Office for
Budget Responsibility

Welfare trends report

June 2015

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Foreword

The Office for Budget Responsibility (OBR) was created in 2010 to provide independent and authoritative analysis of the UK's public finances. In December 2013, the Chancellor of the Exchequer asked the OBR to take on additional responsibilities in relation to the Government's newly announced cap on a subset of welfare spending, which was then quantified in the March 2014 Budget. This request was in two parts: to assess the Government's performance against the welfare cap and, in order to facilitate open and constructive debate about welfare spending, to "*prepare and publish information on the trends in and drivers of welfare spending within the cap*."

In our first *Welfare trends report (WTR)* last year, we presented a broad survey of historical trends and our latest medium-term forecasts and long-term projections for welfare spending delivered through the benefits system (administered by the Department for Work and Pensions) and the tax credits and child benefit systems (administered by HM Revenue and Customs). We did not consider spending on benefits in kind, for example social housing, education and health care.

As we noted last year, at any one time around half the UK population receives income from at least one social security benefit – and over a lifetime most people will – which underlines the potential scope of a report that aims to explain trends in welfare spending. Having carried out a broad survey last year – and since the Government has asked us to produce an additional economic and fiscal forecast to accompany its summer Budget – we have reduced the scope of this *WTR* and brought forward the publication. We have therefore focused on two main issues in this year's report:

- we have refreshed our high-level discussion of the main trends in welfare spending that are embodied in our medium-term forecasts, and described the changes we have made to those forecasts since the last *WTR* (partly in response to that analysis); and

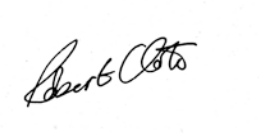
- we have considered UK expenditure on social protection – a broader definition of welfare spending – in international context, using information compiled by the Organisation for Economic Cooperation and Development (OECD) and Eurostat.

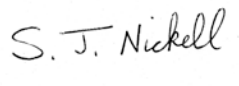
As with all our flagship reports, the *WTR* remains a work-in-progress. We have refined and modified our other reports in response to feedback from users and we would be very keen to hear suggestions on the scope and format of this report.

The analysis and projections in this report represent the collective view of the three independent members of the OBR's Budget Responsibility Committee. We take full responsibility for the judgements that underpin them and for the conclusions we have reached. We have, of course, been supported in this by the full-time staff of the OBR, to whom we are enormously grateful. We have also drawn on the help and expertise of officials across government, including the Department for Work and Pensions (DWP), HM Revenue and Customs and HM Treasury. Where resources permitted, we have been provided with all the information and analysis that we requested.

We are also grateful to a wide range of external stakeholders who gave of their time and shared their expertise in helping us to produce this second *WTR*. In particular, we would like to thank Professor Sir John Hills at the London School of Economics and Willem Adema and his colleagues in the OECD's Social Policy Division for their valuable advice and comments on the international comparisons presented in Chapter 3.

We provided the Chancellor of the Exchequer with a full and final copy of the report 24 hours in advance of publication.





Robert Chote Steve Nickell Graham Parker

The Budget Responsibility Committee

Executive summary

1 This is our second *Welfare trends report (WTR)*, in which we examine trends in public spending on different elements of the welfare system, including those items subject to the Government's 'welfare cap'. Reflecting the remit that we have been given by Parliament – to focus on the sustainability of the public finances – the report does not consider the impact of the welfare system on the income distribution or measures of poverty.

2 In our first *WTR*, we undertook a wide-ranging review of trends in welfare spending over the past 30 years, and in our latest medium-term forecasts and long-term projections. We focused on elements of spending delivered through the social security and tax credits systems. We do not believe there would be value in repeating such a comprehensive historical review on an annual basis, so will focus our coverage more narrowly in this and subsequent reports, repeating the comprehensive exercise later in this Parliament.

3 This year, we consider two main issues:

- first, we revisit the conclusions we reached last year and discuss how the analysis of specific forecast risks identified in that report – and the further scrutiny we undertook in response – led us to revise our medium-term forecasts. We also summarise our latest long-term welfare spending projections, published alongside this report in our 2015 *Fiscal sustainability report*. And we have briefly reviewed some of the larger welfare policy measures implemented during the last Parliament, in order to learn any lessons that might be relevant to new measures in the forthcoming Budget or beyond; and

- second, we present international comparisons of social protection spending – a broader definition of welfare spending than used in our forecasts and main *WTR* analysis – drawing on data published by the OECD and Eurostat.

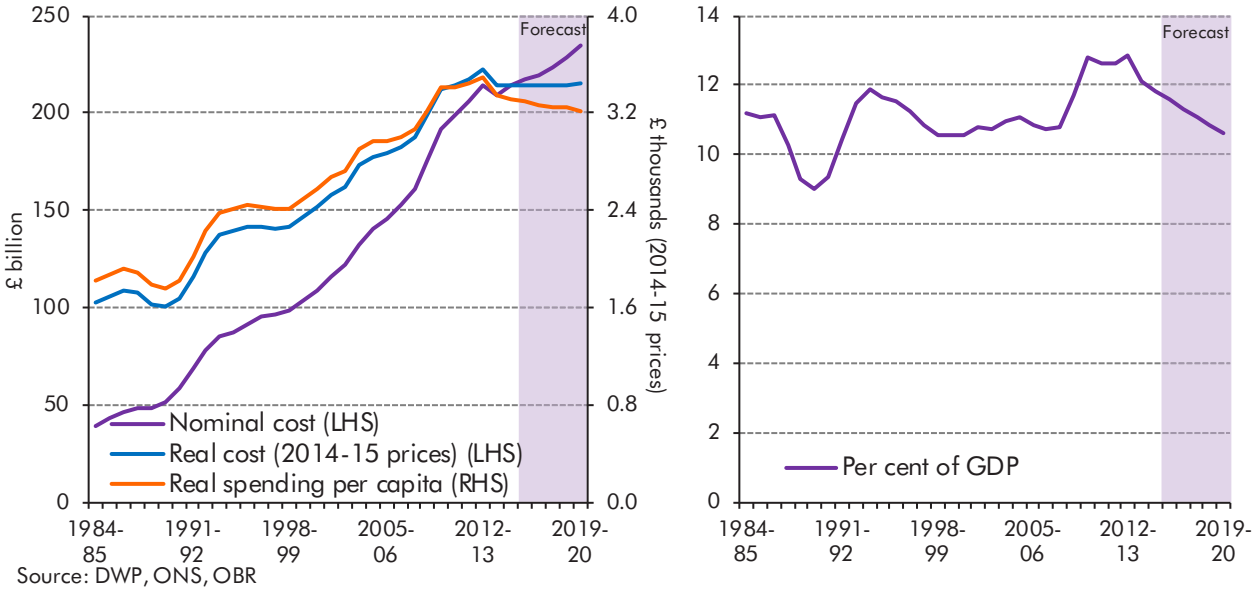
Trends in UK welfare spending

Historical trends

4 In our first report, we noted that trends in welfare spending reflect underlying economic and social drivers (demographics, the labour market, inflation, earnings growth and housing tenure). These interact with Government decisions about the scope of support that it will provide to people through the welfare system. That was apparent in the rising share of welfare spending devoted to pensioners – which reflects demographic trends and policy decisions (such as the 'triple lock' on uprating or the introduction of winter fuel payments) – and to children, due to the large expansion of tax credits focused on families with children.

5 Over the past 30 years, welfare spending has risen steadily in cash and real terms, but on average that increase has been broadly in line with growth in the economy. So the proportion of national income devoted to welfare spending has not shown a significant upward or downward trend. The trend in real spending per person has also been generally upward – consistent with rising productivity. Over the forecast period, spending is expected to fall both as a share of GDP and in real per capita terms.

Chart 1: Total welfare spending in the UK



Source: DWP, ONS, OBR

Medium-term welfare spending forecast

6 In our 2014 *WTR*, we identified a number of important risks and uncertainties that we felt would be relevant to our medium-term forecasts. The analysis that underpinned that report allowed us to focus on the relevant evidence ahead of our December 2014 and March 2015 *Economic and fiscal outlooks (EFOs)*. That prompted some significant revisions to our welfare spending forecasts. In summary:

- we noted issues in the delivery of reforms to **incapacity benefits** – in particular, the backlog of work capability assessments for employment and support allowance (ESA) and the higher proportion of claimants in the more expensive support group. Our latest forecast shows incapacity benefits spending around £1 billion a year higher than our March 2014 forecast, with upward revisions to the support group caseload more than explaining the increase;

- similar issues arose in the delivery of reforms to **disability benefits** – with the transfer from disability living allowance (DLA) to the new personal independence payment (PIP) slower than planned and delivering smaller savings in the process. We revised up the expected proportion of new PIP claims that would be successful for the claimant, helping to explain around £1 billion a year higher spending relative to our March 2014 forecast;

- **universal credit** presents similar issues on an even larger scale, with the rollout repeatedly delayed. The implications of these delays for our forecast are limited, in part because universal credit is currently added into our forecast as a marginal cost relative to the legacy benefits system and in part because (unlike ESA and PIP) the reforms themselves are not associated with large expected cash savings. The Government pushed back its expected timetable for the rollout of universal credit, which we assume, for the purposes of our forecasts, will be delayed further still;

- due to the faster than expected fall in unemployment – and the additional fall in the claimant count relative to total unemployment – **jobseeker's allowance** was noted as an area where spending was likely to be revised down. In the event, we revised it down by between £0.6 billion and £1.0 billion a year relative to our March 2014 forecast. In relative terms, that was one of the largest revisions in any part of our fiscal forecasts – the biggest single year revision (in 2015-16) saw expected spending lowered by almost 30 per cent;

- we highlighted the uncertainty around our **housing benefit** forecast associated with trends in housing tenure (where owner occupation has fallen significantly in recent years) and rent inflation. In the end, we revised down our forecast for spending on housing benefit for other reasons, including slower expected growth in the number of households and the lower claimant count forecast; and

- we noted that **inflation** was potentially the most important general source of uncertainty in our welfare spending forecast. We pointed out that this represented a risk to the welfare cap, which is set in cash terms. Since our last *WTR* was published in October 2014, oil prices have fallen dramatically, pushing CPI inflation close to zero. The effect of lower inflation on the uprating of most benefits and tax credits saved over £3 billion in 2016-17, rising to around £5 billion by 2018-19.

Table 1: Sources of changes in welfare spending since the 2014 *WTR*

	£ billion				
	Estimate	Welfare cap period			
	2014-15	2015-16	2016-17	2017-18	2018-19
March 2014 forecast	213.9	218.8	224.5	230.6	236.3
March 2015 forecast	214.5	216.9	219.5	223.6	229.3
Change	**0.6**	**-1.9**	**-5.0**	**-7.0**	**-7.0**
of which:					
CPI inflation	0.0	-0.5	-3.2	-4.6	-5.1
Claimant count unemployment[1]	-1.0	-2.3	-2.1	-1.6	-1.4
Fertility and mortality assumptions	-0.2	-0.4	-0.5	-0.7	-0.8
Number of renting households	-0.1	-0.1	-0.2	-0.3	-0.5
Incapacity benefits modelling changes[2]	0.5	1.0	1.2	0.9	0.7
Disability benefits modelling changes[3]	0.5	0.7	1.1	1.3	1.4
Universal credit rollout delay	0.0	-0.1	-0.4	-0.9	0.1
Other factors	0.8	-0.2	-0.9	-1.2	-1.3

[1] Including the direct effect of lower claimant count on jobseeker's allowance and the associated indirect effect on passported housing benefit spending.

[2] Includes incapacity benefit, employment and support allowance, severe disablement allowance and income support (incapacity part)

[3] Disability benefits includes disability living allowance and personal independence payment, but not attendance allowance.

7 Our latest medium-term forecast shows welfare spending rising by just under 10 per cent in cash terms between 2014-15 and 2019-20. That is smaller than the 12½ per cent increase in last year's *WTR* from 2013-14 to 2018-19, in large part reflecting the effect of lower inflation on most elements of welfare spending. The expected increase in cash spending is significantly slower than our forecast for growth in nominal GDP over the same period, so welfare spending falls from 11.9 per cent of GDP in 2014-15 to 10.6 per cent in 2019-20.

Table 2: Medium-term forecast of welfare spending

		Welfare cap period				
	Estimate	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
£ billion						
Total welfare spending	214.5	216.9	219.5	223.6	229.3	235.1
of which:						
Inside welfare cap	119.4	120.6	121.0	121.8	124.0	126.5
Outside welfare cap	95.1	96.3	98.5	101.8	105.2	108.6
Per cent of GDP						
Total welfare spending	11.9	11.6	11.3	11.1	10.9	10.6
of which:						
Inside welfare cap	6.6	6.4	6.2	6.0	5.9	5.7
Outside welfare cap	5.3	5.1	5.1	5.0	5.0	4.9

8 Spending that will be subject to the welfare cap is expected to fall by 0.9 per cent of GDP over the next five years, driven by:

- a 0.18 per cent of GDP fall in the cost of **tax credits** – the largest category of spending subject to the cap. This largely reflects the result of previously announced measures (uprating capped at 1 per cent in 2015-16) and operational changes targeting debt and error and fraud;

- smaller falls in **housing benefit** (0.13 per cent of GDP) and **incapacity benefits** (0.10 per cent of GDP) – the next largest spending lines. Spending on housing benefit falls as average awards grow more slowly than GDP-per-adult. Clearing the backlog of work capability assessments for incapacity benefits should reduce the overall caseload relative to the adult population;

- a substantial fall in spending on **disability benefits** (worth 0.18 per cent of GDP). This is driven by an assumed reduction in caseloads as people's eligibility for support is reassessed when cases are migrated from the existing DLA to the new PIP; and

- falls in spending on **pension credit** (0.12 per cent of GDP) in part due to the rise in the state pension age and **child benefit** (0.10 per cent of GDP) due to uprating by less than earnings growth and a rise in the number of families opting out of payment as a result of the 'high income child benefit charge'.

9 Spending outside the welfare cap is expected to fall more slowly than spending subject to the cap, and by 0.4 per cent of GDP in total. This reflects:

- a 0.22 per cent of GDP decline in spending on **state pensions** as the pressure from population ageing is more than offset by raising the state pension age, which leads to a decline in caseloads relative to the adult population. The 'triple lock' on uprating means that average awards rise broadly in line with earnings;

- spending on the unemployed – comprising **jobseeker's allowance and housing benefit paid to jobseekers** – falls by 0.09 per cent of GDP, as caseloads fall further in 2015-16 and average awards rise more slowly than earnings over the forecast period; and

- a classification change means that spending on **war pensions** amounting to 0.05 per cent of GDP has moved from the definition of welfare spending used in our forecasts into the Ministry of Defence's resource departmental expenditure limit.

10 It is apparent from this decomposition that lower average awards are expected to play a bigger role than caseloads in reducing the share of GDP spent on benefits and tax credits subject to the welfare cap. By contrast, lower caseloads as a share of the adult population are the main driver in reducing spending as a share of GDP outside the welfare cap.

11 As we always stress, our forecasts are subject to a number of risks and uncertainties. In last year's report, we noted that a particular forecast risk of relevance to the welfare cap was inflation, since the cap is set in nominal terms. In this year's report, we have looked back at some of the larger welfare policy measures from the last Parliament, in order to consider any lessons that might be applied when scrutinising any new policies in the forthcoming Budget

or beyond. Given the time available between our last forecast and this report, and the complexity of some of the reforms, this has been a relatively high-level exercise looking at the less complex policy measures. The two main conclusions to be drawn are:

- **errors in our economic forecasts** – which underpin the pre-measures forecasts to which policy costings are applied – **can be significant sources of error in costings themselves**. This has been particularly relevant to the major uprating policy measures: the 'triple lock' on state pension uprating; switching from RPI to CPI inflation uprating for most benefits and tax credits; and subsequently limiting the uprating of most working-age benefits to 1 per cent for three years; and

- **costings associated with structural changes to the welfare system** – e.g. the switch from incapacity benefit to the employment support allowance, from disability living allowance to the personal independence payment and the introduction of universal credit – **are subject to even greater uncertainty**. In some cases these require judgements about the proportion of the population that will claim a new benefit and at what rate, but they also typically require judgements about the capacity of departments or contractors to deliver the new policies.

Long-term welfare spending projection

12 Our 2015 *Fiscal sustainability report (FSR)* contains long-term projections of welfare spending. These largely capture the effects of demographic change, with neutral assumptions in most other areas. An important difference from our medium-term forecasts is that we assume benefits are uprated with earnings rather than inflation, which effectively switches off the fiscal drag effect of average awards rising more slowly than GDP-per-adult.

13 Since last year, we have changed the migration assumption underpinning our medium-term forecasts and long-term projections from the ONS low migration variant to its principal projections. This raises population growth and reduces the old-age dependency ratio, since migrants to the UK are more likely to be of working age than the native population.

14 Our projections show total welfare spending rising by 2.2 per cent of GDP between 2019-20 – the end of our medium-term forecast – and 2064-65, with almost all the rise accounted for by benefits paid to the elderly. This is largely driven by demographic trends, which are partly offset by further expected increases in the state pension age – based on the principle set out by the Government that people should expect to spend up to a third of their adult life in receipt of the state pension. The triple lock on uprating is assumed to put further upward pressure on state pensions spending as a share of GDP over the long term.

15 Among other benefits, the main projected changes over the long term are:

- spending on incapacity and disability benefits rises in large part due to the ageing of the population. We assume constant age-specific shares of the population in receipt of incapacity benefits, which means that cohort effects raise the caseload as a share of the adult population as the population ages. For disability benefits, even assuming

increases in disability-free life expectancy, the significant rise in the population of very old people lifts spending overall. The number of people aged 85 and over is projected to rise from 2.4 per cent of the population in 2015 to 7.4 per cent in 2065. The projected rise in spending on disability benefits is smaller than in last year's projections, largely due to the lower old-age dependency ratio; and

- spending on housing benefit for both pensioners and those of working age falls. Among pensioners, that reflects cohort effects – newly-retired pensioners are assumed to have higher home-ownership rates than the oldest pensioners. Among those of working age, it reflects an assumption that age-specific home-ownership rates among recent cohorts (which have fallen in recent years) pick up to historical averages over time. These assumptions mean that the proportion of the adult population eligible for housing benefit falls slightly in our projections.

Table 3: Long-term projections of welfare spending

	Per cent of GDP						
	2014-15	2019-20	2024-25	2034-35	2044-45	2054-55	2064-65
State pensions[1]	5.5	5.1	5.4	6.2	6.8	7.0	7.3
Housing benefit	1.4	1.2	1.2	1.1	1.2	1.1	1.1
Personal tax credits	1.7	1.5	1.5	1.5	1.4	1.4	1.4
Disability benefits[2]	1.2	1.0	1.0	1.0	1.1	1.1	1.1
Incapacity benefits[3]	0.8	0.7	0.8	0.8	0.8	0.8	0.8
Income support	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Unemployment benefits[4]	0.3	0.1	0.1	0.1	0.1	0.1	0.1
Child benefit	0.7	0.5	0.6	0.5	0.5	0.5	0.5
Other welfare benefits	0.4	0.4	0.3	0.3	0.3	0.3	0.3
Total welfare spending	**12.1**	**10.6**	**10.9**	**11.8**	**12.4**	**12.7**	**12.8**

[1] Basic state pension, state earnings related pension scheme, state second pension, single-tier pension, other elements of state pension, pension credit and other pensioner benefits.

[2] Disability living allowance, personal independence payments and attendance allowance.

[3] Incapacity benefit, employment and support allowance, severe disablement allowance and income support (incapacity part).

[4] Jobseeker's allowance.

Note: Figures for 2014-15 and 2019-20 presented on a UK-basis, consistent with our 2015 *Fiscal sustainability report* projections.

International comparisons of social protection spending

Comparing welfare spending across countries

16 In order to compare welfare spending in the UK with that in other advanced countries, we need to define the scope of spending to be covered and to locate data that is sufficiently consistent to make comparisons meaningful. We focus on two sources in this report: the OECD's social expenditure database and Eurostat's integrated social protection statistics. Both are based on a definition of spending on 'social protection' that is broader than the definition of welfare spending used in our reports and that the Government used in setting the welfare cap. Social protection includes "*all interventions from public or private bodies intended to relieve households and individuals of the burden of a defined set of risks or needs, provided that there is neither a simultaneous reciprocal nor an individual arrangement*

involved." That includes health care and other goods and services provided as benefits in kind, as well as the transfers that are the focus of our *WTRs*.

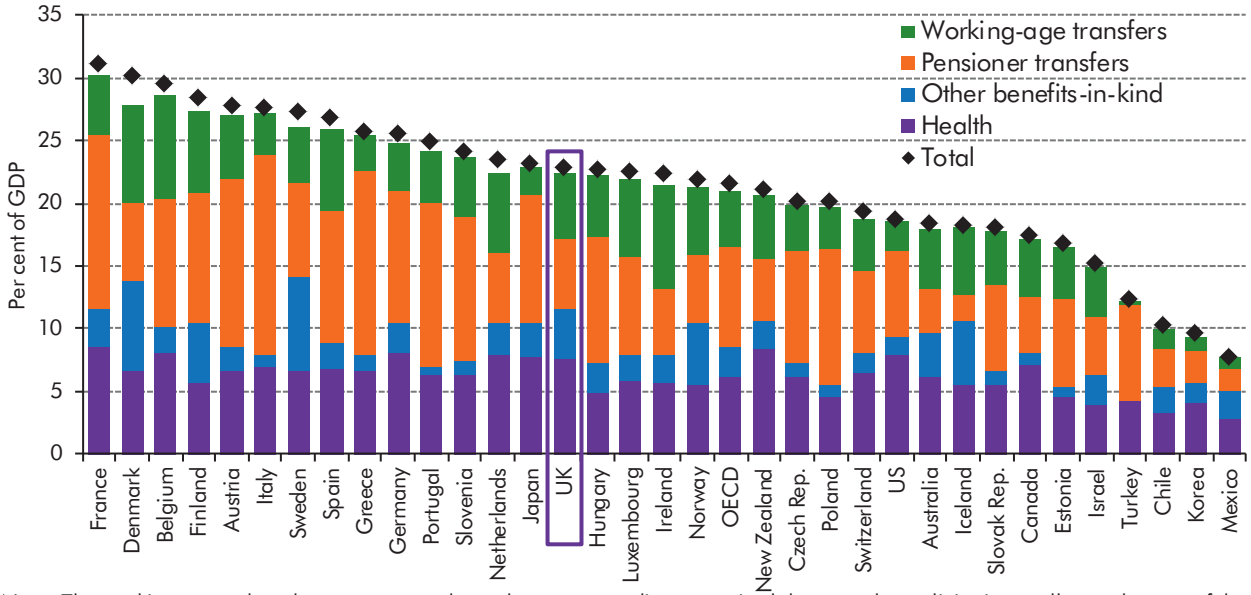
17 As well as the OECD average, we focus on countries from three broad groupings of advanced economies – Anglophone, Continental European and Nordic – that are classified on the basis of the extent and approach to social protection spending. Both Nordic and Anglophone countries tend to finance more of their social expenditure via general taxation as opposed to earmarked social contributions, but Nordic systems devote a higher share of national income to such spending. Continental European systems tend to finance more expenditure via social contributions that play a role in determining individuals' eligibility for support.

Total expenditure on social protection

18 The OECD collects data that allow us to consider how different countries' welfare systems deliver social protection to their populations. This shows the importance of comparing not just the gross amount of public spending on social protection, but also the degree to which the private sector is incentivised or mandated to deliver the equivalent support and interactions with the tax system. Taking those factors into account can significantly alter our understanding of the share of national income a country devotes to social protection.

19 Looking first at the gross measure of public spending on social protection, the UK is estimated by the OECD to have spent 21.7 per cent of GDP in 2014. That was very close to the OECD average, lower than in Nordic and Continental European systems and the third lowest in the G7 (after Canada and the US). On this definition (as shown in Chart 2), UK public spending is roughly evenly split between cash transfers and the provision of benefits in kind, with pensioner benefits accounting for around half of cash transfers and health spending for two-thirds of benefits in kind.

Chart 2: Estimated gross public expenditure on social protection



Note: The total is greater than the components shown because spending on active labour market policies is not allocated to any of the individual areas. Australia, Canada, Chile, Israel, Korea, New Zealand and the US refer to 2012 data, otherwise they refer to 2011.
Source: OECD

20 To move from gross public expenditure on social protection to a measure of net total expenditure, we need to consider two other methods of delivering on social objectives:

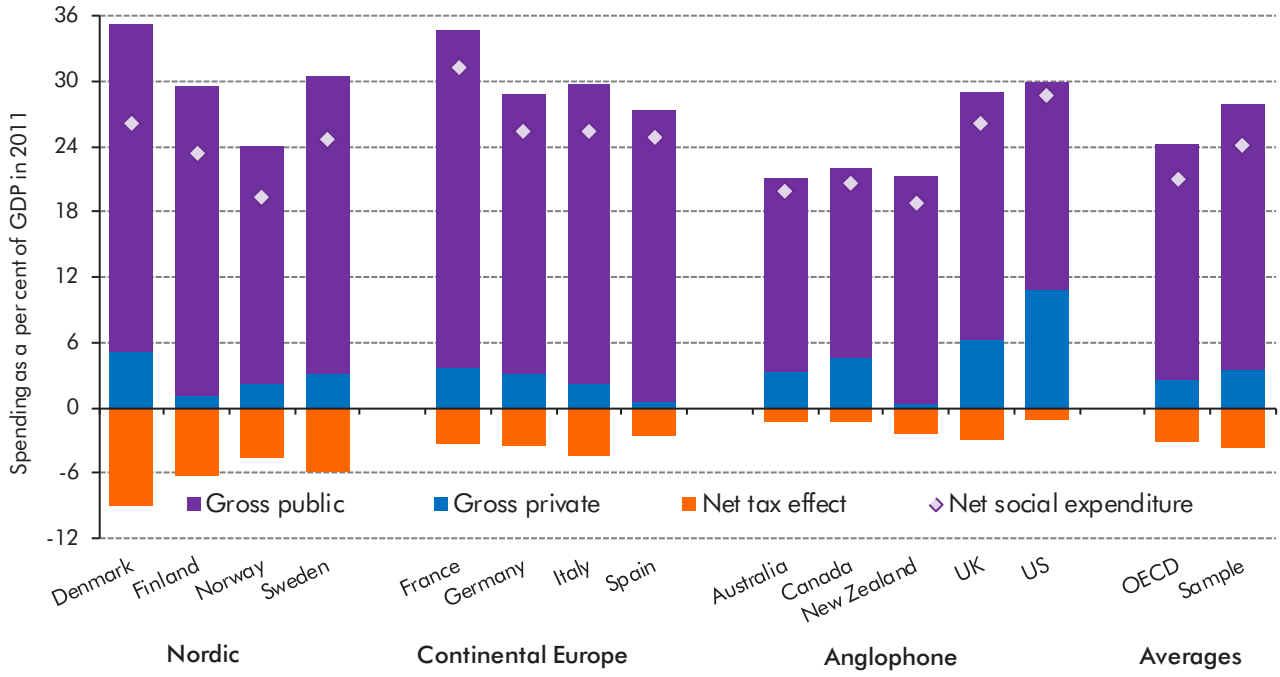
- **gross private social expenditure** amounted to 2.7 per cent of GDP in 2011 across the OECD. The main components were incapacity spending (e.g. sickness-related payments), old-age spending (e.g. employer-based pension schemes) and health spending. There is considerable variation in the extent to which countries incentivise or mandate the private sector to provide social protection. That said, two countries with high private sector spending on social welfare provision are Anglophone countries: the US (due to high levels of private spending on health care and private pensions) and the UK (due to extensive private pension spending); and

- the **effects of the tax system** on the overall fiscal cost of social protection. Countries can levy income tax on cash transfers to individuals – the UK does so on pensions and some other benefits, while Nordic countries tend to on most benefits. Consumption taxes are levied on spending out of income from cash transfers – the effect of this is much larger in European countries (where gross benefit income and indirect tax rates are often relatively high) than in Australia, Canada, and the US (where both are relatively low). These effects reduce the net fiscal cost of social protection. Countries can also use tax incentives for social purposes – for example by tax relief for collective health insurance (as in the US) or pension saving (as in the UK). The OECD database does not include tax incentives for pension saving, which can have a significant cost in foregone revenue.

21 In terms of net total social expenditure in 2011 (the latest year available on this measure), spending in the UK was significantly higher than the OECD average at 26.1 per cent of GDP

against 21.1 per cent. By contrast, gross public social expenditure in the UK in that year was only a little higher than the OECD average. The main factor explaining this difference is higher private spending on employer-based pensions. The US also looks very different on this measure: public spending is well below the OECD average, but net total expenditure is second only to France because of high private spending on health services and pensions. France ranks highest in the OECD for both gross public expenditure and net total expenditure.

Chart 3: Net total expenditure on social protection



Expenditure on selected social protection programmes

Support for the elderly

22 Payments to pensioners are mainly driven by demographic trends, so they tend to be less sensitive to the economic cycle than social spending on the working-age population. Thanks to the ageing of the population and the maturation of pension systems, public pension spending has been rising as a share of GDP in most advanced economies (including the UK). Many OECD countries are reforming their pension systems to limit the growth of spending, with the goal of achieving long-term financial sustainability of pension systems.

23 In the UK, spending on pensioners is the largest category of social spending, with gross public spending at 6.1 per cent of GDP in 2010 (slightly below the OECD average of 7.3 per cent) and gross private spending at 5.2 per cent (significantly higher than the OECD average of 2.4 per cent). Among the countries we focus on, Italy has the highest public spending on pensioners (at 13.3 per cent of GDP) and New Zealand the lowest (at 4.5 per cent).

24 Putting the UK in international context, a number of features are apparent:

- public spending on pensioners – primarily on cash transfers – is slightly higher in the UK than in the other Anglophone countries, but much lower than in most Continental European and Nordic countries;

- private spending on pensioners in the UK is the highest in the OECD. This reflects the relative importance of employer-based pensions in the UK. The US and Denmark also have relatively high shares of the working-age population enrolled in private sector pension schemes;

- the UK has a similar old-age dependency ratio to the OECD average, with roughly one pensioner for every four people of working age. This ratio is higher than in other Anglophone countries, but lower than in many Continental European countries; and

- the replacement rate for state pensions in the UK (i.e. their generosity relative to pre-retirement earnings) is among the lowest among the countries considered. By contrast, replacement rates from those schemes classified as private spending are close to the OECD average.

Support for sick and disabled people

25 In advanced economies, income support for those unable to work due to sickness or disability is common. Spending on such benefits is driven both by underlying factors (such as demographics and age-specific health status) and by policy decisions (such as eligibility rules, benefit replacement rates and access to other social programmes). These factors determine the proportion of populations in receipt of sickness and disability transfers and the relative generosity of the benefits they receive.

26 In the UK, public spending on sick and disabled people in 2011 – the latest year for which detailed OECD data are available – stood at 2.5 per cent of GDP, slightly above the OECD average of 2.2 per cent. Most was spent on cash transfers. Private spending was 0.5 per cent of GDP – slightly below the OECD average of 0.7 per cent. This was mostly sickness payments made by employers.

27 Putting the UK in international context, we note a number of features:

- the UK spends somewhat less on benefits-in-kind (i.e. goods and services) for disabled people, particularly compared to the Nordic countries. Overall spending is similar to Nordic levels, with the UK delivering more help through cash benefits. This includes the additional costs support of DLA that is closely linked to the cost of providing necessary goods and services for disabled people – a model unusual among OECD countries;

- the UK spends less on sickness payments (private spending) than Continental European and Nordic countries. One reason for this is the lower generosity relative to previous earnings of such payments in the UK;

- the UK is estimated to have a lower self-reported prevalence of disability than the Nordic countries, but higher than most Anglophone and Continental European countries. In the late 2000s, just under 1 in 5 working-age people in the UK were self-reported as having a long-standing health problem that limited daily activity; and

- the UK has a slightly lower than average net replacement rate (a proxy for relative generosity) for disability-related benefits, whereas Nordic countries have higher replacement rates.

