

Office for
**Budget
Responsibility**

Welfare trends report

January 2018

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Office for Budget Responsibility: Welfare trends report

Presented to Parliament by
the Exchequer Secretary to the Treasury by
Command of Her Majesty

January 2018



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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 Government asked the OBR to take on additional responsibilities in relation to its 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 to "*prepare and publish information on the trends in and drivers of welfare spending within the cap*", so as to facilitate open and constructive debate. Parliament formally included these requirements in the *Charter for Budget Responsibility* when it was updated in October 2015.

In our first *Welfare trends report (WTR)*, we presented a broad survey of historical trends and our latest judgements on the prospects for benefits and tax credits spending. Our second considered the UK's public spending on social protection – a broader definition of welfare spending – in international context. Our third looked at how policy changes affected welfare spending over the 2010 to 2015 and the then planned 2015 to 2020 Parliaments relative to a counterfactual in which spending increased in line with demographics and pre-existing uprating policy.

This year's report seeks to increase transparency around one particularly complex and uncertain part of our forecast: the introduction of 'universal credit' (UC), which in coming years will absorb most existing benefits and tax credits paid to people of working age. Once fully rolled out, UC is expected to make up around a quarter of all welfare spending and around two-thirds of working-age welfare spending. Around seven million individuals and families are expected to be in receipt of it by the mid-2020s.

Reflecting the remit Parliament has given us, our focus here is on the potential cost of UC, not on its distributional impact, the efficiency of its delivery, its value for money or its contribution to government policy objectives, important though these are.

The analysis in this report represents the collective view of the OBR's Budget Responsibility Committee. We take full responsibility for the judgements that underpin it 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. And we have also drawn on the help and expertise of officials across government, in particular from the Department for Work and Pensions and HM Revenue and Customs. We have been provided with all the information and analysis that we requested.

We are also grateful to external stakeholders who gave their time and shared their expertise. In particular, we would like to thank Professor Sir John Hills at the London School of Economics, David Finch at the Resolution Foundation and Andrew Hood at the Institute for Fiscal Studies.

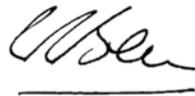
Foreword

As with all our 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.

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



Robert Chote



Sir Charles Bean



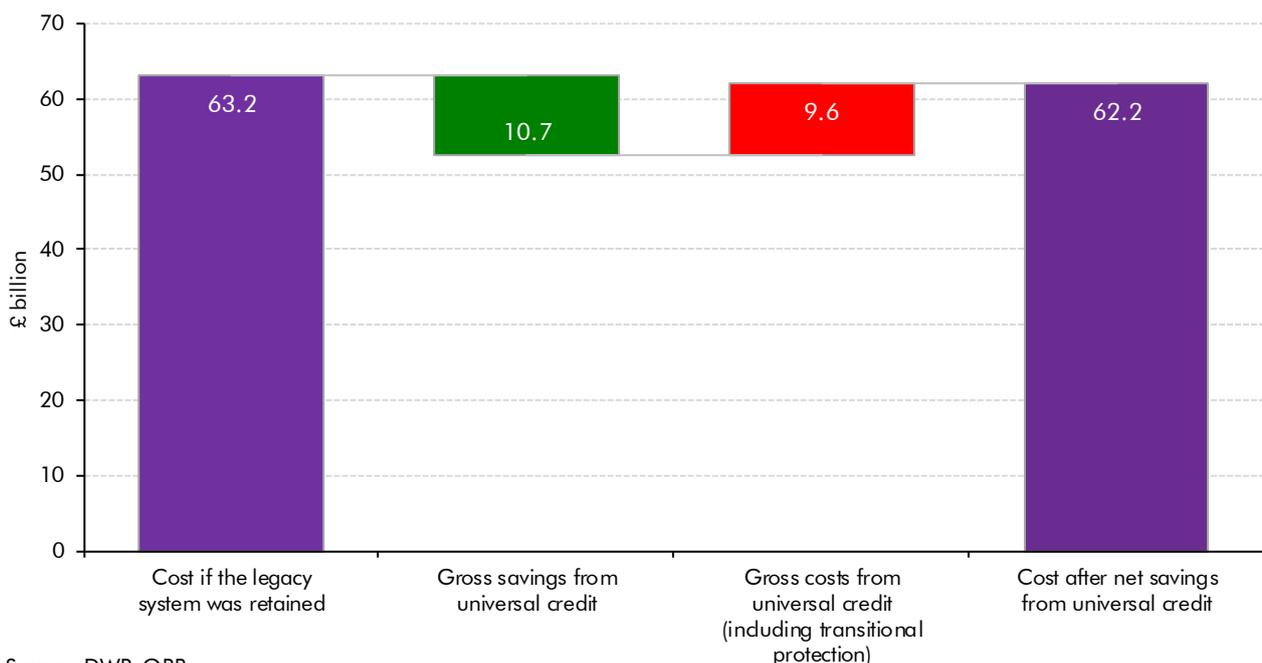
Graham Parker CBE

The Budget Responsibility Committee

Executive summary

- 1 The introduction of universal credit (UC) is one of the most significant reforms to the welfare system since the Beveridge Report. It will replace six existing means-tested benefits and tax credits for people of working age, paying more than £60 billion a year to around 7 million households by the time it is fully rolled out.
- 2 The move to UC has been – and remains – an enormous design and delivery challenge for the Government, notably the Department for Work and Pensions (DWP). The rollout has already been delayed repeatedly. And UC is now designed to save money, relative to the legacy system it replaces, rather than to cost more, as in the original vision. A welfare reform of this scale and nature is also a huge forecasting challenge and a source of significant risk to the Treasury in terms of public spending control.
- 3 At first glance, the implications of UC for the public finances look modest. In the absence of the reform, we estimate that the legacy system would cost £63.2 billion in 2022-23. On the current design, UC would reduce that by £1.0 billion. But this small saving is the net effect of £10.7 billion of gross savings and £9.6 billion of gross costs. (The underlying net saving is a slightly larger £2.3 billion, if you exclude £1.3 billion of temporary payments to some people moved to UC.) If any errors predicting these gross savings and costs add to rather than offset each other we could see large errors in the forecast for overall spending.

Chart 1: Universal credit and the legacy system in 2022-23



Source: DWP, OBR

- 4 Many of the features of UC that lead to these costs and savings are highly uncertain in their impact. This arises from the uncertain outlook for the economy and labour market, the complexity of modelling the new system with limited information and sometimes poorly integrated models, and the difficulty of predicting how people's behaviour will respond to altered financial incentives and the wider imposition of conditions on claimants.
- 5 The introduction of UC will see conditions extended to claimants in work for the first time (as well as to more out-of-work claimants). DWP's 'work coaches' must decide whether claimants are working sufficient hours or earning enough to receive UC (or, if they are self-employed, whether they are 'gainfully' so). The coaches will have discretion over the conditions and will be able to impose sanctions if they are not met. Much will depend on how they operate in practice and if their decisions are challenged.
- 6 Assessing the cost of UC once it is fully rolled out is difficult enough, but forecasting exactly how spending will evolve over the remaining five-year transition brings additional challenges – not least because the pace and composition of the roll-out is uncertain and only partly under government control. Migration of claimants to UC is already making it hard to interpret spending data in real time, as DWP cannot tell us what the UC recipients would have been receiving in the legacy system. This will become more of a problem as the overlap widens. This information gap will also make it harder to evaluate the impact on spending after the event, for example via changes to entitlement and take-up.
- 7 DWP has several trials underway to understand how UC will affect claimants' labour market outcomes, arguing that it will deliver additional savings and economic benefits by getting more people into work and onto higher earnings. Studies to date find modest, but positive effects. But we have not yet incorporated these into our forecasts, as it is not yet clear that the impact found for the simple cases migrated so far will be replicated for the more complex ones to come or if the resources devoted to the early cases will be sustained.
- 8 The quantitative analysis in this report is based on the current policy design for UC, albeit with some elements still to be finalised. But, as we have seen on repeated occasions since UC was originally launched, this and future governments may well make further changes to the design. In that context, it is worth noting that some of the largest projected savings from UC come from self-employed recipients and that there will be winners and losers from changes in the way UC supports disabled people. In recent years both groups have been affected by Budget measures that the Government has subsequently reversed.
- 9 The introduction of UC is a radical reform, simplifying the financial incentives and administration of the welfare system in several important respects. We believe that our forecast for spending on UC is central, given the current policy design and the information and models available to us. But the experience of past – typically smaller – welfare reforms is that they often take longer than expected to deliver, save less than anticipated and create political pressure to compensate losers.

UC and the *Welfare trends report*

- 10 This is our fourth *Welfare trends report (WTR)*, in which we examine public spending on different elements of the welfare system. Reflecting the remit that we have been given by Parliament – to focus on the sustainability of the public finances – these reports do not consider the impact of the welfare system on the distribution of income or measures of poverty, important though these issues are.
- 11 Previous *WTRs* surveyed a 30-year history of welfare spending, considered it in international context and looked at the role of successive Governments' welfare cuts in explaining the path of spending since 2010. This year we devote the entire report to UC.
- 12 We have included estimates of the effect of UC on welfare spending in our Budget and Autumn Statement forecasts since December 2012, following passage of the 2012 Welfare Reform Act. But it is only now that the number of individuals and families receiving UC has reached material levels. The first cases under UC were recorded in May 2013, but the caseload did not pass 100,000 until August 2013 and had reached 660,000 by November 2017. We expect it to reach around 2 million by the end of the 2018-19 fiscal year and around 7 million in 2022-23, when the rollout would be close to complete.
- 13 Given the imminent scaling up of UC caseloads and spending, and the importance UC spending has for the outlook for the public finances, we felt the time was right to increase the transparency around our UC forecast, to review the methods being used and to explain some of the risks and uncertainties involved. In doing so, we have benefited from the time and expertise of numerous officials across government departments, notably DWP.
- 14 Notwithstanding DWP analysts' considerable efforts and assistance, in several respects the monitoring and forecasting architecture for UC is less than ideal. Many elements are opaque, poorly integrated and take too long to produce robust results. We will continue to work with DWP on these issues and hope that improvements in monitoring and forecasting capacity will be included in the full UC business case that DWP will present to the Treasury and the Cabinet Office for approval later this year.

What is UC and how does it work?

- 15 Universal credit will become the main source of means-tested financial support for working-age households in the UK. It will replace tax credits, non-contributory jobseeker's allowance and employment and support allowance (ESA), housing benefit and income support. Eventually it will account for two thirds of working-age welfare spending and around a quarter of total benefit and tax credit spending.
- 16 UC is intended to simplify the administration of the benefit system and to improve and simplify the financial incentives for people to enter and progress in work. Non-financial incentives to enter and progress will also be increased, with greater provision of coaching and wider imposition of conditions for receiving benefits.

Figure 1: Working-age welfare spending: pre- and post-universal credit



- 17 UC will be administered by DWP in Great Britain and by the Department for Communities in Northern Ireland. For claimants dealing with DWP, this will mean that out-of-work and in-work claims will be administered by one institution rather than the present mix of three: DWP for most out-of-work benefits, HM Revenue & Customs for tax credits and their local authority for housing benefit.
- 18 UC is awarded to 'benefit units' – individuals or families that meet certain criteria for eligibility. Entitlement depends on their specific financial and personal circumstances. The maximum award a recipient is entitled to comprises a standard amount, plus additional elements in respect of children, housing costs, capacity to work, caring responsibilities and childcare costs, plus the presence of disabled children.
- 19 Deductions are then made to reflect the recipient's earned and unearned income, savings, and the terms of the 'benefit cap'. For earned income, UC awards are tapered away at a rate of 63 pence for every extra pound beyond a 'work allowance'; for other forms of income they are reduced pound for pound. The use of a single 63 per cent taper is a key element of the intended improvement in financial work incentives, relative to the various tapers and hours rules that complicate the legacy system. For self-employed claimants that have been self-employed for more than a year, a 'minimum income floor' will be used in the UC award calculation rather than actual reported earnings if those are lower.
- 20 Claimants that are moved from the legacy system to UC at DWP's discretion – rather than because their circumstances have changed or they are making a new claim – will be eligible for transitional protection payments where their UC award is lower than their legacy system award had been. The payment is fixed in cash terms and will be eroded by other changes and the future inflation-linked uprating of UC awards. It ends entirely with certain changes in claimants' circumstances. So the costs of transitional protection are temporary.
- 21 All UC claimants will be required to agree a 'claimant commitment', which forms the basis of the conditions attached to receiving UC. This extends the existing conditionality regime

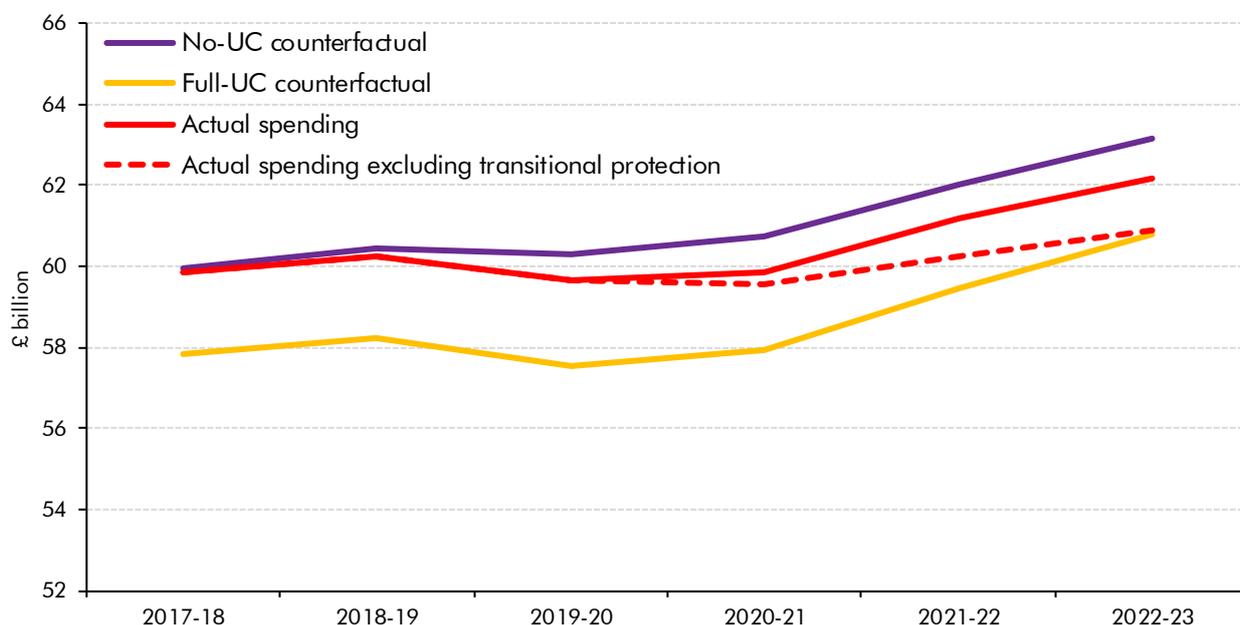
under jobseeker's allowance and ESA to in-work recipients and to partners in couples. Out-of-work claimants will be required to spend 35 hours a week searching for work, while in-work claimants will be required to seek more hours if they are deemed to be working too few. Self-employed claimants must seek to increase their earnings if they are deemed too low. Sanctions will apply to claimants that do not meet the terms of their claimant commitment, removing some or all their entitlement for a specified period.

- 22 'Work coaches' will play a crucial role in the conditionality regime, as well as helping clients. They will have discretion to set conditions for receiving UC and to decide when to apply sanctions if they are not met. The role of the work coaches looks wide ranging and challenging, especially in the context of the likely rates of pay. It is not clear how easy it will be to hire sufficient work coaches of good quality, how they will behave in practice and how often their decisions will be challenged. At this stage, we have not made any adjustment to our wider economy forecasts for the operation of the new conditionality regime.

How we estimate the effect of UC on welfare spending

- 23 Once sufficient administrative data on UC are available, we will be able to forecast spending on it in the same way that we forecast spending on most parts of the welfare system – by assessing the latest outturns and predicting how much spending will rise or fall from that level over time given our forecasts for the various factors that drive the caseload and the average amounts received.
- 24 But for now the available data are insufficient to support this standard approach. So rather than forecasting spending on UC directly, we use a three-step approach:
- We start by generating a **no-UC counterfactual** forecast for a world in which the legacy benefits continue indefinitely (described in Chapter 2). This allows us to draw on the richer data available for the legacy system.
 - Next, we calculate how much more or less would be spent in a **full-UC counterfactual** world in which the rollout to UC had already been completed (described in Chapter 5). On our latest estimates, UC is expected to cost around £2½ billion a year less than the legacy system would in this steady-state counterfactual.
 - Finally, we estimate the proportion of that steady-state difference that will be reflected in **the real world**, given the pace at which we expect UC to be rolled out. We apply this to the no-UC counterfactual, and add the cost of transitional protection to managed migrants, to generate our actual forecast for spending (described in Chapter 6).
- 25 Chart 2 shows how spending in the real world is expected to move from near the no-UC counterfactual this year to closer to the full-UC counterfactual by the end of our current forecast period in 2022-23. By this point the rollout is assumed to be almost complete, so most of the remaining difference between actual spending and the full-UC counterfactual is the temporary cost of transitional protection.

