May 2022 *Welfare trends report*

Office for **Budget Responsibility**

Transcript of Presentation by:

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Slide 1

Slide 2

Thanks for joining us today. I'm going to outline some of the main findings of the *Welfare trends report* that we published this morning. I'll leave plenty of time for questions and discussion.

To start with some housekeeping:

- First, this is our eighth *Welfare trends report*…
- …Whose scope, given our remit, is limited to spending. So you won't hear anything from me on distributional consequences or implications for poverty, important though they are.
- As with all of our publications we are hugely grateful for the hard work of many officials, in this case those at the Department for Work and Pensions in particular for providing much of the data we've used; and of course the OBR welfare experts here with us today.
- And finally, the analysis and conclusions are the collective responsibility of the OBR's Budget Responsibility Committee, from which Richard and Andy are here to answer your trickier questions.

Moving onto the substance, the exam question for this year's *Welfare trends report* is how recent changes in non-pensioner welfare spending, and those we forecast for the coming years, compare to the experience during and after the previous three recessions in the UK. From our perspective this assessment is helpful for understanding the risks and uncertainties around our forecasts, and we hope it's informative to your work too.

Slide 3

One of the main challenges we had to overcome in making these historical comparisons was the frequent and often significant changes to the welfare system over the past half-century – with the rollout of universal credit (UC) and the creation of the furlough and self-employment support schemes being the most recent examples. We did this by creating eight broadly consistent spending categories that look through various reforms, shown on this chart.

Before diving into the detail, this chart makes clear that each of the past four UK recessions has had a sizeable impact on welfare spending, with successively higher peaks as a share of national

income, but that the pandemic dwarfs these prior peaks thanks to the creation of new support mechanisms for short-time working by employees and the self-employed.

Slide 4

Thinking through the things that drive these changes, we have policy choices, which I'll come onto, and also structural trends continuing in the background relating to things like demographics and the health of the population, which I'll say less about but are covered in the report. But more significant than either of these two is the size, speed and composition of the economic shock.

The pandemic stands out on all of these fronts. As this chart shows the fall in output was three-and-a-half times larger than that in the financial crisis, while real GDP recovered its pre-recession peak very quickly given the size of this fall. And the fall in GDP was largely made up of lower average hours rather than falling employment or lower productivity.

These latter two factors are attributable to the unprecedented level of government support to protect viable jobs and businesses from a temporary shock that originated outside of the economy.

Slide 5

It is that temporary support that marks the welfare spending response in the pandemic out from previous recessions. Spending rose by 90 per cent in real terms in one year when these schemes are included, five times the rise excluding them and far larger than any of the initial increases in previous recessions.

Slide 6

Relative to the size of the economic shock, these schemes also greatly reduced the initial impact of the pandemic on conventional welfare spending. Those changes are really very similar across these four recessions, ranging between 16 per cent and 25 per cent real rises, but they differ in their composition. We can see that the 17 per cent real-terms rise in 2020-21 was largely explained by unemployment and housing-related spending – the purple and orange bars on the right. That reflected new welfare spending commitments in the form of the £20-a-week rise in the standard allowance in UC and increases to local housing allowance; and the various easements to claims processes and conditionality that effectively increased eligibility for these categories of spending; plus a rise in fraud and error.

In view of time I'll draw out one key difference between the pandemic each of the preceding three recessions:

- Comparing Covid to the 1980s, the biggest difference is the much larger role played by unemployment benefits spending back then, reflecting an increase in the unemployment rate around four times greater.

- The 1990s saw a much larger rise in incapacity and parenthood benefits spending than the pandemic. This reflected rising inactivity in the labour market, and in particular changes to the operation of benefits over this period that drove flows onto incapacity benefit.

- And the financial crisis saw much larger rises in child-related and particularly in-work spending. This reflects discretionary child tax credit increases in successive Budgets and the in-work benefit system's automatic stabiliser effect as real pay fell.

Slide 7

With the short-term role of policy and other factors as context, we then turn to medium-term changes on this chart, which are what matters most for fiscal sustainability.

The 0.3 per cent of GDP medium-term increase in welfare spending that we forecast would be less than one-third of the rise that followed the preceding three recessions. I'll say something about the main elements of this difference and the forecast judgements they rest on, starting with the 0.3 per cent of GDP fall in in-work spending between 2019-20 and 2024-25, which might come as a surprise given the recent increase in UC's work allowances and reduction in the taper rate. A sizeable minority of this reflects a classification issue related to the allocation of spending for couples in UC. Where one person is in work and the other is not, both are allocated to out-of-work conditionality groups. But on top of this we have factors like fiscal drag taking some people out of eligibility over our forecast as earnings rise faster than inflation-linked benefit thresholds, and the gradual roll-out of the two-child limit.

Slide 8

More striking still is the much smaller rise in unemployment benefits spending following the pandemic…

Slide 9

…Which a simple decomposition shows is almost entirely explained by the impact of persistently higher unemployment on caseloads in the preceding three recessions. By contrast, our forecast now assumes no unemployment scarring at all, thanks in no small part to the furlough and self-employment schemes. The very small rise after the pandemic is more than explained by a higher medium-term caseload relative to unemployment in the economy, which largely reflects the wider scope of the 'intensive work search' conditionality group within UC.

Slide 10

As a result, the main driver of the medium-term increase in non-pensioner welfare spending following the pandemic is higher spending on incapacity and disability benefits. This is a much larger increase than following the early-1980s recession or the financial crisis, driven by a continuation of the structural rise in disability prevalence and our judgements in respect of the long-term impacts of Covid and the pandemic's indirect health implications. By contrast, the larger increase in the early 1990s reflected a growing share of (mainly older) working-age men moving onto incapacity benefits as the unemployment benefits regime was tightened relative to the incapacity one.

Slide 11

Our remit requires us to highlight the risks around our forecasts, and this comparison of our welfare spending forecast to what happened in the wake of previous recessions points to some key areas of risk and uncertainty.

One category relates to the outlook for the economy:

- Unemployment has fallen further since we completed our last forecast, and a continuation of this trend settling down close to 3 per cent would reduce spending by around £2 billion.

- On the other hand, doubling the 210,000 rise in health-related inactivity we assume compared to pre-pandemic could add £2.7 billion to spending.

- And higher or lower scarring to output relative to the 2 per cent we assume would have wide-ranging implications.

A second category of risks relates to policy and its operation:

- This includes lags in benefit uprating in the face of rapidly rising inflation that are causing the real value of benefits to fall by £12 billion this year before catching up next year.

- The associated squeeze on real incomes also creates a risk of increased take-up of benefits relative to our assumptions – each 1 per cent equals a little over £1 billion.

- And there are also risks around the reduction in fraud and error assumed in our forecast from the very high levels seen in 2020-21.

Beyond these, perhaps the clearest and simplest message of this *Welfare trends report* is that while the initial and lasting consequences of recessions for welfare spending differ greatly, they all leave it much higher in the near term and in most cases higher in the medium term too. And this often shapes subsequent welfare policy as governments seek to reduce those costs. So a clear and present risk to our forecast is the weaker near-term growth outlook due to the Russian invasion of Ukraine and its effects on energy and other prices, heightening the risk of the UK falling back into recession this year.