Support for unemployed people

28 In 2011, the UK spent 0.4 per cent of GDP on unemployment spending. That was well below the OECD average of 1.0 per cent of GDP. Indeed, spending in the UK is equal lowest as a share of national income among the countries we focus on in this report.

29 Three main factors help to explain cross-country differences in the cost of unemployment benefits as a share of national income:

- the unemployment rate – which fluctuates with the economic cycle. In 2011, the unemployment rate in the UK was close to the OECD average, so this factor did not explain the UK's relatively low spending on unemployment benefits. Spain saw the highest unemployment rate among the countries we consider, having been hit particularly hard by the late 2000s recession, which caused unemployment to rise above the internationally high levels seen in Spain in the mid-1990s;

- the ratio of the unemployment benefit caseload to total unemployment – this is a proxy for a more structural element that is influenced by the conditions determining eligibility for the benefit. In 2011, the jobseeker's allowance caseload in the UK was around half the level of unemployment as reported in the Labour Force Survey. That too was close to the OECD average. In Spain, eligibility is tighter than in many countries, so only a small proportion of the large number of unemployed people receive the primary unemployment benefit; and

- the generosity of those benefits – this contains a structural element determined by policy, but can also be varied in response to the economic cycle. This factor explains the UK's relatively low spending, with the replacement rate associated with jobseeker's allowance low by international comparisons. It appears that much of this is explained by the UK delivering support for housing costs via a separate scheme – housing benefit – whereas most systems set benefit awards at levels that reflect housing costs.

Support for people on low incomes

30 Public spending on **family benefits** is defined as financial support that is exclusively for families and children. This means that spending recorded in other social policy areas that assist families – notably health spending – are not included under the 'families' heading. On this definition, public spending on support for families amounted to 4.3 per cent of GDP in the UK in 2011, significantly above the OECD average of 2.6 per cent.

31 Tax credits are the largest component of spending on families in the UK. Spending on them has doubled as a proportion of national income since 2002-03, in particular reflecting the expansion of tax credits in 2003-04 – when child tax credits in particular became the Labour Government's preferred policy tool to try to meet its child poverty targets. More recently, during the late 2000s recession, spending increased because of generous discretionary uprating (especially of the child element).

32 As noted above, the UK's **housing benefit** system is relatively unusual in providing support for housing costs via a separate benefit rather than factoring those costs into the generosity of other benefits. OECD data show that the UK spends more subsidising housing costs as a share of GDP than any other country in the OECD. At 1.5 per cent of GDP, this figure is more than three times the OECD average of 0.4 per cent. We have not been able to determine whether, if the difference of approach could be appropriately adjusted for, the cost of subsidised rent in the UK was genuinely higher than in the other countries. But this might be possible given the high cost of housing in general. It is a subject we may return to in future *WTRs*.

1 Introduction

Defining welfare spending

1.1 The term 'welfare' means different things to different people. At its broadest, welfare spending might be considered as any spending that plays a part in the provision of the welfare state – including health, long-term care, education and social housing, as well as social security benefits and tax credits for children, people of working-age and pensioners.

1.2 In Chapter 2 of this report, we focus on spending on benefits and tax credits – cash transfer payments from some parts of the population to others – as they appear in our medium-term forecasts. This includes all spending subject to the Government's welfare cap.

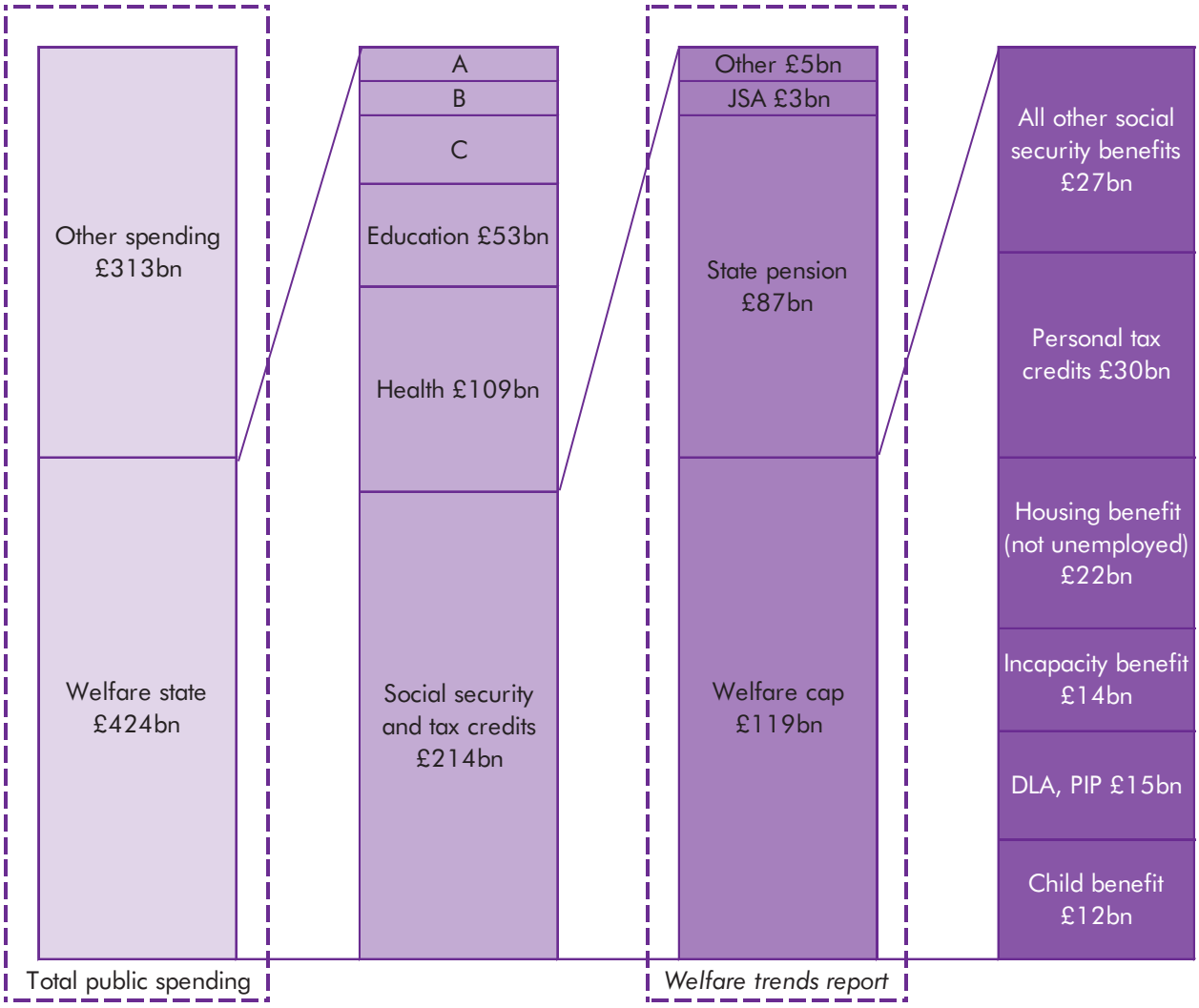
1.3 Most social security and tax credit spending is administered by three organisations:[1]

- the Department for Work and Pensions (DWP), which administers most benefits in Great Britain;
- HM Revenue and Customs (HMRC), which administers the personal tax credits and child benefit systems across the United Kingdom; and
- the Northern Ireland Social Security Agency, which administers most benefits in Northern Ireland.

1.4 Figure 1.1 shows how the definition of welfare spending used in Chapter 2 relates to total public spending and to some other possible definitions of welfare spending. In Chapter 3, we use a broader definition of spending on social protection (see Figure 3.1 in that chapter).

[1] Some smaller benefits are administered by other departments – for example, paternity pay is administered by the Department for Business, Innovation and Skills.

Figure 1.1: Welfare spending in the UK in 2014-15



Note: A: Housing, £7bn; B: Public sector pensions, £12bn; C: Public and social services, £29bn. Figures for housing, public and social services are based on 2013-14 outturns of the latest available data. As a result, figures in the first column are estimates of published outturns. The components will be available in the July release of PESA.
Source: DWP, HMRC, HMT, OBR

Deciding what period to consider

1.5 There have been forms of social protection in the UK for centuries, from the Elizabethan and Victorian poor laws to the workplace compensation schemes of the industrial revolution. The welfare system in its current form began to take shape under the Liberal Government of Herbert Asquith with the introduction of a state pension for the elderly – initially those aged over 70 – in the Old Age Pensions Act 1908. This was followed by the introduction of contributory insurance against sickness and unemployment in the National Insurance Act 1911. The creation of the 'cradle to grave' welfare state as we now know it came during the post-war Labour Government of Clement Attlee, following the Beveridge Report of 1942. This included the introduction of child benefit in the Family Allowances Act 1945, the

creation of the NHS in the National Health Service Act 1946 and the expansion of compulsory social insurance in the National Insurance Act 1946.[2]

1.6 A full history of trends in welfare spending lies beyond the scope of our reports. Last year, we focused on the three decades from 1983-84, a period that covers two recessions and a number of major reforms to the welfare system. This permitted a reasonably full analysis of the drivers of trends in welfare spending from which we drew out common themes and challenges that we felt were relevant to fiscal sustainability and our forthcoming assessments of the Government's performance against the welfare cap.

1.7 The analysis undertaken for last year's report identified a number of issues that we expected to be relevant for our medium-term forecasts. In some of these areas we amended our forecasts as a result. In this year's report, we focus on those revisions – and other sources of changes in spending – in 2014-15 and over our 5-year medium-term forecast period. We provide greater detail on the assumptions and judgements that fed into our central forecasts and how the revisions to our forecasts can be decomposed into specific judgements and new evidence. Finally, we summarise our latest illustrative long-term projections – published alongside this report in our *Fiscal sustainability report* – which extend 50 years to 2064-65.

Identifying appropriate spending metrics

1.8 Having established which types of spending to analyse over what time period, the next decision is to choose which metrics to focus on. Different metrics are appropriate for different questions. The three most common measures of aggregate spending used are:

- **cash or nominal spending**: this is simply the cash amount spent in a given period. It is the metric most relevant to the Government's welfare cap, which was initially set in cash terms for the period from 2015-16 to 2018-19 and has since been extended to 2019-20. But without putting the cash amount into context – by asking what the recipients could buy with it or how much national income is available to fund it – interpreting changes in cash spending is difficult, particularly over longer time periods;

- **spending in real terms**: trends in cash spending can be adjusted for whole economy or consumer price inflation, to give a sense of the volume of goods and services that could be purchased with that spending – either across the whole economy or in the hands of the recipients; and

- **spending as a share of national income**: trends in cash spending can be related to the cash value of the economic activity that can be taxed to finance it. This is the most relevant metric when considering the sustainability of the public finances.

1.9 There are other possible metrics that might be considered, including:

[2] See for example Briggs (1961) or Gregg (2008).

- as a share of total public spending – which would illustrate the trade-offs between welfare and other priorities within a given spending envelope;
- relative to revenues – a more direct measure of spending relative to the resources available to finance it; or
- in per capita terms – either cash or real – which could be related more directly to individual incomes or living standards.

1.10 In this report we focus on spending in cash terms – as the welfare cap is a cash ceiling – and as a share of GDP – given our focus on the sustainability of the public finances.

1.11 As noted above, the majority of welfare spending in the UK is administered at the Great Britain level by DWP, with benefits in Northern Ireland administered separately. For simplicity, we use UK GDP as the denominator in all of the analysis in this report. This is also consistent with our focus on comparing spending to the full UK national income that can be taxed to finance it.

Our approach to analysing trends in welfare spending

1.12 When analysing trends in welfare spending there are a number of different drivers that need to be taken into account. The approach we take in this report is to split those drivers into those that affect the number of recipients of a benefit – the caseload – and those that affect the amount paid to each recipient – the average award.

1.13 In our analysis of the UK, total spending on each benefit and the average caseload through each year are derived from administrative data, with the average award calculated from the relationship between the two. The average award is not the same as the statutory rate or rates for a given benefit. In some cases, an average annual award is a meaningful concept – for example, those receiving the basic state pension will claim throughout each year once they have started to receive payments. In other cases, it is less meaningful – for example, currently around 70 per cent of those claiming jobseeker's allowance have been doing so for less than 12 months.

1.14 When considering trends in cash spending, we are interested in absolute changes in the different drivers of the caseload and average award. Taking each in turn, changes in spending will reflect:

- changes in the caseload, which among other things can be affected by:
    - changes in the population eligible for a benefit, due to demographic or economic factors – such as growth in the number of people aged above the state pension age or changes in the number of people unemployed;
    - the proportion of those eligible who take up their entitlement – this may be affected by knowledge of the entitlement or stigma associated with claiming; and

    - policy changes that alter eligibility criteria – such as raising the state pension age.

- changes in the implied average award, which among other things can be affected by:

    - statutory or default uprating of benefits and the economic factors that affect the measures by which benefits are uprated – for example, the default setting for most benefits since the Coalition Government's 2010 reforms is uprating by consumer price (CPI) inflation each year, which means the actual rate of CPI inflation is a key driver of changes in average awards;

    - policy choices to uprate benefits by an amount that differs from the default setting – for example, the Government decided that most working-age benefits would be uprated by 1 per cent over the three years from 2013-14 rather than by CPI inflation; and

    - changes in the composition of the caseload, which can change the average award when different groups receive different amounts. This is particularly true of housing benefit, where the amount paid to each recipient varies considerably across the country and in the social- and private-rented sectors, and the state pension, where a growing proportion of recipients are women entitled to the full state pension.

1.15 When considering trends in spending as a share of GDP, we also need to consider how all the factors affecting cash spending relate to GDP growth. To assess the relative importance of changes in caseload and average award drivers for the ratio of spending to GDP, we have to decompose GDP growth itself into relevant components. We do that by considering changes in caseloads relative to the population – in this report the adult population aged 16 and over – and changes in average awards relative to GDP per person – GDP per adult in this report. GDP per adult can be thought of as a proxy for average incomes, so the ratio of the average award to GDP-per-adult is a measure of the 'generosity' of a given benefit.

1.16 This approach allows us to analyse whether a rise (fall) in spending on any benefit is explained by a rise (fall) in the proportion of the adult population claiming or because the average award has risen faster (slower) than average incomes. Where sufficient data are available, we can further decompose these explanations into the factors identified above. For example, we can calculate the extent to which spending on state pensions changes as a share of GDP due to the ageing of the population, recent changes in the state pension age, the effects of the triple lock on uprating and changes in the composition of the caseload.

1.17 For the international comparisons presented in this report, our approach to analysing welfare spending has been guided to an extent by data availability. Internationally comparable data on spending is published by the OECD, but data that proxy for caseloads and generosity are not readily available for all elements of welfare spending covered in our forecasts. Where they are – e.g. showing how spending on support for the unemployed is affected by the Labour Force Survey measure of the unemployment rate, the proportion of the unemployed that claim unemployment benefit and the replacement rate (the ratio of benefits to previous earnings) – we have been able to follow a similar approach.

Structure of the report

1.18 This year's report is structured as follows:

- Chapter 2 updates our analysis of overall trends in welfare spending in the recent past and over our medium-term forecast period, explaining the revisions we have made since our first *WTR* (some of which were prompted by the analysis undertaken for that report). We also describe our updated long-term projections, which are consistent with the 2015 *Fiscal sustainability report* published alongside this report. We bring these discussions together to set out the implications for the Government's performance against its welfare cap and to illustrate some forecast and policy risks to which it may be subject; and

- Chapter 3 presents an international comparison of welfare spending in advanced economies. For these comparisons we have drawn on OECD and Eurostat data on social protection – a wider definition of welfare spending than used in Chapter 2. This includes benefits-in-kind (the largest of which in most countries is spending on health care). The OECD data also include spending by the private sector (e.g. employer-based occupational pension schemes in the UK) and interactions with the tax system (e.g. where cash benefits are taxed or where support is delivered via tax breaks rather than spending).

2 Overall trends in welfare spending

Introduction

2.1 We published our first *Welfare trends report (WTR)* in October 2014. Since then, we have updated our medium-term forecasts twice, in the *Economic and fiscal outlooks* in December 2014 and March 2015, and our latest long-term projections are published in the 2015 *Fiscal sustainability report* alongside this report. In this chapter we:

- summarise and update the main conclusions we reached in our first *WTR* about the trends and drivers of historical trends in welfare spending (from paragraph 2.2);
- describe our latest medium-term forecasts and the ways in which the issues identified in our first *WTR* informed the judgements we took in our December and March forecasts (from paragraph 2.10);
- summarise our latest long-term projections and the main sensitivities relevant to welfare spending over the long term (from paragraph 2.42); and
- bring these discussions together to set out the implications for the Government's performance against its welfare cap and to illustrate some forecast and policy risks to which it may be subject (from paragraph 2.49).

Historical trends in welfare spending

Summary of the 2014 *Welfare trends report* conclusions

2.2 In our first report, we noted that trends in welfare spending reflect underlying economic and social drivers (demographics, the labour market, inflation, earnings growth and housing tenure) and Government decisions about the scope of support that it will provide to people through the welfare system. That was apparent in the rising share of welfare spending devoted to pensioners – which reflects demographic trends and policy decisions (such as the 'triple lock' on uprating and the introduction of winter fuel payments) – and to children – due to the large expansion of tax credits focused on families with children.

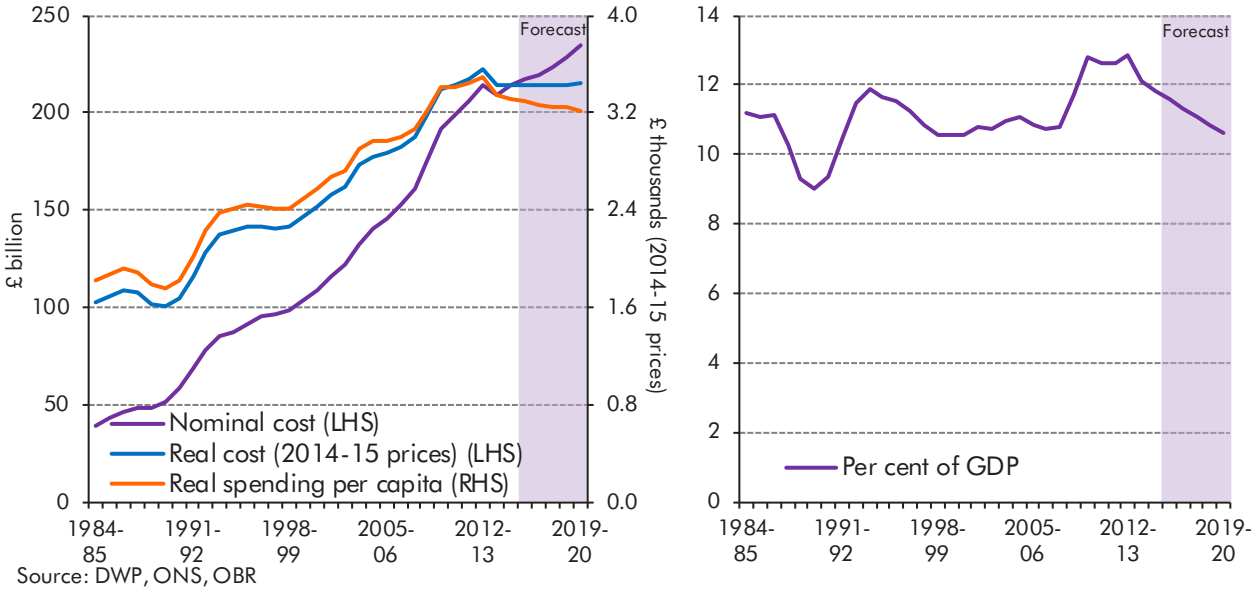
2.3 Over the past 30 years, welfare spending has risen steadily in cash, real, and real spending per capita terms. But on average that increase has been broadly in line with growth in the economy. So the proportion of national income devoted to welfare spending has not shown a significant upward or downward trend over time. Over the forecast period, welfare spending is forecast to fall as a share of GDP and in real per capita terms (Chart 2.1).

2.4 But welfare spending has fluctuated significantly with the ups and downs of the economic cycle. That has reflected two important features:

- first, the caseloads of highly counter-cyclical benefits (like jobseeker's allowance) rise significantly in recessions and fall significantly in recoveries. These elements of spending are now relatively small and are excluded from the Government's welfare cap; and

- second, the average awards of large and mildly counter-cyclical benefits (like state pensions or disability benefits) are more stable than GDP over the economic cycle, which means that they fluctuate negatively with the cycle relative to GDP. With the exception of state pensions, these elements of spending are subject to the welfare cap.

Chart 2.1: Total welfare spending in the UK



Source: DWP, ONS, OBR

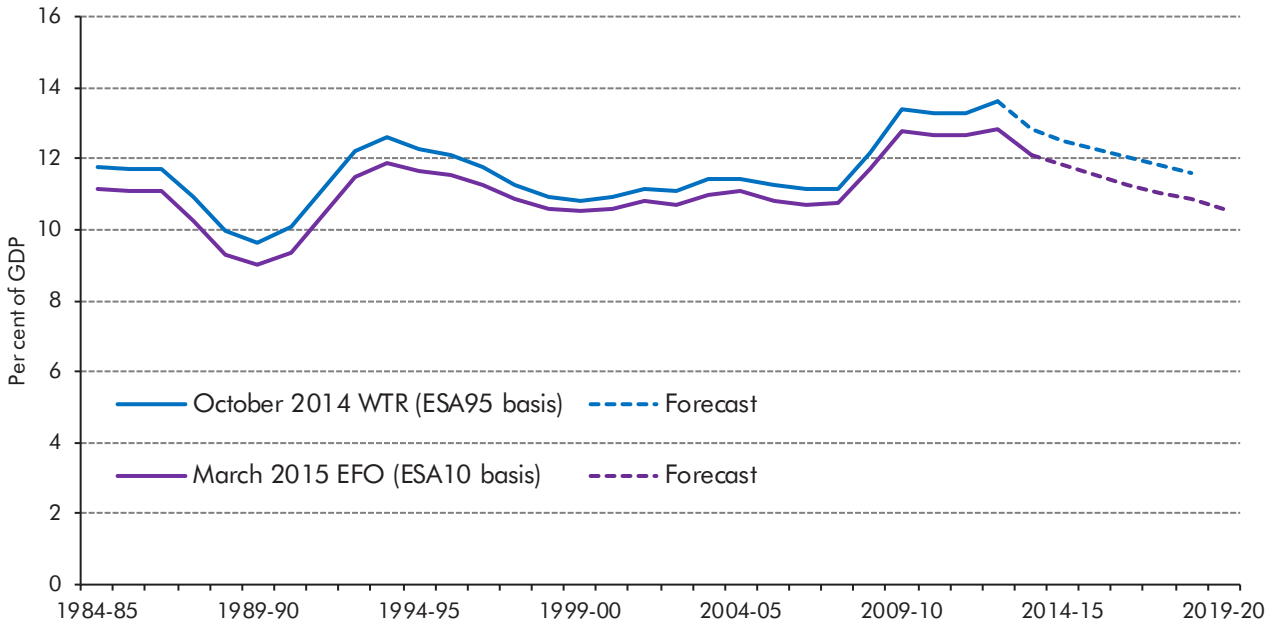
Developments since our last report

2.5 There has been little change to the public finances data on which last year's conclusions were based and the provisional 2014-15 cash outturns for welfare spending were generally close to the March 2014 forecasts used in the report. By contrast, there have been significant revisions to GDP data that affect measures of welfare spending expressed as a share of national income.

2.6 The Office for National Statistics (ONS) has aligned the UK's National Accounts to the latest international guidance, as set out in the European System of Accounts 2010 (ESA10), as well as carrying out the usual annual process of reflecting the latest annual survey data and methodological changes. The main effect of these changes has been to revise up nominal GDP significantly (e.g. by 6.2 per cent in 2013). The revisions also reduced the depth of the late 2000s recession and increased the pace of the subsequent recovery. More detail can be found in Chapter 2 of our December 2014 *Economic and fiscal outlook (EFO)*.

2.7 As shown in Chart 2.2, these revisions – where nominal GDP has been revised up, and so welfare spending as a per cent of GDP has been revised down – leave the profile of welfare spending as a share of national income little changed. As such, they do not materially affect our conclusions about historical trends in welfare spending set out below.

Chart 2.2: Welfare spending as a per cent of GDP



Source: DWP, ONS, OBR

Historical trends in welfare spending

2.8 Our first *WTR* looked at the factors that have explained the rises and falls in welfare spending as a share of GDP over the past 30 years. Updating the analysis to reflect the latest GDP data, our main conclusions hold:

- during the period of strong GDP growth **from 1984-85 to 1989-90**, spending fell by 2.2 per cent of GDP. The largest contributions to that fall were lower spending on unemployment benefits as the economy boomed and lower spending on state pensions as earnings growth outpaced uprating largely in line with inflation. The rising proportion of adults receiving incapacity benefits slightly offset those falls;

- **between 1989-90 and 1993-94**, a period that included the early 1990s recession, spending increased by 2.9 per cent of GDP. The largest contributions were caseload-driven increases in spending on unemployment and incapacity benefits, and average award-driven increases in spending on housing benefit, as the recession bit. Spending on state pensions was pushed up as a share of GDP thanks to the weakness of earnings growth relative to the amount by which they were uprated;

- **between 1993-94 and 2007-08**, a period of sustained economic growth, spending fell by 1.1 per cent of GDP. The largest contribution was the steady reduction in the

unemployment rate. Spending on incapacity benefits also fell as uprating and other factors pulled average awards lower relative to earnings. This period also saw a big shift in spending from different parts of the benefits system to tax credits; and

- **between 2007-08 and 2013-14**, a period that spans the late 2000s recession and slow recovery that followed, spending increased by 1.3 per cent of GDP. The rise in the caseload for jobseeker's allowance made a surprisingly small contribution to the increase in spending. The largest contribution was from the uprating of state pensions, as inflation outstripped growth in earnings and GDP. Spending on tax credits and housing benefit also increased significantly, the former reflecting generous discretionary uprating (especially of the child element) and the latter reflecting growth in the number of renters and rent inflation outstripping earnings growth.

Preliminary estimate of spending outturns in 2014-15

2.9 Table 2.1 sets out our latest estimate of welfare spending in 2014-15 from our March 2015 *EFO* and compares it with the forecast for that year used in last year's *WTR*, which was drawn from our March 2014 *EFO*. Total welfare spending was close to forecast, with the latest estimate £0.6 billion (0.3 per cent) higher than forecast in March 2014. That relatively small overall forecast error reflected a number of broadly offsetting differences in spending on particular benefits. The larger of these changes are explained more fully in the rest of the chapter, but in summary the table shows that spending on:

- **incapacity benefits** was £0.7 billion (5.5 per cent) higher than expected, reflecting both higher caseloads (particularly in the 'support group') and higher average awards (due in large part to the composition of the caseload, with support group cases receiving higher average awards than the 'work-related activity group');

- **disability benefits** (disability living allowance (DLA) and personal independence payment (PIP), but not attendance allowance) were £0.6 billion (3.8 per cent) higher than expected. The difference was more than explained by higher caseloads, with both the DLA children caseload and the combined DLA/PIP working-age caseload around 8 per cent higher than expected;

- **jobseeker's allowance** was £0.5 billion (15.0 per cent) lower than expected, reflecting the much sharper fall in the claimant count measure of unemployment than expected during the year. In March 2014 we forecast that the claimant count would fall to 1.16 million by the first quarter of 2015. In fact it has fallen to 0.85 million;

- **housing benefit** was £0.2 billion (1.0 per cent) lower than expected. Spending passported to jobseeker's allowance claimants was much lower (down £0.5 billion or 15.0 per cent) as unemployment fell faster than expected. Spending on all other claimants was slightly higher (up £0.2 billion or 1.2 per cent) due to higher-than-expected average awards;

- **statutory maternity pay** was £0.2 billion (6.8 per cent) lower than expected. In part, that reflected lower spending in 2013-14 than was known at the time of the March 2014 forecast. But it also reflected a lower-than-expected birth rate; and

- **state pensions** – the largest element of welfare spending covered in our forecasts – were in line with our forecast at £86.5 billion. This reflected small offsetting errors: a slightly lower caseload (due to a greater number of deaths than assumed) and a slightly higher average award (reflecting the composition of the caseload).

Table 2.1: Welfare spending in 2014-15: changes since the 2014 *WTR*

	£ billion					
	2014 *WTR* estimate	2015 *WTR* estimate	Difference	*of which due to:* Caseloads	Average awards	Not allocated
Welfare cap						
DWP social security	73.3	74.6	1.3	1.2	0.1	0.0
of which:						
Housing benefit (not on JSA)	21.3	21.5	0.2	0.0	0.2	0.0
DLA and PIP	14.8	15.4	0.6	0.9	-0.3	0.0
Incapacity benefits	13.4	14.1	0.7	0.5	0.3	0.0
Pension credit	6.6	6.6	0.0	0.0	0.0	0.0
Attendance allowance	5.5	5.4	-0.1	0.0	-0.1	0.0
Statutory maternity pay	2.4	2.2	-0.2	-0.1	-0.1	0.0
Personal tax credits	29.5	29.7	0.2			0.2
Child benefit	11.7	11.6	-0.1			-0.1
NI social security in welfare cap	3.2	3.4	0.1			0.1
Other benefits	9.4	9.4	0.1			0.1
Total welfare cap	**117.8**	**119.4**	**1.6**	**1.2**	**0.1**	**0.3**
Welfare spending outside the welfare cap						
DWP social security	93.0	92.0	-1.0	-1.5	0.5	0.0
of which:						
State pension	86.5	86.5	0.0	-0.2	0.3	0.0
Jobseeker's allowance	3.6	3.1	-0.5	-0.8	0.3	0.0
Housing benefit (on JSA)	2.8	2.4	-0.5	-0.5	0.0	0.0
NI social security outside welfare cap	2.3	2.3	0.0	0.0	0.0	0.0
Other benefits	0.9	0.9	0.1			0.1
Total welfare outside the welfare cap	**96.1**	**95.1**	**-1.0**	**-1.5**	**0.5**	**0.0**
Total welfare	**213.9**	**214.5**	**0.6**	**-0.3**	**0.5**	**0.3**

Medium-term welfare spending forecasts

Review of our 2014 *Welfare trends report* analysis

2.10 In last year's report, our in-depth analysis of recent trends in welfare spending led us to identify a number of risks and uncertainties that we expected to be relevant to our medium-term forecasts. In terms of individual benefits, we noted:

- uncertainty over prospects for spending on housing benefit, associated with developments in the housing market, including trends in rents and housing tenure;

- upside risks to spending on incapacity benefits and disability benefits, associated with ongoing structural reforms to delivery of those benefits;

- similar uncertainties over the delivery of universal credit, which is subject to many of the same challenges as the reforms to incapacity and disability benefits; and

- downside risks to spending on jobseeker's allowance, due to the unexpectedly rapid fall in unemployment.

2.11 We also noted that one of the more important uncertainties affecting most elements of welfare spending related to prospects for inflation. Higher or lower inflation than expected feeds through to most benefits and tax credits through default uprating policy.

2.12 Our *WTR* analysis helped to shape the subsequent work we undertook for the December 2014 and March 2015 *EFOs*. In this section, we look back at each of the major risks highlighted in last year's report and explain the forecast revisions that were made in the subsequent forecasts. The section ends by bringing this together with other factors to describe our latest medium-term forecast, which represents the baseline against which any policy measures introduced by the new Government will be compared.

Housing benefit

2.13 In last year's report, we noted that our forecasts for housing benefit had, on average, underestimated spending. The extent of this underestimation was significant in forecasts made up to 2012: relative to our March 2015 estimate of spending in 2014-15, our June 2010, March 2011 and March 2012 forecasts underestimated spending by between £1.7 billion (6.9 per cent) and £2.4 billion (10.1 per cent). These errors reflected both higher-than-expected caseloads – particularly among the 'housing benefit only' group and among those also receiving incapacity benefits – and higher-than-expected average awards.

