numerical necessity for the broadest range of benefits to be placed inside the AME cap.

This will mean that, following the next election, disability benefits, pensioner benefits and pensions themselves will need to be considered. Without inclusion of these aspects, it could be extremely difficult for major savings to be delivered in order to meet a cap and this would leave a welfare-focussed AME cap lacking credibility.

In fact, given the cyclical nature of much of working-age benefit jobseeking-related benefit spend, rather than being the element that could be used to meet an AME cap, it would be the most sensible aspect of AME spending to allow for outside of the cap. This would mean that cyclically driven elements of Jobseekers Allowance, Housing Benefit and tax credits should be left outside of the cap.

Figure 6: Welfare-related Annually Managed Expenditure 2013/14 forecast (£ million, 2011/12 prices)



Source: Benefit expenditure and caseload tables, Budget 2013, DWP, https://www.gov.uk/government/publications/benefit-expenditure-and-caseload-tables-2013

Overall this would mean that:

- Only aspects of unemployment-related benefit expenditure that are related to the economic cycle should be provided for outside of the AME cap.
- Pensions, pensioner benefits and benefits related to sickness and disability should all be included within the AME cap.
- The level of the cap should be set by reference to the rules above and taking into account the level of GDP which the included elements comprised before the recession.

How spending is controlled

The analysis above outlines the advantages of a welfare-focussed AME cap in opening up a debate over the overall cost of the welfare state in the future and where savings are delivered if (as the data suggest) costs rise and begin to squeeze out spending on public services.

At a macro level, under the broad principles of a cap outlined here, it would seem likely that the government would be expected to publish forecasts of AME spending that is subject to a cap over (perhaps) a five year period to align with the fiscal mandate. If this forecast suggested that the likelihood was that the cap would be breached, they would be expected to announce policies to return forecasted expenditure below the cap, to be assessed by the OBR. In an analogous fashion to the government's fiscal mandate,[16] this would provide an accountability framework through which pressure could be applied to push governments into making difficult choices.

However, there are also wider potential advantages in terms of how spending is controlled and how services could be provided. For instance, once it is accepted that large parts of welfare AME are expected to be managed and are not "exceptionally volatile", these budgets could be transferred to DWP or other organisations to manage. This would fundamentally change the risk profile of the spending and the associated incentives to improve employment support and wider social services. This idea is not new: the so-called "AME-DEL switch" has been discussed in Whitehall circles for many years and is currently being used in the Work Programme. However, there are much broader opportunities.

[16] That the cyclically adjusted current balance should be in balance by the end of a rolling five year forecast period.

For instance, it may be possible to transfer the relatively stable elements of disability benefits to DWP's DEL to manage. They would then face greater incentives to work with the Department for Health and local government to improve care, support and condition management in order to help more people back into work. The savings of doing so could be shared between DWP and the Treasury.

The City Deals also provide similar opportunities at a local level. Under the AME cap, benefits over a multi-year period for whole cohorts of benefit claimants could be rolled up and given in a lump sum to a local commissioner of services.[17] This could apply to specific types or groups of benefit claimants, or the benefit costs of particular areas or estates. Commissioners would then hold responsibility for coordinating and joining up support services and reimbursing DWP for any benefit costs over the contract period. Any savings from large portions of the group moving into work could be kept by the local organisation: providing sharp incentives to provide effective services. A recent Policy Exchange report argued that a similar scheme could work effectively for 100,000 long-term unemployed individuals a year with the very deepest barriers to employment.

Capping benefits improving outcomes

This note has outlined that while a great deal of scepticism surrounds the introduction of a cap on AME, such an approach has distinct advantages. In the face of spending pressures from an ageing population and difficult political choices to be made in the future, a cap would provide the framework within which these decisions could be made. It would provide a greater level of accountability and would facilitate a more evidenced-based debate.

It also opens up opportunities to go further than a cap and re-think how government services are delivered and how they link with AME. By pooling benefit costs and transferring risks and autonomy from the Treasury to DWP or to local commissioners (for instance through the City Deals), greater incentives would be provided to join up services, improve employment support, boost employment and, ultimately, improve outcomes.

To ensure this happens any cap on AME should consider the majority of welfare spend and only exclude particularly cyclical parts of expenditure such as Jobseekers Allowance, Housing Benefit and tax credits. This will mean that come the 2015 election and beyond, pensions, pensioner benefits and disability benefits should be on the table alongside working age welfare.

[17] Less estimates of non-intervention service outcomes.

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The work of the unit is based around a belief that by encouraging responsibility by individuals, government and business we believe that growth can be secured, public services improved and better outcomes delivered for families across the UK. Our themes cover welfare reform and the labour market, growth and the UK economy, public sector reform, and financial policy.

This publication is part of the welfare reform and the UK labour market programme. This is aimed at providing an evidence-based and balanced debate around the future of the UK welfare system. The ultimate goal is to deliver a welfare system that asks all it can of individuals while providing all it should in terms of support and opportunities. Other reports in the series can be found here:

- Just Deserts?: www.tinyurl.com/PXfairness
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- Personalised Welfare: www.tinyurl.com/PXwelfare2
- Something for Nothing: www.tinurl.com/PXwelfare3
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