Chart 2: Universal credit spending



Source: DWP, OBR

Modelling a world without UC

26 For the time being our forecasts for spending on UC begin with forecasts for what spending on the legacy system would be if UC was not being introduced. This allows us to make our key judgements using administrative data on benefits that are reasonably well understood and for which the forecast models are well established. Until recently, UC had little effect on the legacy benefits and tax credits forecast, other than for jobseeker’s allowance. But this year, as the UC caseload has risen above 0.6 million, it has complicated our understanding of outturns for tax credits and housing benefit spending too.

27 Table 1 sets out our November 2017 forecasts for the legacy benefits in the no-UC counterfactual. It suggests that they would have cost £59.9 billion in 2017-18 if UC were not in place, rising by 5.4 per cent over the following five years to £63.2 billion in 2022-23. This is equivalent to a fall of 5.5 per cent in real terms (when adjusted for CPI inflation) and 0.27 per cent of GDP (from 2.93 to 2.66 per cent of GDP). Most of the decline comes from spending on tax credits and housing benefit, reflecting the ongoing cash freeze for most elements of the working-age welfare system. A cash freeze means that average awards fall in real terms and relative to earnings.

Table 1: Legacy benefit spending in the no-UC counterfactual

	£ billion					
	Forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Legacy benefits: 'no-UC' counterfactual¹	59.9	60.4	60.3	60.8	62.0	63.2
<i>of which:</i>						
Tax credits ²	27.0	26.6	26.2	26.6	27.0	27.3
Housing benefit (working-age)	17.7	18.2	18.5	18.1	18.5	18.9
Income-based employment and support allowance	10.7	11.4	11.2	11.5	11.8	12.2
Income-based jobseeker's allowance	2.2	2.2	2.3	2.3	2.4	2.5
Income support (non-incapacity)	2.3	2.0	2.1	2.2	2.2	2.4
Spending as a share of GDP (per cent)	2.93	2.88	2.79	2.73	2.70	2.66

¹ The figures in this table are on an Autumn Budget 2017 post-measures basis. They differ to Table 4.25 of our November 2017 *Economic and fiscal outlook* which presented the no-UC counterfactual on a pre-measures basis.

² Tax credits expenditure is presented on a UK basis whereas expenditure for the remaining legacy benefits is on a Great Britain basis, consistent with our *Economic and fiscal outlook*.

- 28 As well as forming the basis for our UC estimates, experience forecasting the legacy system provides lessons for UC forecasting. These include the importance of changing trends in the economy, labour market and housing market, which have influenced spending on tax credits, housing benefit and jobseeker's allowance. They also include the challenges of predicting how quickly welfare reforms will be delivered and what effect they will have on spending. Official forecasts under-predicted spending following the reform of tax credits in 2003 and the introduction of ESA in 2008. Our UC forecast has already been subject to significant revisions and we can expect more to follow as the rollout continues.

Modelling a world with UC fully rolled out

- 29 Estimating how much UC would cost if rolled out in full across the country is enormously complicated. Calculating entitlements under the legacy and UC systems is a matter of arithmetic, but there is much greater uncertainty when projecting how many people will be eligible in each year, what their circumstances will be, the extent to which they will take up the awards to which they are entitled, the extent to which their claims will be subject to error and fraud, and the many ways in which UC might affect claimants' behaviour.
- 30 We base our estimates on the best available survey data – currently the 2015-16 vintage of DWP's Family Resources Survey (FRS) – and two large-scale DWP models – the policy simulation model (PSM) and the integrated forecast model (INFORM). Further adjustments are made 'off-model', including estimates for how UC will affect error and fraud. For some elements, even the best available sources are inadequate. For example, only a few hundred cases within the FRS sample have circumstances relevant to the self-employed recipients who would be affected by the minimum income floor. This makes sampling variability a significant source of uncertainty. The time lag from the FRS base year adds further uncertainty. And there is currently little evidence from which to judge how extending conditionality and sanctions to in-work recipients might affect their take-up rates.

31 Bearing all this in mind, our latest estimates suggest that in this counterfactual world in which the new system is fully rolled out, and in which no transitional protection payments are made, UC would cost £2.4 billion less than the legacy system in 2022-23. This reflects a gross cost of £8.5 billion, more than offset by a gross saving of £10.9 billion.

32 The largest gross savings include:

- **Less generous work allowances:** in Summer Budget 2015, the UC work allowances and tax credits income thresholds at which entitlements begin to taper with rising incomes were cut sharply. But in Autumn Statement 2015 the tax credits cuts were reversed before implementation. As a result, UC is now significantly less generous than tax credits for some claimants, saving over £2½ billion.
- **Removal of disability premia:** the legacy system pays additional support to those also in receipt of a disability benefit. UC supports those with disabilities in a different way. On its own, removal of the premia saves more than £2 billion.
- **Reduced error and fraud:** many features of UC are expected to reduce error and fraud relative to the legacy system. Use of HMRC's real-time information system to record in-work claimants' earnings, and the removal of rules about the number of hours worked, should reduce scope for error and opportunity for fraud. Altogether, the resulting gross saving is around £2 billion.
- **Abolishing the tax credits income rise disregard:** UC awards will be adjusted for all changes in earnings, rather than only those exceeding £2,500 a year as in tax credits. This is expected to save more than £1 billion. But this greater sensitivity to changes in earnings also generates a cost from error and fraud (noted below).
- **Minimum income floor:** by assuming that self-employed earnings are at least equal to the MIF, UC is expected to save more than £1 billion a year from the more than 400,000 cases where actual reported earnings are expected to be lower. This is one of the most uncertain elements of the UC forecast, in part for modelling reasons but also because the large implied losses per claimant are likely to prompt behavioural responses that we cannot yet model properly.

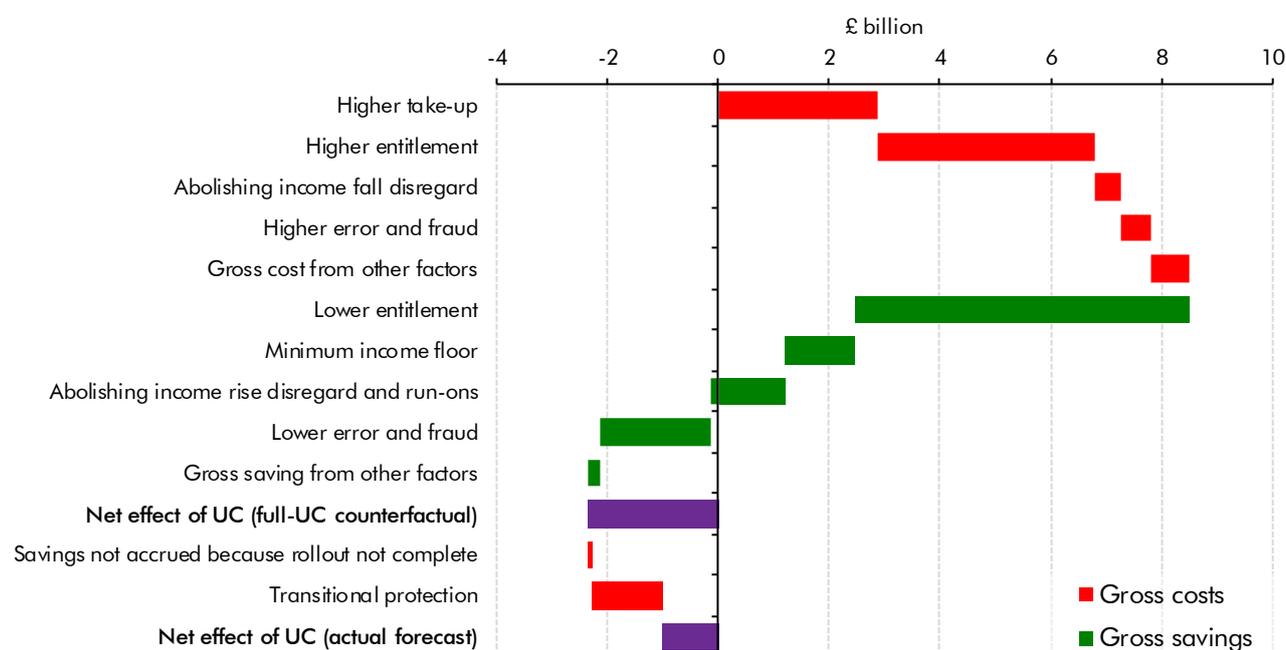
33 The largest gross costs include:

- **Higher take-up:** so long as claimants complete their UC application in full, it is not possible for them to claim only part of their entitlement. This contrasts with the legacy system, where significant numbers of people claim tax credits but not other benefits to which they are entitled. Some people in the legacy system might also choose not to apply for out-of-work benefits for what they expect to be a short period, when they had previously been claiming tax credits. Higher take-up among these 'partial legacy claimers' is expected to cost around £2½ billion.

- **Gains to those working fewer than 16 hours:** UC is more generous than the legacy system for those in low-paid low-hours employment, who would only be eligible for out-of-work benefits in the legacy system (withdrawn pound for pound with higher earnings). Together with other changes in entitlement affecting this group, this is expected to cost around £1½ billion a year.
- **Abolishing the tax credits income fall disregard:** if a tax credits recipient’s income falls by less than £2,500 the change is disregarded for their award, at a cost to the claimant. Removing this is expected to cost around £½ billion a year.
- **Increases in error and fraud:** while the net effect of UC on error and fraud is expected to be negative, there are some features that are expected to increase it. The largest of these relates to the greater sensitivity of UC to changes in earnings, which will generate some additional overpayments and costs where those cannot be recovered. This is expected to cost around £½ billion a year.

34 Another entitlement-related cost – which we cannot identify separately here – is a change in support for people with disabilities. In UC this will be provided via elements of the basic award, related to claimants’ capability for work. The cost of this will partly offset the saving from removing the disability premia in the legacy system.

Chart 3: Sources of the net saving from UC relative to the legacy system (2022-23)



Source: DWP, OBR

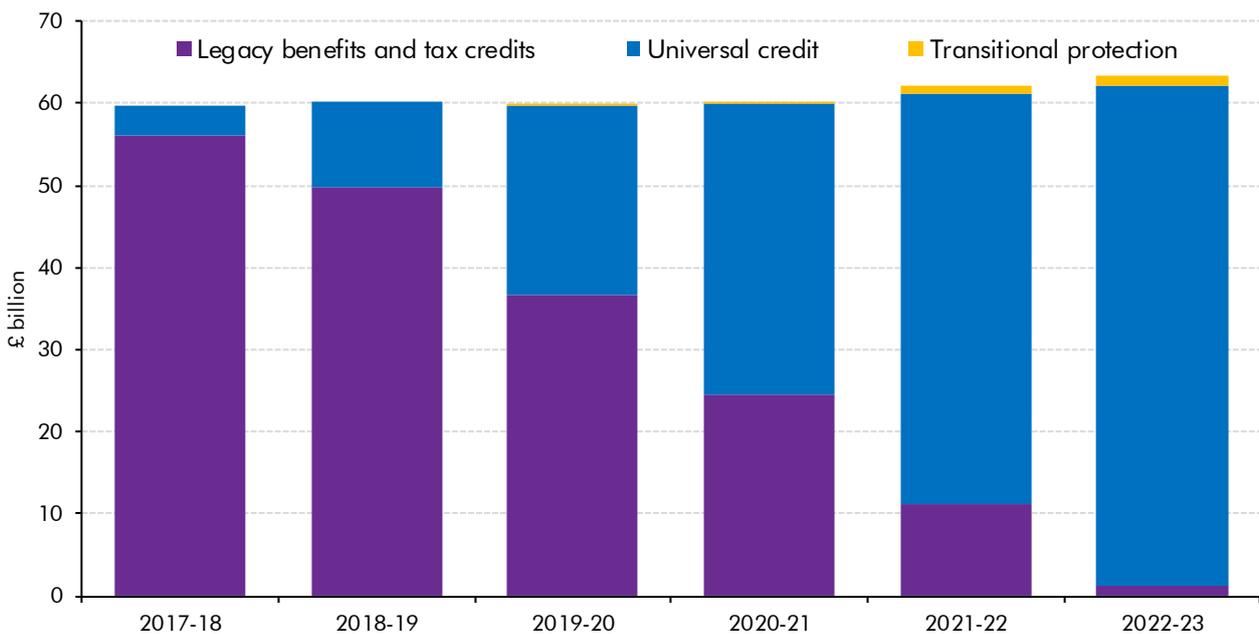
A ‘real world’ forecast of the transition

35 Given the no-UC and full-UC counterfactuals, there are two further steps necessary to forecast actual spending on the legacy benefits and UC combined and the actual net effect of UC’s introduction on welfare spending in each year. First, we factor in the pace at which

UC is expected to roll out to replace the legacy system. Second, we estimate the cost of transitional protection for those cases that are migrated to UC at DWP’s discretion.

- 36 Regarding the rollout, we base our forecast on DWP’s latest plans with a further 6-month delay assumed for the ‘managed’ element of the migration process. This implies that the UC caseload will approach half its ultimate level in 2019-20 and that it will be almost fully rolled out by 2022-23. Most sources of cost and saving move broadly in line with the rollout profile, but savings from the minimum income floor and error and fraud are concentrated among tax credits claimants that are expected to move to UC more slowly. Excluding the cost of transitional protection, the net effect of UC on spending is roughly 25 per cent of the full-UC counterfactual saving in 2019-20 and almost 100 per cent in 2022-23.
- 37 The cost of transitional protection payments is estimated by proxying the overall cost rather than modelling its operation in every respect. INFORM is used to estimate the number of managed-migration cases potentially eligible for transitional protection (rather than the number that will receive it) and the PSM to estimate average losses per UC case (rather than average losses per case in receipt of transitional protection). This approach is relatively efficient from a resource perspective, but it does not match how transitional protection will work in practice – so it will not be possible to monitor in outturn. We will look to refine this approach before the full managed migration begins in 2019.
- 38 The cost of transitional protection is expected to rise from £0.3 billion in 2020-21 to £1.3 billion in 2022-23. Given the rollout profile, this would probably be the peak, but the cost from transitional protection would continue until the final award had been eroded to zero, which could be well beyond when the rollout has been completed.

Chart 4: Actual spending on the legacy benefits, UC and transitional protection



Source: DWP, OBR

Risks and uncertainties

- 39 Our UC forecasts are subject to many real-world and modelling uncertainties:
- **Underlying forecast risks:** these include structural and cyclical trends in the economy, notably in the labour and housing market. Most would create uncertainty around the cost of both the legacy and UC systems, but they could also affect the relative saving from UC if they were concentrated in areas where UC is more or less generous (e.g. stronger growth in low-hours jobs or low-income self-employment respectively).
 - **Modelling risks:** as described above, some elements of the UC estimate are necessarily based on limited information (the sample underpinning the MIF saving) or on proxy methodologies (the cost of transitional protection). More generally, the complexity of the modelling makes it difficult to assure the quality of all inputs and outputs.
 - **Behavioural responses:** we have not yet factored in some potential behavioural responses to UC, focusing to date on how take-up is likely to be affected. We do not believe that there is sufficient evidence to judge yet how claimants' labour market outcomes might change. In particular, it remains to be seen whether the work coaches can deliver the stretching requirements that DWP intends to place on them. The MIF is also likely to prompt claimants to seek other ways to support their incomes.
 - **Policy risks:** the short history of UC to date has already brought significant changes to policy design as well as repeated delays to the rollout – including extra time to incorporate policy design changes into IT systems. It is clearly possible that further changes to either or both will be made before UC is fully rolled out. Some of the gross savings from UC imply relatively large costs for relatively large numbers of families, which Ministers may come under pressure to reduce.
 - **System learning and legal challenges:** new systems that include the discretionary application of rules can be subject to both system learning – e.g. websites advising how best to navigate the system to maximum gain for claimants – and legal challenge – e.g. recent challenges to the interpretation of guidance on personal independence payment assessments. UC involves assessing some claimants' work capability, while work coaches are set to have discretion in several areas in the conditionality regime.
- 40 Perhaps the most important source of uncertainty is that the administrative data currently available do not allow us to scrutinise outturn spending in a way that can usefully inform our forecasts. In particular, we do not know what new UC recipients would have received under the legacy system. This makes it impossible to know the extent to which spending surprises reflect: underlying factors that would influence the legacy and UC systems alike; differences in the pace at which UC is rolled out and the caseload naturally migrates between systems; or differences in the marginal cost or saving per case moving to UC.
- 41 DWP has several trials underway to understand how UC will affect claimants' labour market outcomes, but it will need to improve the availability and analysis of the necessary

administrative data, or conduct separate large-scale exercises, to monitor and evaluate the effect of UC on welfare spending effectively. Without this it would be very hard to know what impact the introduction of UC has had on total welfare spending, even after the event.