2.14 The most substantial errors were those associated with the 'housing benefit only' caseload, for whom eligibility is not associated with the receipt of other benefits. This caseload has risen by 54 per cent between 2010-11 and 2014-15. The errors here had been associated with three inter-related developments in the economy:

- the share of the population renting has continued to rise faster than forecast. This may be associated with house prices remaining high relative to incomes and reduced post-crisis supply of high loan-to-value and loan-to-income mortgages;

- employment growth has been much stronger than expected, but earnings growth has been much weaker. As a result, the number of people in-work but earning sums that would leave them eligible for housing benefit has been higher than expected. (It is also possible that take-up could have risen); and

- rent inflation, as measured in housing benefit administrative data, has been higher than expected – partly driven by compositional changes. This interacts with subdued earnings to increase the eligible population further.

2.15 We noted last year that our forecasts had been revised to reflect the latest evidence on trends in housing tenure, employment and rents, but that significant uncertainties remained. In the event, we have revised our housing benefit forecast down since last year. The scale of the revision rises over time, reaching £1.8 billion by 2018-19. As shown in Table 2.2, there have been three major sources of the revision to our forecast since last year:

- lower unemployment reduced the number of cases passported from jobseeker's allowance onto housing benefit – this is the largest source of the downward revision;

- we reviewed our projection of the total number of households in the UK and decided that the implied path for the average household size was too low, and therefore the total number of households was too high. All else equal, fewer households means fewer housing benefit recipients; and

- we have revised down our CPI inflation forecast, which feeds through to a lower forecast for rents[1] and has therefore reduced average awards.

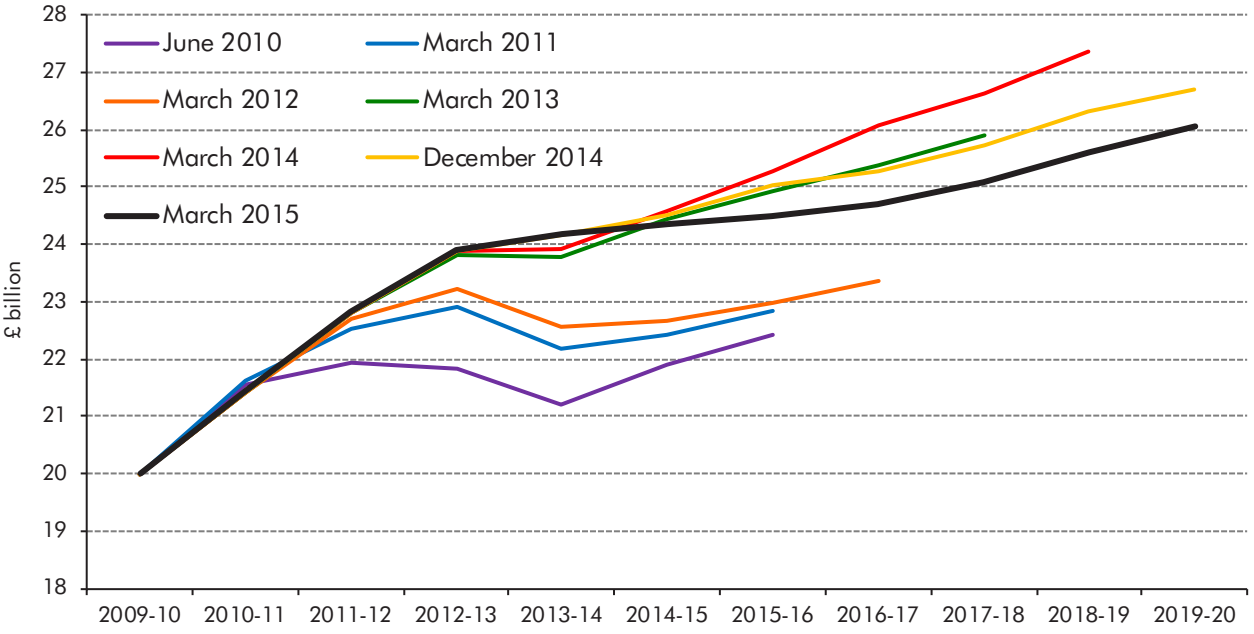
Table 2.2: Revisions to our medium-term housing benefit forecast

	£ billion				
	2014-15	2015-16	2016-17	2017-18	2018-19
March 2014 forecast	24.1	24.8	25.6	26.2	26.9
March 2015 forecast	23.9	24.0	24.2	24.6	25.1
Change	**-0.2**	**-0.8**	**-1.4**	**-1.6**	**-1.8**
of which:					
Caseloads	**-0.4**	**-0.9**	**-1.1**	**-1.1**	**-1.3**
Jobseekers	-0.5	-0.9	-1.0	-0.8	-0.7
Other claimants	0.0	0.0	-0.1	-0.3	-0.5
Average awards	**0.2**	**0.1**	**-0.3**	**-0.5**	**-0.6**
Jobseekers	0.0	0.0	0.0	-0.1	-0.1
Other claimants	0.2	0.1	-0.3	-0.4	-0.5

2.16 As Chart 2.3 shows, the downward revisions to housing benefit spending in our two most recent forecasts have reversed only part of the earlier upward revisions we highlighted last year. For example, spending in 2015-16, the final year of the June 2010 forecast period, is expected to be £2.1 billion higher than that forecast; in 2016-17, it is expected to be £1.3 billion higher than in the final year of the March 2012 forecast; but in 2017-18 it is expected to be £0.8 billion lower than in the final year of the March 2013 forecast.

[1] Most housing benefit rents are now mechanically linked to CPI, through either social sector rent regulations or the cap on increases in Local Housing Allowance rates.

Chart 2.3: Successive OBR housing benefit forecasts since June 2010



Source: DWP expenditure tables

Incapacity benefits

2.17 In last year's report, we identified the uncertainties associated with the shift from incapacity benefit to employment and support allowance (ESA) as a likely upside risk to our medium-term forecasts. We showed that our forecasts for incapacity benefits had, on average, underestimated spending. The extent of underestimation was significant in forecasts made up to 2013: relative to our March 2015 estimate of spending in 2014-15, our March 2011, 2012 and 2013 forecasts underestimated spending by between £2.7 billion (19.1 per cent) and £4.1 billion (29.3 per cent). These errors reflected a number of factors, including:

- a higher-than-expected caseload (partly reflecting higher than expected inflows from other benefits such as jobseeker's allowance);
- slightly slower-than-expected migration from incapacity benefit to ESA and the associated backlog of work capability assessments (WCAs);
- differences in the assumed proportions of claims being assessed as fit for work, or assigned to the work-related activity and support groups of ESA in the WCAs (partly reflecting over-optimistic assumptions and partly due to operational changes in response to a number of internal and external reviews of the process);
- differences in appeal success rates; and
- lower than expected savings from the Spending Review 2010 policy measure time-limiting support from ESA to one year for those in the work-related activity group.

2.18 Consistent with the direction of the risk flagged in our last *WTR*, we have made further significant upward revisions to our forecasts for spending on incapacity benefits since March 2014. As Table 2.3 shows, these revisions reflect both higher caseloads and a more costly composition of the caseload, with lower than expected inflation providing only a partial offset. In slightly greater detail, we made the following judgements:

- in December 2014, we considered the implications for the WCA backlog of DWP's new contract with the Centre for Health and Disability Assessment – succeeding the previous contract with Atos Healthcare. The terms of the contract implied that the backlog could be cleared within 12 to 18 months, but we assumed it would take two years, raising expected spending in 2015-16 and 2016-17 in particular;

- the caseload leaving the support group – where average awards are highest – was revised down in light of the latest evidence; but

- partly offsetting these sources of higher spending, our downward revision to CPI inflation – largely due to lower oil prices – fed through to lower uprating and thereby reduced average awards.

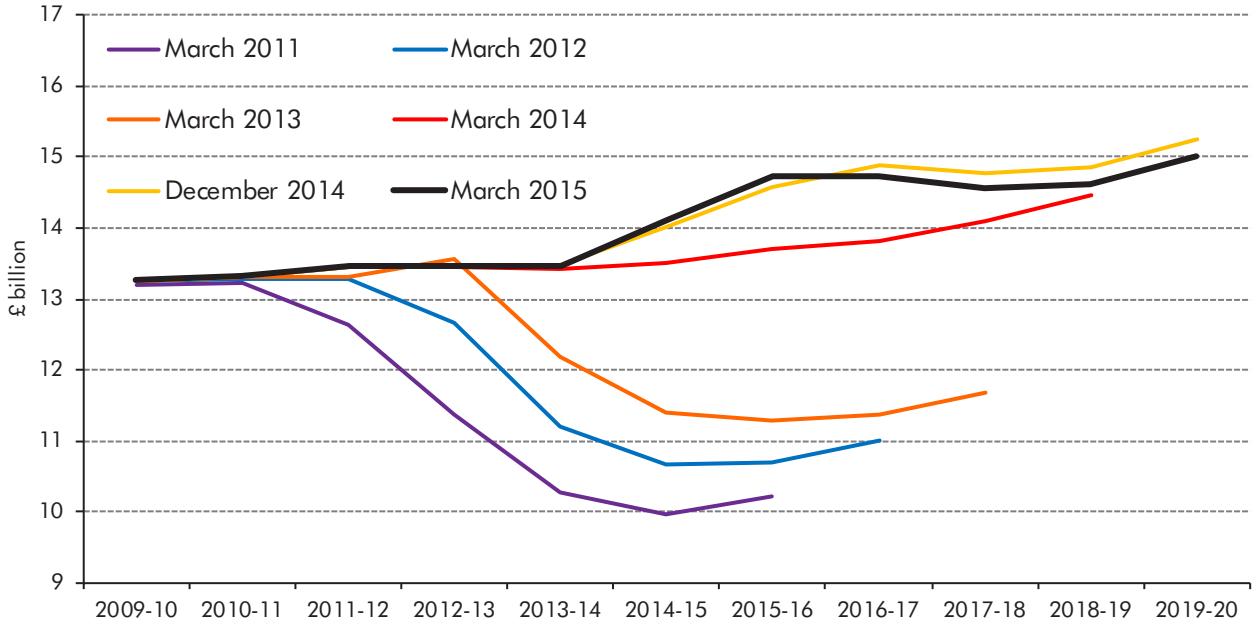
Table 2.3: Revisions to our medium-term incapacity benefits forecast

	£ billion				
	2014-15	2015-16	2016-17	2017-18	2018-19
March 2014 forecast	13.4	13.6	13.7	14.0	14.3
March 2015 forecast	14.1	14.7	14.7	14.5	14.6
Change	**0.7**	**1.1**	**1.0**	**0.6**	**0.3**
of which:					
Caseloads	**0.5**	**0.8**	**0.9**	**1.0**	**0.9**
Support group[1]	0.4	1.0	1.4	1.8	2.0
Other incapacity groups	0.0	-0.2	-0.5	-0.8	-1.1
Average awards	**0.3**	**0.4**	**0.1**	**-0.4**	**-0.7**
Support group[1]	0.5	0.5	0.3	0.1	0.0
Other incapacity groups	-0.2	-0.1	-0.2	-0.5	-0.7

[1] Includes both the income based and contributory based support groups.

2.19 As Chart 2.4 shows, while our latest forecast for spending on incapacity benefits is significantly higher than previous forecasts, we continue to assume that spending will be relatively flat in cash terms from 2015-16 onwards. The forecast is underpinned by an assumption that statutory rates of incapacity benefits rise with CPI inflation, which all else equal would put upward pressure on cash spending via its effect on average awards. But that is offset by the assumption that outcomes of reassessments save more money over time and appeal rates settle in the medium term.

Chart 2.4: Successive OBR incapacity benefits forecasts since March 2011



Source: DWP expenditure tables

2.20 Also implicit in our forecast is the assumption that flows off ESA generally reduce welfare spending overall. But early evidence suggests there may be some recycling of those found fit for work into jobseeker's allowance and then back onto ESA. The design of ESA means that more people are moved around the benefit system while the backlog of applications encourages claimants previously not found eligible for ESA simply to reapply. We do not make explicit adjustments to our forecast for these flows, so to the extent that they are not captured implicitly within other judgements this could represent a risk to the welfare spending forecast.

2.21 We also assume a stable rate of inflows going forward. But there is a risk that inflows associated with the rising state pension age – which increases the number of older working-age people for whom risks of illness are higher – are more or less than we have assumed. Even absent changes to the state pension age, as the population ages cohort effects could result in a greater bunching of the population at the pre-retirement stage when illness is more likely to prevent work.

2.22 As we noted last year, complex judgements are required to forecast the effects of reforms to incapacity benefits – covering both economic factors and policy delivery. We aim to deliver a central forecast that reflects the tendency for major reforms to be rolled out more slowly and with more difficulties than governments initially believe will be the case. But in each forecast we need to reach a judgement about the extent to which any delivery problems are temporary or will persist. As demonstrated by our recent forecast errors on incapacity benefits, we have made insufficient allowance for such slippage. We will continue to review these assumptions – and pay particular attention to the performance of the new contractor – in future forecasts. It is clear that this will remain an area of significant uncertainty in our

welfare spending forecast for some time. And the lessons from these errors will be applied to any policy reforms that may be forthcoming in this Parliament.

Disability benefits

2.23 Reforms to disability benefits – in particular the migration of claimants from disability living allowance (DLA) to the new personal independence payment (PIP) – pose similar forecasting challenges to those just described for incapacity benefits. The savings that were assumed to be associated with the migration to PIP were expected to take effect from 2013-14 onwards. In last year's *WTR*, we noted that our latest forecasts suggested higher than expected success rates for new claims to PIP across the forecast, which had in effect reduced the savings originally expected for this reform and therefore posed an upside risk to spending.

2.24 Consistent with the direction of the risk flagged in our last *WTR*, we have made significant upward revisions to our forecasts for spending on disability benefits since last year. The main source of change was an upward revision to the proportion of new claims to PIP that are assumed to be successful. Alongside other changes, this meant that on average over the period from 2014-15 to 2018-19, the DLA/PIP caseload forecast was revised up by around 280,000 a year, with the DLA and PIP caseloads accounting for roughly equal amounts of the change. Partly offsetting the effect of this change, the downward revision to our inflation forecast fed through to the spending forecast via uprating. As Table 2.4 shows, upward revisions to the overall disability benefits caseload more than explain the total change in spending over the forecast period.

Table 2.4: Revisions to our medium-term disability benefits forecast

	£ billion				
	2014-15	2015-16	2016-17	2017-18	2018-19
March 2014 forecast[1]	14.8	14.7	14.1	13.5	13.6
March 2015 forecast[1]	15.4	15.3	14.9	14.4	14.5
Change	**0.6**	**0.7**	**0.8**	**0.9**	**0.9**
of which:					
Caseloads	0.9	1.1	1.6	1.6	1.2
Average awards	-0.3	-0.4	-0.8	-0.7	-0.3

[1]Disability benefits includes disability living allowance and personal independence payment, but not attendance allowance.

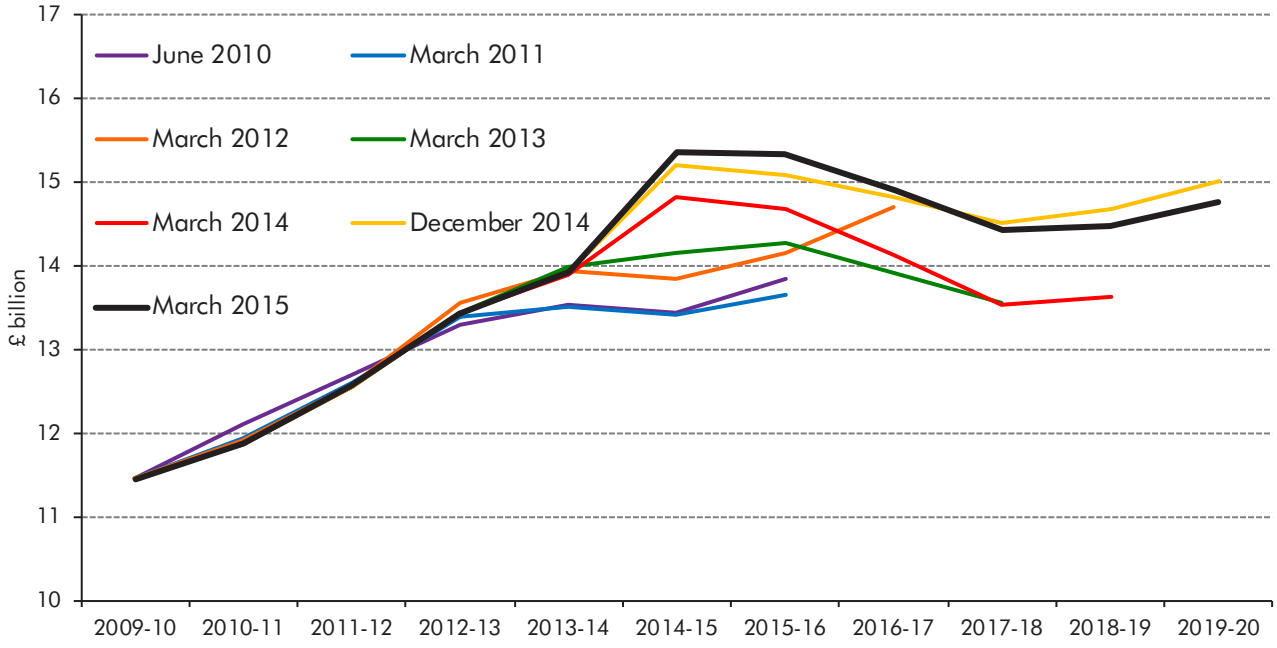
2.25 Chart 2.5 shows that our latest forecast is significantly higher than our earlier forecasts, but that it still assumes spending on disability benefits will fall in cash terms from 2015-16. The key assumptions underpinning our March 2015 forecast – and the risks to which they are subject – include:

- that 24 per cent of the working-age DLA/PIP caseload will be on PIP in 2015-16, rising to almost 100 per cent by 2019-20 – as migration of working-age claimants is assumed to be completed;
- the introduction of PIP and the process of reassessing DLA claims during the migration to PIP will deliver a 25 per cent reduction in the reassessed caseload, reducing

spending by £2.4 billion a year by 2019-20. This saving is sensitive to the speed with which the caseload is migrated to PIP and the outcomes of reassessments and any subsequent appeals; and

- the proportion of new PIP claims in which the claimant is successful falls from around 56 per cent in 2013-14 to 43 per cent from 2017-18, as the system beds down and the assessment process is refined so that it better delivers the policy intent. Success rates appear to have fallen in line with our updated assumptions through 2014-15, but there is little evidence available to inform the further reduction in success rates assumed thereafter. If success rates did not continue to fall as expected, our spending forecasts would need to be increased, other things being equal. Assumptions on the rate of appeals – and the proportion that are successful – pose further risks to the PIP forecast.

Chart 2.5: Successive OBR disability benefits forecasts since June 2010



Source: DWP expenditure tables

2.26 As with reforms to incapacity benefits, the key judgements in our disability benefits forecast are gauging the extent to which delivery challenges are likely to be temporary or persistent. As the rollout to PIP is at a much earlier stage than that for ESA, this judgement is subject to even greater uncertainty. We will continue reviewing all these assumptions.

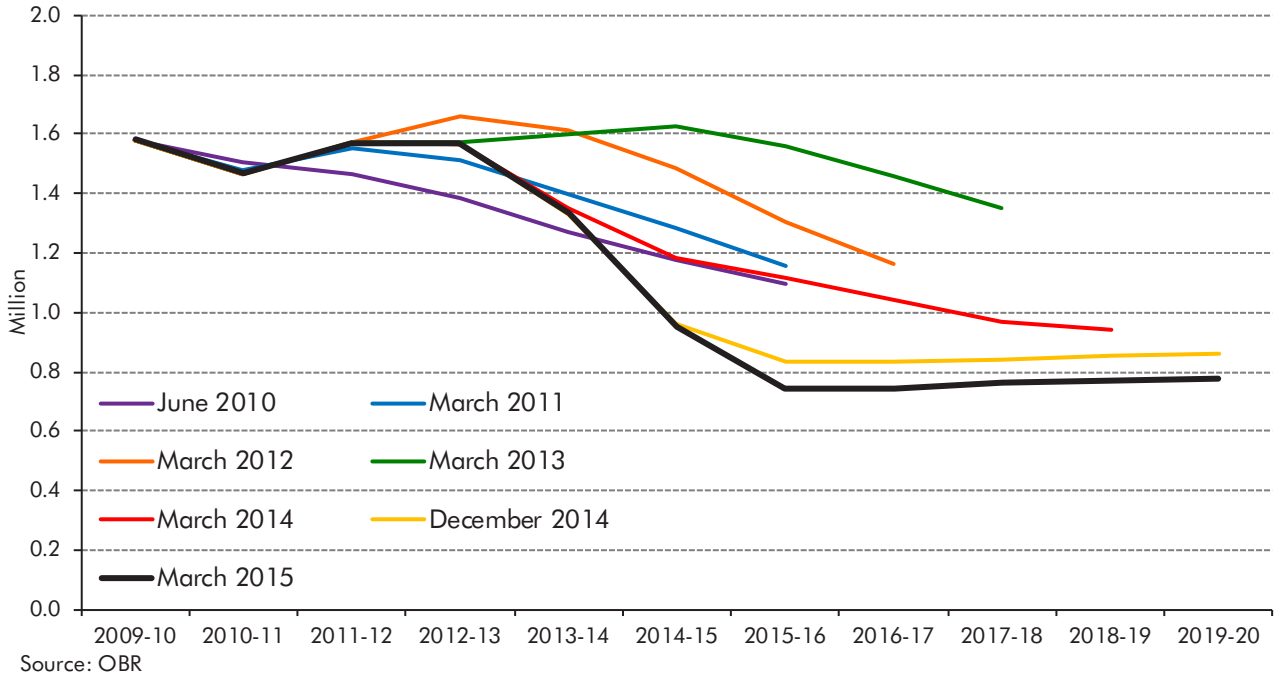
Jobseeker's allowance

2.27 In last year's *WTR*, we noted that the claimant count was falling much faster than expected and that we therefore expected to revise down our forecast of spending on jobseeker's allowance. We did so in both our December 2014 and March 2015 forecasts. As Chart 2.6 shows, our latest claimant count forecast is significantly lower than a year ago.[2] For

[2] Our latest forecast includes 25,000 unemployed claimants on universal credit in the first quarter of 2015.

example, the level in 2015-16 was revised down by around 25 per cent in our December *EFO* and then by a further 10 per cent in the March *EFO* as outturn data continued to fall faster than expected. Indeed, our latest forecast for the level of the claimant count in 2015-16 is more than 30 per cent lower than was expected in the June 2010 OBR forecast, despite cumulative GDP growth over the period having disappointed by around 5 per cent.

Chart 2.6: Successive OBR claimant count forecasts since June 2010



Source: OBR

2.28 As Table 2.5 shows, our jobseeker's allowance forecast has been revised down by between £0.6 billion and £1.0 billion a year since March 2014. In relative terms, that represents one of the largest revisions we have made in any part of our fiscal forecasts – the biggest single year revision (in 2015-16) saw expected spending lowered by almost 30 per cent. The changes reflect a combination of factors:

- the Labour Force Survey (LFS) measure of unemployment – the internationally comparable measure drawn from a household survey, which refers to people who report that they are out of work, but available for and seeking employment – fell faster than expected. In our March 2014 forecast, we expected LFS unemployment to reach 6.6 per cent of the active labour force by the first quarter of 2015. In fact, it has fallen to 5.5 per cent. The largest effect of that change on our forecast is in 2015-16. It diminishes thereafter as we assume the LFS unemployment rate will revert to our estimate of its sustainable rate by the end of the forecast;

- the claimant count has fallen proportionately faster than LFS unemployment. In our March 2014 forecast, we expected the ratio of the claimant count to LFS unemployment to fall gently in the year to the first quarter of 2015 and to reach 53.6 per cent. In fact, it fell sharply to 45.0 per cent. We assume that this lower ratio will persist over the forecast, reducing spending in every year; and

- slightly higher outturns for average awards have partly offset the effect of lower caseloads in the short term, but that effect diminishes over time as the downward revision to our inflation forecast feeds through via lower uprating.

Table 2.5: Revisions to our medium-term jobseeker's allowance forecast

	£ billion				
	2014-15	2015-16	2016-17	2017-18	2018-19
March 2014 forecast	3.6	3.4	3.3	3.2	3.1
March 2015 forecast	3.1	2.4	2.4	2.5	2.5
Change	**-0.6**	**-1.0**	**-0.9**	**-0.7**	**-0.6**
of which:					
Caseloads	**-0.8**	**-1.2**	**-1.0**	**-0.7**	**-0.6**
LFS unemployment	-0.4	-0.6	-0.4	-0.1	-0.2
Claimant count relative to LFS	-0.4	-0.6	-0.6	-0.6	-0.4
Average awards	**0.2**	**0.2**	**0.1**	**0.0**	**0.0**

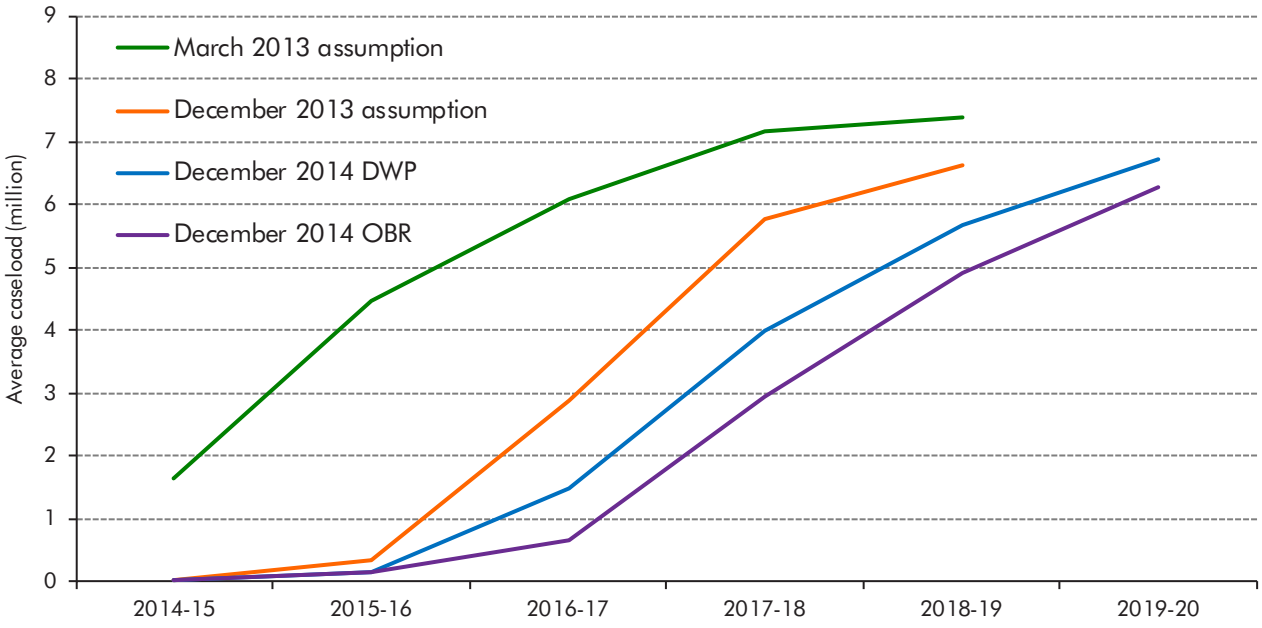
Universal credit

2.29 Universal credit is not yet a major factor in our medium-term forecasts, in part because of the way it has been incorporated in the figures as a marginal cost relative to the legacy systems of social security benefits and tax credits. But, as we highlighted in last year's *WTR*, the migration from six of these existing benefits to the single universal credit that is planned to take place over the coming years will pose many of the same delivery problems as the reforms to incapacity and disability benefits, often to an even greater degree. The associated risk to the spending forecast may be less significant, since – unlike those other reforms – the rollout of universal credit is not associated with large planned savings.

2.30 In our December 2014 *EFO*, we revised our view on the central profile for the pace of the rollout of universal credit. This judgement was reached after considering the available evidence on the Government's plans – including the scrutiny that has taken place across government departments – in the light of the recent history of optimism bias in universal credit plans and other projects of this sort.

2.31 For the purposes of our forecast, we decided to assume that the rollout to non-jobseeker's allowance families would be pushed back a further six months relative to the latest delay the Government had announced, as shown in Chart 2.6. (The same rollout profile was used in our March 2015 forecast.) This judgement reflected a range of evidence, but the risks inherent in making progress on the digital part of the delivery programme were considered to be particularly important. Indeed, the planned move from the 'live service' to the 'digital solution' is likely to remain a key risk to the universal credit forecast.

Chart 2.7: Changes to the universal credit rollout assumption



Source: DWP, OBR

2.32 As we have noted before, our universal credit forecast is based on a continuation of the legacy benefits regime, with universal credit added into the forecast as a marginal cost relative to the legacy system. This top-down approach is the best we can do until there are sufficient data to allow us to start the difficult process of constructing a bottom-up forecast of the rise of universal credit and the fall in the legacy benefits. If the rollout progresses as currently planned, the switch to bottom-up forecasting may be possible relatively soon. Given universal credit is a new benefit that is expected to be claimed by a large number of people with varying circumstances, it is likely that this switch will be challenging and may therefore be the source of significant variability in our welfare spending forecasts.

March 2015 *Economic and fiscal outlook* forecast

2.33 Our latest five-year forecast shows welfare spending rising by 9.6 per cent in cash terms between 2014-15 and 2019-20. That is smaller than the 12.5 per cent increase in last year's *WTR* from 2013-14 to 2018-19, in large part reflecting the effect of lower inflation on most elements of welfare spending (Table 2.6).

Table 2.6: Detailed welfare spending forecast in cash terms

	£ billion						
			Welfare cap period				
	Outturn	Estimate	Forecast				
	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
Welfare cap							
DWP social security	71.7	74.6	75.7	75.3	75.2	76.1	77.6
of which:							
Housing benefit (not on JSA)[1]	20.5	21.5	22.2	22.5	22.8	23.2	23.6
Disability living allowance and personal independence payments	13.9	15.4	15.3	14.9	14.4	14.5	14.8
Incapacity benefits	13.5	14.1	14.7	14.7	14.5	14.6	15.0
Pension credit	7.0	6.6	6.2	5.8	5.6	5.4	5.3
Attendance allowance	5.4	5.4	5.5	5.6	5.7	5.8	6.0
Income support (non-incapacity)	2.6	2.5	2.6	2.6	2.6	2.7	2.8
Statutory maternity pay	2.2	2.2	2.3	2.3	2.4	2.4	2.5
Winter fuel payments	2.1	2.1	2.1	2.1	2.0	2.0	2.0
Carer's allowance	2.1	2.3	2.5	2.5	2.6	2.8	2.9
Universal credit[2]	0.0	0.0	0.0	-0.1	0.1	0.3	0.3
Other DWP in welfare cap	2.3	2.4	2.4	2.4	2.4	2.4	2.4
Personal tax credits[3]	29.7	29.7	29.5	29.8	30.5	31.6	32.3
Tax free childcare	-	-	0.3	0.7	0.8	0.9	0.9
Child benefit	11.4	11.6	11.7	11.6	11.7	11.9	12.0
NI social security in welfare cap	3.2	3.4	3.4	3.4	3.5	3.5	3.6
Paternity pay	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Budget measures	0.0	0.0	0.0	0.0	0.0	-0.1	-0.1
Total welfare cap[3,4]	**116.1**	**119.4**	**120.6**	**121.0**	**121.8**	**124.0**	**126.5**
Welfare spending outside the welfare cap							
DWP social security	90.8	92.0	93.9	96.1	99.3	102.6	105.8
of which:							
State pension	83.1	86.5	89.8	92.0	95.0	98.2	101.3
Jobseeker's allowance	4.3	3.1	2.4	2.4	2.5	2.5	2.6
Housing benefit (on JSA)	3.2	2.4	1.8	1.7	1.8	1.9	1.9
Discretionary housing payments[5]	0.2	-	-	-	-	-	-
Universal credit[2]	0.0	0.1	-	-	-	-	-
NI social security outside welfare cap	2.2	2.3	2.4	2.4	2.5	2.6	2.7
War pensions[6]	0.9	0.8	-	-	-	-	-
Budget measures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Total welfare outside the welfare cap[4]	**93.3**	**95.1**	**96.3**	**98.5**	**101.8**	**105.2**	**108.6**
Total welfare[3,4]	**209.4**	**214.5**	**216.9**	**219.5**	**223.6**	**229.3**	**235.1**
Memo: welfare cap as proportion of total welfare	*55.5*	*55.6*	*55.6*	*55.1*	*54.5*	*54.1*	*53.8*

[1] Housing benefit (not on jobseeker's allowance) is made up of a number of claimant groups. The main claimant groups are pensioners, those on incapacity benefits, lone parents, and housing benefit only claimants.

[2] Universal credit actual spending for 2013-14 and 2014-15. Spending from 2015-16 onwards represents universal credit additional costs not already included against other benefits (i.e. UC payments that do not exist under current benefit structure).

[3] 2013-14 outturn figures now include the negative tax credit element of tax credit spending, in line with ESA10 changes. This element was excluded for 2013-14 outturn at Autumn Statement 2014 as the change had not yet been made by the ONS.

[4] Total welfare outturn inside and outside of the welfare cap in 2013-14 is sourced from OSCAR, consistent with PESA 2014. For 2013-14 only, the components reflect departments' own outturns, which may not be on a consistent basis to OSCAR. For this year the components may not sum to the total for this reason.

[5] Transferred to DEL in 2014-15.

[6] Transferred to DEL from 2015-16.

2.34 The expected increase in cash spending is significantly slower than our forecast for growth in nominal GDP over the same period (22.6 per cent), so welfare spending falls from 11.9 per cent of GDP in 2014-15 to 10.6 per cent of GDP in 2019-20 (Table 2.7). The main drivers of this fall are explained more fully below, but can be summarised as:

- economic factors reduce spending as a share of GDP. First, much lower inflation in 2015 feeds through to the uprating of most benefits in 2016-17. The expected pick-up in productivity then leads to earnings and GDP-per-adult rising faster than inflation, while small further falls in unemployment reduce cyclical caseloads;

- policy measures reduce spending further as a share of GDP, notably by raising the female state pension age to 65. This offsets the effect of demographic trends on spending on benefits for the elderly. Savings are also assumed to accrue from operational measures (particularly in relation to tax credits); and

- the assumed savings associated with ongoing reforms to incapacity and disability benefits, which are still expected to build over time despite the upward revisions we have made to our forecasts of spending in these areas.

Table 2.7: Medium-term forecast of welfare spending

		Welfare cap period				
	Estimate	Forecast				
	2014-15	2015-16	2016-17	2017-18	2018-19	2019-20
£ billion						
Total welfare spending	214.5	216.9	219.5	223.6	229.3	235.1
of which:						
Inside welfare cap	119.4	120.6	121.0	121.8	124.0	126.5
Outside welfare cap	95.1	96.3	98.5	101.8	105.2	108.6
Per cent of GDP						
Total welfare spending	11.9	11.6	11.3	11.1	10.9	10.6
of which:						
Inside welfare cap	6.6	6.4	6.2	6.0	5.9	5.7
Outside welfare cap	5.3	5.1	5.1	5.0	5.0	4.9

2.35 Table 2.8 decomposes the 1.3 per cent of GDP fall in welfare spending expected between 2014-15 and 2019-20 into contributions from the different benefits inside and outside the welfare cap. This decomposition is based on our central forecast. The risks and uncertainties to which the forecast is subject are discussed later in the chapter.

2.36 For spending that will be subject to the welfare cap, the expected fall of 0.9 per cent of GDP over the next five years is driven by:

- a 0.18 per cent of GDP fall in the cost of **tax credits** – the largest category of spending subject to the cap. This reflects average awards growing more slowly than GDP-per-adult as a result of previously announced measures (uprating capped at 1 per cent in

2015-16) and operational changes targeting debt and error and fraud, while caseloads fall as a share of the adult population;

- smaller falls in **housing benefit** (0.13 per cent of GDP) and **incapacity benefits** (0.10 per cent of GDP) – the next largest spending lines. Spending on housing benefit falls as average awards grow more slowly than GDP-per-adult. The expected fall in spending on incapacity benefits is partly driven by our assumption that a clearance of the backlog of work capability assessments (under the new contractor) is expected to reduce the overall caseload relative to the adult population;

- a substantial fall in spending on **disability benefits** (worth 0.18 per cent of GDP) that is driven by the assumed reduction in caseloads as people's eligibility for support is reassessed when cases are migrated from the existing disability living allowance to the new personal independence payment; and

- falls in spending on **pension credit** (0.12 per cent of GDP) in part due to the rise in the state pension age and **child benefit** (0.10 per cent of GDP) due to uprating by less than earnings growth and a rise in the number of families opting out of payment as a result of the 'high income child benefit charge'.

2.37 Spending outside the welfare cap is expected to fall more slowly than spending subject to the cap, and by 0.4 per cent of GDP in total. This reflects:

- a 0.22 per cent of GDP decline in spending on **state pensions** as the pressure from population ageing is more than offset by raising the state pension age, which leads to a decline in caseloads relative to the adult population. The 'triple lock' on uprating means that average awards rise broadly in line with earnings;

- spending on the unemployed – comprising **jobseeker's allowance and housing benefit paid to jobseekers** – falls by 0.09 per cent of GDP, as caseloads fall further in 2015-16 and average awards rise more slowly than earnings over the forecast period; and

- a classification change means that spending on **war pensions** amounting to 0.05 per cent of GDP has moved from the definition of welfare spending used in our forecasts into the Ministry of Defence's resource departmental expenditure limit.

2.38 It is apparent from this decomposition that lower average awards are expected to play a bigger role than caseloads in reducing the share of GDP spent on benefits and tax credits subject to the welfare cap. By contrast, lower caseloads as a share of the adult population are the main driver outside the welfare cap.

Table 2.8: Breakdown of expected changes in welfare spending as a share of GDP

	Per cent of GDP				
	Welfare cap period				
	Forecast				
	2015-16	2016-17	2017-18	2018-19	2019-20
Change from 2014-15	**-0.30**	**-0.56**	**-0.80**	**-0.99**	**-1.25**
of which:					
Welfare spending subject to the welfare cap					
Incapacity benefits[1]	**0.00**	**-0.02**	**-0.06**	**-0.09**	**-0.10**
Caseloads	-0.01	-0.02	-0.03	-0.04	-0.04
Average awards	0.01	-0.01	-0.03	-0.05	-0.06
Pension credit	**-0.04**	**-0.06**	**-0.09**	**-0.11**	**-0.12**
Caseloads	-0.02	-0.04	-0.06	-0.07	-0.08
Average awards	-0.01	-0.02	-0.03	-0.04	-0.05
Disability benefits[2]	**-0.03**	**-0.08**	**-0.13**	**-0.16**	**-0.18**
Caseloads	-0.01	-0.04	-0.09	-0.09	-0.09
Average awards	-0.03	-0.04	-0.05	-0.07	-0.09
Housing benefit (not on JSA)[3]	**-0.01**	**-0.03**	**-0.06**	**-0.09**	**-0.13**
Caseloads	0.01	0.01	0.01	0.00	-0.01
Average awards	-0.02	-0.05	-0.07	-0.09	-0.12
Personal tax credits	**-0.07**	**-0.11**	**-0.13**	**-0.14**	**-0.18**
Child benefit	**-0.02**	**-0.04**	**-0.06**	**-0.08**	**-0.10**
Other benefits	**-0.01**	**-0.02**	**-0.04**	**-0.05**	**-0.07**
Total	**-0.18**	**-0.37**	**-0.57**	**-0.72**	**-0.89**
Welfare spending outside the welfare cap					
State pension	**0.00**	**-0.05**	**-0.08**	**-0.13**	**-0.22**
Caseloads	-0.01	-0.04	-0.07	-0.13	-0.20
Average awards	0.01	-0.01	-0.01	-0.01	-0.01
Unemployment benefits[4]	**-0.08**	**-0.09**	**-0.09**	**-0.09**	**-0.09**
Caseloads	-0.07	-0.07	-0.07	-0.07	-0.07
Average awards	-0.01	-0.01	-0.02	-0.02	-0.03
Other benefits	**-0.05**	**-0.05**	**-0.05**	**-0.05**	**-0.05**
Total	**-0.13**	**-0.19**	**-0.22**	**-0.27**	**-0.36**

[1] Incapacity benefits includes incapacity benefit, employment and support allowance, severe disablement allowance and income support (incapacity part).

[2] Disability living allowance and personal independence payment, but not attendance allowance.

[3] Housing benefit (not on jobseeker's allowance) is made up of a number of claimant groups. The main claimant groups are pensioners, those on incapacity benefits, lone parents, and housing benefit only claimants.

[4] Jobseeker's allownace and housing benefit for jobseekers.

2.39 In the previous section of this chapter, we described how our forecasts have been revised in the areas we identified in last year's *WTR* as the main sources of risk to the forecast. We also highlighted last year that inflation is one of the most important economic drivers of welfare spending, because of its use in uprating decisions. This is particularly relevant to the welfare cap, since it is set in cash terms. The roles played by these and other factors in explaining the revisions to our medium-term forecasts over the past year are set out in Table 2.9. It shows that:

- lower CPI inflation (due largely to lower oil prices) is the biggest source of revision. Lower inflation reduces uprating of most benefits, particularly in 2016-17, which feeds through to later years. We also assume that it is mirrored in lower rents, reducing spending on housing benefit. This has significantly reduced spending from 2016-17 onwards, with the associated downward revisions rising to more than £5 billion by 2018-19;

- lower claimant count unemployment has reduced spending on jobseeker's allowance and associated housing benefit payments (outside the welfare cap) by between £1 billion and £2¼ billion a year between 2014-15 and 2018-19;

- recent evidence of lower fertility rates (affecting child benefit, child tax credits and statutory maternity pay) and slightly higher mortality rates (affecting state pensions in particular) reduced spending by less than £1 billion a year;

- a downward revision to expected growth in the number of households reduced spending on housing benefit by relatively small amounts, rising to £0.5 billion by 2018-19;

- the key modelling changes reflect our updated judgements on the speed with which reforms to incapacity and disability benefits will be implemented. This raises our forecast by around £1 billion a year on average between 2014-15 and 2018-19 for both incapacity and disability benefits; and

- the slower expected rollout of universal credit reduces spending in the medium term. That reflects the fact that fewer cases are moved onto the more generous universal credit[3] and fewer cases are migrated with transitional protection. This outweighs the reduced savings from fraud and error and the minimum income floor, which affect tax credit cases. In terms of tax credits expenditure, this also means that there are a larger number of cases affected by the operational programmes in place to reduce spending in that area.

[3] On average due to entitlement rules and higher expected rates of take-up.

Table 2.9: Sources of changes in welfare spending since the 2014 *WTR*

	£ billion				
	Estimate	Welfare cap period			
	2014-15	2015-16	2016-17	2017-18	2018-19
March 2014 forecast	213.9	218.8	224.5	230.6	236.3
March 2015 forecast	214.5	216.9	219.5	223.6	229.3
Change	**0.6**	**-1.9**	**-5.0**	**-7.0**	**-7.0**
of which:					
CPI inflation	0.0	-0.5	-3.2	-4.6	-5.1
Claimant count unemployment[1]	-1.0	-2.3	-2.1	-1.6	-1.4
Fertility and mortality assumptions	-0.2	-0.4	-0.5	-0.7	-0.8
Number of renting households	-0.1	-0.1	-0.2	-0.3	-0.5
Incapacity benefits modelling changes[2]	0.5	1.0	1.2	0.9	0.7
Disability benefits modelling changes[3]	0.5	0.7	1.1	1.3	1.4
Universal credit rollout delay	0.0	-0.1	-0.4	-0.9	0.1
Other factors	0.8	-0.2	-0.9	-1.2	-1.3

[1] Including the direct effect of lower claimant count on jobseeker's allowance and the associated indirect effect on passported housing benefit spending.

[2] Includes incapacity benefit, employment and support allowance, severe disablement allowance and income support (incapacity part)

[3] Disability benefits includes disability living allowance and personal independence payment, but not attendance allowance.

Key risks to the medium-term forecast

2.40 As we stress in every *EFO*, all fiscal forecasts are subject to considerable uncertainty. The demographic and economic developments that underpin the fiscal forecast are unlikely to turn out precisely as expected. Even if they did, there would still be uncertainty over how fiscal variables evolved for a given economic environment. For example, the composition of household incomes or employment may affect eligibility for certain benefits, even if the totals were as expected. Our March 2015 *EFO* forecast for the benefits and tax credits covered in this report are therefore subject to all the usual risks and uncertainties associated with fiscal forecasting. But it is possible to identify some of the major or more complex judgements that we have had to make and that we consider to be subject to greater uncertainty. These issues are likely to be particularly relevant to the Government's performance against the welfare cap.

2.41 As discussed earlier, the four largest sources of uncertainty – and therefore risks to the forecast – continue to relate to housing benefit, incapacity benefits and disability benefits, and universal credit. In the case of housing benefit, the major uncertainties relate to the underlying economic drivers of both the caseload and the implied average award per claim. For incapacity and disability benefits and for universal credit, the major uncertainties are associated with the impact of policy reforms – the effect on caseloads and average awards as the systems are changed, as existing caseloads are migrated from old to new benefits, and as savings are assumed to flow from the associated reassessment process.

Long-term welfare spending projections

June 2015 *Fiscal sustainability report* projections

2.42 Our 2015 *Fiscal sustainability report (FSR)* contains long-term projections of welfare spending. These projections largely capture the effects of demographic change on spending, with neutral assumptions made in most other areas. An important difference from our medium-term forecasts is that we assume benefits are uprated in line with earnings rather than inflation, which effectively switches off the fiscal drag effect of average awards rising more slowly than GDP-per-adult.

2.43 Since last year, we have changed the migration assumption underpinning our medium-term forecasts and long-term projections from the ONS low migration variant to its principal projections. This change raises population growth and reduces the old-age dependency ratio, since migrants to the UK are more likely to be of working age than the native population.

2.44 Our projections show total welfare spending rising by 2.2 per cent of GDP between 2019-20 – the end of our medium-term forecast – and 2064-65, with almost all the rise accounted for by benefits paid to the elderly. This is largely driven by demographic trends, which are partly offset by further expected increases in the state pension age – based on the principle set out by the Government that people should expect to spend up to a third of their adult life in receipt of the state pension. The triple lock on uprating is assumed to put further upward pressure on state pensions spending as a share of GDP over the long term.

2.45 The rise in spending on pensions is 0.2 per cent of GDP smaller than we projected last year, reflecting our decision to use population projections that assume slightly higher annual net migration to the UK. Due to the age structure of migrants to the UK, higher migration over a 50-year horizon boosts GDP by more than it increases spending on pensions, reducing spending as a share of GDP.

2.46 Among other benefits, the main projected changes over the long term are:

- spending on incapacity and disability benefits rises in large part due to the ageing of the population. We assume constant age-specific shares of the population in receipt of incapacity benefits, which means cohort effects raise the caseload as a share of the adult population as the population ages. For disability benefits, even assuming increases in disability-free life expectancy, the significant rise in the population of very old people lifts spending overall. The number of people aged 85 and over is projected to rise from 2.4 per cent of the population in 2015 to 7.4 per cent in 2065. The projected rise in spending on disability benefits is smaller than in last year's projections, largely due to the lower old-age dependency ratio associated with higher migration in the central projection; and

- spending on housing benefit for both pensioners and those of working age falls. Among pensioners, that reflects cohort effects – newly-retired pensioners are assumed

to have higher home-ownership rates than the oldest pensioners. Among those of working age, it reflects an assumption that age-specific home-ownership rates among recent cohorts (which have fallen since the late 2000s financial crisis and recession) pick up to historical averages over time. These assumptions mean that the proportion of the adult population eligible for housing benefit falls slightly in our projections.

Table 2.10: Long-term projections of welfare spending

	Per cent of GDP						
	2014-15	2019-20	2024-25	2034-35	2044-45	2054-55	2064-65
State pensions[1]	5.5	5.1	5.4	6.2	6.8	7.0	7.3
Housing benefit	1.4	1.2	1.2	1.1	1.2	1.1	1.1
Personal tax credits	1.7	1.5	1.5	1.5	1.4	1.4	1.4
Disability benefits[2]	1.2	1.0	1.0	1.0	1.1	1.1	1.1
Incapacity benefits[3]	0.8	0.7	0.8	0.8	0.8	0.8	0.8
Income support	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Unemployment benefits[4]	0.3	0.1	0.1	0.1	0.1	0.1	0.1
Child benefit	0.7	0.5	0.6	0.5	0.5	0.5	0.5
Other welfare benefits	0.4	0.4	0.3	0.3	0.3	0.3	0.3
Total welfare spending	**12.1**	**10.6**	**10.9**	**11.8**	**12.4**	**12.7**	**12.8**

[1] Basic state pension, state earnings related pension scheme, state second pension, single-tier pension, other elements of state pension, pension credit and other pensioner benefits.

[2] Disability living allowance, personal independence payments and attendance allowance.

[3] Incapacity benefit, employment and support allowance, severe disablement allowance and income support (incapacity part).

[4] Jobseeker's allowance.

Note: Figures for 2014-15 and 2019-20 presented on a UK-basis, consistent with our 2015 *Fiscal sustainability report* projections.

Key sensitivities in the long-term projections

2.47 Our long-term projections are based on a number of simplifying assumptions. In general, these ensure that spending is not projected to rise or fall indefinitely for reasons that would be unlikely to hold over longer horizons – for example, we assume that most benefits and tax credits are uprated in line with earnings rather than inflation so that their value does not shrink steadily relative to the living standards of the bulk of the population. Varying these assumptions helps to illustrate the sensitivity of different types of spending to different drivers.

2.48 The key sensitivities in our long-term projections include:

- demographic and employment trends can have significant implications for spending, depending on the policy regime. With the SPA now more closely linked to demographic change, the sensitivity of spending to changes in longevity is less than was previously the case. In an ageing population, this is beneficial to fiscal sustainability. But spending as a share of GDP remains sensitive to changes in the number of workers relative to the number of pensioners. For example, higher net

migration[4] or greater than projected labour market participation among older age groups would reduce spending as a share of GDP by increasing GDP proportionally more than spending on pensions. Similarly, higher or lower birth rates would affect spending on child benefit. And changes in the amount or age structure of net migration could affect spending on a wide range of benefits, as well as affecting GDP. The ONS will be updating its population projections later this year, which is likely to affect our long-term fiscal projections next year;

- uprating working-age benefits in line with inflation rather than earnings over the next 30 years would reduce spending on those benefits by about 1¼ per cent of GDP. Our long-term projection of pension spending is also sensitive to the assumption we make about the cost of the triple lock on uprating, which, every time earnings growth drops below inflation or 2.5 per cent, ratchets up average pension awards relative to the economy's capacity to fund them;

- long-term projections of housing benefit spending are sensitive to assumptions about the proportion of the population renting their homes and the rate of rent inflation relative to earnings. If either of these were to rise (or fall), spending on housing benefit would be expected to rise (or fall) as a share of GDP; and

- changes in age-specific prevalence of incapacity and disability – related to changes in the number of disability-free years that an average person can expect to enjoy after retirement – as the population continues to age.

Implications for the welfare cap

The welfare cap

2.49 The previous Government announced in Autumn Statement 2013 that it would introduce a cap on certain items of welfare spending, excluding state pensions – which it argued are "*better planned and controlled over a longer time period*" – and jobseeker's allowance and associated housing benefit payments – which it identified as "*the most cyclical elements of welfare*" in order "*to allow the automatic stabilisers to operate*".[5]

2.50 The cap was formally defined and initially set in Budget 2014. It applied from 2015-16 to the end of the forecast period, which was 2019-20 in Budget 2015.[6] The Government set a forecast margin above the cap of 2 per cent in each year. Table 2.11 shows the welfare cap and additional forecast margin that applied at Budget 2015.

[4] All else equal, net migration increases the working-age population and GDP. See Box 3.4 of our 2014 *Fiscal sustainability report* for a discussion of why all else might not be equal.
[5] HM Treasury (2013) paragraphs 1.100 to 1.102.
[6] The *Charter for budget responsibility* requires the Government to set the level of the welfare cap for each Parliament no later than the first Budget of that Parliament. The Chancellor has announced that there will be a budget on 8 July this year.

Table 2.11: The level of the welfare cap and the forecast margin

	£ billion				
	2015-16	2016-17	2017-18	2018-19	2019-20
Welfare cap	119.7	122.3	124.8	127.0	129.8
2 per cent forecast margin	2.4	2.4	2.5	2.5	2.6

2.51 The *Charter for budget responsibility* sets out how the cap operates – including the actions required if it is exceeded. One requirement is that performance against the cap is assessed annually, alongside the Autumn Statement. In our December 2014 *EFO*, we therefore formally assessed whether relevant spending exceeded the welfare cap for discretionary policy reasons or the cap-plus-forecast-margin for any reason. We concluded that the Government was on track to meet its commitment. In March we forecast that spending would be between £1.3 and £3.2 billion below the cap between 2016-17 and 2019-20. It would be £0.8 billion above the cap in 2015-16, but within the forecast margin.

Forecast risks

2.52 As discussed above, there are risks on both sides of our central forecast of overall welfare spending. In terms of the welfare cap specifically, the biggest sources of uncertainty remain the judgements that are necessary to forecast the impact on spending of reforms to incapacity and disability benefits. These risks are in addition to the general forecast risks that stem from forecasting inherently complex demographic and economic determinants. Table 2.12 presents some illustrative ready reckoners of the effect on welfare spending of different changes in some of the main economic determinants. It shows that:

- a 1 per cent change in the CPI inflation level in September 2015, affecting uprating in 2016-17, would raise spending in 2016-17 by around £1.3 billion. This comes primarily through higher uprating on the state second pension and disability-related benefits, and higher rents for housing benefit;
- a 5 per cent increase in the claimant count would raise spending on jobseeker's allowance and associated housing benefit – which are both outside the welfare cap – by around £0.2 billion;
- a 1 per cent rise in housing benefit eligible rents – affecting both the social and private rented sectors – would increase spending on housing benefit by around £0.3 billion; and
- a 1 per cent rise in the number of children would add around £0.1 billion to child benefit spending. A 1 per cent rise in the number of pensioners would – assuming they had the same entitlements as current pensioners – add £1.2 billion to spending, mostly from higher spending on state pensions that are outside the welfare cap.

2.53 As our forecast revisions over the past year have illustrated, inflation surprises therefore represent a key risk to the welfare cap, which is set in cash terms. Recent inflation surprises have been to the downside, providing the Government some breathing space relative to the

cap (which has partly been taken up by the revisions we have made to incapacity and disability benefits caseloads). Absent any policy changes, upside inflation surprises would reduce the margin by which the welfare cap is met.

Table 2.12: Ready reckoners for the sensitivity of welfare spending

	Impact on spending in 2016-17 £ billion
Inflation[1]	
1 per cent change in CPI level (uprating by CPI for most benefits)	1.3
Labour market	
5 per cent increase in claimant count[2]	0.2
Housing market	
1 per cent increase in housing benefit eligible rents affecting 2016-17[3]	0.3
Demographics	
1 per cent increase in child benefit caseload	0.1
1 per cent increase rise in pensioner caseloads[4]	1.2

[1] Impact of an increase in the preceding September that affects uprating in the following fiscal year.

[2] Impact on jobseeker's allowance and passported housing benefit.

[3] Impact on housing benefit only.

[4] Impact on all benefits for which pensioner caseloads are available.

2.54 There are a number of potential operational and legal risks to the forecast, including:

- continued challenges in the reassessment of claims as incapacity benefits are reformed could lead to differences relative to forecast, both via the number of cases being assessed and the outcomes from those that are assessed;
- similar problems with the rollout of universal credit could present more significant risks in the future, once sufficient data are available to switch our forecasting approach from top-down to bottom-up. (This change in forecasting approach might itself have implications for the cap if it led to significant changes in the overall welfare spending forecast or the split between spending inside and outside the cap); and
- the Government's welfare reforms have already been subject to a number of legal challenges, and it is possible that there could be further challenges in the future to existing or new policy changes.

Policy risks

2.55 In setting the OBR's remit, Parliament has required us to consider only the current policies of the current Government, so we do not quantify any policy risks to our forecasts as these would constitute alternative policies. But with the new Government having committed in its manifesto to finding an additional "*£12 billion from welfare savings*" there is clearly significant scope for policy changes to affect our forecasts.

2.56 As with welfare spending forecasts, the costs or savings associated with welfare policy measures are subject to revision. In order to learn any lessons that might be relevant to our

scrutiny and certification of future policy measures in this area, we have worked with DWP and HMRC officials to review and understand factors that affected the costings of some of the larger welfare policy measures in the last Parliament.[7] This is rarely straightforward and it is not always possible to measure the effect of policy changes directly – as discussed above in the context of our forecast of the personal independence payment, for example. Given the time available between our last forecast and this report, and the complexity of some of the reforms, this has been a relatively high-level exercise looking at the simpler policy measures.

2.57 The two main conclusions to be drawn from this exercise are:

- **errors in our economic forecasts** – which underpin the pre-measures forecasts to which policy costings are applied – **can be significant sources of error in costings themselves**. This has been particularly relevant to the major uprating policy measures: the 'triple lock' on state pension uprating; switching from RPI to CPI inflation uprating for most benefits and tax credits; and later limiting the uprating of most working-age benefits to 1 per cent for three years; and

- **costings associated with structural changes to the welfare system** – the switch from incapacity benefit to employment support allowance, from disability living allowance to the personal independence payment, the introduction of universal credit (all discussed above), and the high-income child benefit charge – **are subject to even greater uncertainty**. In some cases these require judgements about the proportion of the population that will claim a new benefit and at the average amount that will be claimed, but they also typically require judgements about the capacity of departments or contractors to deliver the new policies.

2.58 These and other factors mean that the outturn (rise) fall in welfare spending in a specific year will inevitably differ from initial estimates of the cumulative (costs) savings of policy measures. The lessons learnt in this area – notably delivery issues associated with operational measures – are already being applied to the estimated savings from past measures that feature in our forecast and will be applied to future costings of similar nature.

2.59 The following sections provide a summary of the evidence from re-examining the costings for selected welfare policy measures.

Basic state pension uprating: the 'triple lock'

2.60 The 'triple lock' on uprating the basic state pension was announced in the June 2010 Budget. It means that the basic state pension award rises by the highest of CPI inflation, average earnings growth or 2.5 per cent. Uprating takes place at the start of the fiscal year, based on the annual inflation rate from the previous September or average earnings growth from the previous July. The pre-measures forecast against which it was compared was based on average earnings uprating that had been legislated by the previous government.

[7] For a fuller discussion or our approach to including policy costings in our economic and fiscal forecasts, see *Briefing Paper No.6: Policy costings and our forecast*, which is available on our website.

2.61 Table 2.13 shows that:

- in June 2010, our forecasts for inflation and earnings growth meant that the triple lock was expected to increase uprating by 0.6 percentage points in 2012-13 and a further 0.4 percentage points in 2013-14. There was no additional impact from 2014-15, as the forecast assumed that earnings growth would be higher than CPI inflation and 2.5 per cent in each year. The total cost in 2014-15 – the end of the Treasury's scorecard period in the June 2010 Budget – was originally estimated to be £0.4 billion; and

- outturns have been significantly different, reflecting a combination of sustained shortfalls in productivity and real earnings and high inflation relative to the June 2010 forecast. In 2012-13, uprating was in line with CPI inflation of 5.2 per cent in September 2011, twice the June 2010 forecast (as global energy and food commodity prices increased significantly) and much higher than the average earnings growth counterfactual. In 2013-14 and 2014-15, the earnings growth counterfactual was much weaker than expected, meaning uprating by the 2.5 per cent floor and CPI inflation respectively was more costly than initially expected.

2.62 Higher inflation and lower average earnings growth relative to the June 2010 forecast mean that the triple lock is estimated to have cost around £2.9 billion in 2014-15 – £2.4 billion higher than the original estimate. It will continue to cost more than uprating by average earnings in 2015-16 and our March 2015 forecast implied that this would be the case in 2016-17 too.

Table 2.13: Impact of the triple-lock guarantee on basic state pension uprating

	Per cent uprating and percentage point differences						
	June 2010 Budget			March 2015 Budget			Change
Year of uprating	Pre-measures	Triple-lock uprating	Difference	Pre-measures	Triple-lock uprating	Difference	Difference
2012-13	2.0	2.6	0.6	2.9	5.2	2.3	1.7
2013-14	2.1	2.5	0.4	1.6	2.5	0.9	0.5
2014-15	3.9	3.9	0.0	1.2	2.7	1.5	1.5
Note that shading in the cells denotes uprating by:				Earnings	CPI	2.5 per cent	

Social security and tax credits uprating: switch to CPI

2.63 In the June 2010 Budget, the Government decided to switch the uprating of most benefits, tax credits and public sector pensions from RPI or ROSSI[8] (measures that generally overstate inflation due to the method of calculation) to CPI inflation, which typically rises more slowly. The savings on benefits administered by DWP were estimated at the time to be around £2.6 billion in 2014-15 – the end of the Treasury scorecard period in the June 2010 Budget.

2.64 As with the triple lock, the savings associated with this policy have been affected by differences between inflation outturns and the June 2010 forecast. As Table 2.14 shows:

[8] The ROSSI measure of inflation is RPI less housing costs. It was previously used to uprate means-tested benefits.

- the difference between CPI and both RPI and ROSSI inflation proved slightly larger in September 2010 (affecting 2011-12 uprating), increasing the saving from uprating by CPI;

- in September 2011 (affecting 2012-13 uprating), the gap between ROSSI and CPI was bigger than expected due to a larger contribution from the methodological differences that cause ROSSI to overstate inflation. That increased savings further; but

- since 2011 the gap between CPI and RPI inflation in each September has been smaller than forecast in June 2010 – in part because interest rates and mortgage lending have been lower than expected. This meant that the mortgage interest payments component of RPI (which is not in the CPI) did not rise as much as forecast, which reduced the estimated saving from uprating by CPI. (As mortgage interest payments are excluded from ROSSI too, the gap between CPI and ROSSI was closer to the June 2010 forecast in September 2012 and 2013.)

2.65 While savings are now estimated to have been higher in 2011-12 and 2012-13, by 2014-15 total savings on benefits administered by DWP from the switch to CPI uprating are estimated to have been around 20 per cent lower than initially expected at £2.1 billion.

Table 2.14: Impact of switching uprating from RPI or ROSSI to CPI

	Per cent (unless otherwise stated)			
	2011-12	2012-13	2013-14	2014-15
June 2010 Budget				
Inflation rate (previous September):				
RPI	4.3	3.4	3.0	3.2
ROSSI	4.5	3.0	2.4	2.5
CPI	2.9	2.6	1.9	2.0
Difference (percentage points):				
CPI-RPI	-1.4	-0.8	-1.1	-1.2
CPI-ROSSI	-1.6	-0.4	-0.5	-0.5
March 2015 Budget				
Inflation rate (previous September):				
RPI	4.6	5.6	2.6	3.2
ROSSI	4.8	6.8	2.8	3.4
CPI	3.1	5.2	2.2	2.7
Difference (percentage points):				
CPI-RPI	-1.5	-0.4	-0.4	-0.5
CPI-ROSSI	-1.7	-1.6	-0.6	-0.7
Change (percentage points)				
CPI-RPI	-0.1	0.4	0.7	0.7
CPI-ROSSI	-0.1	-1.2	-0.1	-0.2

2.66 HMRC was unable to provide updated estimates relating to the savings associated with tax credits and child benefit, which accounted for almost half of the initial estimate of total savings from the switch to CPI uprating. For tax credits and child benefit, the difference between RPI and CPI is the relevant comparison. It is therefore likely that savings would

have been higher than initially estimated in 2011-12, but then significantly lower from 2012-13 onwards. The lack of an offsetting ROSSI-CPI impact as in the DWP benefits means it is likely that by 2014-15 the original estimate of £2.0 billion savings would have fallen short by more than the 20 per cent cited above.