Conclusions

42 The main conclusions that we draw from this report are that UC is:

- **Fiscally significant:** UC is set to affect about 7 million households. At a cost of more than £60 billion a year it will make up around a quarter of all welfare spending and around two-thirds of working-age welfare spending.
- **Complicated:** it looks simpler to administer the main means-tested benefits under the single banner of UC and (outside Northern Ireland) solely through DWP. But the prospective reach of UC, the number of factors that determine eligibility, the conditions attached to it and the nature of the transition make it very challenging for DWP to deliver and for us to forecast.
- **A reform that delivers a small net saving, but where that masks much larger gross savings and costs:** the £1 billion saving from UC in 2022-23 is equivalent to less than 2 per cent of the cost of the legacy benefits, but comprises large offsetting gross costs and savings of close to £10 billion each.
- **A source of large costs and benefits for some groups:** the gross costs and savings from UC are frequently concentrated within specific groups, notably the amounts saved by less generous work allowances and from imposing the minimum income floor on self-employed claimants. It remains to be seen whether these prompt behavioural responses from claimants or generate pressure on Ministers to compensate losers.
- **A risk to public spending control:** our estimate of the impact of UC on welfare spending is subject to many forecast, modelling, behavioural and policy risks. These are compounded by the lack of reliable information on how UC is affecting welfare spending today. This makes it impossible to distinguish between errors in predicting the impact of UC itself from those that would have existed in any event in forecasting the legacy system. This will make it hard to learn from these errors for future forecasts.

1 Introduction

- 1.1 'Welfare spending' means different things to different people. At its broadest, it could cover any public spending that plays a part in the provision of the welfare state – including health, social care, education and social housing, as well as social security benefits and tax credits for people of all ages. Our *Welfare trends reports (WTRs)* focus on benefits and tax credits, which transfer cash from some parts of the population to others on the basis of eligibility.
- 1.2 This year's *WTR* focuses on universal credit (UC). This is set to become a major part of the benefit and tax credit system, absorbing most existing benefits and tax credits that are paid to people of working age.
- 1.3 In this chapter we introduce the metrics and methodological approach that we use to analyse the evolution of welfare spending over time. We then introduce UC: what it is, how it will fit into this system and how we factor its effects into our forecasts.

Welfare spending

How we measure welfare spending

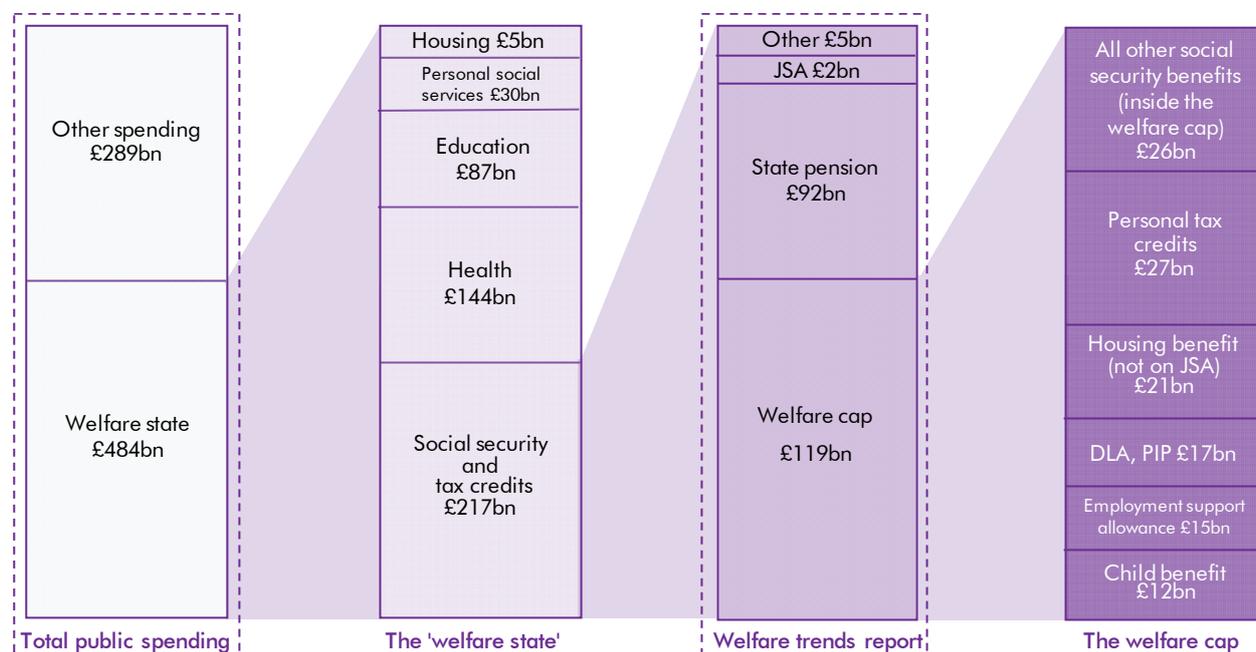
- 1.4 Our *WTRs* focus on those elements of benefit and tax credit spending that are financed by central government as part of what the Treasury calls 'annually managed expenditure' (AME). Most social security and tax credit spending is administered by three central government organisations:¹
 - the **Department for Work and Pensions** (DWP) administers most benefits in Great Britain;
 - **HM Revenue and Customs** (HMRC) administers the personal tax credits, child benefit and tax-free childcare systems across the United Kingdom; and
 - the **Department for Communities** administers most benefits in Northern Ireland.
- 1.5 Housing benefit and local council tax support are administered by local authorities. Most of the cost of housing benefit in Great Britain is met by DWP.

¹ Some smaller benefits are administered by other departments – for example, paternity pay is administered by the Department for Business, Energy and Industrial Strategy.

Introduction

- 1.6 Due to the administrative separation of the benefits system between Great Britain and Northern Ireland, we tend to focus on DWP-administered spending in Great Britain. HMRC-administered spending is considered on a UK basis.
- 1.7 UC will be a UK-wide benefit. It will be administered by DWP in England, Scotland and Wales and the Department for Communities in Northern Ireland. Some powers over the design of UC have been devolved to Scotland and Northern Ireland. Northern Ireland has already departed from the system in Great Britain in several ways – for example, paying UC fortnightly rather than monthly; allowing partners to choose who receives payments; and paying the housing element direct to the landlord. The Scottish Government has also legislated to give Scottish claimants the option of receiving UC payments twice a month and for the housing element to be paid directly to the landlord.
- 1.8 Figure 1.1 shows how the definition of welfare spending used in this report relates to total public spending and to other possible definitions of welfare spending. It shows that AME spending on social security and tax credits accounted for 28 per cent of the £772 billion of total public spending in 2016-17 and 45 per cent of a broader definition of spending on the ‘welfare state’. The Government’s ‘welfare cap’ applies to 55 per cent of welfare spending as defined here and 15 per cent of total public spending.

Figure 1.1: UK welfare spending in context (2016-17)



Source: HMT, OBR

- 1.9 In describing how welfare spending evolves over time, different metrics are appropriate for different purposes. The three we use most often are:
- **Spending in cash or nominal terms:** this is simply the cash amount spent in a given period. But without putting the cash amount into context – by asking what 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.
- **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 metric most relevant when considering the sustainability of the public finances.

1.10 Other possible metrics include welfare spending as a share of total public spending (illustrating the trade-offs with other priorities in a given spending envelope), relative to revenues (a more direct comparison with 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).

How we analyse trends in welfare spending

1.11 Trends in welfare spending reflect many different drivers. We split these into:

- those that affect the number of recipients – **the caseload**; and
- those that affect the amount paid to each – **the average award**.

1.12 The nature of the caseload varies across benefits, depending on how they are administered – most importantly whether eligibility refers to an individual or to a family or household. In the administrative data, each case is referred to as a ‘benefit unit’ and may be an individual (e.g. a personal independence payment claimant) or more than one person (e.g. housing benefit or tax credit claim). This distinction is important in this report because eligibility for UC is determined at the benefit unit level. It is possible for more than one benefit unit to live within a single household. For simplicity, whenever we use the terms ‘cases’ and ‘recipients’ in this report we refer to benefit units.

1.13 Total spending on each benefit and the average caseload through each year are derived from administrative data, with the average award calculated from the two. The average award is not necessarily the same as the statutory rate or rates for a given benefit, as it will usually depend on the composition of the caseload. For some benefits the average annual award will be very different from the average amount each claimant receives during the year. For example, almost half the jobseeker’s allowance caseload have currently been claiming for less than six months.² This means that the average caseload through the year is

² *Jobseeker's allowance by age and duration*, ONS, December 2017.

made up of a higher number of shorter claims, so the average award will be higher than the average amount received by individual cases.

1.14 Changes in caseload can be affected by:

- **changes in the population eligible for a benefit**, due to demographic or economic factors – such as the rising number of people above the state pension age or changes in the number of people unemployed;
- **the proportion of those eligible who take up their entitlement** – this could be affected by knowledge of the entitlement, by conditions placed on receiving it or by perceived stigma that deter people from making a claim;
- **changes in income brought to account** – especially earnings and changes in housing costs; and
- **policy changes that alter eligibility criteria** – such as raising the state pension age or revising the parameters that guide assessment decisions for new or existing claims.

1.15 Changes in the implied average award can be affected by:

- **Statutory (or default) uprating of benefits and the economic factors that affect the measures by which benefits are uprated** each year. For example, where rates are linked to inflation, they would be affected if exchange rate or oil price movements led to higher or lower inflation or if the Government changed the measure used (as the Coalition Government did in 2010, moving from the RPI to CPI measure).
- **Policy choices to uprate benefits by a discretionary amount instead of the default setting**. For example, the four-year cash freeze on most working-age benefits and tax credits in the Conservative Government's July 2015 Budget.
- **Changes in the composition of the caseload**. If different groups receive different amounts, these changes can alter the average award even when the overall caseload is stable. For example, a lower rate of employment and support allowance (ESA) is paid to those deemed to be in the 'work-related activity group' and a higher one for those deemed to be in the 'support group', so a shift towards one or other of these groups will affect the average award across the aggregate ESA caseload.

1.16 This approach is also useful when considering the effect of a new policy. The effect of a new policy can be split into the number of recipients affected and the average amount they are expected to gain or lose. This is important for UC, given the approach we use to factor it into our forecast.

Universal credit

What is universal credit and how has it evolved?

- 1.17 There have been many proposals for the simplification or aggregation of different elements of the tax and benefits systems over the years. The genesis of the particular reform that the current and previous governments have embarked upon was a 2009 report published by the Centre for Social Justice, a think-tank set up by Iain Duncan Smith MP in 2004 (when the Conservative Party was in opposition). Among many recommendations, it proposed “replacing the current confusing array of benefits with a ‘Universal Credit’ – a simpler, more cost-effective system that provides greater rewards for work.”³
- 1.18 In November 2010, the Coalition Government – in which Iain Duncan Smith served as Secretary of State for Work and Pensions – published *Universal credit: welfare that works*. This white paper started the process for introducing the legislation that would eventually underpin UC. It set out a number of features of the new system, which it said would:
- be **an integrated benefit** in place of six existing benefits and tax credits: income support, income-based jobseeker’s allowance, income-based ESA, housing benefit, child tax credit and working tax credit;
 - be **means-tested** – with awards determined by family income and other circumstances;
 - be **payable in and out of work** so that existing rules, including hours rules, that applied when starting or leaving a job, would be removed in order to improve work incentives;
 - have **a simple structure** designed “to provide a basic income for people out of work”, to “make work pay as people move into and progress in work” and to “help lift people out of poverty”; and
 - use **a single taper to withdraw support as earnings rise** and introduce a new approach to earnings disregards.
- 1.19 The legislation underpinning UC was passed in 2012, within the broader Welfare Reform Act of that year. This was followed by an initial set of UC regulations in 2013, setting out greater detail on how it would work. Since then, Governments have frequently revised the parameters of the system, requiring revisions and additions to the regulations. The most significant have been:
- **Entitlement cuts announced in the July 2015 Budget:** as part of the Conservative Government’s post-election package of measures to cut £12 billion a year from welfare spending, the generosity of UC was cut in various ways. These included reducing ‘work allowances’ (the point at which UC awards start to be tapered away), including removing them altogether for non-disabled claimants without children;

³ *Dynamic benefits: Towards welfare that works*, Centre for Social Justice, September 2009.

removing support for third and subsequent children from new claims; and removing the first-child premium from new claims. Similar cuts were announced to the legacy system, but the tax credits equivalent of the work allowances measure was dropped before being implemented. For the first time, this resulted in UC being significantly less generous on average than the legacy system, making it a source of spending cuts as well as a major reform to the system.

- **Increasing the generosity of the taper in Autumn Statement 2016:** a fraction of the effect of the cuts announced in July 2015 was offset by this subsequent announcement that the UC taper rate would be reduced from 65 to 63 per cent, which means that UC recipients keep more of each extra pound they earn. The award is, however, still tapered from the significantly reduced work allowance thresholds.

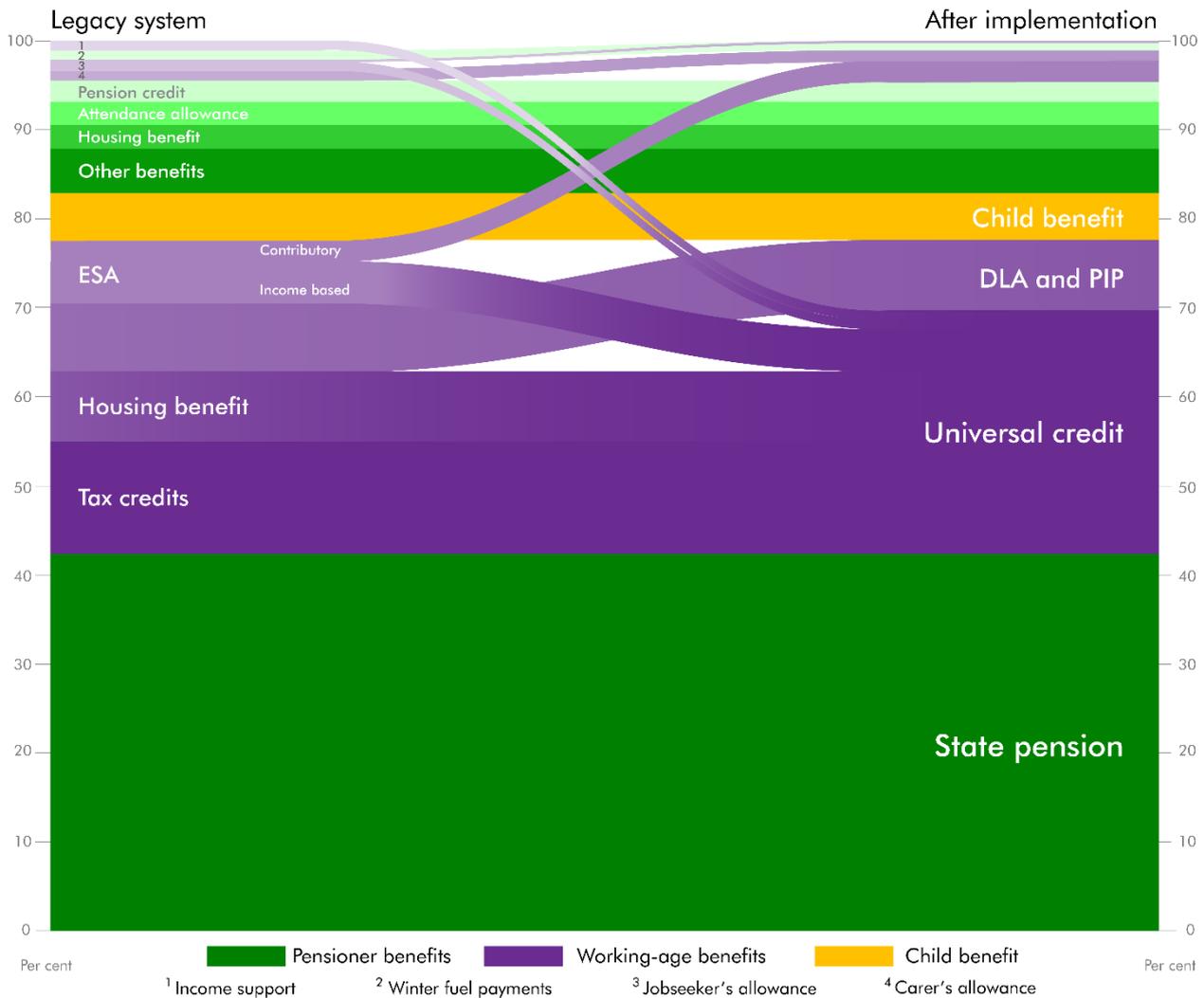
1.20 The 2010 white paper included a provisional timetable that had been “developed with a view to completing the transfer to Universal Credit by October 2017” – a point now passed. The 2013 start date in this timetable was met, but the pace of the rollout has been much slower than originally expected. The first cases taken through pilots in the North West of England started in October 2013. As the system was tested and rolled out gradually to other parts of the country, the caseload edged higher. By October 2017 – the originally planned completion date – it had reached 635,000. This marked the start of the accelerated national rollout phase, with the UC caseload at this point standing at around a tenth of where it is expected to reach once the rollout has been completed.

How will universal credit affect the welfare system?

Structure of welfare spending

- 1.21 The replacement of six legacy benefits and tax credits with UC will change the structure of the welfare system significantly. By the time it is fully rolled out, the caseload is expected to reach around 7 million. This is a little over half the number of individuals receiving the state pension and similar to the number of families receiving child benefit.
- 1.22 As Figure 1.2 shows, the pre-UC system of working-age welfare spending is split across many different benefits and tax credits. Once UC is fully rolled out, welfare spending will be dominated by the four largest payments: the state pension, UC, the personal independence payment (for disabled adults) and child benefit. Some fragmentation will remain, because the contribution-based versions of jobseeker’s allowance and ESA are being retained. Despite UC accounting for around two-thirds of working-age welfare spending once rolled out, it will still only account for a quarter of overall welfare spending as more than half of that is paid to pensioners.

Figure 1.2: The composition of welfare spending before and after universal credit



Differences of design and administration

1.23 UC will affect the quantum of welfare spending because it has many features that differ from the legacy system it replaces. It is these differences – and their often uncertain implications for spending – that are the subject of this report. They include:

- **Entitlement:** some parts of UC are more generous than the legacy system, for example the combined work allowance and taper in UC provides greater support to employees working fewer than 16 hours a week on low hourly rates of pay. But other parts are less generous, for example the work allowance in UC is significantly lower than the equivalent income threshold in tax credits. This means that UC awards start to be tapered away at lower incomes than tax credit awards. The application of a ‘minimum income floor’ (MIF) also makes UC much less generous than the tax credits system for the self-employed with low incomes.
- **Single claim and single payment:** rather than making separate claims for different legacy benefits, claiming UC will involve only one application. If it is completed in full, claimants will receive all the cash that they are entitled to once they are in the system –

it is not possible to claim only part of UC (e.g. the tax credits equivalent, but not the housing benefit equivalent) if all the relevant information has been provided to DWP. This is expected to increase the proportion of the aggregate cash entitlement taken up. The single award will be paid monthly in arrears.

- **Conditionality:** potentially the most significant difference between UC and the legacy benefits is that all UC awards will come with conditions policed by DWP via a 'claimant commitment'. In the legacy system, conditionality is confined to a subset of out-of-work benefits – particularly jobseeker's allowance and the work-related activity group in ESA. Out-of-work conditionality in UC will be extended to many recipients that currently only claim child tax credit, where no conditions currently apply. UC also introduces a degree of conditionality to claimants that are already working. Both forms will apply to both partners in a benefit unit, further expanding the population subject to conditions. Work coaches will have discretion over the conditions set and will be able to impose sanctions where they are not met.
- **Capital limits:** the means-testing of UC will consider a claimant's assets as well as income. In the legacy system this only applies in some benefits. In particular, no capital rules are applied in the tax credits system.
- **Monthly reporting requirements:** self-employed claimants and former tax credits claimants will become subject to monthly reporting requirements, having previously been required to report their incomes and personal circumstances annually or at the point of change. This could be particularly challenging for the self-employed, whose incomes can fluctuate significantly from month to month and whose post-tax income only becomes clear much later when self-assessed taxes are paid.
- **Self-employed 'minimum income floor' (MIF):** when calculating the UC entitlement of the self-employed, the claimant will be assumed to have an income at least as large as a 'minimum income floor' set by the Government. The current policy is for the MIF to be set at the equivalent of working 35 hours a week at the National Living Wage (or National Minimum Wage for the under-25s). The MIF is assumed to overwrite actual declared income for around two-thirds of self-employed UC claimants.
- **Removal of income disregards:** in the tax credits system, the first £2,500 of any increase or decrease in income since the previous year is disregarded when calculating entitlements. This reduces the number of relatively small over- and underpayments that would otherwise need to be pursued through debt collection or additional future payments. In contrast, there will be no disregards in UC.
- **Removal of certain disability premia:** in the legacy benefits system, individuals that meet the terms of a disability test receive a premium in their ESA, income support and jobseeker's allowance awards. No premia will be paid in UC, which instead incorporates a 'limited capability for work' element among its main elements.

When will the effects be felt?

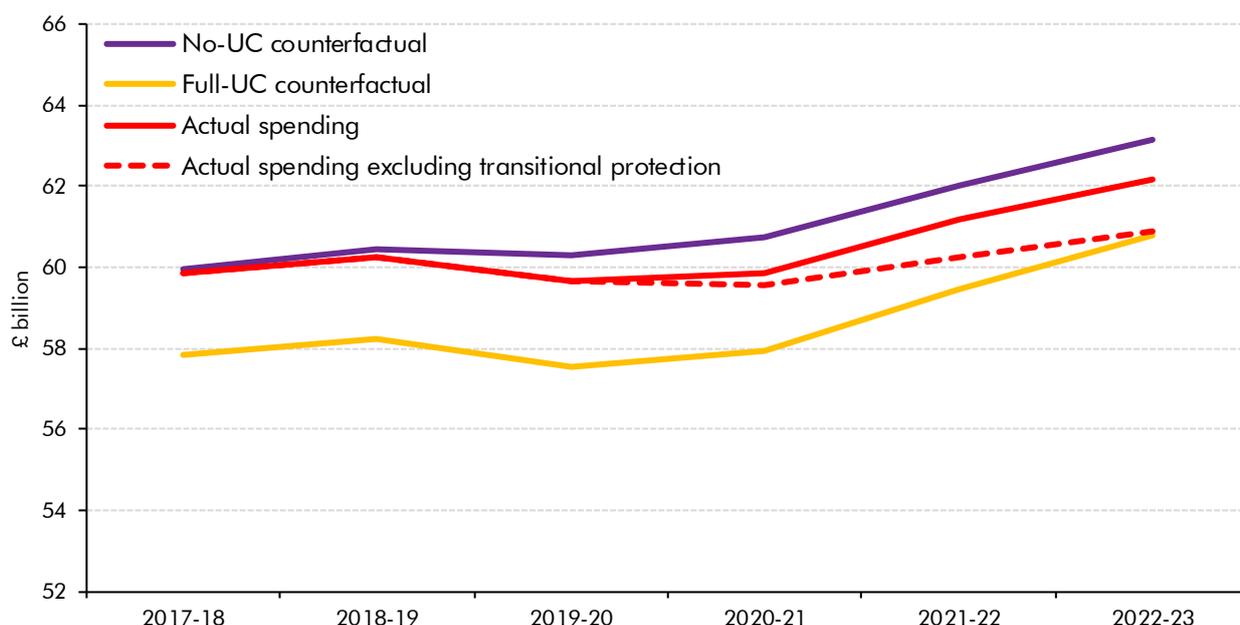
- 1.24 The effects of introducing UC are expected to build up gradually. Our latest forecast assumes that 8 per cent of the potentially affected legacy caseload will be in receipt of UC this year (within which, over 40 per cent of the jobseeker's allowance caseload will have moved, but only 3 to 5 per cent of the larger tax credits and ESA caseloads). By 2022-23, the final year of our November 2017 forecast period, 99 per cent of the legacy system caseload is expected to be on UC. This reflects DWP's current rollout plans and a six-month delay that we have assumed for some elements given previous delays.
- 1.25 Up to 2018-19, the transition is dominated by 'natural migration' – where an individual or family moves onto UC when they make a new claim or report a qualifying change of circumstances. From 2020-21, a proportion of the migration is 'managed' – where continuing claims are shifted from the legacy system to UC at DWP's discretion. Claimants affected by managed migration will be eligible for 'transitional protection' if their UC award is lower than their existing award. The protection will stop when a qualifying change of circumstances is reported. It will not be uprated so it will only be temporary for all cases.

How do we factor universal credit into our forecasts?

- 1.26 Once sufficient administrative data on UC are available, we will be able to forecast spending on it in the same way that we forecast spending on most parts of the welfare system – by assessing the latest data and using forecast models to predict how much it will rise or fall over time given our forecasts for the various factors driving the caseload and the average amounts received. But at present this is not possible, because the caseload is still too small and not yet representative of the future composition of the full caseload.
- 1.27 So rather than forecast spending on UC directly, we use a three-step approach:
- We start by generating a **no-UC counterfactual** forecast for a world in which the legacy benefit system continues indefinitely (described in Chapter 2). This allows us to make most of the key working-age welfare spending forecast judgements using established forecasting models and on the basis of full administrative data.
 - We then calculate how much more or less would be spent in a **full-UC counterfactual** world where the rollout to UC had already been completed (described in Chapter 5). This allows us to make most of the key UC-specific forecast judgements via DWP's established policy simulation model and Family Resources Survey, with the overall size of the caseload and spending determined by the no-UC counterfactual in the absence of a reliable bottom-up forecast methodology.
 - Finally we estimate what proportion of that difference will actually be reflected in **the real world**, given the Government's plans for the rollout of UC and any adjustment we make to reflect past over-optimism. We then apply this proportion to the full-UC counterfactual, adjusted for the expected cost of transitional protection, to generate our forecast for actual spending in each year (described in Chapter 6).

1.28 Chart 1.1 illustrates these three steps using our November 2017 forecast. We assume that the rollout of UC will be almost, but not fully, complete at the five-year horizon of our forecast. But despite this, actual spending is expected to remain materially higher than in the ‘full-UC’ counterfactual at that point. This largely reflects transitional protection, which is expected to cost £1.3 billion in 2022-23. Actual spending would not be expected to converge on the full-UC counterfactual until the last transitional protection award had been eroded to zero, which could be well beyond when the rollout is completed.

Chart 1.1: Universal credit spending



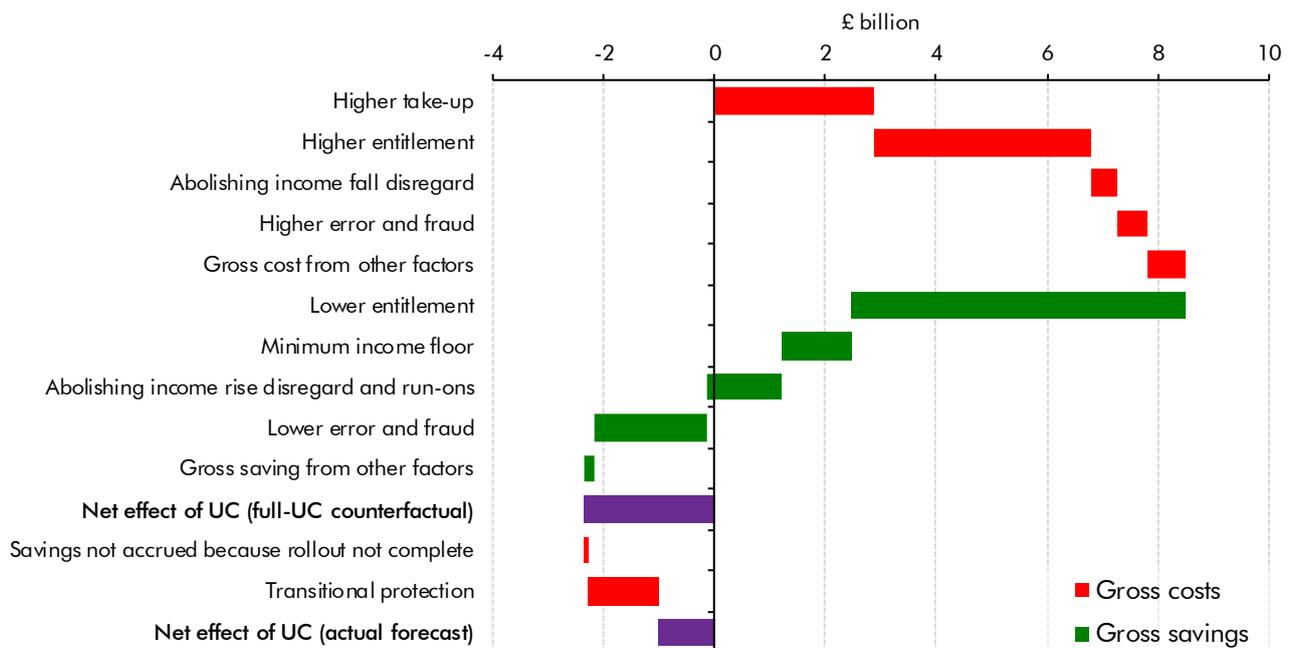
Source: DWP, OBR

1.29 Until recently, the biggest challenge in forecasting UC has been generating the full-UC counterfactual. There are elements of UC that are more generous than the legacy system and others that are less generous, so the net effect of UC relative to the legacy system reflects larger and partially offsetting gross costs and savings. The introduction of UC is also expected to change the proportion of entitlement that is taken up by eligible individuals and families. The two systems also differ significantly for the self-employed – a group that has been increasing as a share of total employment in recent years. And on top of this complexity, successive Governments have made frequent and often significant changes to both UC and the legacy system, adding to the challenges that we face when trying to estimate the net effect of UC *relative to* the legacy system.

1.30 More recently, it has also become increasingly challenging to generate the ‘no-UC’ legacy benefits counterfactual, because the introduction of UC is now affecting spending outturns. As of now, this is especially true for jobseeker’s allowance, where around 40 per cent of the caseload has moved to UC, but also for tax credits and housing benefit. This will be significantly more challenging in 2018-19 as the UC/legacy overlap increases.

- 1.31 Chart 1.2 shows how the £2.4 billion difference between our ‘no-UC’ and ‘full-UC’ counterfactuals for 2022-23 reflects £8.5 billion of gross costs (where UC is more generous or take-up is higher) and £10.9 billion of gross savings (where UC is less generous and expected to result in lower costs from error and fraud). Chapter 5 details these steps.
- 1.32 Estimating where actual spending will lie between the ‘no-UC’ and ‘full-UC’ counterfactuals presents a further challenge. The two key inputs to this judgement are the pace and composition of the rollout schedule and the cost of transitional protection. The Government has repeatedly pushed the rollout back and we currently assume that it will be almost, but not fully, complete by 2022-23. This means the actual savings before considering transitional protection are estimated to be £0.1 billion less than in the ‘full-UC’ counterfactual. The expected cost of transitional protection in 2022-23 is £1.3 billion. Together, these explain why the actual effect of UC relative to the legacy system is estimated to be £1.0 billion rather than the £2.4 billion difference between the two counterfactuals.

Chart 1.2: Estimating the net effect of UC relative to the legacy system



Source: DWP, OBR

- 1.33 As the real-world UC caseload builds up, it will become more difficult to interpret trends in actual welfare spending. Outturn data will be affected by the drivers of legacy and UC spending, but also the uncertain pace and effects of the transition between the two systems.

Structure of the report

1.34 The report is structured as follows:

- Chapter 2 discusses trends in, and our forecasts for, the **legacy benefits and tax credits**;
- Chapter 3 sets out the **design of UC** and how it differs from the legacy system;
- Chapter 4 describes **how we model the effects of UC** relative to the legacy system;
- Chapter 5 details the latest **full-UC counterfactual** underpinning our forecast;
- Chapter 6 describes our forecast for **the transition to UC** and what that means for our welfare spending forecast as a whole; and
- Chapter 7 considers **risks and uncertainties** around our estimates of the effect of UC on welfare spending.

2 What will universal credit replace?

Introduction

- 2.1 Universal credit (UC) will combine six existing benefits and tax credits that together constitute what we refer to as the 'legacy system'. They are:
- **child tax credit** and **working tax credit**;
 - the working-age element of **housing benefit**;
 - income-based **employment and support allowance** (ESA);
 - income-based **jobseeker's allowance** (JSA); and
 - **income support**.
- 2.2 UC is not replacing the contributions-based elements of JSA or ESA, which will continue in a new form. Nor is it replacing housing benefit for pensioners, which will become a new 'housing credit' paid as part of pension credit.
- 2.3 As noted in Chapter 1, we currently forecast UC on a marginal basis as the cost or saving relative to a counterfactual where the legacy benefits continue to exist. Under this approach, the forecast for spending on UC is the sum of forecast expenditure on the legacy benefits in this 'no-UC' counterfactual plus the net effect of UC relative to that, adjusted for the expected pace of the UC rollout. This places more weight on established legacy benefit forecasting models while the UC caseload is building up. It also means that the UC forecast is sensitive to changes in the forecasts of legacy benefits.
- 2.4 Until recently, the real world was very similar to the 'no-UC' counterfactual: spending on UC was just £56 million in 2014-15 and £491 million in 2015-16, compared to £61.7 billion and £60.5 billion respectively for spending on the legacy benefits. But by 2016-17 spending on UC had reached £1.6 billion and our November forecast suggested that it would reach £3.4 billion this year. As the real world diverges from the 'no-UC' counterfactual, our marginal approach to factoring in UC becomes more challenging. This is evident already for JSA, where 42 per cent of the equivalent caseload is now receiving UC and actual spending on JSA in 2017-18 is expected to be 39 per cent lower than the 'no-UC' counterfactual that forms the basis of our full spending forecast.
- 2.5 In this chapter, we describe the legacy forecasts that provide the first step in our estimates of the effects of UC. We start with an overview of the 'no-UC' counterfactual and a breakdown

What will universal credit replace?

of the types of individuals and families that receive the legacy benefits. Then, for each one that UC will replace, we discuss:

- the **key features** of the legacy benefits;
- our **November 2017 forecast** on a 'no-UC' counterfactual basis;
- previous analysis of **trends in spending** and what influenced them; and
- any **lessons that might be learned for forecasting UC**.