Social security and tax credits uprating: 1 per cent limit

2.67 In Autumn Statement 2012, the Government further limited uprating of most working-age benefits by introducing a 1 per cent cap that applied for three years from 2013-14. Across tax credits and benefits, this was originally estimated to save around £2.6 billion by the end of the forecast period in 2017-18. More than half of the savings were expected to come from tax credits, but, as above, HMRC has been unable to provide updated estimates of these savings.

2.68 The savings to benefits administered by DWP from the 1 per cent cap were originally estimated at £1.0 billion by 2017-18. While savings were close to original estimates in 2013-14 and 2014-15, the saving now looks more like £0.7 billion by 2017-18. This is driven by:

- significantly lower claimant count unemployment than forecast. That means a lower jobseeker's allowance and housing benefit caseload to which the lower average award was applied; and

- a sharply lower CPI inflation outturn in September 2014 (affecting uprating in 2015-16, shown in Table 2.15), due to sharp falls in global energy and food commodity prices and a significant appreciation of sterling. That means the counterfactual of uprating by CPI inflation would have cost less than was factored into the original pre-measures forecast.

2.69 Tax credits savings would have been less affected by lower unemployment, but – as with DWP-administered benefits – would have been reduced by lower CPI inflation in the counterfactual.

Table 2.15: Impact of uprating most working-age benefits by 1 per cent

	Per cent (unless otherwise stated)		
	2013-14	2014-15	2015-16
December 2012 Autumn Statement			
CPI	2.2	2.6	2.2
1 per cent cap	1.0	1.0	1.0
Difference (percentage points)	-1.2	-1.6	-1.2
March 2015 Budget			
CPI	2.2	2.7	1.2
1 per cent cap	1.0	1.0	1.0
Difference (percentage points)	-1.2	-1.7	-0.2
Change			
Difference (percentage points)	0.0	-0.1	1.0

Child benefit: withdrawal from high-income families

2.70 At Spending Review 2010, the Government decided that from January 2013 it would withdraw child benefit from families where at least one adult had income above the higher rate tax threshold. The estimated savings from this policy were included in our November 2010 forecast (as we did not produce a forecast alongside the Spending Review). In Budget 2012, the Government amended the policy so that child benefit would be withdrawn fully from families with at least one adult earning more than £60,000 and a taper would be introduced where one adult was earning between £50,000 and £60,000. In the final estimate before this policy's introduction, these changes were estimated to have reduced the original savings by around £600 million a year. The policy as implemented was expected to save around £2.2 billion in 2017-18 (the end of the December 2012 forecast period).

2.71 There were a number of uncertainties around this costing, since it required an estimate of the number of families where at least one adult earned an amount at or above a specific point in the income distribution, the number of families that would choose to opt out of receiving child benefit in the first place, and the number of families that would choose to pay it back through the income tax system after the end of the year.

2.72 HMRC's latest estimate of the savings expected in 2017-18 is £1.6 billion, around a third lower than the final estimate before implementation. Revisions to economic determinants this time explain little of the variation from original estimates. Instead, differences in key assumptions (such as the number of families affected by the policy) have reduced estimated savings by around £0.5 billion – the bulk of the revision.

2.73 It is worth noting that HMRC cannot know precisely how many families that would previously have become newly eligible for child benefit have chosen not to apply because one adult earns above the threshold. This uncertain quantity of savings is not recorded, since those families do not interact with HMRC's child benefit systems – but it will reduce spending relative to the counterfactual in which those families receive child benefit. The latest costings include an amount of savings that is assumed to be associated with this group, but is subject to considerable uncertainty.

Tax credits operational changes

2.74 In recent fiscal events, there have been a growing number of operational measures seeking to reduce welfare spending, mainly relating to the operation of the tax credits system. The four main operational measures we consider here are:

- using real-time information (RTI) on earnings and hours worked (announced in Spending Review 2010);
- greater checks on children in full-time non-advanced education (announced in Autumn Statement 2012);
- extending debt recovery across awards (announced in Autumn Statement 2012); and

- improving collection and administration via additional capacity (announced in Autumn Statement 2013).

2.75 Operational measures are inherently more uncertain to cost. This is partly due to time lags between policies being announced and implemented, to delivery issues that are difficult to anticipate – sometimes relating to the system, sometimes relating to departments working with outside contractors – and to interactions with other benefit reforms, such as the protracted rollout of universal credit.

2.76 Summing the original costings for these measures, savings were estimated at around £1.2 billion in 2014-15. HMRC now estimates that these measures are expected to have saved approximately £0.4 billion in 2014-15 – a shortfall of around two-thirds – with large parts of the expected savings pushed into later years due to delays in delivery.

2.77 Many of the measures generated lower than expected savings due to delivery issues that were unforeseen at the time. The Autumn Statement 2013 measure announcing additional error and fraud capacity provides a clear example of this. The initial start date of April 2014 was first pushed back to September 2014, and then to November 2014. A number of other assumptions have also proven to be optimistic.

2.78 The size of the savings associated with these measures also varies as the underlying rate of error and fraud in the system changes. The overall level of error and fraud in the tax credit system is now estimated to be lower than when these measures were originally costed, reducing the overall scope to make savings. For example, this lower level of error and fraud reduces expected savings from the RTI measure by around 20 per cent. Of course, lower error and fraud in general reduces spending, while at the same time reducing the savings associated with measures that aim to reduce it.

2.79 Delays in the rollout of universal credit have meant that some of the benefits of these measures are scheduled to extend into future years – i.e. tax credit error and fraud will still be there to be tackled because the tax credit caseload will not have migrated to universal credit. This offsets some of the reductions in savings in future years.

Conclusion

2.80 The assessment of trends in welfare spending described in this chapter lead us to draw a number of overarching conclusions:

- over the past 30 years, welfare spending has risen steadily in cash and real terms, but on average that increase has been broadly in line with growth in the economy. So the proportion of national income devoted to welfare spending has not shown a significant upward or downward trend over time;

- a number of risks to our medium-term forecasts that were identified in last year's *WTR* prompted substantial revisions in our December 2014 and March 2015 forecasts. In particular, spending on incapacity and disability benefits was revised up following

further scrutiny of the delivery of reforms while spending on jobseeker's allowance was revised down due to faster than expected falls in unemployment. We also assumed further delays in the rollout of universal credit;

- by 2019-20, welfare spending as a share of GDP is forecast to fall back to its pre-crisis level thanks to reductions in the generosity of working-age benefits relative to average earnings, reduced caseloads in cyclically sensitive benefits such as jobseeker's allowance, and the assumed savings associated with reforms to incapacity and disability benefits (which remain significant after the revisions made over the past year). Spending on state pensions falls as a share of GDP as the state pension age is raised;

- within total welfare spending, that covered by the welfare cap is forecast to fall from 55.6 per cent of the total in 2014-15 to 53.8 per cent in 2019-20, reflecting in part the more generous uprating of state pensions relative to working-age benefits;

- there remain significant risks to our forecasts for welfare spending. Specific risks include: uncertainties about housing benefit from trends in housing tenure and rents and risks from delivery challenges in incapacity and disability benefits and universal credit. More generally, with the welfare cap having been set in cash terms, inflation surprises that feed through to welfare spending via uprating represent a key risk; and

- new policy measures are likely to be important factors affecting our forthcoming forecasts, given the new Government's commitment to finding £12 billion of savings from the welfare budget. Our brief review of some of the larger welfare policy costings from the last Parliament has shown how savings can differ from original estimates due to a range of factors, particularly the economic assumptions underpinning pre-measures forecasts and issues relating to the delivery of operational measures.

3 International comparisons

Introduction

3.1 In our first *Welfare trends report (WTR)* and in Chapter 2 of this report, we have considered UK welfare spending in a historical context and in the context of medium- and long-term prospects for the UK's public finances. But the UK is not unique in allocating a significant proportion of public spending to social policy objectives. Different countries take different approaches, both in terms of the scale and composition of public spending and in the role of private sector spending and service delivery. Here we examine welfare spending in the UK in the international context.

3.2 This chapter:

- defines the social expenditure that will be covered and describes the data available to compare spending across countries. It also considers the different types of welfare systems that operate in advanced economies (from paragraph 3.3);
- compares total amounts allocated to social expenditure in the UK to other countries (from paragraph 3.12); and
- looks in greater detail at international comparisons of spending on pensions (from paragraph 3.26), disability and sickness benefits (from paragraph 3.43), unemployment benefits (from paragraph 3.52) and support for people on low incomes (from paragraph 3.66).

Comparing welfare spending across countries

Defining 'social protection' activities

3.3 An international comparison of welfare spending must start by defining the scope of such spending. While there is no universally accepted definition, there are commonly used definitions of 'social protection' that will be used for the international comparisons in this chapter. These definitions are broader than the welfare spending covered in Chapter 2:

- the OECD, which maintains a database on social expenditure (known as SOCX), defines social protection as the "*provision by public and private institutions of benefits to, and financial contributions targeted at, households and individuals in order to provide support during circumstances which adversely affect their welfare, provided*

that the provision of the benefits and financial contributions constitutes neither a direct payment for a particular good or service nor an individual contract or transfer";[1] and

- Eurostat, which maintains a 'European system of integrated social protection statistics' (ESSPROS), defines social protection as encompassing "*all interventions from public or private bodies intended to relieve households and individuals of the burden of a defined set of risks or needs, provided that there is neither a simultaneous reciprocal nor an individual arrangement involved.*" It states that, by convention, the risks or needs that may give rise to social protection are: sickness and health care; disability; old age; survivors; family and children; unemployment; housing; and other elements of social exclusion not captured in other categories.[2]

International data on social expenditure

3.4 International comparisons of social expenditure are complicated by the structural differences between welfare systems that make it challenging to compile data that are comparable across countries. For this chapter, we use the OECD's SOCX database.[3] We have followed an approach similar to that set out in two recent OECD papers, which also provide further detail about the SOCX database.[4] This is supplemented by Eurostat's ESSPROS database in some of the analysis in this chapter. (A number of methodological and other differences mean these figures will not reconcile with those published by the Department for Work and Pensions and HM Revenue and Customs for the UK that were used in Chapter 2.)

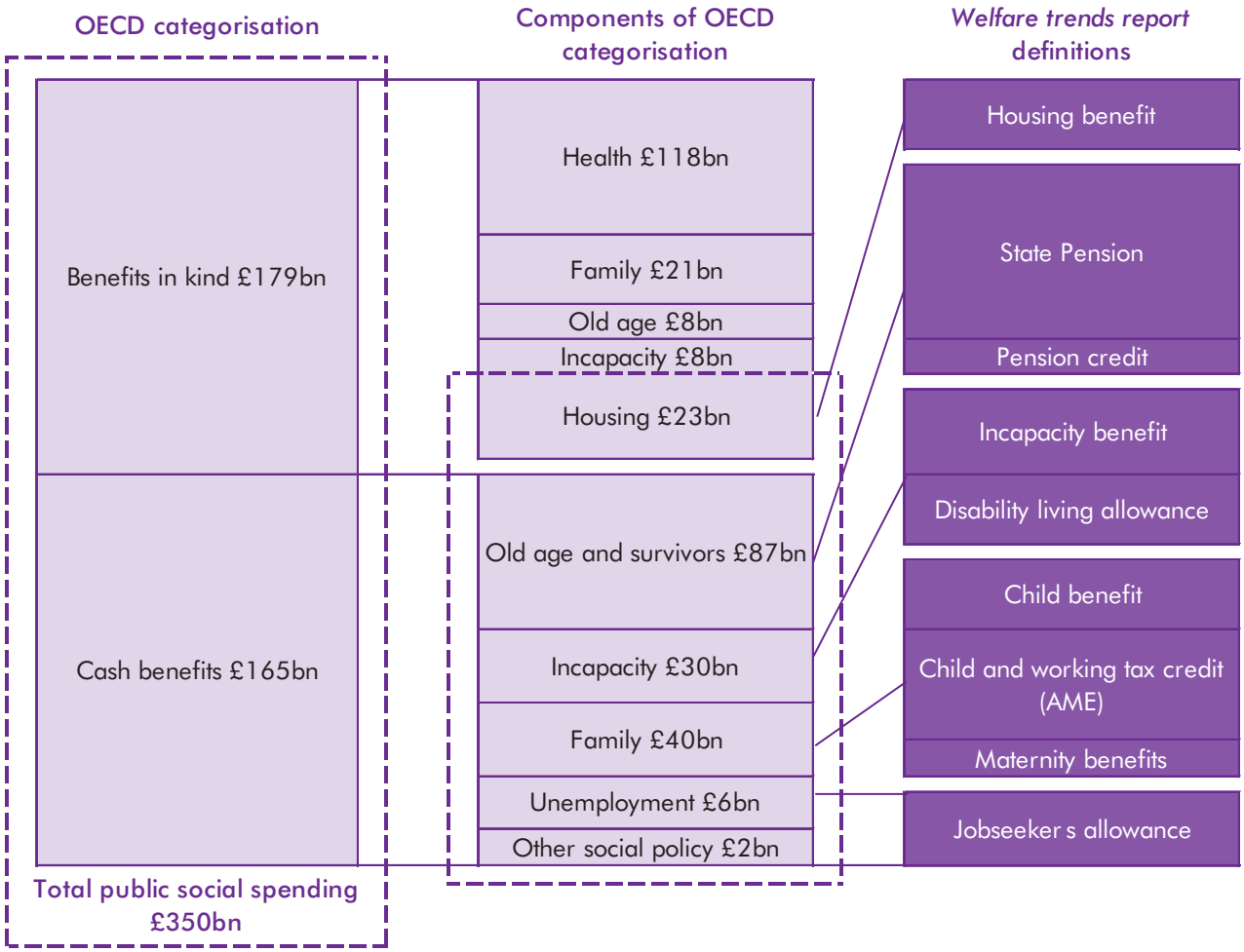
3.5 Social expenditure in the SOCX is split into spending on cash benefits (i.e. social security and other cash transfers) and on benefits-in-kind (i.e. public services associated with social protection, the largest item being health care spending). We focus mainly on cash transfers, as this most closely relates to the coverage of our *WTRs*. But meaningful comparisons across countries also require examination of spending on benefits-in-kind, and indeed private social spending and interactions with the tax system.

3.6 Figure 3.1 shows how the elements of public spending on social protection map across to the main elements of UK welfare spending as defined in Chapter 2. The first two columns show spending as defined in the SOCX database: first split between benefits-in-kind and cash benefits and then disaggregated further into the main spending categories. The third column shows how these spending categories can be mapped onto the main UK elements of social security and tax credits spending that we refer to as 'welfare spending' in our *WTRs*.[5]

[1] Adema *et al* (2011).
[2] Eurostat (2012).
[3] Where indicators are expressed as a share of GDP, this is done using the level of GDP as recorded in the SOCX database. As noted in Chapter 2, there have been substantial methodological revisions to GDP data over the past year. While these may affect the level of spending-to-GDP ratios, they should be less important for the relative position of different countries in international comparisons.
[4] See Adema *et al* (2011) and OECD (2014a).
[5] An explanation of the differences between the OECD SOCX database and the Eurostat ESSPROS database is available in Adema *et al* (2011).

3.7 One important difference between the OECD categorisation and our definition of welfare spending is the treatment of housing benefit, which we treat as a cash transfer but which the OECD treats as the provision of housing as a benefit-in-kind. Beyond this, it is worth noting that the data on support for housing costs do not include capital spending on housing or any implicit subsidy of housing via below-market rents either.

Figure 3.1: Total UK public spending on social protection in 2011



Note: The matching between OECD categories and UK benefits was made using the OECD's metadata for the UK. This is not a comprehensive matching, in that it only shows the main benefits covered by this spending. Total public social spending is greater than the sum of cash benefits and benefits in kind shown because spending on active labour market policies is not allocated to cash benefits or benefits in kind.
Source: OECD, OBR

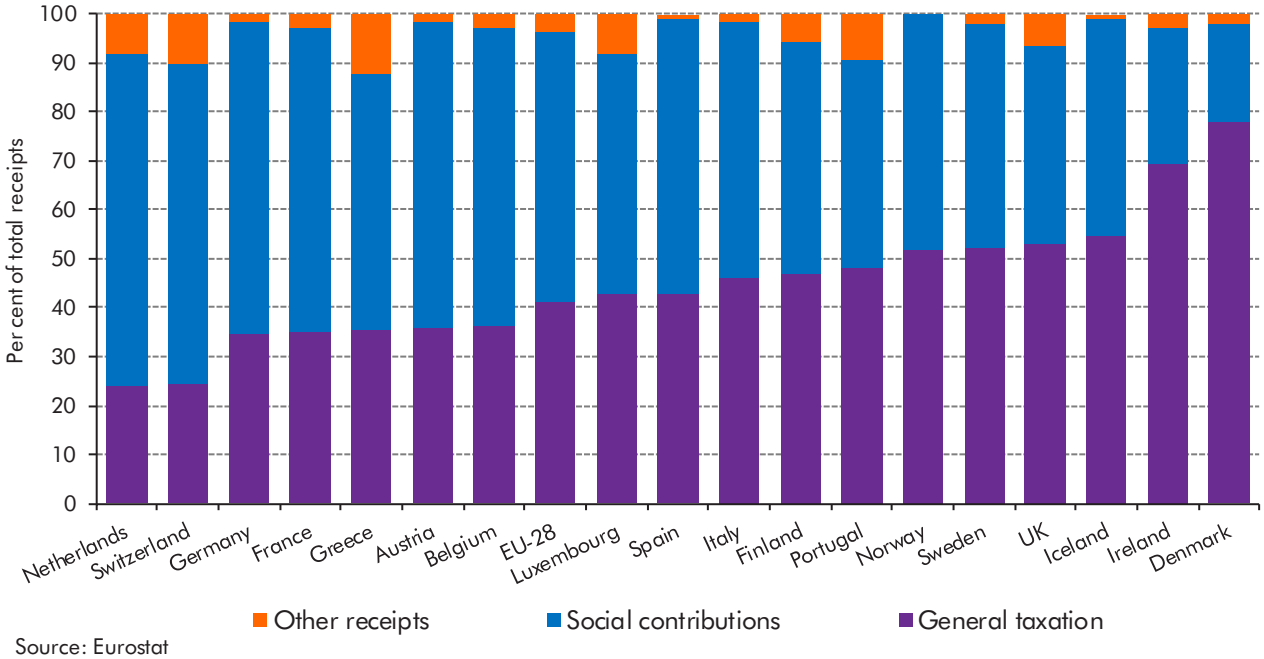
Welfare systems in advanced economies

3.8 While every country's welfare system is unique, it is common to distinguish two basic funding models: the Bismarck system (primarily funded by social contributions – the costs incurred by employers on behalf of their employees or by protected persons to secure entitlement to social benefits) and the Beveridge system (primarily funded out of general

taxation).[6] In practice, most systems in the advanced economies we examine here represent a mixture of these two approaches. Countries may also finance some social protection from other sources, for example by using the tax system to incentivise private sector delivery of social objectives.

3.9 Chart 3.1 illustrates the relative importance of these funding sources in a selection of European countries. For the EU as a whole, social contributions funded 55 per cent of total social protection spending in 2012.

Chart 3.1: Sources of funding for social protection in 2012



Source: Eurostat

3.10 The following patterns can be identified:

- among the larger European countries (including France, Germany and the Netherlands), social contributions financed more than 60 per cent of social protection spending. These systems are typically considered to be of the Bismarck variety;

- in contrast, many of the Nordic countries finance at least half of their social protection spending from general taxation (almost 80 per cent in Denmark). In that sense these systems are considered to be closer to the Beveridge model; and

- on this Eurostat definition, the UK finances slightly more than half its social protection spending from general taxation and has done so since the early 2000s. The majority of social contributions in the UK come from the National Insurance contributions (NICs) that are paid by employers and employees, which fund a variety of benefits and health spending via the National Insurance Fund. The extent to which NICs meet the 'securing entitlement' definition of a social contribution varies across benefits – state

[6] DICE database (2008).

pension entitlement is directly linked to years of contributions, though not the amount; for many benefits, the difference between contributory-based and income-based eligibility is relatively small.

3.11 In the following sections of this chapter, we focus on a wider sub-set of advanced economies drawn from these different types of welfare systems:

- **Anglophone** countries: Australia, Canada, New Zealand, the UK and the US;
- **Continental European** countries: France, Germany, Italy and Spain; and
- **Nordic** countries: Denmark, Finland, Norway and Sweden.

Total expenditure on social protection

3.12 In this section we use the OECD SOCX database to compare overall spending on social protection across countries. We consider how countries' systems differ in the composition of public and private expenditure and the effects of tax systems. In the next section we look at selected areas in more detail.

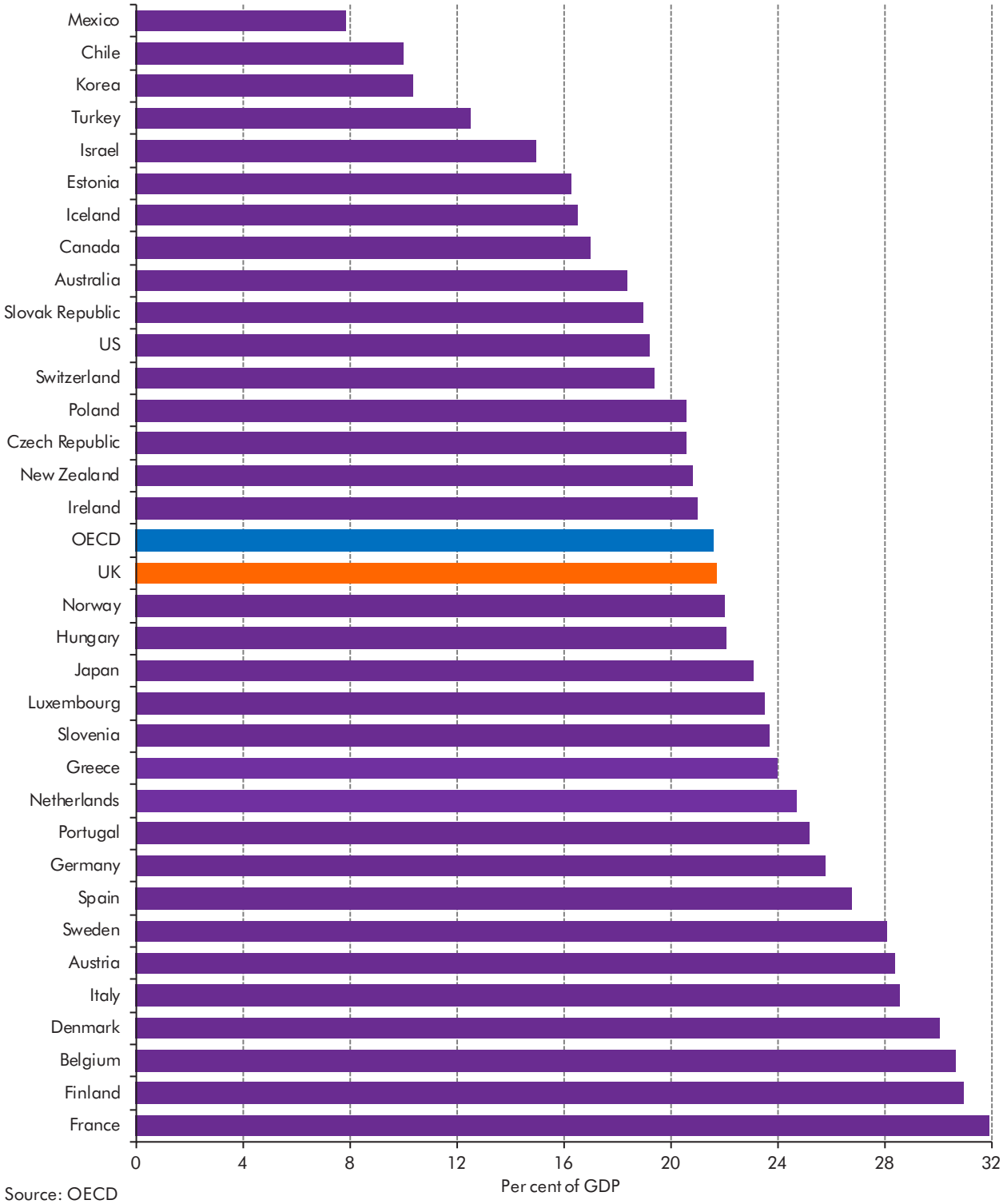
Gross public social expenditure

3.13 Across OECD countries, the scale and composition of social expenditure differs in a number of ways. For example:

- the balance between public and private provision;
- the balance between cash transfers and in-kind provision of services; and
- the split between support for people of working age and for pensioners.

3.14 At the highest level, Chart 3.2 shows the comparison of public social spending in 2014 as a share of GDP across 34 OECD countries, as estimated in the SOCX database. On this measure – which as Figure 3.1 showed is broader than the measure we focus on in Chapter 2 – social spending in the UK of 21.7 per cent of GDP is very close to the OECD average. Of the countries shown in the chart, social spending in the UK is sixth lowest among EU Member States (above Ireland and four Eastern European countries) and the third lowest in the G7 countries (after Canada and the US).

Chart 3.2: Estimated public spending on social protection in 2014



Source: OECD

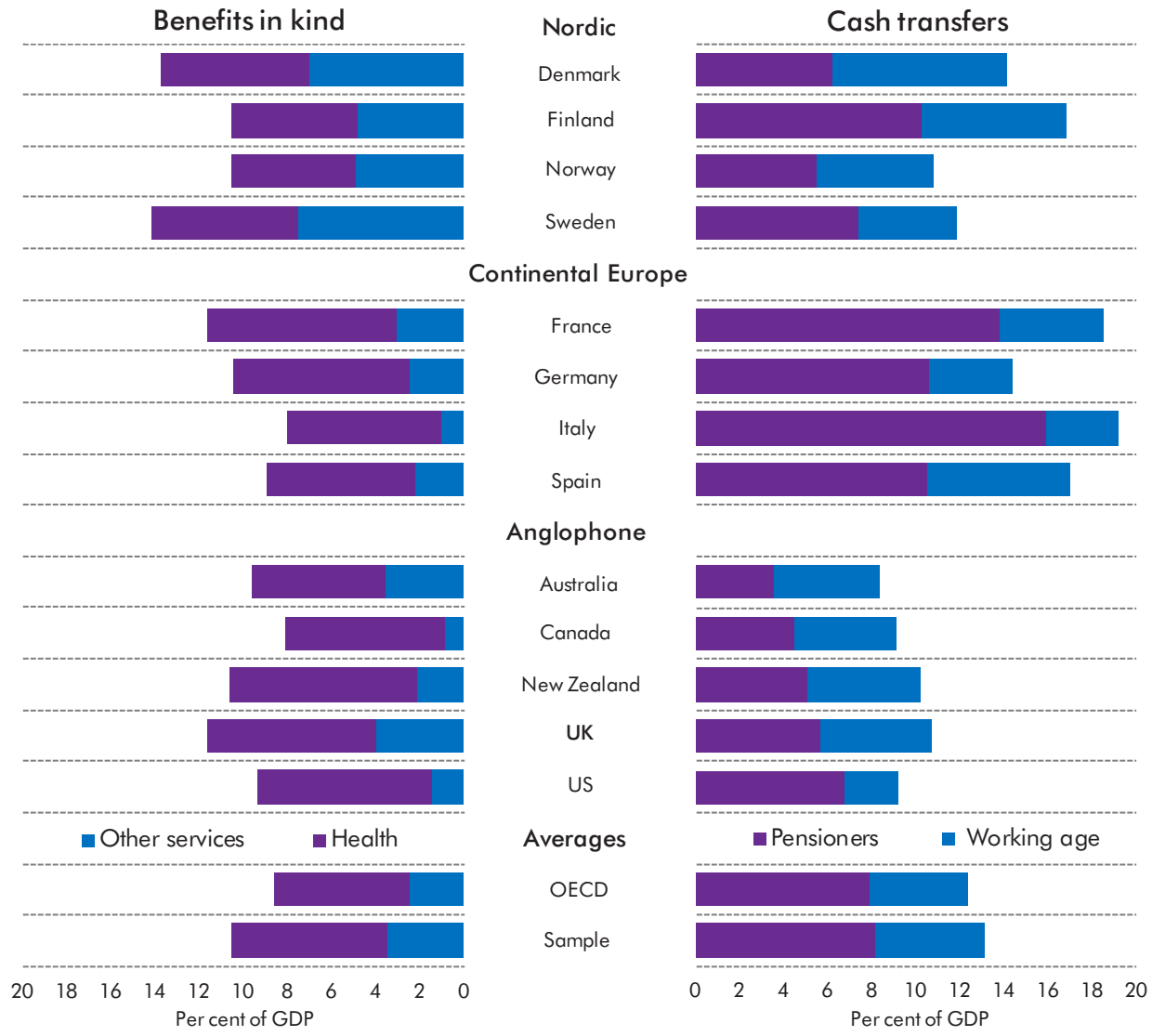
3.15 By comparison with the groups of countries we are focussing on in this chapter, public social spending in the UK is higher than in the other Anglophone countries, but lower than in the Continental European and Nordic countries. But, as we discuss later, gross public spending does not paint a complete picture of the resources a country devotes to social objectives.

3.16 As shown in Chart 3.3, public social spending in the UK is evenly split between cash transfers and benefits-in-kind. A similar pattern is seen in the Nordic countries, Canada and New Zealand. OECD countries as a whole spend more on cash benefits (12.3 per cent of GDP in 2012) than on benefits-in-kind (8.6 per cent of GDP). The countries we focus on in this chapter typically spend a higher share of their national income on benefits-in-kind than the OECD average. In the Anglophone and Continental European countries, this is primarily spent on health care – in the UK, for instance, health accounts for around two thirds of public spending on benefits-in-kind. In contrast, Nordic countries tend to spend a lower proportion of national income on health and more on other social services – for example, childcare.

3.17 Countries where benefits are related to the past earnings of the recipients (e.g. France and Germany) tend to spend a higher share of national income than those where benefits are means-tested on current income and/or wealth (e.g. Australia, the UK and US). This applies in particular to spending on unemployment and on sickness and disability benefits. In contrast, expenditure on family benefits in Anglophone systems, including in the UK (e.g. child benefit and tax credits), is not generally low relative to other advanced economies.[7] In the UK case, this is not because tax credits are not means-tested on current income, but because they are set at relatively generous levels.

[7] Gaffney (2015).

Chart 3.3: Public social spending on cash transfers and benefits-in-kind in 2012



Note: Spending on cash transfers (cash benefits) and benefits in kind does not include spending on active labour market policies because it is not allocated to cash benefits or benefits in kind.
Source: OECD, OBR

3.18 Within spending on cash transfers, OECD countries on average spend more on pensioners than on people of working age and children (7.9 per cent and 4.4 per cent of GDP respectively). In the UK, public spending on pensioners is only slightly higher than on the working age and child population. As explained below, this is in part because private sector pension provision plays a greater role in the UK system than in most other OECD countries, particularly employer-based occupational pension plans.[8] The treatment of public sector pensions in the SOCX database also differs across countries (also discussed in the section on support for the elderly below).

3.19 As already noted, gross public expenditure paints an incomplete picture of the resources a country devotes to social protection. It is also important to consider the broader context of

[8] Queisser *et al* (2007).

how governments deliver such provision. Drawing on the OECD's approach and data, this section uses additional information to generate a measure of net total social expenditure that gives a fuller picture.[9] This measure is made up of:

- gross public spending on cash benefits and in-kind service provision (as discussed above);
- gross private spending on social benefits and services (e.g. employer-based occupational pensions in the UK or private medical insurance in the US); and
- interactions between benefits and the tax system (e.g. income tax paid on pensions in the UK, the much wider taxation of benefits in Nordic systems or the use of tax incentives for social purposes, such as pensions tax relief in the UK).