The 'no-UC' legacy benefits counterfactual

2.6 Table 2.1 sets out our November 2017 forecast for each of the legacy benefits and tax credits that will be replaced by UC on a 'no-UC' counterfactual basis. The tax credits forecast is on a UK basis while the DWP-administered benefits are all on a Great Britain basis. This reflects how the forecast is constructed, with benefits administered in Northern Ireland forecast separately. The table shows that the legacy benefits would be expected to cost £59.9 billion in 2017-18 if UC were not in place, rising by 5.4 per cent over the following five years to reach £63.2 billion by 2022-23. This is equivalent to a fall of 5.5 per cent in real terms (adjusted for CPI inflation) and 0.27 per cent of GDP (from 2.93 to 2.66 per cent of GDP).

Table 2.1: Legacy benefit spending: 'no-UC' counterfactual

	£ billion					
	Forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Legacy benefits: 'no-UC' counterfactual¹	59.9	60.4	60.3	60.8	62.0	63.2
<i>of which:</i>						
Tax credits ²	27.0	26.6	26.2	26.6	27.0	27.3
Housing benefit (working-age)	17.7	18.2	18.5	18.1	18.5	18.9
Income-based employment and support allowance	10.7	11.4	11.2	11.5	11.8	12.2
Income-based jobseeker's allowance	2.2	2.2	2.3	2.3	2.4	2.5
Income support (non-incapacity)	2.3	2.0	2.1	2.2	2.2	2.4
Spending as a share of GDP (per cent)	2.93	2.88	2.79	2.73	2.70	2.66

¹ The figures in this table are on an Autumn Budget 2017 post-measures basis. They differ to Table 4.25 of our November 2017 *Economic and fiscal outlook* which presented the no-UC counterfactual on a pre-measures basis.

² Tax credits expenditure is presented on a UK basis whereas expenditure for the remaining legacy benefits is on a Great Britain basis, consistent with our *Economic and fiscal outlook*.

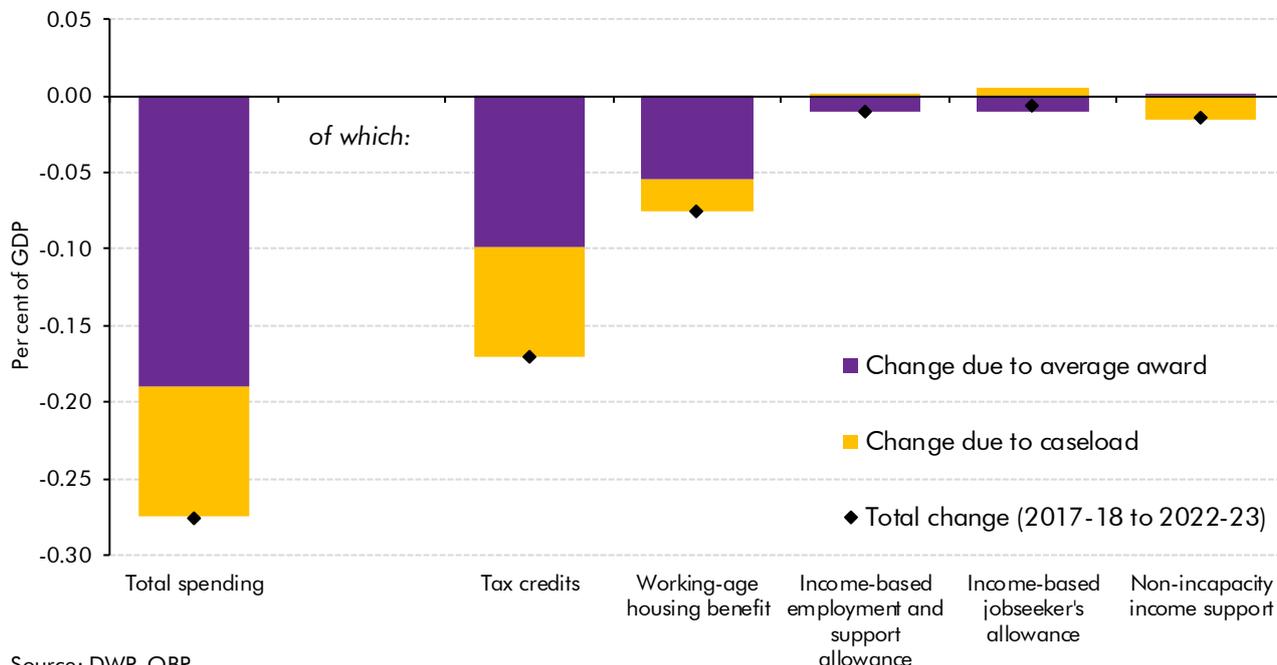
2.7 Chart 2.1 shows the contributions of each benefit and tax credit to this 0.27 per cent of GDP fall, splitting each between the contribution from the caseload changing (relative to the adult population) and the average award changing (relative to GDP per adult):

- **Tax credits** spending falls by 0.17 per cent of GDP. More than half the fall reflects weak growth in average awards relative to our already historically weak forecast for growth in GDP per adult, thanks to the Government's decision to freeze most elements

in cash terms and to cut support for first children and families with more than two children. The remainder reflects the caseload growing more slowly than the adult population, in part because freezing the thresholds means that a rising share of the population loses entitlement to tax credits as incomes grow.

- **Working-age housing benefit** spending falls by 0.08 per cent of GDP. Again, a little over half the fall reflects weak growth in average awards thanks to the uprating freeze and the Government's decision to force social sector landlords to cut rents by 1 per cent a year. This reduces housing benefit spending but places a financial burden on landlords by cutting their rental income. The drop in the caseload relative to the adult population reflects many factors, including frozen thresholds leading to some people losing entitlement altogether as incomes grow.
- **Income-based ESA** spending only falls by 0.01 per cent of GDP. Average awards rise more slowly than GDP per adult due to the uprating freeze, but this effect is dampened significantly in ESA because it only applies to awards outside the support group. More than 75 per cent of income-based ESA spending in 2019-20 – the final year of the uprating freeze – is expected to be on support group cases.
- **Income-based JSA** falls by 0.01 per cent of GDP. This is more than explained by weak growth in average awards thanks to the uprating freeze. The caseload rises slightly as a share of the adult population, as we expect the unemployment rate to rise modestly as the National Living Wage prices some workers out of employment.
- **Income support** spending falls by 0.01 per cent of GDP. This is largely because some income support cases move onto other benefits – notably JSA – as a result of the lone parent obligation, which removes automatic entitlement to income support for certain out-of-work lone parents based on the age of their youngest child.

Chart 2.1: Sources of changes to legacy benefit spending (2017-18 to 2022-23)



Source: DWP, OBR

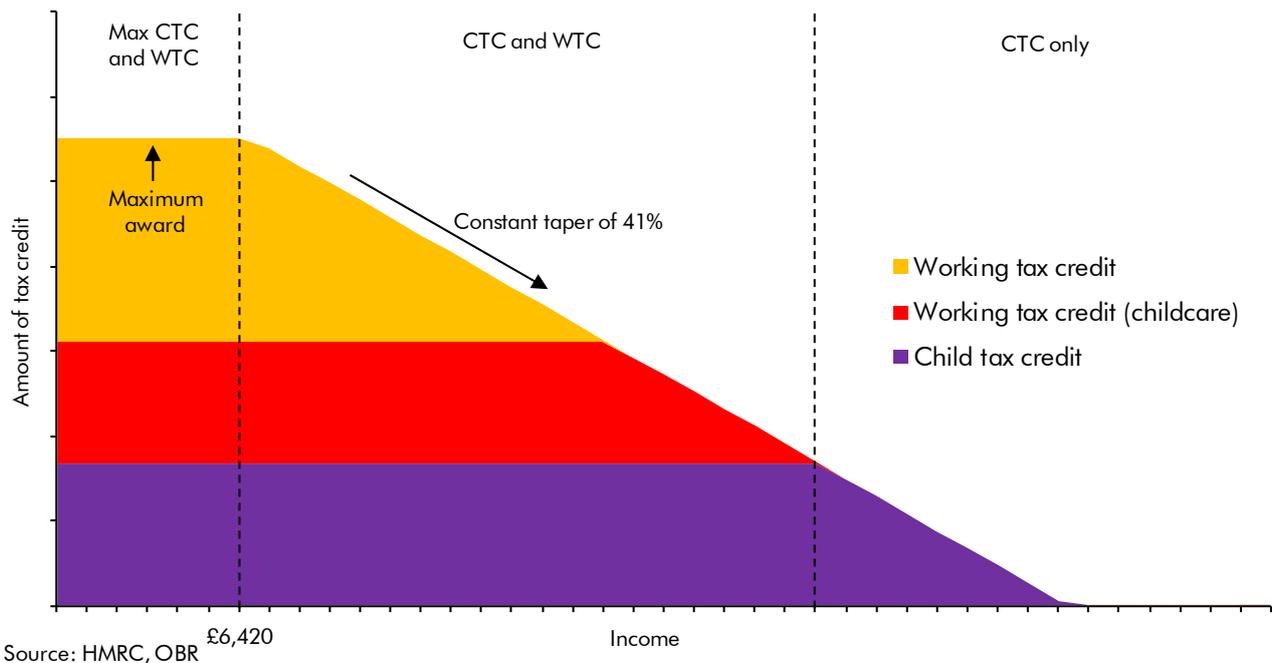
Tax credits

The legacy system

- 2.8 Tax credits in their current form were introduced in 2003-04 to replace the working families tax credit, disabled person's tax credit, children's tax credit and the child additions payable through income support and JSA. The new tax credits extended coverage to households with higher earnings than had previously been eligible.
- 2.9 Tax credits are a means-tested cash benefit aimed predominantly at working-age individuals and families. Their value depends on income and other circumstances. There are two components: working tax credit (WTC) and child tax credit (CTC).
- 2.10 WTC is payable to eligible individuals and families if they meet specific rules about the number of hours a week that they work:
- **30-hours rule:** childless individuals aged between 25 and 59 are required to work at least 30 hours a week. Childless couples in the same age range must have at least one adult working at least 30 hours a week to be eligible.
 - **24-hours rule:** couples with children are required to work at least 24 hours a week in total, within which one adult must be working at least 16 hours a week.
 - **16-hours rule:** individuals who are aged 60 or over, disabled or lone parents are required to work at least 16 hours a week. Where those aged over 60 or with disabilities have partners, at least one adult must be working 16 hours or more.

- 2.11 All families are eligible for a ‘basic element’ of WTC, plus additional elements relating to adult disability, lone parent or couple status and for those working at least 30 hours. The childcare element reimburses costs up to 70 per cent of a capped value, depending on the number of children in the household that are in eligible types of paid childcare.
- 2.12 CTC is payable to families with children regardless of work status. Although it is not considered an unemployment benefit, it does provide payments to the unemployed as well as to those in work. Prior to 2017-18, claimants were eligible for one family element per family and one child element per child, plus additional elements for disabled and severely disabled children. From 2017-18 onwards, the family element is no longer payable to new families and the child element is no longer payable for children born after 6 April 2017 in families that already contain two or more children (subject to a small number of exceptions).
- 2.13 Tax credits awards are calculated in two stages. First, by summing all the elements that a household is entitled to across both WTC and CTC. Second, this maximum award is then tapered by 41 pence for every pound of gross annual income within the benefit unit where it exceeds one of two income thresholds, depending on eligibility for WTC. This varies considerably due to the different elements making up the maximum award, with only the first income threshold common to all cases. The way the calculation works is illustrated in Figure 2.1. The definition of annual income in tax credits is broadly consistent with the definition of taxable income, including earned income from employment as well as ‘unearned’ income from savings and some benefits and pensions.

Figure 2.1: In-work tax credits entitlement changing with income



- 2.14 Entitlement to tax credits is calculated on a daily basis to ensure that changes in household circumstances are factored into new awards. This makes awards highly sensitive to changes in household circumstances and when those get reported. As recipients’ circumstances can

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change frequently during a year, and the reporting and administration of them can lag behind these changes, awards are reconciled at the end of each year in a 'finalisation' process. Any underpayments are paid back to the claimant while overpayments are subject to a range of recovery procedures. The number of over- and under-payments subject to these procedures is reduced by 'income disregards' that means that the first £2,500 of any change in annual income since the previous year does not affect the award.¹ This benefits individuals and families whose incomes rise by less than the disregard threshold, who would otherwise be in debt to HMRC, but costs those whose incomes fall by less than the threshold, who would otherwise receive an additional payment at finalisation.

- 2.15 Tax credits awards are paid to claimants either weekly or every four weeks, with the frequency chosen by the claimant. Of the 2.5 million in-work families with children receiving tax credits in April 2017, 63 per cent chose to be paid weekly.² Unlike support from UC, there are currently no conditions attached to receipt of tax credits. This is true whether a recipient is in or out of work.

Our November 2017 forecast

- 2.16 Table 2.2 decomposes our November 2017 'no-UC' counterfactual tax credits forecast into its high-level components. As the tax credits taper is applied to the total tax credits award (WTC plus CTC), it is not meaningful to decompose the total award for claimants that receive both into its constituent parts. We therefore show three groups: those that receive both WTC and CTC (56 per cent of expenditure on average over the period), those that receive CTC only (41 per cent) and those that receive WTC only (4 per cent).

Table 2.2: Tax credits forecast: 'no-UC' counterfactual

	£ billion					
	November 2017 forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Tax credits expenditure	27.0	26.6	26.2	26.6	27.0	27.3
<i>of which:</i>						
Working and child tax credits	15.2	14.9	14.6	14.7	14.9	15.0
Child tax credit only	10.7	10.7	10.6	10.9	11.1	11.2
Working tax credit only	1.0	1.0	1.0	1.0	1.0	1.1

- 2.17 Table 2.3 provides a further breakdown of these forecasts by caseload and average award across the three groups. Overall caseloads are expected to fall by 4.5 per cent between 2017-18 and 2019-20, because of freezes to tax credit thresholds and other policy measures, and then to rise by 1.7 per cent in the three years to 2022-23, broadly in line with growth in the adult population. This gives an overall caseload fall of 2.9 per cent over the forecast period. The decline is driven by falls in the number of claimants receiving both WTC and CTC (7.4 per cent between 2017-18 and 2022-23) and the number of claimants

¹ Of around 3 million in-work tax credit recipients in 2015-16, around 1.7 million saw no change in income or had a change within the disregard limits, around 0.7 million saw a change in excess of the limits that did not affect their award (due to them not being on the income taper), and around 0.7 million saw an income change in excess of the limits that increased or decreased their award (*Child and Working Tax Credits statistics: finalised annual awards - 2015 to 2016*, HMRC, 2017).

² *Child and Working Tax Credits Statistics April 2017*, HMRC, 2017.

receiving WTC only (8.6 per cent over the same period). Offsetting this, the number of claimants receiving CTC only is expected to increase by 1.9 per cent between 2017-18 and 2022-23. This reflects the interaction of positive, albeit modest, income growth and frozen tax credits thresholds, which results in some claimants who previously received both WTC and CTC seeing their WTC award tapered away entirely.

2.18 Average awards exhibit a modest upward trend over the forecast period, rising by 4.3 per cent between 2017-18 and 2022-23 in cash terms. From 2020-21 onwards, this includes the effect of CPI inflation-linked uprating as the uprating freeze ends. But compositional changes in the caseload mean that average awards rise more slowly than inflation even after the uprating freeze has ended. The growth in average awards over this period is highest for WTC-only claimants. This is the group where the caseload falls most, with the increase in average awards reflecting the fact that this fall will be concentrated among WTC recipients with the highest incomes and lowest awards, raising the average award among those that are still entitled. The proportion of the overall tax credits caseload made up of WTC-only recipients falls by 0.5 percentage points between 2017-18 and 2022-23. Since the average award of this group is less than two thirds of that for CTC-only recipients and around a third of that for CTC-and-WTC recipients, this shift will also raise overall average awards.

2.19 The combined effect of the fall in the caseload and the modest cash-terms growth in average awards means that tax credits spending on a no-UC counterfactual basis would be expected to rise by just 1.3 per cent in cash terms between 2017-18 and 2022-23.

Table 2.3: Detailed tax credits forecast: 'no-UC' counterfactual

	November 2017 forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
	Caseloads ('000s)					
Total tax credits	3,934	3,761	3,757	3,788	3,817	3,820
<i>of which:</i>						
Working and child tax credits	1,627	1,504	1,495	1,499	1,502	1,507
Child tax credit only	1,961	1,934	1,946	1,972	1,997	1,997
Working tax credit only	346	322	316	316	318	316
	Average weekly award (£)					
Total tax credits	131	136	133	135	136	137
<i>of which:</i>						
Working and child tax credits	179	190	186	188	190	191
Child tax credit only	105	106	104	106	107	108
Working tax credit only	57	61	60	62	63	64
	Spending (£ million)					
Total tax credits	26,966	26,640	26,178	26,592	27,005	27,311
<i>of which:</i>						
Working and child tax credits	15,195	14,899	14,570	14,717	14,850	15,036
Child tax credit only	10,749	10,722	10,615	10,859	11,116	11,214
Working tax credit only	1,021	1,019	994	1,015	1,039	1,061

Trends in spending on tax credits

- 2.20 We considered longer-term trends in tax credits spending in Chapter 7 of our 2014 *Welfare trends report (WTR)*. Tax credits have been one of the largest items of welfare spending since their introduction, with spending relatively stable at 1.4 to 1.5 per cent of GDP between 2003-04 and 2007-08. During the late-2000s recession and its aftermath, tax credits acted as one of the main counter-cyclical economic shock absorbers (alongside JSA) with spending peaking at 1.8 per cent of GDP in 2009-10. As well as being influenced by developments in the labour market, this increase reflected Government decisions to increase the child element by considerably more than earnings growth or inflation and by the fact that tax credit claimants' incomes on average grew more slowly than incomes in the rest of the economy.
- 2.21 Government policy has been the main driver of trends in tax credits spending since 2010-11. The Coalition and Conservative Governments announced several policies that reduced the scope and generosity of tax credits, including:
- **Up-rating:** the up-rating of tax credits elements was switched from RPI to CPI inflation from 2011-12 onwards. This was followed by a one-year freeze in most WTC rates in 2012-13 and a three-year freeze on up-rating of the basic and 30 hours elements from 2011-12 onwards. Next came a three-year 1 per cent cap on up-rating of (non-disability) elements in 2013-14, 2014-15 and 2015-16. Finally, a four-year freeze in the up-rating of (non-disability) elements was announced in Summer Budget 2015. It applies each year from 2016-17 to 2019-20.
 - **Abolishing elements:** the supplement for babies aged under one was removed from CTC from 2011-12 onwards and the supplement for those aged 50 and over was removed from WTC from 2012-13 onwards. More recently, the family element has been removed for families whose eldest child was born after 5 April 2017.
 - **Childcare support:** support for childcare costs was reduced from 80 to 70 per cent from 2011-12 onwards.
 - **Income taper:** the withdrawal rate was increased from 39 to 41 per cent from 2011-12 onwards.
 - **Second income threshold:** this threshold was reduced from £50,000 to £40,000 in 2011-12 and removed entirely from 2012-13 onwards.³
 - **Entitlement limits for larger families:** a limit on the number of children in a family for which the child element can be claimed took effect this year. For families that have

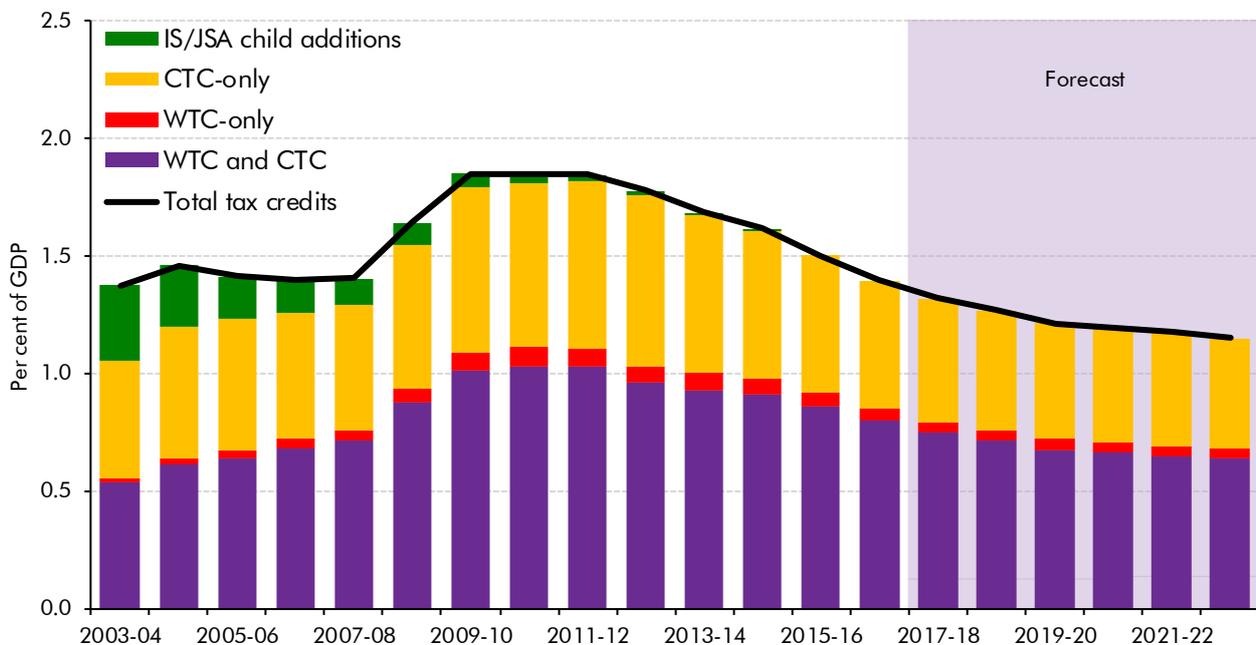
³ The second income threshold in tax credits defined the point at which the family element of child tax credit started to be tapered, at a rate of £1 of award withdrawn for every £15 increase in income. This was set initially at £50,000 meaning that families with children earning up to this level were entitled to at least the full family element award of £545 a year. Abolishing the second income threshold means that the family element is tapered away directly after the other elements. This is closer in design to how UC will work.

children born after 5 April 2017, the child element can only be claimed for the eldest two children. This limit is subject to a small number of exceptions.

2.22 The abolition of several elements of CTC, combined with the removal of the second income threshold, reduced entitlement for higher-income families and increased the tapering of their awards. Many of those families received small – or no – tax credits awards and so ceased their claims. Uprating policies significantly reduced the generosity of tax credits relative to average earnings, placing downward pressure on expenditure as a share of GDP. Reduced caseloads and lower average awards have cut spending on tax credits from 1.8 to 1.4 per cent of GDP between 2011-12 and 2016-17.

2.23 More recently, tax credits caseloads have fallen more than expected, adding to downward pressure on tax credits spending. As outlined in our November 2017 *Economic and fiscal outlook (EFO)*, this is in large part due to falls in the number of new tax credits claims. This may be related to stronger income growth in the relevant population reducing the number of people entitled, or to lower take-up, including among those for whom awards are relatively small. The latest estimates show take-up of WTC and CTC falling by 2 and 3 percentage points respectively between 2014-15 and 2015-16.⁴ While the cause of these trends is not fully understood, possible explanations include higher-than-expected income growth – perhaps because the National Living Wage has had a larger effect on the tax credits population than we had allowed for in our forecasts – and unanticipated effects of the UC rollout.

Chart 2.2: Spending on tax credits



Source: HMRC, OBR

⁴ Child benefit, child tax credit and working tax credit take-up rates 2015-16, HMRC, 2017.

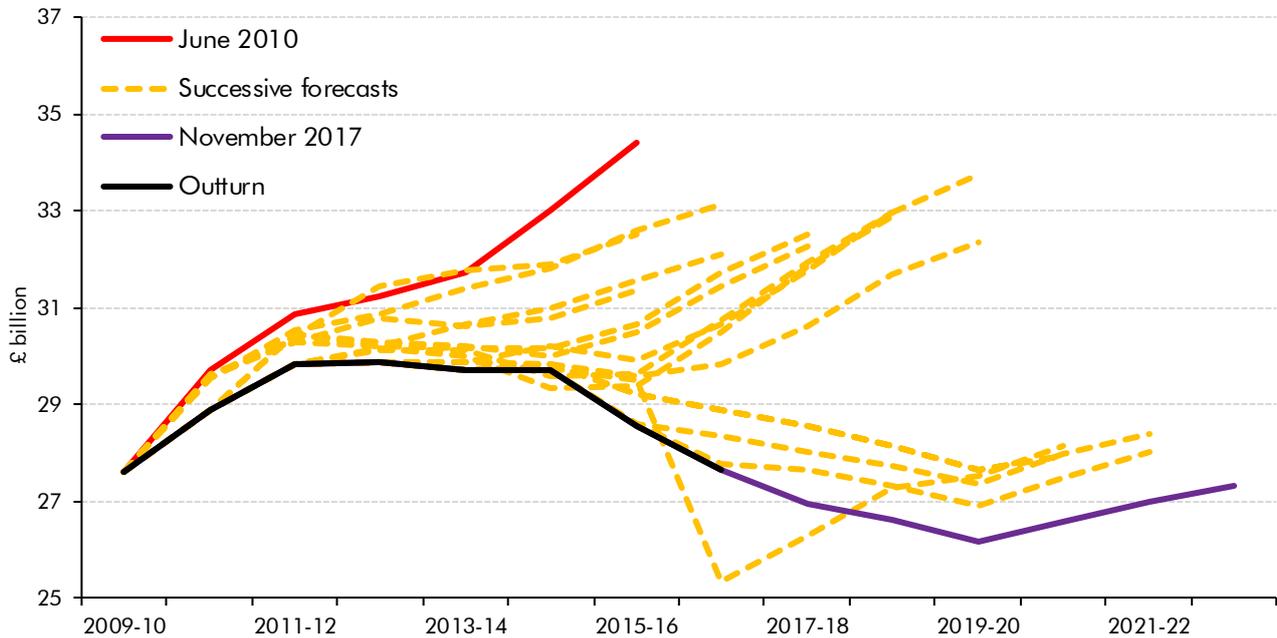
Historical forecast revisions

2.24 Chart 2.3 shows that our forecasts for tax credits expenditure have been subject to repeated downward revisions since 2010. These are the result of:

- **Subsequent policy changes:** in our 2016 WTR we estimated that these had reduced spending in 2015-16 by around £4.8 billion (16.5 per cent) relative to a counterfactual that taking into account demographics and inflation-linked uprating on pre-existing policies from 2010-11 to 2015-16. Among the largest contributors to this were the changes in uprating announced in Autumn Statement 2012 and Summer Budget 2015. Prior to those announcements our forecasts assumed CPI uprating of tax credits elements, in line with the policy announced in the June 2010 Budget. By 2019-20, based on inflation outturns and our latest forecast, the cumulative difference between our March 2012 CPI uprating assumption and the subsequently announced uprating policies will have reached 9.8 percentage points.
- **Lower-than-expected cost of the childcare element:** this reflected reported falls in childcare costs and caseloads from 2010-11 onwards. For example, the assumptions underpinning our November 2010 forecast, based on trends in outturn tax credits data, foresaw childcare caseloads increasing by 20 per cent in the three years to 2013-14. In fact, caseloads peaked in 2009-10 and fell by 12 per cent in the three years to 2013-14. Government policy may have contributed: it is possible that the reduction in support for childcare costs increased the use of informal childcare and thus reduced claims for childcare support in tax credits.
- **Falling caseloads:** faster-than-expected falls in the caseload have been a factor explaining recent downward revisions. Stronger-than-expected income growth among the tax credits population may be one factor, resulting in fewer families being eligible and lowering the average claims of those who remain eligible.

2.25 The main exception to the pattern of forecasts being revised down was our July 2015 forecast, which showed a very sharp fall in spending in 2016-17 that did not materialise. This reflects the cuts that the Government announced in Summer Budget 2015, but reversed before they were implemented. Similar cuts were announced for UC, but they were not reversed in Autumn Statement 2015. This is one of the main reasons why UC is now expected to save money relative to the legacy system.

Chart 2.3: Successive OBR tax credits forecasts since 2010



Source: DWP, HMRC, OBR

Lessons for our UC forecast

2.26 As the element of the legacy system closest in design to UC, the tax credits experience has several lessons for the forecasting of UC, including:

- The labour market impacts of tax credits appear to have been mixed.** Tax credits were designed to improve work incentives, increasing the number of people working and encouraging in-work progression. They do indeed appear to have provided a modest additional incentive to take up work, concentrated among households with children. The increased incentive to work was particularly strong for lone parents. The Resolution Foundation has estimated that tax credits and their predecessor can explain around half the rise in single-parent employment between 1998 and 2009.⁵ But the eligibility thresholds at 16 and 30 hours led to some bunching around these points – particularly at 16 hours for lone parents. The impact on in-work progression is less clear. Although tax credits lowered effective marginal tax rates relative to their predecessors, they have remained relatively high at between 68 and 70 per cent of each extra pound earned (and higher for households also in receipt of tapered housing benefit).
- Take-up of child tax credit has been high, while take-up of working tax credit has remained relatively low.** Take-up of CTC by caseload has typically been in the 80 to 90 per cent range, whereas take-up of WTC has ranged from 56 to 68 per cent. Take-up for those only entitled to WTC is currently just 63 per cent.⁶

⁵ *Creditworthy: Assessing the impact of tax credits in the last decade and considering what this means for universal credit*, Resolution Foundation (2012).

⁶ *Child benefit, child tax credit and working tax credit take-up rates 2015-16*, HMRC (2017).

- **When claimants have complex circumstances that change frequently, relatively high rates of error and fraud are likely.** Error and fraud was estimated to cost around £1.4 billion (net) in 2015-16, with most of it (76 per cent) relating to claimant error.⁷ There were 0.9 million cases of error in the claimant's favour in 2015-16. The most common causes were mis-statement of: income (0.4 million cases); work and hours (0.3 million cases); and childcare (0.2 million cases). This partly reflects the difficulty that many claimants have in understanding reporting rules and assessing their own circumstances relative to them.
- **Online administration can introduce additional fraud risks.** The tax credits e-portal was opened for new claims in 2003-04 and subsequently closed in 2005-06 following an organised fraud attack that was estimated to cost £55 million.⁸ While HMRC has continued running renewals online for several years, it has not re-opened the online system to new claims.
- **There is a fundamental tension between responsiveness and the risk of incorrect payments.** Making payments more responsive to changes in circumstances inevitably increases the risk of incorrect payments arising from lags in reporting or from mis-reporting. The tax credits design in 2003-04 allowed income rises of up to £2,500 to be disregarded. In 2006-07, this was raised to £25,000 to reduce the amount of overpayments that had to be recovered at the cost of paying higher awards to those whose incomes rose by more than the old disregard but less than the new one. But, to reduce those costs, the disregard was subsequently reduced to £10,000, then to £5,000 and finally back to £2,500, leading predictably to a rise in over-payments relative to these tighter rules. In 2015-16, 1.4 million families received overpayments and 0.8 million were underpaid.⁹
- **Transfers from DWP benefits took longer than expected.** Claimants receiving the child additions in JSA or income support were expected to transfer to CTC very soon after the new system was introduced. Fourteen years later there are still a small number of cases remaining to be transferred.

Housing benefit

The legacy system

2.27 The current housing benefit system was introduced in 1988. It is an income-related benefit designed to help households pay their rent. It is available to people on low incomes who rent their homes in either the private or social sector.¹⁰ Housing benefit is administered by local authorities, but the cost is largely borne by DWP. Awards are based on a combination of 'eligible' rent – for example, local housing allowance rates in the private sector – and

⁷ *Child and working tax credits error and fraud annual error and fraud statistics 2015-16*, HMRC (2017).

⁸ *HM Revenue & Customs 2005-06 Accounts, the Comptroller and Auditor General's Standard report*, NAO (2006).

⁹ *Child and working tax credits supplement on payments in 2015-16*, HMRC (2017).

¹⁰ When analysing housing benefit spending, social-sector renting includes housing provided by housing associations. In England, housing associations themselves have recently been reclassified from the public to the private sector, but the housing they provide continues to form part of the social-sector housing stock.

household circumstances, such as income, age and disability status. These two factors mean that, unlike other benefits, there is no set amount of housing benefit to be paid to claimants. Unlike other working-age benefits, there is also no sanction mechanism in housing benefit. Recipients of some out-of-work benefits who rent their homes receive housing benefit automatically through ‘passporting’ from another benefit. For in-work recipients the award is tapered at 65 per cent of net income above a threshold. There are currently no conditions attached to housing support.

Our November 2017 forecast

2.28 Total spending on housing benefit is expected to increase in cash terms over the forecast period by 3.7 per cent (Table 2.4), but to fall by 0.1 per cent of GDP. The increase in cash spending is the result of increases in working-age expenditure, whose share of total spending increases by 1.8 percentage points between 2017-18 and 2022-23 to 76.5 per cent. It is the working-age element that is being replaced by UC.