Adding public and private spending together, but adjusting for the interaction between the tax and social welfare systems, gives a net total measure of social spending.

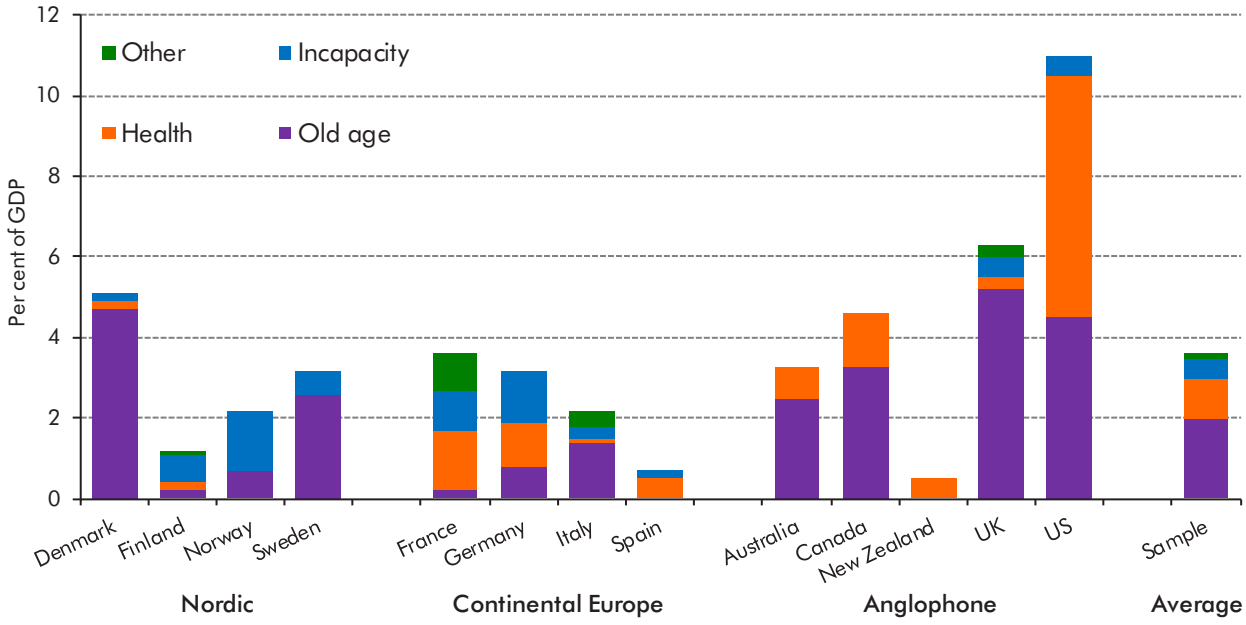
Gross private expenditure

3.20 International comparisons of social spending are affected by differences in the extent to which societies require or incentivise private actors to take out social protection arrangements outside the public sector. All social spending that involves financial flows controlled by different levels of government and social security funds is treated as public sector spending in the OECD data. All other social benefits are considered as private spending. However, these benefits can in reality be quite similar. For example, sickness benefits financed by compulsory employer and employee contributions to social insurance funds are by convention treated as public sector spending, but sickness payments directly paid by employers to their absent employees required by legislation – e.g. as in the UK and Sweden – are treated as private sector spending.

3.21 Gross private social expenditure amounted to 2.7 per cent of GDP in 2011 across the OECD. The main components were incapacity spending (e.g. sickness-related payments), old-age spending (e.g. employer-based pension schemes) and health spending. As Chart 3.4 shows, there is considerable variation within the groups of countries we are focusing on. That said, the two countries with the highest private sector spending on social welfare provision are Anglophone countries: the US (due to high levels of private spending on health care services and private pensions) and the UK (due to extensive private pension spending).

[9] OECD (2014a).

Chart 3.4: Gross private social expenditure by type of social protection in 2011



Source: OECD, OBR

Effects of tax systems

3.22 Tax systems can affect social spending in three different ways that are not captured in gross public expenditure data.[10] Governments are able to:

- levy income tax and social security contributions on cash transfers to recipients. For example, in 2011 it is estimated that the Danish government recouped 4 per cent of GDP by taxing benefit income from gross public social spending;[11]

- levy consumption taxes on household spending financed by benefit income. On average across the OECD, this was estimated to have raised close to 2 per cent of GDP in 2011.[12] The value of benefit income recovered through taxes on consumption is much larger in European countries (where gross benefit income and indirect tax rates are often relatively high) than in Australia, Canada and the US (where both are relatively low);[13] and

- use tax incentives for social purposes. The tax system can provide support directly, in a similar fashion to social security benefits, through tax credits for example. It can also be used to encourage private provision of social support, for example by tax relief for collective health insurance (as in the US) or pension saving (as in the UK). These reliefs are generally less important in countries with relatively high direct taxes, such as Denmark, Finland and Sweden.

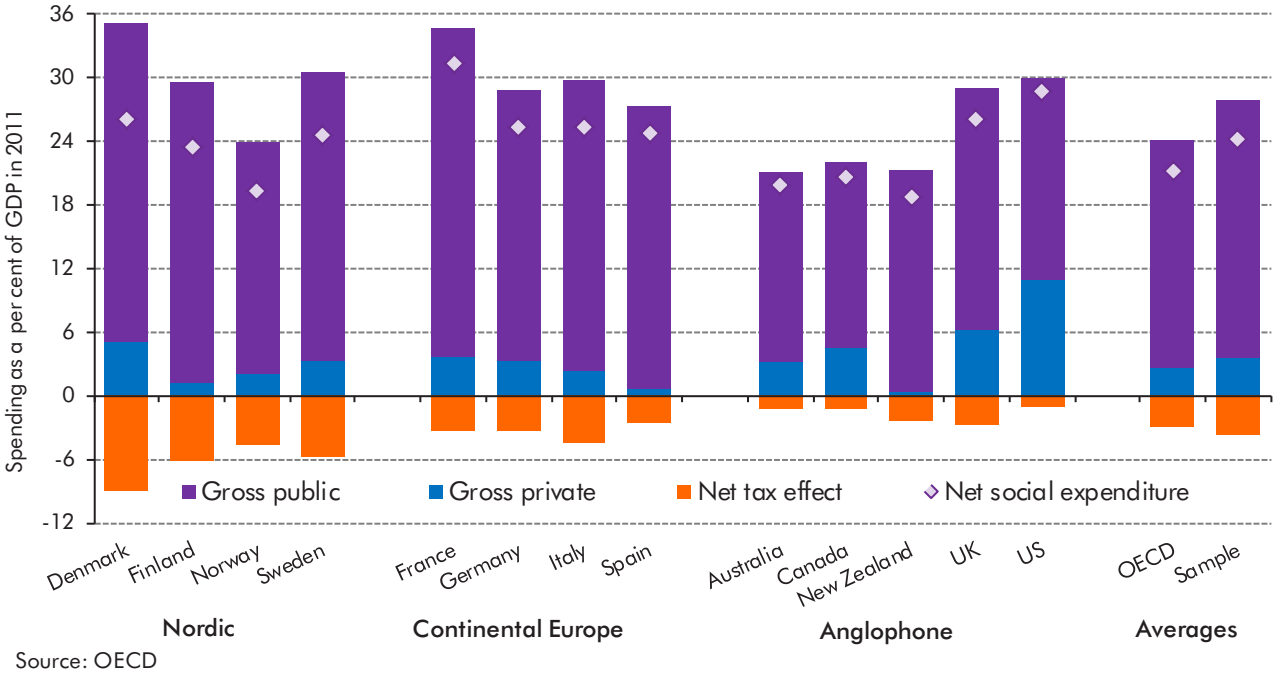
[10] Adema *et al* (2011).
[11] OECD (2014a).
[12] OECD (2014a).
[13] Adema *et al* (2011).

3.23 In comparing systems internationally, it is important to remember that the SOCX database does not include tax incentives for pension saving, which can have a significant cost in foregone revenue.

Net total social expenditure

3.24 By combining estimates of total public and private social expenditure, and netting off the estimated interactions with the tax system, we reach the measure of 'net total social expenditure'. This is a relatively comprehensive measure of the resources that a country devotes to social protection, abstracting from the different channels along which those resources are deployed. On this definition, spending in the UK was significantly higher than the OECD average in 2011 at 26.1 per cent of GDP against 21.1 per cent. By contrast, gross public social expenditure in the UK was only a little higher than the OECD average at 22.7 per cent against 21.5 per cent. The main factor explaining this difference is higher private spending on pension benefits. The US also looks very different on this measure: public spending is well below the OECD average, but net total expenditure is second only to France because of its high private spending on health services and pensions. France ranks highest in the OECD for both gross public expenditure and net total expenditure.

Chart 3.5: Gross public and total net social spending in 2011



Source: OECD

Expenditure on selected social protection programmes

3.25 In this section, we focus on four areas of social spending: support for the elderly, for sick and disabled people, for the unemployed, and support for people on low incomes.

Support for the elderly

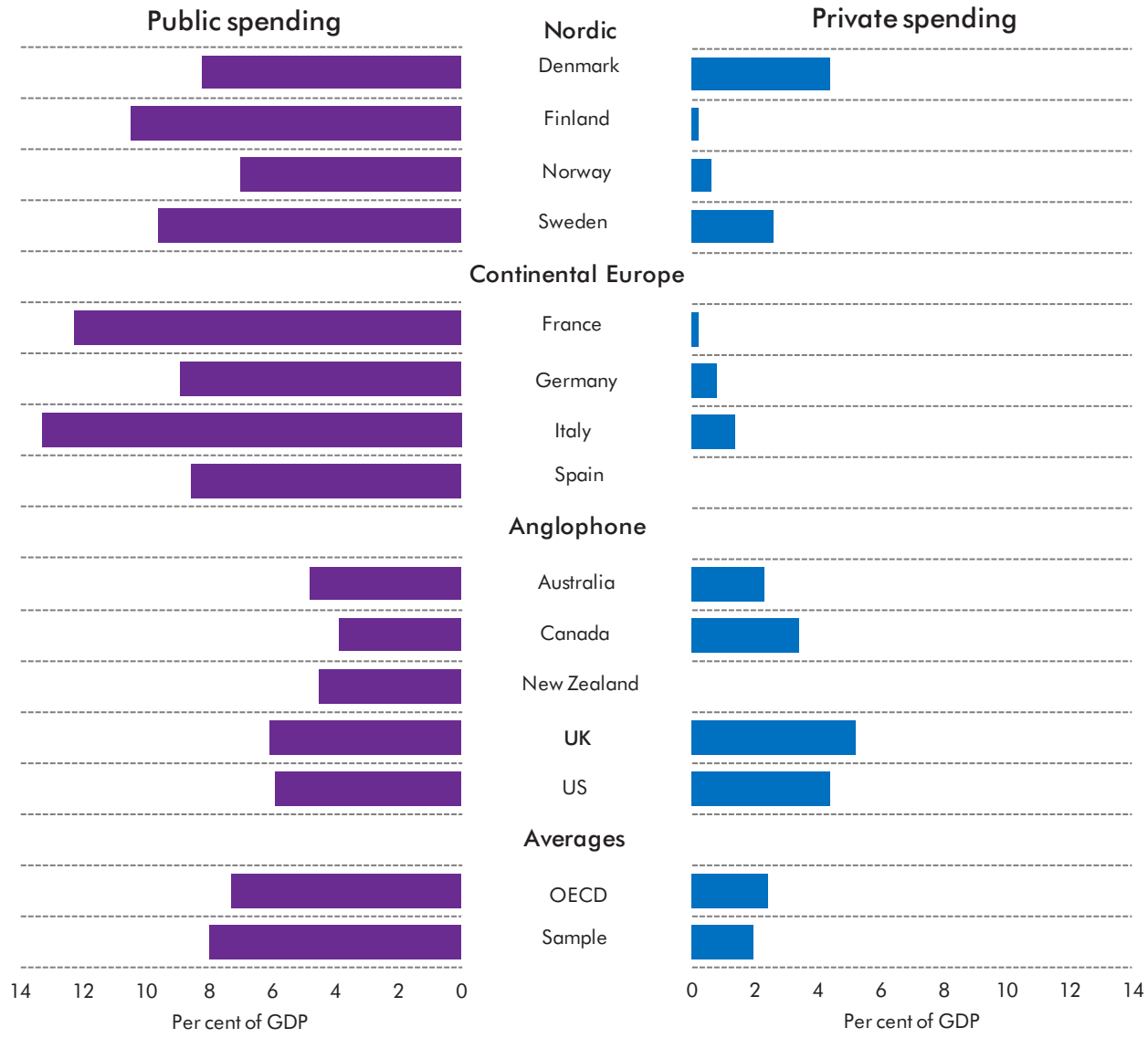
3.26 Payments to pensioners reflect long-term entitlements and financial commitments. They are mainly driven by demographic trends, so they tend to be less sensitive to the economic cycle than social spending on the working-age population. Thanks to the ageing of the population and the maturation of pension systems, public pension spending has been rising as a share of GDP in most advanced economies (including the UK). Many OECD countries are reforming their pension systems to limit the growth of spending, with the goal of achieving long-term financial sustainability of pension systems.[14] In this section we use the SOCX database as well as drawing on academic research and on data from the OECD's *Pension outlook* and *Pensions at a glance* publications.

The UK in international context

3.27 In the UK, spending on pensioners is the largest category of social spending, with gross public spending at 6.1 per cent of GDP in 2010 (slightly below the OECD average of 7.3 per cent) and gross private spending at 5.2 per cent (significantly higher than the OECD average of 2.4 per cent).[15] As Chart 3.6 shows, among the countries studied in this chapter, Italy has the highest public spending on pensioners (at 13.3 per cent of GDP) and New Zealand the lowest (at 4.5 per cent). In terms of private sector spending – explored more in the next section – the UK has the highest level of spending, with Canada, Denmark and the US also spending more than the OECD average.

[14] Adema *et al* (2011).
[15] Defined as old-age spending in the SOCX database.

Chart 3.6: Private and public spending on pensioners in 2010



Source: OECD

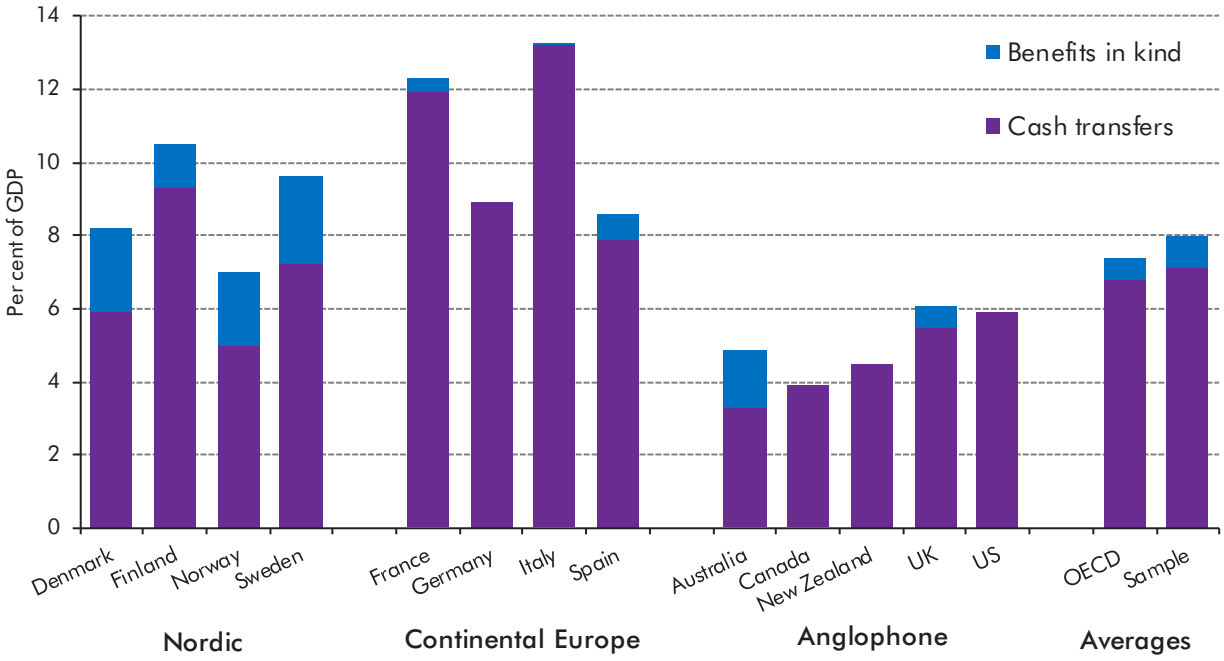
3.28 Between 1980 and 2010, public spending on pensioners increased by 2.2 per cent of GDP across the OECD, as the ageing of populations continued to exert upward pressure.[16] Spending in the UK increased by a similar margin over this period, from 4.2 to 6.1 per cent of GDP on this OECD definition. In our 2014 *WTR*, we showed that while demography had been a consistent source of upward pressure on state pension spending, generous uprating relative to weak real earnings growth had also been a material driver of spending rising as a share of GDP over the past five years (see Table 5.1 and accompanying discussion in that report).

3.29 The vast majority of public spending related to pensioners – particularly in Anglophone and Continental European systems – is on cash transfers (Chart 3.7). In the UK, this primarily takes the form of the state pension and pension credit. As the chart shows, Nordic welfare

[16] OECD (2013).

systems include a greater role for benefits-in-kind. (Services for elderly people include day care and rehabilitation services, home-help services and institutional residential care.)

Chart 3.7: Public spending on pensioners in 2010



Source: OECD

3.30 As the discussion that follows will show, comparing the UK with the countries we focus on in this chapter, a number of features are apparent:

- public spending on pensioners – primarily on cash transfers – is slightly higher in the UK than in the other Anglophone countries, but much lower than in most Continental European and Nordic countries;
- private spending on pensioners in the UK is the highest in the OECD;
- the UK has a similar old-age dependency ratio to the OECD average, with roughly one pensioner for every four people of working age. This ratio is higher than in other Anglophone countries, but lower than in many Continental European countries; and
- the replacement rate for state pensions in the UK (i.e. their generosity relative to pre-retirement earnings) is relatively low among the countries considered. By contrast, replacement rates from those schemes classified as private spending are close to the OECD average.

The role of private sector expenditure and the tax system

3.31 One reason why UK public sector spending on pensions is low relative to comparable countries is the large role played by the private sector in pensions provision. Spending by private pension schemes is also relatively high in the US and Denmark.[17]

3.32 In the UK, 43 per cent of the working-age population are members of a private sector pension plan. Private coverage is slightly higher in the US, at 47 per cent of the working-age population. A high proportion of individuals in the US – higher than in the UK – are members of both occupational and individual pension schemes, with 40 per cent of individuals covered by occupational pension plans also covered by individual plans. The pension systems in Denmark and Switzerland include some degree of mandatory membership to occupational and/or personal schemes. As a result, coverage in these countries is higher still, at over 80 per cent of the working-age population in Denmark and 70 per cent in Switzerland.[18]

3.33 Around half of what is classified as UK private sector pension spending in the SOCX database is on occupational pensions, such as employer-based pension schemes. The other half mainly comprises pension schemes for public sector employees, which, to ensure consistency with National Accounts definitions, are classified in the SOCX database as private spending.[19] This is also the case in Canada, Denmark and Sweden, but not France, Germany, Spain and the US.[20] In the UK public finances data, on which we base our medium-term forecasts and long-term projections, public sector pensions are classified as public spending. This classification difference will inevitably be an important factor to bear in mind in any cross-country comparisons. (As public sector pensions are not classified as a social security benefit, they have not been included in our *WTRs*.)

3.34 The personal tax system plays an important role in old-age support. In many countries, including the UK, pensioners typically do not pay social security contributions. Also, as personal income taxes are progressive and pension entitlements are usually lower than earnings before retirement, the average tax rate on pension income is typically less than the average rate on earned income. In addition, most income tax systems give preferential treatment either to pension incomes or to pensioners, by giving additional allowances or credits to older people.[21] Most Anglophone countries provide significant tax relief on pension contributions, with OECD calculations suggesting that the value of this favourable tax treatment exceeds 1 per cent of GDP in these countries.[22] In the UK, HMRC estimates

[17] OECD (2014b).
[18] OECD (2013).
[19] See Lindeman (2002) and Ponds *et al* (2011), which explains that "*In practical terms, for pension payments to former civil servants to be classified as private, these payments have to go through autonomous private funds (e.g., separate pension and/or insurance companies), for which the government does not make up the deficit on a regular basis (e.g., in practice benefit schemes which are defined contributions plans). Non-autonomous pension schemes (including pension benefits paid directly from the government budget) remain institutionally in the government sector.*"
[20] Queisser *et al* (2007).
[21] OECD (2013).
[22] Ponds *et al.* (2011).

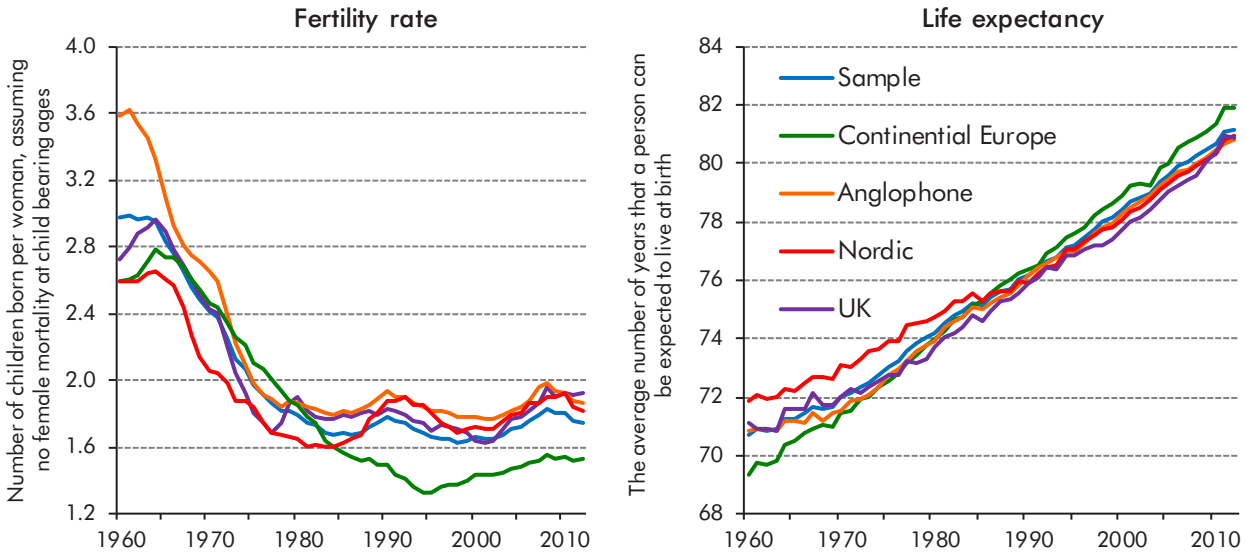
that in 2014-15 the cost of income tax relief on registered pension schemes was £22.0 billion (around 1 per cent of GDP).[23]

Demographic drivers of pensioner caseloads

3.35 One of the most important drivers of public and private spending on pensioner benefits is demography. If the proportion of the population in age groups entitled to receive pensions rises, that puts upward pressure on spending as a share of national income. This population ageing has been happening in most advanced economies in recent years, reflecting both trends in fertility rates (which have been falling in many countries) and trends in life expectancy (which has been rising, including for older people). These are shown in Chart 3.8.

3.36 In the early 1990s, the average old-age dependency ratio in the OECD countries we are focusing on (defined as the population aged 65 and over as a proportion of the population aged 15-64) was 21 per cent. By 2010, it had risen to 25 per cent.[24] The UK dependency ratio is similar to this OECD average – higher than in other Anglophone countries, but lower than in many of the Continental European countries.

Chart 3.8: Fertility rates and life expectancy



3.37 Chart 3.9 shows the positive correlation between the age structure of the population and the share of national income devoted to pensioner benefits. The relationship holds for both public spending and total spending across the public and private sectors. The two panels again illustrate the importance of private sector pension provision in the UK. Looking just at public spending, the UK spends relatively little given the age structure of the population. But, adding in private spending, UK spending is relatively higher.

[23] HMRC *Estimated costs of the principal tax expenditure and structural reliefs.* It is important to note that this is a 'static' estimate of the tax foregone due to this relief, not an estimate of the tax that would be raised by its removal, which would need to take into account any behavioural effects that were induced.
[24] Marcinkiewicz *et al* (2014).

3.38 Looking to other countries,[25] Chart 3.9 also shows that:

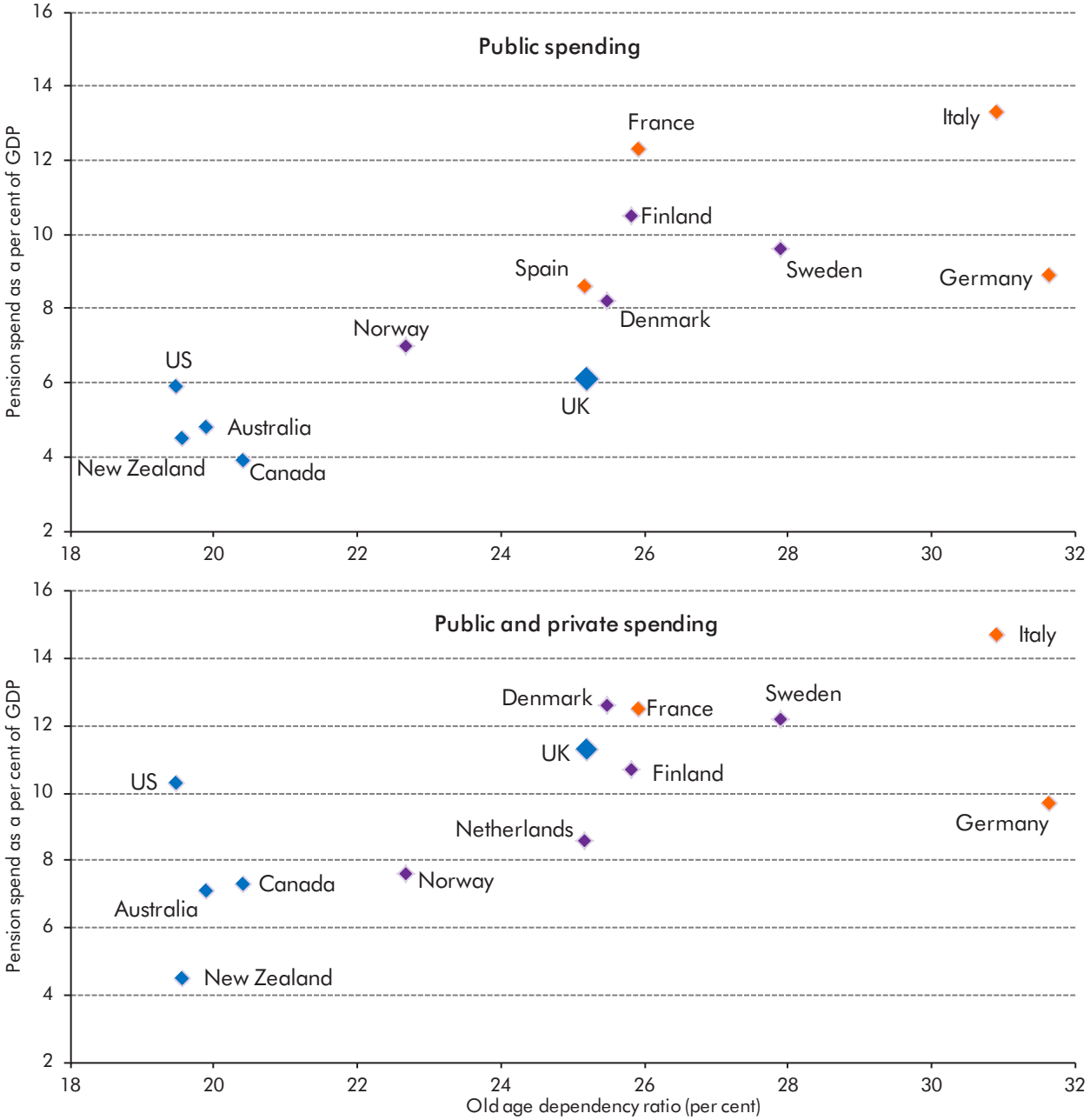
- Germany and Italy have similar old-age dependency ratios (one pensioner for every three people of working age), but spending on pensioners is significantly higher in Italy. One explanation is that Italy has a higher net replacement rate for public pensions than Germany – i.e. entitlements are higher relative to pre-retirement incomes. This is discussed further in the next section;

- France is the second highest spender on public pensions behind Italy, and – in contrast with other OECD nations – there is no role for private pensioner spending. The relatively high spending in France is in part demographically driven, but also reflects the fact that it has one of the lowest retirement ages in the OECD (62 years) and a high life expectancy after retirement age (in 2010 it reached 21.7 years, 3.2 years longer than the OECD average);[26] and

- spending on pensioners in New Zealand is among the lowest in the OECD. In part this reflects a relatively low old-age dependency ratio. But New Zealand also has a relatively low net replacement rate for private pensions, and so sits slightly lower in the bottom panel of Chart 3.9 when considering public and private spending together.

[25] See also Figure 2 of Marcinkiewicz *et al* (2014).
[26] IMF (2013).

Chart 3.9: Demographic structure and pensioner spending in 2010



Source: OECD, UN, OBR

Generosity drivers of expenditure on pensioners

3.39 As well as demography, spending on pensioners is also driven by the generosity of pensions. The most common measure used to compare generosity is the pension replacement rate – the ratio of pension benefits to pre-retirement earnings. The OECD's 2013 *Pensions at a glance* provides a comparison of net replacement rates by classification of spending and earnings levels (Chart 3.10).[27] It shows that:[28]

[27] The specific measure used by the OECD is defined as the individual net pension entitlement divided by net pre-retirement earnings, taking account of personal income taxes and social security contributions paid by workers and pensioners.

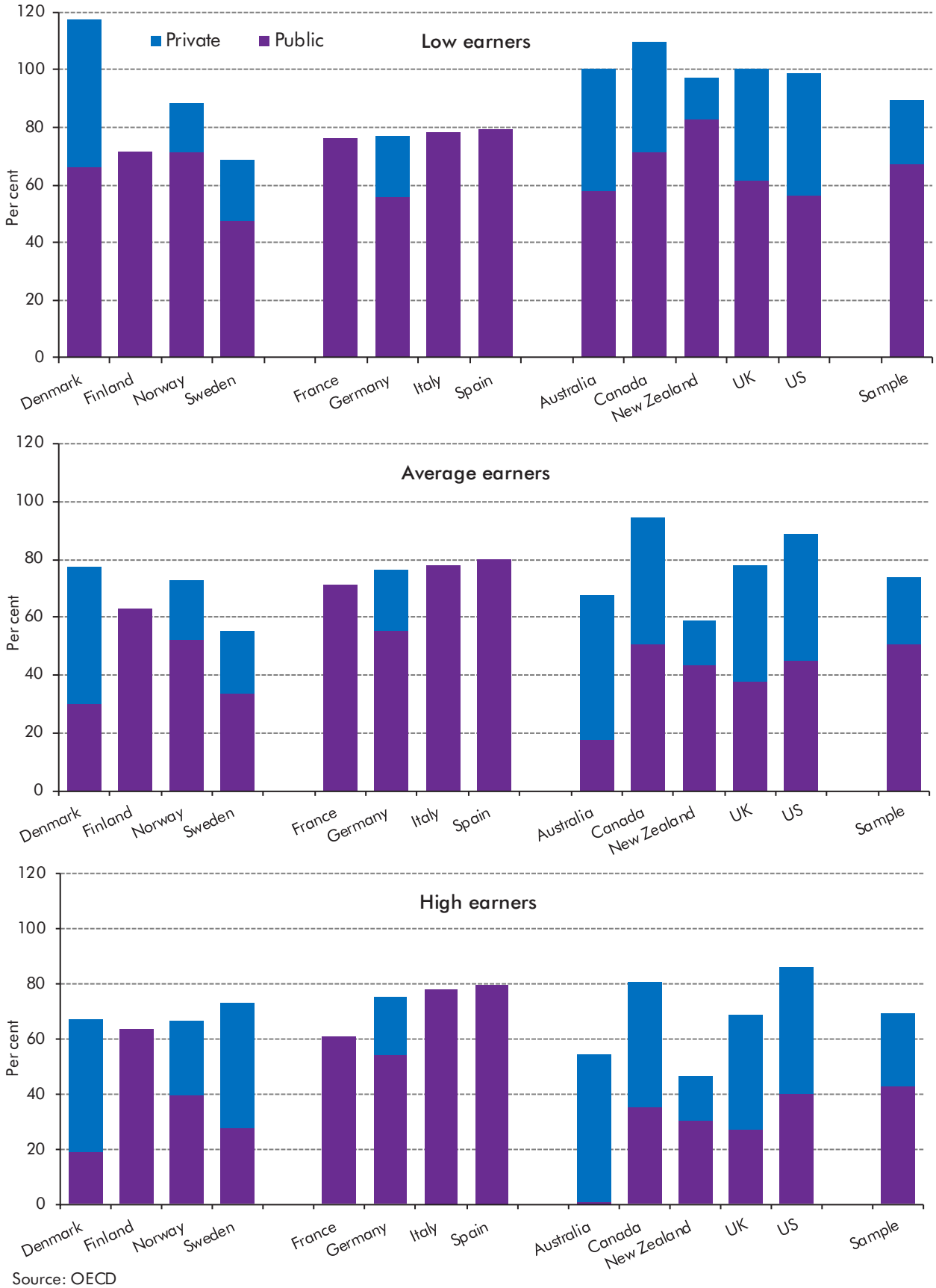
- in countries where private schemes play a significant role – such as Canada, the UK and the US – public pension generosity is towards the bottom of the scale, particularly for average and high earners. Once private schemes are included, replacement rates in the UK are closer to the average of the OECD countries we focus on across the earnings range. In Canada and the US replacement rates are also higher on this basis;

- in Denmark, pension entitlements are very high for low earners and towards the middle of the range for average and high earners; and

- the countries with pure flat-rate systems – such as New Zealand – are the least generous to high earners. Canada and the UK also provide benefits that are broadly flat-rate, but with some earnings-related elements in their schemes.

[28] These comparisons also draw on OECD (2005).

Chart 3.10: Net pension replacement rates in 2013



Source: OECD

Reforming pension systems

3.40 Many countries have improved the financial sustainability of their pensions systems through:

- less generous indexation of benefit payments – e.g. in the Czech Republic, Hungary and Norway, pensions are no longer indexed to wage growth[29] and in France, indexation was postponed from April to October in 2014.[30] These examples are in marked contrast to the triple lock on uprating the basic state pension in the UK, which has increased the generosity of the state pension relative to average earnings since its introduction;

- a greater reliance on private and/or defined contribution schemes – e.g. in Australia, defined contribution private pensions are mandatory for all individuals with incomes above a certain threshold.[31] In Austria, two new voluntary defined contribution pension schemes were introduced in 2012, with the aim of supplementing the public pension system that currently provides a high proportion of income during retirement;[32] or

- higher retirement ages – e.g. the gradual increase in the minimum age for 'New Zealand superannuation' from 60 to 65 between 1992 and 2001. This contributed to a decline in public pension spending in New Zealand from around 7 per cent to 5 per cent of GDP over this period.[33] (The UK has also raised the state pension age in recent years and has legislated to raise it further.)

3.41 In the UK there have been several reforms affecting the long-term sustainability of public spending on state and public sector pensions:

- starting in 2010, the female state pension age has been increasing incrementally, so that it is brought into line with the male state pension age by 2018. The state pension age for men and women will then rise to 66 by 2020, and will be raised to 67 between 2026 and 2028;

- the Government has also legislated for a review of the state pension age to take place at least once every six years, based on a technical assessment by the Government Actuary and other factors. Details of the core principle to guide that review were set out alongside Autumn Statement 2013, including that people should expect to spend on average up to a third of their adult life (beginning from age 20) in receipt of the state pension.[34] In our July 2014 *Fiscal sustainability report (FSR)*, we estimated that this reform would reduce spending by 0.9 per cent of GDP in 2063-64 compared to the current legislated path for the state pension age. It also reduces the risk to fiscal sustainability if life expectancy increases more rapidly than expected;

[29] OECD (2013).
[30] Ministère des Affaires Sociales, de la Santé et des Droits des Femmes (2015).
[31] OECD (2013).
[32] OECD (2014b).
[33] OECD (2012).
[34] For further detail on the Government's announcement, see DWP (2013).

- in June 2010, the Government announced that public service pension scheme payments would rise in line with inflation as measured by the Consumer Prices Index (CPI) rather than the Retail Prices Index (RPI). The former rises less quickly than the latter over the long term. As set out in our latest *FSR*, this is the main reason behind the projected fall in spending on public service pensions over the long term from 2.0 per cent of GDP in 2019-20 to 1.1 per cent of GDP in 2064-65; but

- in contrast to these reforms, which reduce spending as a share of GDP in our long-term projections, the triple lock on uprating the state pension has increased spending. The triple lock states that the basic state pension will rise by the highest of earnings growth, CPI inflation or 2.5 per cent. In 2015-16, the basic state pension was uprated by the minimum 2.5 per cent and our March 2015 forecast implies that the same will be true in 2016-17. This would be the fifth successive year since the triple lock was announced that the basic state pension increased faster than average earnings, with a cumulative difference over that period of 8.2 per cent. The triple lock would see pension spending rise as a share of GDP if earnings growth was higher than nominal GDP growth or if both earnings and GDP growth were low relative to CPI inflation, as in recent years.

3.42 UK reforms affecting private sector pension spending include the introduction of auto-enrolment, which means that by 2018 every employer must automatically enrol workers into a workplace pension scheme if they are aged between 22 and the state pension age, earn more than £10,000 a year, and work in the UK. Individuals can then opt out if they choose (reversing the previous system whereby individuals were not automatically enrolled but could opt in). To the extent that auto-enrolment raises the proportion of employees enrolled in workplace schemes, this will increase private spending on pensioners in the UK. The latest evidence suggests that so far 4.7 million people have been automatically enrolled on a pension scheme and that between 2012 and 2013, the number of eligible employees participating in a workplace pension rose by 0.9 million.[35]

Support for sick and disabled people

3.43 In advanced economies, income support for those unable to work due to sickness or disability is common. Spending on such benefits is driven both by underlying factors (such as demographics and age-specific health status) and by policy decisions (such as eligibility rules, benefit replacement rates and access to other social programmes). These factors determine the proportion of populations in receipt of sickness and disability transfers and the relative generosity of the benefits they receive.[36]

3.44 In the SOCX database, incapacity spending for the UK consists primarily of incapacity benefits, disability living allowance (DLA) and attendance allowance.

[35] Department for Work and Pensions (2014).
[36] Burkhauser *et al* (2013).

The UK in international context

3.45 In the UK, public spending on sick and disabled people in 2011 – the latest year for which detailed SOCX data are available – stood at 2.5 per cent of GDP, slightly above the OECD average of 2.2 per cent. Most was spent on cash transfers – mainly incapacity benefits and DLA. Private spending was 0.5 per cent of GDP – slightly below the OECD average of 0.7 per cent. This was mostly sickness payments made by employers. Comparing the UK with the countries that we focus on in this chapter, a number of features are apparent:

- the UK spends somewhat less on benefits-in-kind (i.e. goods and services) for disabled people, particularly compared to the Nordic countries. Overall spending is similar to Nordic levels, with the UK delivering more help through cash benefits. This includes the additional costs support of DLA that is closely linked to the cost of providing necessary goods and services for disabled people – a model that appears to be unusual among OECD countries;

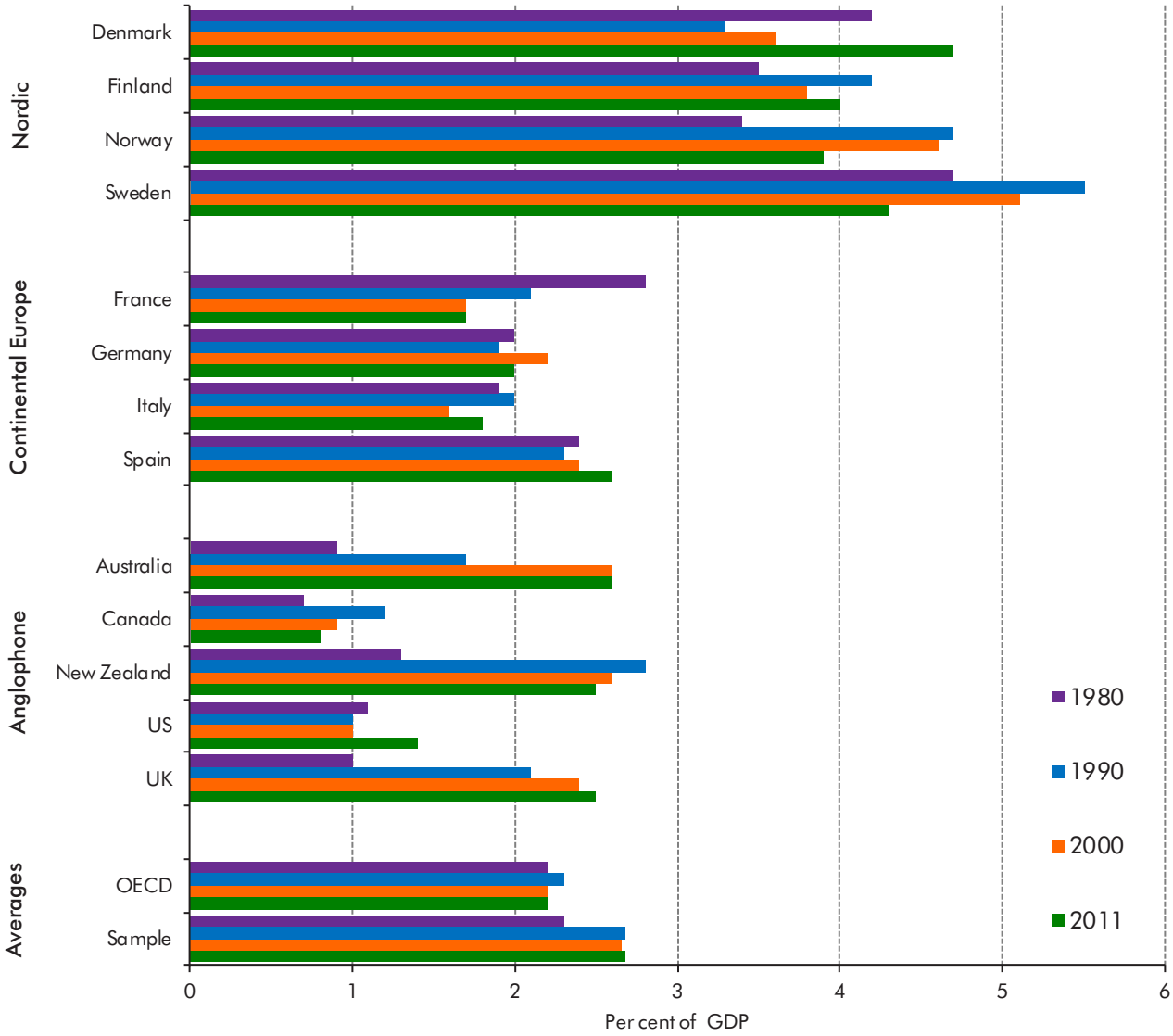
- the UK spends less on sickness payments (private spending) than Continental European and Nordic countries. One reason for this is the lower generosity of sickness payments in the UK;

- the UK is estimated to have a lower self-reported prevalence of disability than the Nordic countries, but higher than most Anglophone and Continental European countries. In the late 2000s, just under 1 in 5 working-age people in the UK were self-reported as being disabled;[37] and

- the UK has a slightly lower than average net replacement rate (a proxy for relative generosity) for disability-related benefits, whereas Nordic countries have higher replacement rates.

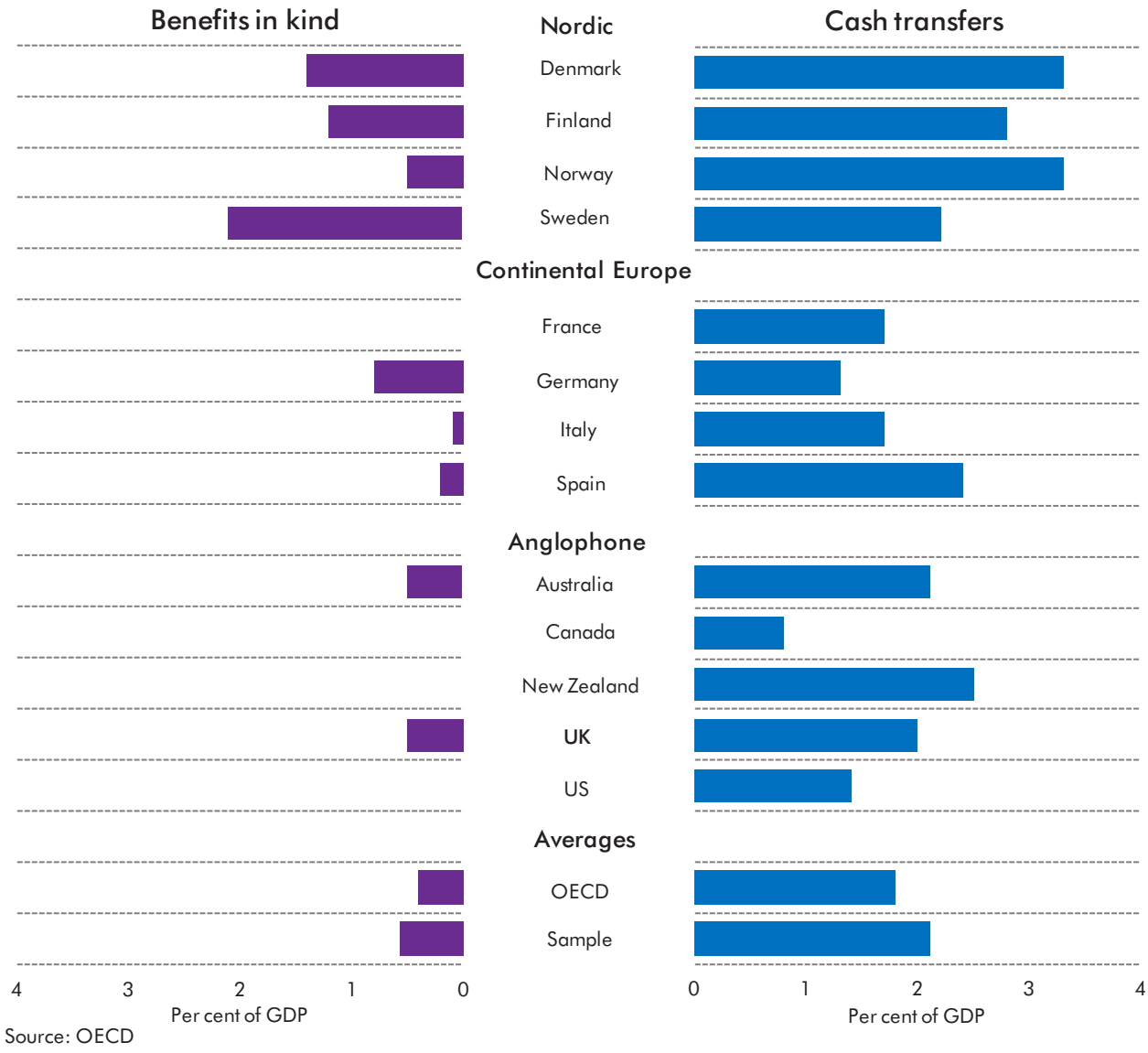
[37] In the UK Labour Force Survey, this is defined as persons with reduced capacity due to a long-lasting health problem of more than a year.

Chart 3.11: Public spending on incapacity



Note: In the OECD SOCX database, incapacity spending for the UK consists primarily of incapacity benefits, disability living allowance and attendance allowance.
Source: OECD

Chart 3.12: Incapacity spending via cash transfers and benefits-in-kind in 2011



Source: OECD

Drivers of sick and disabled spending caseloads

3.46 The proportion of the working-age population in receipt of disability benefits may vary across countries and over time for a number of reasons. These will include differences in the age structure or age-specific health status of populations, and differences in the structure of benefit systems.[38] For example:

- the number of disabled people relative to the population is an important driver of disability caseloads. Chart 3.13 shows a measure of disability prevalence by country. While the precise definition varies across countries, it typically captures a self-reported measure of health problems that are both long-standing and that limit daily

[38] See, for example, Burkhauser *et al* (2013) and MacInnes *et al* (2014).

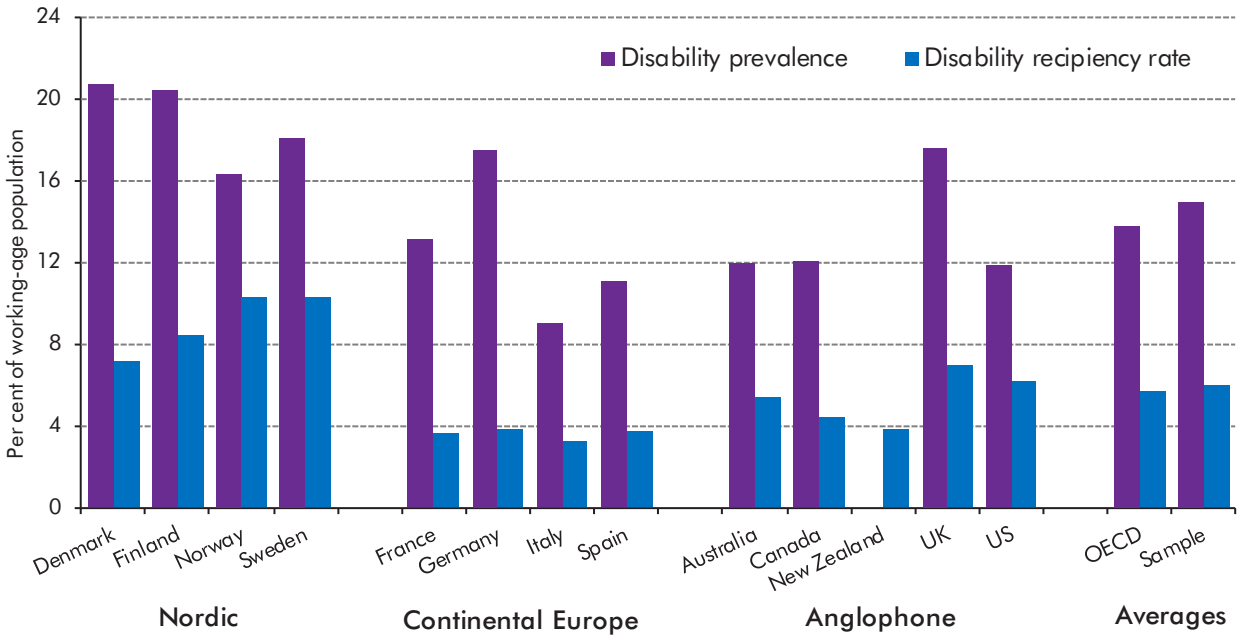
activities.[39] In the UK, disability prevalence has stayed relatively stable since the mid-1990s;

- the generosity of disability benefits has risen significantly relative to other benefits in a number of OECD countries, primarily because policymakers have reduced payments or imposed stricter eligibility criteria on other programmes, including unemployment benefits and general social assistance (e.g. income support in the UK). As we noted in our 2014 *WTR*, the tightening of conditionality for unemployment benefits in the 1990s was associated with an increase in the incapacity benefits caseload;

- structural changes in the economy can also play a role. Again, as we noted last year, industrial restructuring in the UK in the 1980s was associated with an increase in incapacity benefit caseloads as a proportion of the adult population; and

- disability benefits may have become an option for displaced or long-term unemployed workers detached from the labour market during economic downturns. Studies in the US have shown that the cyclical sensitivity of disability insurance application rates has risen over time. One recent study suggests that the movement of disability insurance eligibility in the US from identifiable medical listings towards the use of vocational criteria has contributed to this increased sensitivity.[40]

Chart 3.13: Disability prevalence and benefit caseloads in the late 2000s



Source: OECD

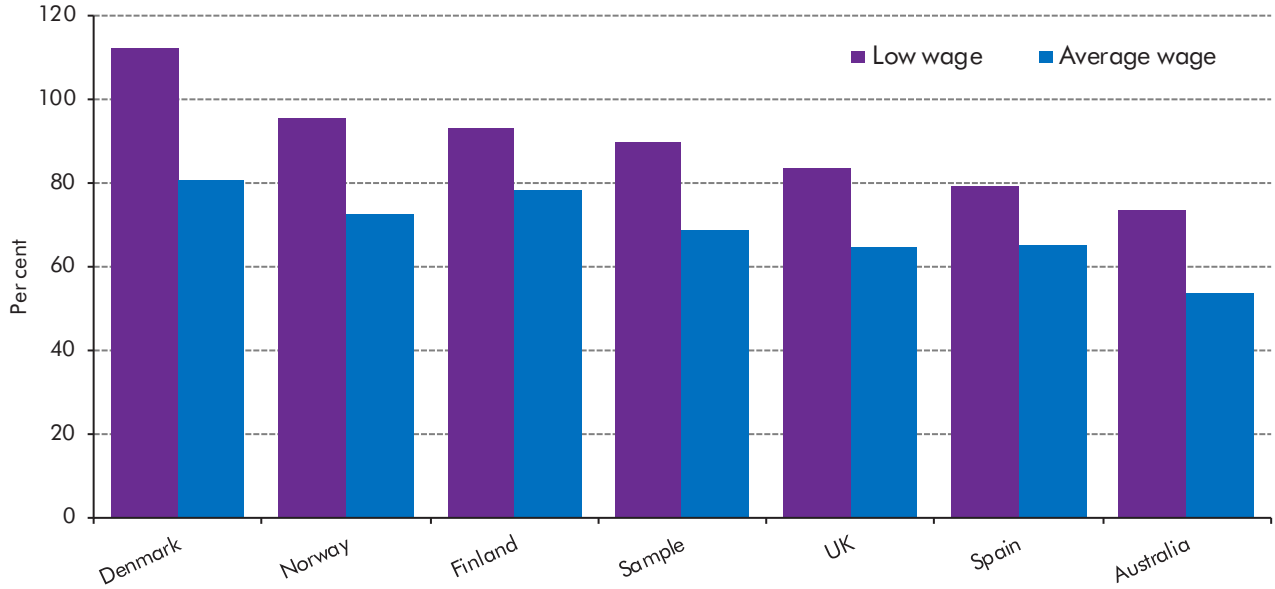
Generosity drivers of spending on sick and disabled people

3.47 Cross-country comparisons of disability benefits typically focus on their generosity relative to previous earnings over a given reference period and set of household of types. This net

[39] Precise definitions for individual countries can be found in Figure 1.1 of OECD (2010).
[40] Burkhauser *et al* (2013).

replacement rate is defined as the ratio of disposable income while out of work receiving disability benefits to disposable income while in work. In the UK, OECD estimates of net replacement rates for low and average earners claiming a sample of disability related benefits is slightly below the average of the countries presented in Chart 3.14. In particular, they are lower than in the Nordic countries. One factor that may be relevant is the UK's separation of support for housing costs of people on low incomes into a distinct benefit – housing benefit. This is discussed more fully in the context of unemployment benefits below.

Chart 3.14: Net replacement rates for disability schemes in the mid-2000s



Note: Net replacement rate for the UK represents that for long-term incapacity benefit and income support disability premium.
Source: OECD

3.48 One driver of the average award or replacement rate in the UK disability benefits system is the 'extra costs' approach of DLA. A recent report produced for the Joseph Rowntree Foundation[41] argued that no other country, as far as the authors were aware, makes such extensive use of a cash benefit focused on meeting the specific additional costs associated with disability (as opposed to meeting those needs via provision of benefits-in-kind).

Reforms to support for sick and disabled people

3.49 Over the past 25 years, a number of countries have pursued a variety of policy reforms to sickness and disability benefits. Notable examples include:

- in 2008, the Swedish Government reformed its sickness and long-term disability programmes,[42] with the aim of restricting growth in caseloads and of actively returning newly impaired workers to back to the labour market. Sweden's reforms reduced caseloads relative to the population, mainly by reducing the number of new claimants rather than by encouraging or forcing existing claimants to return to work. For example, in January 2013 the Swedish Government launched an experiment that allowed a large

[41] MacInnes *et al* (2014).
[42] These reforms are detailed in Hartman (2011) and OECD (2009).

group of existing claimants to return to work without fear of losing their right to return to benefits. Early evidence suggested that the programme had little impact on the work effort of existing claimants eligible for the programme. This limited impact suggests that returning claimants to the labour market after a long absence is difficult;[43] and

- during the 1980s and 1990s, incapacity spending in the Netherlands was the highest in the OECD (6.5 per cent of GDP in 1980 and 6.3 per cent in 1990). Since the mid-1990s, reforms that targeted employers, employees and benefit recipients helped reduce spending.[44] The measures included reassessment for claimants under the age of 45, which contributed to a significant fall in sickness absence. In addition, the disability benefit inflow rate fell by around 60 per cent between 2001 and 2007.[45]

3.50 The UK has also reformed its sickness and disability benefits systems – for instance, in 1995 the UK government reformed incapacity benefits. The immediate impact of this reform was to reduce inflows into the long-term incapacity benefit caseload, through tighter testing and the allocation of recipients to short-term groups. Since 2008, incapacity benefit has been gradually replaced by employment and support allowance (ESA). This has not delivered the savings originally expected (as discussed in Chapter 2).

3.51 The OECD has noted that across the countries that have reformed incapacity and disability benefits, policy has tended to shift towards a more employment-oriented approach (as in the UK's work capability assessments for ESA), but this does not yet seem to have been reflected in the labour market outcomes of people with disabilities. The OECD suggests that *"it appears that policy implementation is lagging behind policy intentions. The big shift in rhetoric and policy has yet to translate in many cases to an actual shift in everyday practice of doctors, caseworkers, benefit-granting authorities and service providers."*[46]

Support for the unemployed

3.52 There are two main models by which income protection for the unemployed is provided: contribution-based social insurance models, where payments are related to previous earnings (as in France, Germany and the US) and tax-funded income protection at a level determined by need (e.g. income-based jobseeker's allowance in the UK). As has been the case for other aspects of social protection reviewed in this chapter, systems often incorporate aspects of both (e.g. contributory jobseeker's allowance in the UK is linked to past National Insurance contributions, though the amount paid is not linked to past earnings). Australia and New Zealand provide other examples of insurance-type models where unemployment benefits are not earnings-related.

3.53 Spending on unemployment benefit is relatively volatile, as the rate of unemployment fluctuates with the economic cycle. The following was observed in the late 2000s recession:

[43] Burkhauser *et al* (2013).
[44] For more detail on these reforms, see OECD (2007).
[45] OECD (2010).
[46] OECD (2010).

- the International Labour Organisation (ILO) definition of the unemployment rate across the OECD increased from 5.6 per cent in 2007 to of 8.3 per cent in 2010. In the UK, unemployment stood at 5.3 per cent in 2007, and rose by slightly less than the OECD average to 7.8 per cent in 2010;

- despite nearly four years of GDP growth, the unemployment rate in the UK and the OECD in 2013 was still high at 7.6 per cent and 7.9 per cent respectively. By 2014, it had fallen markedly to 6.2 per cent in the UK but only to 7.4 per cent in the OECD;

- the size of the unemployment rate movements during the recession varied greatly across the OECD – Spain recorded one of the largest increases (11.7 percentage points) – whereas Germany actually saw its unemployment rate fall between 2007 and 2010; and

- much of the increased spending on unemployment benefit reflected the role of the automatic stabilisers helping cushion the economy from the cycle, but discretionary policy initiatives also played a role. For instance in the US there was a near fourfold increase in the maximum benefit entitlement period along with modest increases in benefit levels.[47]

The UK in the international context

3.54 In 2011 – the latest year for which detailed SOCX data are available – the UK spent 0.4 per cent of GDP on the unemployed. That was well below the OECD average of 1.0 per cent of GDP. Indeed, spending in the UK is equal lowest as a share of national income among the countries we focus on in this chapter (Chart 3.15).

3.55 Three key factors – each considered in more detail below – help to explain cross-country differences in the cost of unemployment benefits as a share of national income:

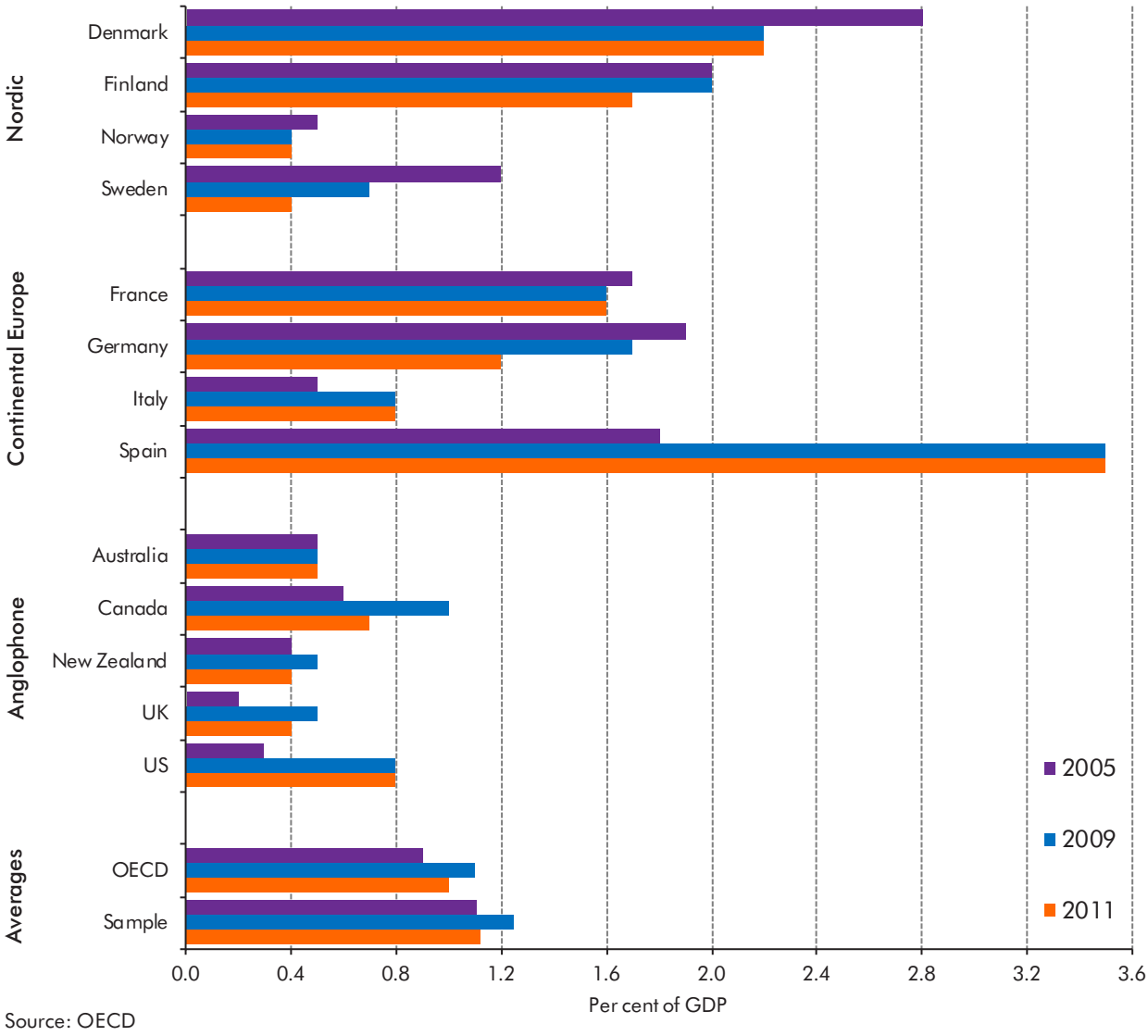
- the unemployment rate (on an ILO basis) in a country – this is an indicator of that part of unemployment benefits spending that fluctuates with the economic cycle;

- the ratio of the unemployment benefits caseload to the unemployment rate – this is a proxy for a more structural element of spending that is influenced by the conditions attached to eligibility for the benefit. (Eligibility conditions are generally quite closely related to the ILO concept of unemployment, but the mapping will tend not to match completely); and

- the generosity of those benefits – this contains a structural element determined by policy, but can also be varied in response to the economic cycle.