Table 2.4: Housing benefit forecast: ‘no-UC’ counterfactual

	£ billion					
	November 2017 forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Total housing benefit	23.8	23.8	23.9	23.5	24.1	24.6
<i>of which:</i>						
Working-age	17.7	18.2	18.5	18.1	18.5	18.9
Non-working-age	6.0	5.7	5.4	5.4	5.6	5.8

2.29 Table 2.5 breaks down our latest forecast into the ten claimant groups that we use when producing the forecast. The first nine are driven by other parts of our welfare spending forecast, plus assumptions about the proportion of each driver caseload that will receive housing benefit. The final group – termed ‘housing benefit only’ – largely represents the in-work caseload. Even though they are not in receipt of other DWP benefits, many in this group are likely to be eligible for tax credits too. To complete the 2017-18 picture on a ‘no-UC’ counterfactual basis, we have apportioned UC housing support cases to individual groups based on DWP analysis of administrative data.

2.30 Between 2017-18 and 2022-23, spending on a ‘no-UC’ counterfactual basis is expected to rise by just 3.7 per cent in cash terms, reflecting a 3.2 per cent fall in the caseload being more than offset by a 7.1 per cent rise in average awards. The main drivers are:

- **Carers:** despite accounting for only around 5 per cent of the caseload, growth in the carer’s allowance caseload (in turn driven by growth in the disability benefits caseload) is expected to increase housing benefit spending on this group by a third over this period, accounting for 1.4 percentage points of overall spending growth. Abstracting from compositional effects in the pensioner caseload, this group represents the largest source of upward pressure on housing benefit spending.

What will universal credit replace?

- **Housing benefit only:** the caseload is expected to rise only modestly as we assume that the proportion of people renting in the private sector will stabilise. But this is one of the larger claimant groups, so this rise, plus similarly modest rises in average awards, contributes 1.0 percentage points to overall spending growth.
- **Pensioners:** the two pensioner groups combined add little to spending thanks to offsetting trends. The caseload shifts towards those in receipt of the main state pension and away from those receiving other income-related benefits. This reflects the new single-tier state pension reducing the pension credit caseload. Overall this reduces the caseload. But, largely offsetting that, those pensioners who remain eligible for housing benefit are expected to receive higher average awards.
- **Incapacity benefits:** the caseload eligible for housing benefit via incapacity benefits is expected to fall over the forecast period. But this is a relatively large group and average awards are expected to rise, so cash spending is expected to rise a little.
- **Jobseekers and lone parents:** these groups are worth considering together, because the lone parent obligation shifts cases between the two groups. The combined caseload is expected to fall over the forecast period, but rising average awards lead to slightly higher cash spending.
- **Other income-related benefits for working-age recipients:** this small group is expected to see a drop in the caseload of more than a third, mainly across 2019-20 and 2020-21. This is largely because funding for expensive short-term supported housing cases – which combine housing and support for needs including substance abuse and mental health difficulties – is being moved outside of the benefits system to the Department for Housing, Communities and Local Government’s DEL budget. This policy was announced in Autumn Budget 2017.

Table 2.5: Detailed housing benefit forecast: 'no-UC' counterfactual

	November 2017 forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
	Caseloads ('000s)					
Total housing benefit	4,658	4,612	4,590	4,485	4,495	4,510
<i>of which:</i>						
Jobseekers	389	439	448	434	433	434
Incapacity benefits	1,328	1,320	1,321	1,282	1,280	1,271
Lone parents	337	274	272	265	264	263
Carers	195	208	223	232	238	241
Other IRB ¹ - working age	42	34	32	26	26	26
Other IRB ¹ - pension age	891	837	781	736	725	724
Disabled	63	66	70	71	71	71
Bereaved	8	9	9	9	9	9
State pension	368	377	384	392	407	423
Housing benefit only	1,037	1,048	1,050	1,038	1,042	1,048
	Average weekly award (£)					
Total housing benefit	98	99	100	101	103	105
<i>of which:</i>						
Jobseekers	101	104	105	105	108	111
Incapacity benefits	100	101	101	100	103	106
Lone parents	111	118	120	121	124	127
Carers	98	100	99	102	104	107
Other IRB ¹ - working age	108	115	117	100	102	105
Other IRB ¹ - pension age	96	97	98	101	104	108
Disabled	95	98	97	99	101	103
Bereaved	74	93	94	97	99	101
State pension	71	71	70	73	76	78
Housing benefit only	100	101	102	104	104	104
	Spending (£ million)					
Total housing benefit	23,771	23,840	23,942	23,517	24,075	24,646
<i>of which:</i>						
Jobseekers	2,054	2,377	2,467	2,373	2,444	2,516
Incapacity benefits	6,922	6,946	6,973	6,669	6,852	7,008
Lone parents	1,957	1,681	1,713	1,668	1,705	1,744
Carers	1,002	1,082	1,159	1,232	1,290	1,339
Other IRB ¹ - working age	234	203	197	135	139	142
Other IRB ¹ - pension age	4,453	4,241	4,005	3,889	3,947	4,063
Disabled	311	339	356	365	374	382
Bereaved	32	44	44	45	46	47
State pension	1,370	1,389	1,411	1,491	1,608	1,730
Housing benefit only	5,434	5,538	5,617	5,649	5,670	5,672

¹ Income-related benefit

Trends in spending on housing benefit

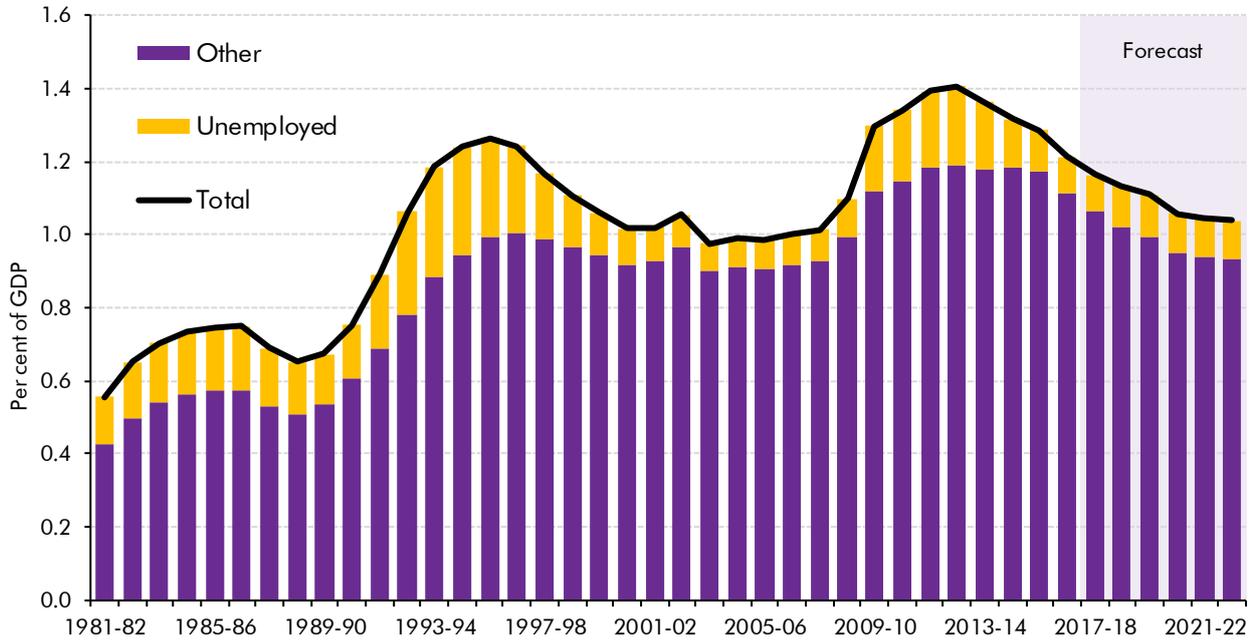
2.31 Spending on housing benefit is counter-cyclical, rising relatively sharply in economic downturns and falling more slowly when economic conditions improve. Between 8 and 11 per cent of housing benefit is paid to claimants also in receipt of JSA (or unemployment

What will universal credit replace?

benefit previously), so spending moves with unemployment. Spending on non-JSA claimants also tends to rise during economic downturns, but has been slower to fall during recoveries. Government policy has increased the cyclical nature of housing benefit with a steady flow of policy changes intended to reduce overall spending having the consequence that cyclical changes in the unemployed caseload are the main driver of changes in spending (Chart 2.4). Most of the variation in housing benefit spending as a share of GDP has related to the working-age caseload, so it seems reasonable to expect this to be repeated to some extent under UC too.

- 2.32 We considered longer-term trends in housing benefit spending in Chapter 9 of our 2014 WTR. Spending on housing benefit increased from 0.7 per cent of GDP during the late-1980s boom to more than 1 per cent of GDP in 1992-93 at the end of the early-1990s recession. It continued to rise during the early years of the recovery, peaking at 1.3 per cent of GDP in 1995-96. This upward trend (on top of the cyclical pattern) was mainly driven by the deregulation of the private-rented sector, rising social-sector rents and declining investment in social housing. These led to higher average awards which – alongside higher caseloads and other compositional changes – increased spending. The housing benefit caseload rose from 4.0 million in 1990-91 to 4.8 million in 1995-96, mostly thanks to increases in the number of sick and disabled and lone parent claimants. Unemployment also pushed the caseload up during the early-1990s recession.
- 2.33 Stronger income growth during the long economic expansion of the late-1990s through to the early-2000s reduced caseloads and stopped the rise in average awards relative to GDP per adult. This saw overall spending on housing benefit falling to around 1 per cent of GDP by 2002-03, where it remained until the late-2000s recession, at which point increases in unemployment and low wage growth began to increase caseloads. Spending rose again following the recession, reaching 1.4 per cent of GDP in 2012-13 due to weak earnings growth and the upward pressure on caseloads and average awards from a rising share of people renting rather than owning their homes – and doing so in the private-rented sector where rents are typically higher than in the social sector. Policy also played a role in this trend, with the local housing allowance significantly increasing the awards for private sector tenants to pay their landlords.
- 2.34 Government policy began to reduce spending as a share of GDP from 2012-13 onwards – in particular, policies affecting the local housing allowance, where a cap was introduced limiting entitlement to the 30th percentile of local rent distributions in 2011 and where restrictions on uprating were introduced in 2013-14. Combined with slower growth in the working-age caseload, this meant that between 2012-13 and 2016-17, spending fell by 0.2 per cent of GDP to reach 1.2 per cent.

Chart 2.4: Spending on housing benefit

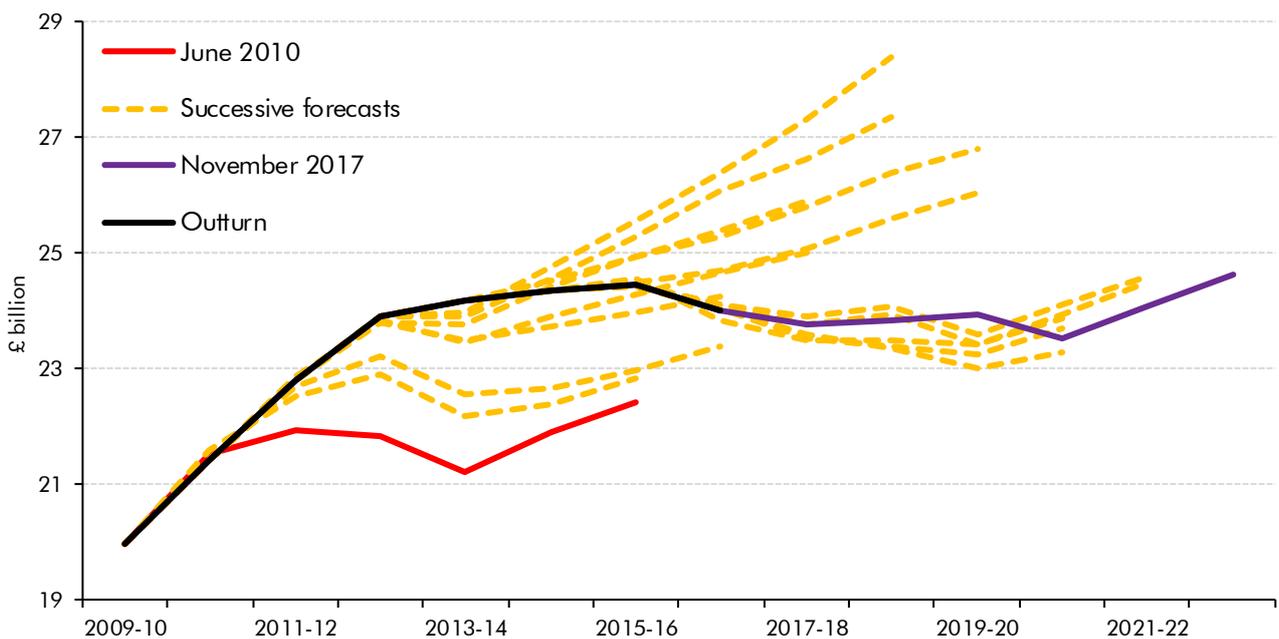


Source: DWP, OBR

Historical forecast revisions

2.35 Our forecast for housing benefit spending was steadily revised up until March 2014 as higher-than-expected increases in the proportion of the population renting, and changes in the income distribution, led to larger-than-expected numbers of in-work claimants on housing benefit. Thereafter the forecast was revised progressively lower, reflecting slower growth of in-work claimants relative to the higher path that had been assumed.

Chart 2.5: Successive OBR housing benefit forecasts since 2010



Source: DWP, OBR

Lessons for our UC forecast

2.36 Trends in housing benefit spending and analysis of our past forecasts point to the importance of interactions between spending and the wider economy and Government policy. As well as general cyclical fluctuations, key lessons relate to:

- **Housing market trends:** spending is sensitive to shifts in housing tenure – notably the rising share of people renting from private-sector landlords charging market rents. It is also sensitive to trends in rents themselves, where upward trends in both private- and social-sector rents have been important at different times.
- **Labour market trends:** since housing benefit is means-tested, trends in earnings growth and the income distribution can affect spending. In recent years, strong employment growth but weak earnings growth, combined with the trend towards private renting, put upward pressure on the in-work housing benefit caseload.
- **Turning points:** The recent slower growth in the number of in-work claimants on housing benefit also illustrates the difficulty in predicting turning points in different trends. It is difficult to determine in real time whether a new development is something temporary that will be reversed, a one-off that will be neither repeated nor reversed, or a new trend that will be repeated in future years. Judgements on such issues are often a source of differences between forecast and outturn.
- **Take-up rates:** take up among working households was relatively low in the late 2000s at around 40 per cent of eligible households in 2009-10. This was largely due to a lack of awareness around eligibility and was geared toward lower awards. But take-up rose by over 15 percentage points between 2009-10 and 2014-15, to reach 55 per cent, perhaps due to rents taking up a higher proportion of household incomes.

Employment and support allowance

The legacy system

2.37 Employment and support allowance (ESA) was introduced in 2008-09. Over time, it has replaced incapacity benefit, severe disablement allowance and the incapacity element of income support to become the main benefit for people who are unable to work because of sickness or disability. We describe these income-replacement benefits as ‘incapacity benefits’. There are also several benefits designed to meet the additional costs of sickness or disability – such as the personal independence payment (PIP) – which we describe as ‘disability benefits’. ESA accounted for a quarter of incapacity benefits spending by 2011-12, half by 2012-13 and 90 per cent by 2014-15. In 2016-17 it reached 98 per cent of the total.

2.38 There are two types of ESA:

- **Income-based ESA:** this is the means-tested element, paid to claimants who satisfy a household-based income test. It accounted for around two-thirds of ESA expenditure in 2016-17 and will be replaced by UC.
- **Contributory ESA:** this is paid to individuals with sufficient National Insurance contributions paid or credited in the two tax years prior to the date of the claim. It accounted for around a third of ESA expenditure in 2016-17. It will not be replaced by UC but will instead become a 'new style' ESA alongside the UC rollout.

2.39 Recipients of both types are divided into a 'work-related activity group' (WRAG) and a 'support group'. Claimants are subject to a work capability assessment (WCA) carried out on DWP's behalf by private contractors. Claimants deemed able to undertake work-related activity are placed in the WRAG and those deemed unable in the support group. While awaiting a WCA, claimants are placed in an 'assessment phase' group.

2.40 ESA awards vary by group, with two rates in the assessment phase (in 2017-18 they are £57.90 a week for under-25s and £73.10 for those aged 25 and over), and one each in the WRAG and support groups (£73.10 and £109.65 a week respectively; the WRAG rate was cut significantly in April 2017 to be equal to the main JSA rate). Contributory ESA claims in the WRAG group are time-limited to one year.

2.41 There are two disability premia that can apply within income-related ESA. Typically, single people in the support group are entitled to the enhanced disability premium at £15.75 a week, while some may qualify for the severe disability premium of £61.85 a week. We estimate that disability premia paid to ESA claimants cost around £2.0 billion in 2016-17. These premia will not be part of UC and represent one of the largest sources of gross saving in UC relative to the legacy system. Most current ESA claimants who do not have a disability premium could gain from the higher limited capability for work-related activity element in UC, one source of gross costs in UC relative to the legacy system.