[47] OECD (2011).

Chart 3.15: Unemployment spending



Source: OECD

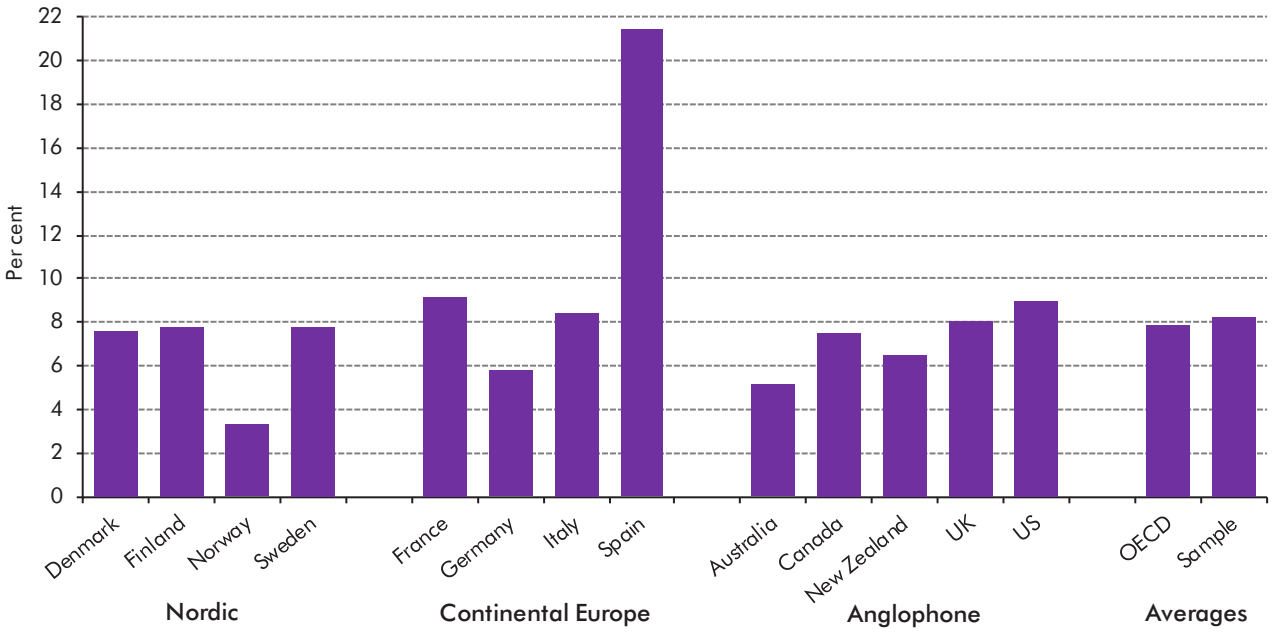
Unemployment driver of caseloads

3.56 The first key driver of spending on unemployment benefit relative to GDP is the unemployment rate. This rate will reflect both a structural element (which we estimate to be around 5¼ per cent in the UK) and a cyclical element (when the economy is either operating below capacity or overheating, so unemployment is above or below its long-term rate). Both elements might explain some of the difference between countries at any particular point in time, which means that care must be taken when drawing conclusions about relative amounts spent on unemployment benefits across countries.

3.57 The internationally comparable ILO measure of unemployment is based on whether an individual reports in the Labour Force Survey (LFS) that they are out of work and are actively seeking and available to work – it is not explicitly linked to the individual's entitlement to unemployment benefit (covered in the next section). The UK's unemployment rate in 2011 was similar to both the OECD average and the average of the sample countries we look at

in this chapter (Chart 3.16). This average is skewed by the 21.4 per cent rate in Spain, which is generally considered to be high for both structural and cyclical reasons. Excluding Spain, the average was 7.2 per cent compared to the UK's 8.1 per cent. As such, the unemployment rate does not appear to be a driver of the lower-than-average UK spending on unemployment benefits in this 2011 comparison.

Chart 3.16: ILO unemployment rates in 2011



Source: OECD

Ratio of those claiming benefits to the number of unemployed

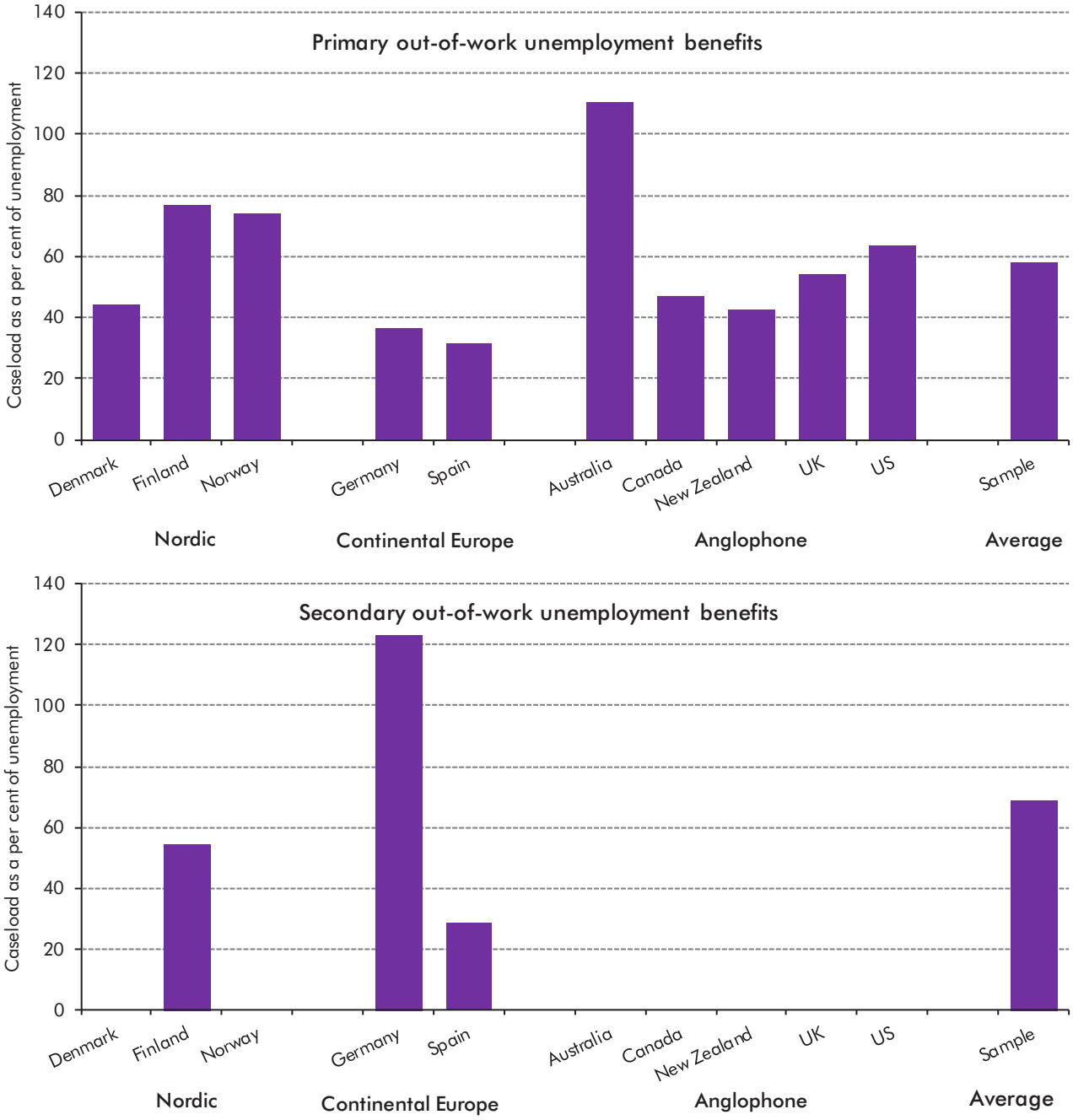
3.58 The second major driver of unemployment spending is the number of people claiming benefits relative to the number of unemployed. To illustrate this, we have drawn on data from the OECD's *Social benefits recipients* database on primary and secondary out-of-work unemployment benefit recipients. Primary out-of-work benefits are those that are typically received during an initial phase of unemployment (unemployment insurance in most countries). Some countries that have no unemployment insurance instead operate means-tested unemployment assistance as the primary benefit – jobseeker's allowance in the case of the UK.[48] Secondary benefits (unemployment assistance) are defined as those for people who are not (or are no longer) entitled to insurance benefits – this is particularly relevant in Germany.[49]

3.59 This ratio will generally be affected by the criteria that each country places on being eligible for a benefit. It is possible for the ratio to be greater than 100 per cent if the eligibility criteria extend to some of those who would be classed as inactive rather than unemployed in the ILO definitions. In the UK, this ratio is close to the average of the sample countries,

[48] Eligibility for primary benefits typically requires previous employment or insurance contributions. Exceptions are assistance benefits in Australia and New Zealand, which are not conditional on earlier employment. All primary out-of-work benefits are subject to active job search and related requirements, although implementation and enforcement differs across countries and programmes.
[49] OECD (2014c).

with the number of people in receipt of primary out-of-work unemployment benefits being just over half of the number of people who meet the ILO definition of being unemployed (Chart 3.17).

Chart 3.17: Ratio of unemployment benefit caseload to ILO unemployment in 2010



Note: In the UK, jobseeker's allowance can be income based or contributions based. The OECD 's social benefits recipients database does not include this breakdown. As the majority of claimants are income based, which is more closely associated with primary out-of-work-benefits, the full jobseeker's allowance caseload is included in the primary out-of-work-benefits panel for illustrative purposes.
Source: OECD

3.60 As discussed in our 2014 *WTR*, differences between the LFS and claimant count measures of unemployment in the UK partly reflect differences in coverage. For example, the LFS

measure captures full-time students looking for part-time work and pensioners that are not entitled to jobseeker's allowance, while the claimant count includes some low earners who are in work but are still entitled to jobseeker's allowance. The difference between the two measures also changes over time. Having peaked at similar levels during the early 1990s recession, a gap has opened up since, with the claimant count roughly 1 million below the LFS measure since 2010. As well as coverage differences, this will reflect changes in eligibility for, and take-up of, jobseeker's allowance. These could be affected by many factors, including changes to conditionality or sanctions rules.

3.61 Among other countries:

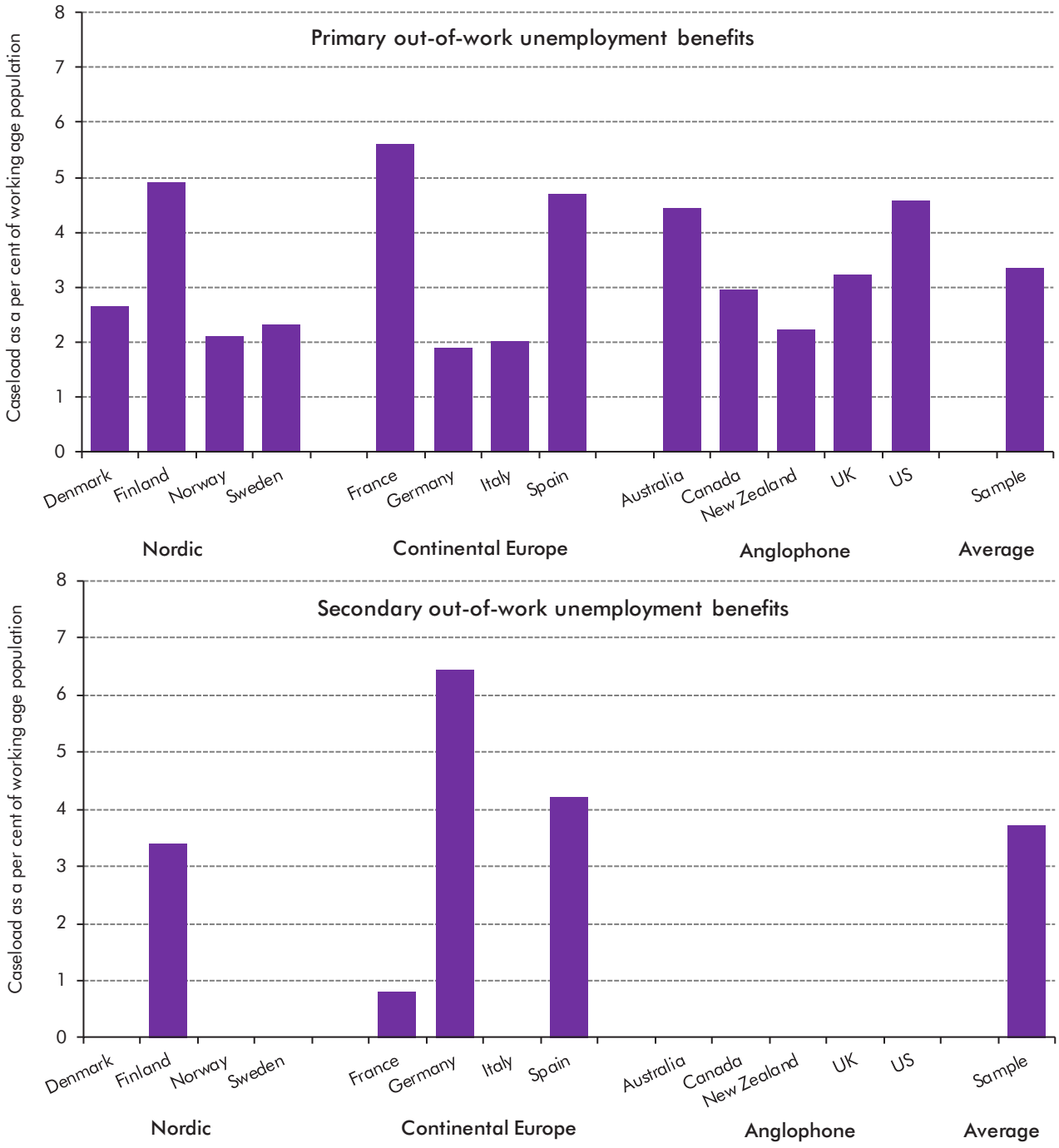
- Spain has a low ratio of the primary unemployment benefit caseload to ILO unemployment, which partly offsets the effect of high unemployment on spending. This reflects fairly strict eligibility criteria, with those who left their last job voluntarily not being able to claim (most other countries have a limited stand-down period) and severe sanctions for turning down job offers or failing to take part in active labour market programmes; while

- at the other end of the spectrum, Australia had more people claiming unemployment benefits than met the ILO definition of being unemployed. Australia has fairly lenient eligibility criteria, with people able to claim while working until they reach a certain income threshold. People may also be in training or undertaking voluntary work, thereby not meeting the ILO definition of unemployment (as they are not available for work), but they can continue to claim the benefit.[50]

3.62 The combination of the proportion of the population unemployed and the ratio to those who claim benefits will determine the proportion of the population in receipt of benefits. With the UK being close to average on both metrics as defined here, it is also close to average in terms of the unemployment benefit caseload (Chart 3.18).

[50] For more information of the benefit criteria of different countries see Venn (2012).

Chart 3.18: Unemployment benefit caseloads in 2010



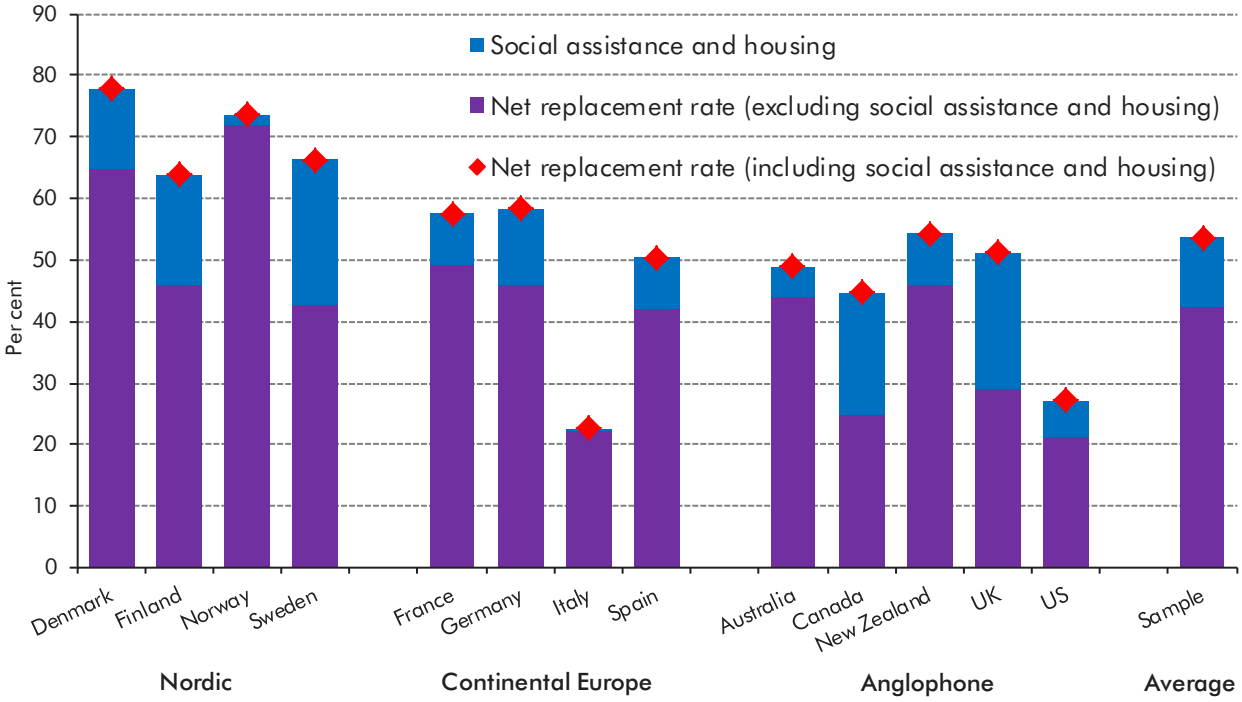
See note to Chart 3.17.
Source: OECD

Generosity drivers of expenditure on the unemployed

3.63 The third main driver of unemployment spending is how generous the benefits are to those who claim them, with cross-country comparisons typically focusing on benefits relative to previous earnings (e.g. OECD (2007)). One such measure is the net replacement rate: the ratio of average household disposable income received from the unemployment benefit to the average disposable income gained from work.

3.64 In the UK, jobseeker's allowance provides a low net replacement rate relative to other OECD countries – 13 percentage points lower than the average of the countries we focus on in this chapter. This measure does not include financial support for housing costs and other forms of social assistance. In the UK, housing benefit is important as a means of assisting low-income households with their rent payments, whereas in many countries low-income benefit levels are set such that households are expected to pay their rent out of benefits. As Chart 3.19 shows, including housing benefit and social assistance in the measure of the net replacement rate means the UK moves closer to the average of the countries covered.

Chart 3.19: Unemployment benefit net replacement rates in 2011



Note: The OECD summary measure is defined as the average of the net unemployment benefit replacement rates for two earnings levels, three family situations and three durations of unemployment. For further details, see OECD (1994) and Martin (1996).

Source: OECD

3.65 Taken together, the low share of national income spent on unemployment benefits in the UK relative to other OECD countries is due to a low generosity relative to income earned while working. The rate of unemployment and the ratio of those claiming benefits to the number of unemployed is close to the average of other countries for primary out-of-work benefits. But the low generosity of unemployment benefits is at least partly due to housing costs for the unemployed being met via a separate benefit – housing benefit – which is discussed briefly in the next section.

Support for people on low incomes

Family benefits

3.66 The SOCX database includes in public spending on family benefits – financial support that is exclusively for families and children.[51] This means that spending recorded in other social policy areas that assist families – notably health spending – are not included under the 'families' heading. As with other areas of the SOCX database, public financial support is recorded under three main types:

- **cash transfers**: including child allowances (e.g. child benefit in the UK) and income support during periods of parental leave (e.g. statutory maternity leave);
- **benefits-in-kind**: including provision of free or subsidised childcare or family services; and
- **support through the tax system**: including child tax allowances (i.e. child-related deductions from gross income that reduce taxable income) and, under the accounting methodology currently used in SOCX, child tax credits. (Under ESA10 National Accounts methodologies, tax credits of this sort are now classified entirely as cash benefits rather than being split between spending and negative tax.[52])

3.67 On the SOCX definition, public spending on support for families amounted to 4.3 per cent of GDP in the UK in 2011, significantly above the OECD average of 2.6 per cent. (In Chart 3.20, we have combined the cash benefits and tax expenditures figures for the UK, to be more consistent with the presentation of tax credits under ESA10 in our forecasts.)

3.68 Tax credits are the largest component of spending on families in the UK. Spending on them has doubled as a proportion of national income since 2002-03, in particular reflecting the expansion of tax credits in 2003-04 – when child tax credits in particular became the Labour Government's preferred policy tool to try to meet its child poverty targets. More recently, during the late 2000s recession, spending increased because of generous discretionary uprating (especially of the child element).

3.69 Comparing the UK system of tax credits with the countries we focus on in this chapter, a number of features are apparent:

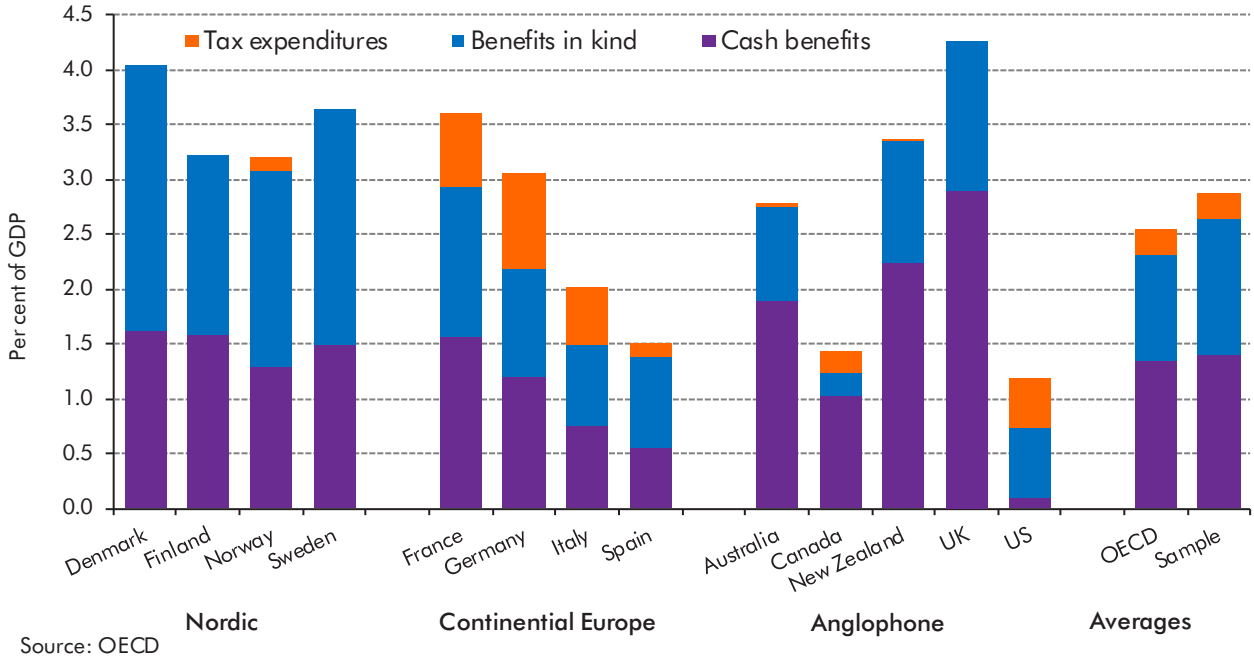
- the split between cash transfers and tax expenditures varies across countries. In the UK, tax credits are now all classified as spending, but even under previous accounting practices the majority was spending with only a relatively small proportion considered to be negative tax element. This is in contrast to other countries such as Germany and the US, where the majority of the financial support provided is offset against tax liabilities and thus recorded as a tax expenditure; and

[51] OECD (2014d).
[52] The effect of ESA10 revisions on public finances data was discussed in Chapter 4 of our December 2014 *Economic and fiscal outlook*.

- other Anglophone countries (excluding Canada) tend to focus means-tested support on low earners with children, whereas European countries, such as Germany and France, provide more generous support for average earners with children.[53]

3.70 It is also apparent from Chart 3.20 that the Nordic countries spend significantly more than other countries on benefits-in-kind – particularly on childcare services[54] – for families.

Chart 3.20: Spending on family benefits in 2011



Source: OECD

Support for housing costs

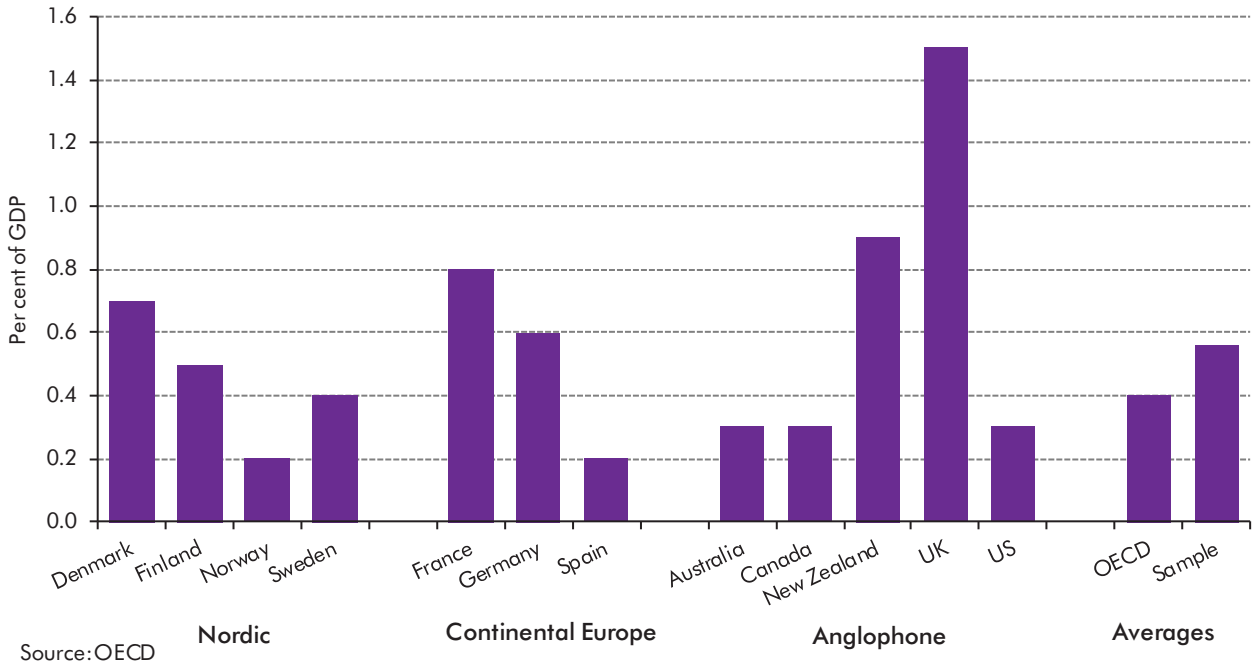
3.71 Most countries have a demand-side subsidy or housing benefit scheme that reduces the gross rent paid by low-income households.[55] The 'housing' category of the SOCX database records spending on rent subsidies – e.g. housing benefit in the UK – and other support to individuals with housing costs. As the benefit is earmarked to housing costs, it is classified in SOCX as a benefit-in-kind. In the UK public finance statistics, and therefore our forecasts and *WTRs*, housing benefit is classified as a cash transfer.

3.72 The available data on support for housing costs do not include capital spending on housing or implicit subsidy of housing via below-market rents. They also exclude spending on areas such as housing the homeless and people fleeing domestic violence – spending in these areas is captured in the catch-all 'other social policy' category. So while support for housing costs is an important component of support for low-income households, it very difficult to deal with in comparative studies.[56]

[53] Bradshaw (2007).
[54] See OECD (2014e).
[55] Bradshaw (2007).
[56] See Bradshaw and Finch (2004) and Kuivalainen (2002).

3.73 From the SOCX database, it appears that the UK spends more on subsidising housing costs as a share of GDP than any other country in the OECD. At 1.5 per cent of GDP in 2011, this figure is more than three times the OECD average of 0.4 per cent, and substantially greater than in countries such as Norway, Spain, the US, Canada and Australia. But as explained above, the UK's approach to reducing the amount of rent paid by people on low incomes is relatively unusual in being delivered through a separate cash benefit. We have not been able to determine whether, if the difference of approach could be appropriately adjusted for, the cost of subsidised rent in the UK was genuinely higher than in the other countries. But this might be possible given the high cost of housing in general. It is a subject we may return to in future *WTRs*.

Chart 3.21: Spending on support for housing costs in 2011



Source: OECD

3.74 One metric that illustrates the effect of delivering housing support separately in the UK is a comparison of net replacement rates for unemployed people. Table 3.1 is drawn from a report by the Institute for Public Policy Research.[57] It reports two measures of the net replacement rate – post-tax income from benefits as a proportion of previous post-tax income from employment – for different household types that had previously been on average wages, during an initial phase of unemployment. The first relates to the basic benefit payment; the second includes all other top-ups, including support for housing costs. On average across these four family types, the net replacement rate in the UK is 31 percentage points lower when looking only at the basic unemployment benefit, but is a much smaller 10 percentage points lower when including other forms of social assistance.

[57] IPPR (2013).

Table 3.1: Net replacement rates for households previously on average earnings in 2011

	Per cent		
	UK	OECD average	Difference
Single person: no children			
No extra social assistance	13	56	-43
With extra social assistance	38	57	-19
One-earner couple: no children			
No extra social assistance	21	58	-37
With extra social assistance	46	59	-13
Lone parent: two children			
No extra social assistance	40	67	-27
With extra social assistance	65	71	-6
One-earner couple: two children			
No extra social assistance	47	64	-17
With extra social assistance	72	72	0

Note: This table recreates Table 2.1 in IPPR (2013)

Conclusion

3.75 The comparisons presented in this chapter show that spending on social protection in the UK:

- is broadly in line with the average of advanced economies covered in this chapter in terms of public spending;
- is above average when private spending (particularly on pensions) and the net effects of the tax system are taken into account. This is despite the international data not being available to reflect the cost of tax relief for pension contributions, which is also estimated to be relatively high in the UK;
- is relatively unusual in relying quite heavily on private provision for pensions, but relatively close to average in terms of the overall resources devoted to pensions given the demographic structure of the population;
- spends a similar share of national income on support for sick and disabled people, with a high share of that support in the form of cash benefits rather than benefits-in-kind. It has been suggested that disability living allowance in the UK is unusual in its 'extra costs' model, which aims to contribute towards the costs of certain goods and services associated with differing severity of disability, rather than providing those goods and services as benefits-in-kind;
- spends much less than average on unemployment benefits, mainly because the generosity of jobseeker's allowance (as measured by the ratio of benefits to previous earnings from employment) is relatively low. But that partly reflects the use of housing benefit to deliver support for housing costs among those out of work and renting;

- spends more than other OECD countries on family benefits, defined as financial support exclusively for families and children. In large part, that reflects child tax credits, which our previous report showed had increased in cost in the mid-2000s (when they became the main tool for trying to reduce child poverty) and since the late 2000s recession (when they were subject to generous uprating); and

- spends much more than average on support for housing costs, but that is likely to be largely because that support is not wrapped up in the level of other benefits, such as unemployment or incapacity benefits.

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