Our November 2017 forecast

2.42 Table 2.6 shows the high-level breakdown of our November 2017 incapacity benefits forecast on a 'no-UC' counterfactual basis. Income-based ESA accounts for 68.7 per cent of spending in 2017-18, gradually increasing to 72.5 per cent in 2022-23. Indeed, the means-tested share of ESA spending has risen every year since ESA was introduced in 2008-09. Of the non-ESA spending, the majority relates to severe disablement allowance, with around 25,000 pensioners expected to remain in receipt of payments over this period.

Table 2.6: Incapacity benefits forecast: 'no-UC' counterfactual

	£ billion					
	November 2017 forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Incapacity benefits expenditure	15.5	16.1	15.9	16.2	16.5	16.8
<i>of which:</i>						
Income-based ESA	10.7	11.4	11.2	11.5	11.8	12.2
Contributory ESA	4.7	4.6	4.6	4.6	4.5	4.5
Other incapacity benefits	0.1	0.1	0.1	0.1	0.1	0.1
<i>Memo: income-based ESA (per cent of total)</i>	<i>68.7</i>	<i>70.8</i>	<i>70.7</i>	<i>71.2</i>	<i>71.8</i>	<i>72.5</i>

2.43 Table 2.7 breaks our income-based ESA forecast down into the three groups. It shows that the caseload is expected to rise by 2.7 per cent over the five years to 2022-23, in line with growth in the overall adult population but more slowly than growth in the working-age population. The composition of the caseload is expected to shift significantly towards the support group, which rises from 66.5 to 73.9 per cent of the total. Since these cases receive higher average awards, this compositional shift means that spending is forecast to rise by 14.1 per cent in the five years to 2022-23, only slightly slower than nominal GDP.

Table 2.7: ESA forecast: 'no-UC' counterfactual

	November 2017 forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
	Caseloads ('000s)					
Total income-based ESA	1,747	1,776	1,800	1,806	1,800	1,794
<i>of which:</i>						
Assessment phase	232	205	205	206	207	211
Work-related activity group	354	337	316	297	276	257
Support group	1,161	1,235	1,279	1,303	1,318	1,326
	Average weekly award (£)					
Total income-based ESA	117	123	119	122	126	130
<i>of which:</i>						
Assessment phase	67	68	68	69	71	72
Work-related activity group	122	117	110	108	108	109
Support group	126	134	130	134	138	144
	Spending (£ million)					
Total income-based ESA	10,676	11,416	11,222	11,520	11,825	12,186
<i>of which:</i>						
Assessment phase	808	732	727	745	763	797
Work-related activity group	2,257	2,050	1,818	1,675	1,555	1,457
Support group	7,611	8,634	8,676	9,100	9,507	9,931

Trends in spending on incapacity benefits

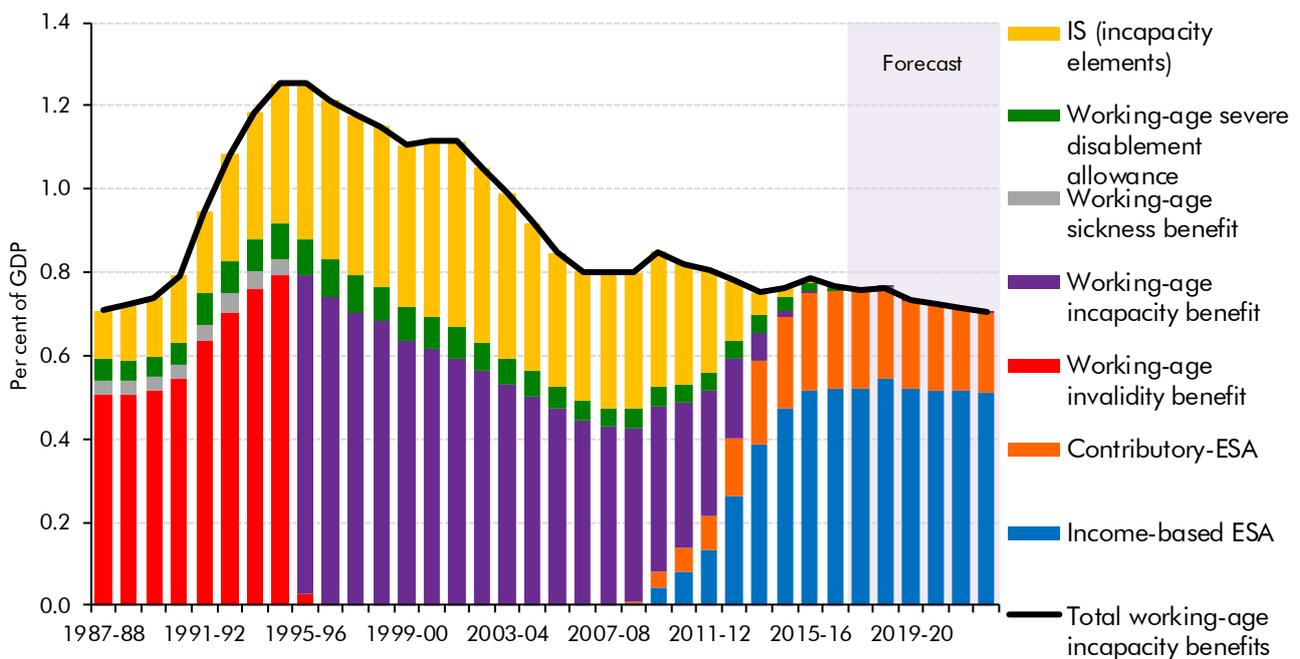
2.44 Incapacity benefits have been subject to a succession of reforms in recent decades, as discussed in Chapter 6 of our 2014 WTR. Spending peaked at 1.5 per cent of GDP in 1994-95, as high unemployment coupled with tighter conditions for unemployment benefits prompted large numbers of out-of-work people to claim the more generous invalidity

benefit. The overall incapacity benefits caseload increased by 86 per cent between 1987-88 and 1995-96.

2.45 In 1995, invalidity benefit was replaced by incapacity benefit. Over the following 12 years, thanks to cuts in generosity, the tightening of eligibility and sustained economic growth, spending halved as a share of GDP to reach 0.8 per cent in 2007-08. Over that period, the working-age incapacity benefits caseload increased by 4.4 per cent in absolute terms (from 2.5 to 2.6 million), thereby falling from 6.3 to 5.5 per cent of the working-age population. The average working-age incapacity benefit award increased by just 10.5 per cent in 12 years, thereby falling from 25.4 to 15.9 per cent of GDP per adult and accounting for most of the drop in spending as a share of GDP.

2.46 In 2008, incapacity benefit was replaced by ESA for new claimants. This coincided with the financial crisis and recession, which meant spending increased as a share of GDP – largely because growth in GDP per adult was weaker than the inflation-linked uprating of incapacity benefits. In recent years, statutory rates have been uprated by less than inflation and several other policies have cut awards (e.g. cutting the WRAG rate by 28 per cent to bring it into line with the JSA rate). Compositional effects have pushed in the opposite direction, with a rising proportion of cases in the support group, where the statutory rate is higher and disability premia apply. This trend is related to rising disability benefits caseloads, as discussed in Chapter 5 of our 2016 WTR.

Chart 2.6: Spending on incapacity benefits



Source: DWP, OBR

Historical forecast revisions

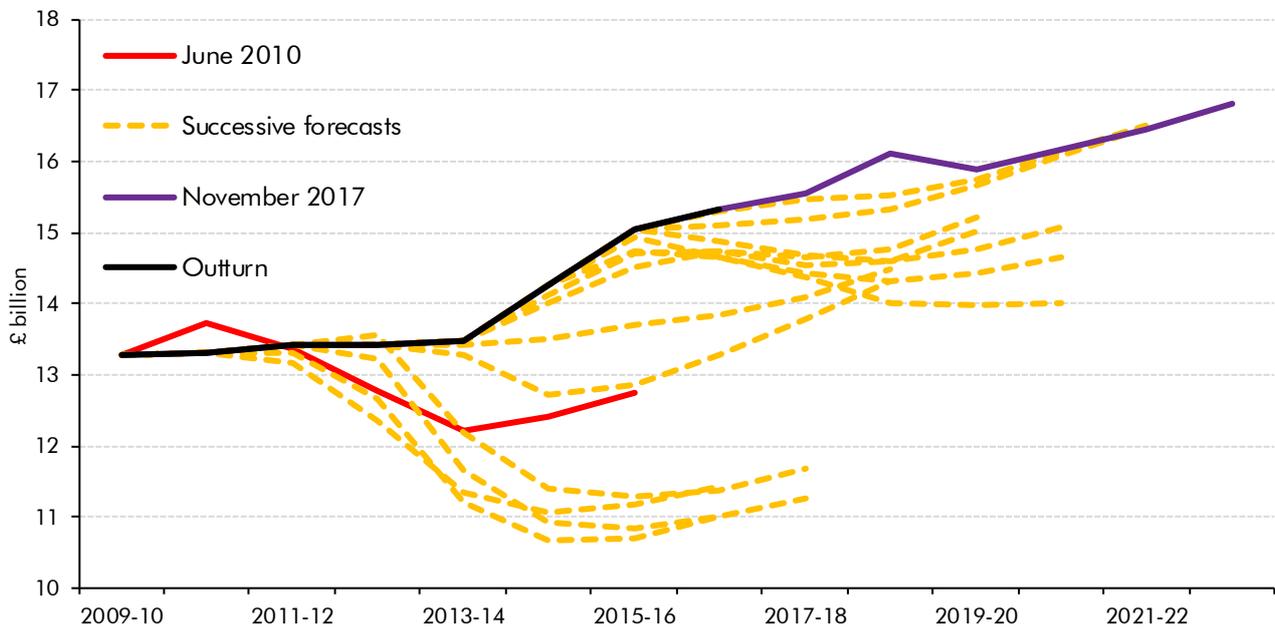
2.47 The revisions to our incapacity benefits forecasts illustrate the challenge of forecasting the effects of a major reform. The introduction of ESA was expected to reduce welfare spending,

but the effects were not as great as initially expected. As Chart 2.7 shows, we have revised our spending forecasts up much more often than we have revised them down. The largest revision came in December 2013, when we made significant changes to judgements about the number of WCAs that would take place each year and the proportion of them resulting in higher-cost support group outcomes. We have had to revise our forecasts up further since then.

2.48 Factors that have affected our incapacity benefits forecasts include:

- **The composition of the caseload:** because the different rates apply to different groups, judgements about the outcomes of WCAs and the resulting proportions of cases in each group are crucial to the spending forecast. Early forecasts overestimated the proportion that would be declared fit for work or placed in the work-related activity group and underestimated the proportion that would enter the support group. For example, our March 2012 forecast assumed that in 2016-17 just 36 per cent of ESA cases would be in the support group, when in fact 65 per cent were. This reflected differences relative to our assumptions for both initial WCA outcomes and the proportion of cases that would successfully appeal against those outcomes.
- **Subsequent policy changes and their uncertain effects:** further cuts to ESA have been announced in recent years, some of which saved less than expected. Most notably, time-limiting ESA payments for contributory WRAG claimants was expected to reduce spending by £2.0 billion by 2015-16. When we reviewed this costing in our 2016 WTR, the saving appeared closer to £0.2 billion as the affected caseload was much lower than expected.
- **The rollout profile:** this was somewhat slower than originally expected. Our March 2011 forecast assumed that ESA would account for 98 per cent of incapacity benefits spending by 2014-15, but it did not reach that level until 2016-17. As the WCAs undertaken under ESA were expected to reduce spending relative to incapacity benefit, a slower rollout generally raised our spending forecasts.

Chart 2.7: Successive OBR incapacity benefits forecasts since 2010



Source: DWP, OBR

Lessons for our UC forecast

- 2.49 The key lesson from our efforts to forecast incapacity benefits spending has been the difficulty of predicting the impact of large-scale reforms for which clear outturn evidence is not yet available. Under these circumstances the forecast relies heavily on uncertain judgements and assumptions. And if these are not borne out, the implications for spending can be significant, especially if a large number of claimants is involved.
- 2.50 With the benefit of hindsight, our initial forecasts were too optimistic in terms of the scale and pace of savings to be made from reforming incapacity benefits. We underestimated the proportion of cases that would be allocated to the more-expensive support group and overestimated the proportion that would fall in the contributory-only WRAG group, thereby overestimating the amount to be saved by time-limiting their claims.
- 2.51 Initially optimistic estimates about the savings from reforming disability benefits (as discussed in Chapter 5 of our 2016 *WTR* and in successive *EFOs*) also had knock-on implications for spending on incapacity benefits. This reflects the severe disability premium in ESA, for which eligibility is linked to receipt of disability benefits. For example, new assumptions relating to successful PIP reassessment rates and average awards resulted in disability benefits spending being revised up by £1.4 billion in 2020-21 in our March 2016 forecast. Higher-than-expected numbers receiving enhanced disability elements fed through to higher-than-expected expenditure on ESA, which was revised up by £0.1 billion in that forecast. This also affects our estimates of the saving from UC associated with the removal of these disability premia.

What will universal credit replace?

- 2.52 The experience of forecasting ESA delivery is also instructive. Ambitious targets for external contractors' delivery of work capability assessments proved too optimistic. Shortfalls against these targets reduced expected savings directly, while also generating administrative backlogs that slowed the reassessment of incapacity benefit cases.
- 2.53 The rollout of ESA was accompanied by regular internal and external reviews. One result was a series of changes in the scope of ESA eligibility – more often widening than narrowing it. These changes are very difficult to anticipate – and indeed to incorporate them would have been beyond the scope of our forecasts if implementing a review finding required a change of government policy.
- 2.54 The history of incapacity benefits reforms also shows the varying speeds at which reform can take place. While sickness benefit and invalidity benefit claimants were swiftly migrated to incapacity benefit after its launch in 1995, the incapacity benefit caseload has taken several years to migrate to ESA. The 1995 reforms were helped by the fact that all invalidity benefit records were held on the same computer system, which facilitated migration to the new benefit. This was not the case for ESA, where records held on several different systems had to be brought together.

Jobseeker's allowance

The legacy system

- 2.55 Jobseeker's allowance (JSA) was introduced in October 1996, replacing unemployment benefit and income support for unemployed people. JSA provides support to those who are unemployed and actively looking for work. Currently, there are two types of JSA:
- **Income-based (or non-contributory) JSA** is paid to claimants who satisfy a household-based income test. At £2.2 billion, counterfactual income-based JSA accounted for 90 per cent of total counterfactual JSA expenditure in 2016-17. It is being replaced by UC, and – since the rollout of UC focused initially on simpler cases i.e. single people that are out-of-work – the transition from income-based JSA to UC will be almost half completed by the end of 2017-18.
 - **Contributory JSA** is paid to individuals who have paid enough Class 1 National Insurance contributions in the two tax years prior to the date of claim. This accounted for just 10 per cent (£264 million) of total JSA expenditure in 2016-17 (on a 'no UC' counterfactual basis). Contribution-based JSA is not being replaced by UC but will be replaced by 'new style' JSA alongside the rollout of UC.
- 2.56 Income-based JSA is means-tested, with both household income and capital factored into award calculations. Increases in earnings reduce income-based JSA awards pound-for-pound, subject to an earnings disregard of £5 a week for single claimants and £10 a week for couples. The capital assessed for JSA includes savings, stocks and shares as well as trusts and property (excluding the claimant's residence). Capital over £6,000 is assumed to provide a 'tariff income' of £1 for every £250 in excess of this lower limit, which acts like an

income taper by progressively reducing entitlement for those with assets above £6,000. Eligibility is removed entirely from households with capital valued above £16,000. JSA capital rules match those that currently apply to income support claimants and those that will apply to all claimants under UC.

Our November 2017 forecast

- 2.57** JSA spending is very sensitive to the economic cycle, with spending rising and falling as unemployment does. Our latest forecast assumes only modest cyclical fluctuations over the coming years. We expect the unemployment rate to edge higher from its current historically low level, in part because we expect further increases in the National Living Wage to price some workers out of employment. Spending on JSA in the 'no UC' counterfactual is therefore expected to rise by around £0.3 billion between 2017-18 and 2022-23 (Table 2.8). The recent extension of the lone parent obligation (LPO) to parents of 3- and 4-year-olds is also expected to increase JSA spending (and reduce spending on income support) over the forecast as more lone parents move onto JSA.
- 2.58** Our JSA forecast is driven by the assumptions we make about the broader International Labour Organization (ILO) measure of unemployment that is drawn from the Labour Force Survey (LFS). The JSA caseload is almost always lower than LFS unemployment because, among other things, some unemployed people are not eligible for JSA (e.g. those in full-time education looking for work) and some will choose not to engage with the benefits system (e.g. those who expect to be out of work for a very short period or who would prefer not to subject themselves to the conditionality regime). Absent clear information about how the gap between the two measures will evolve in the future – as with the LPO changes – we tend to assume that it will remain constant.

Table 2.8: Jobseeker's allowance forecast: 'no-UC' counterfactual

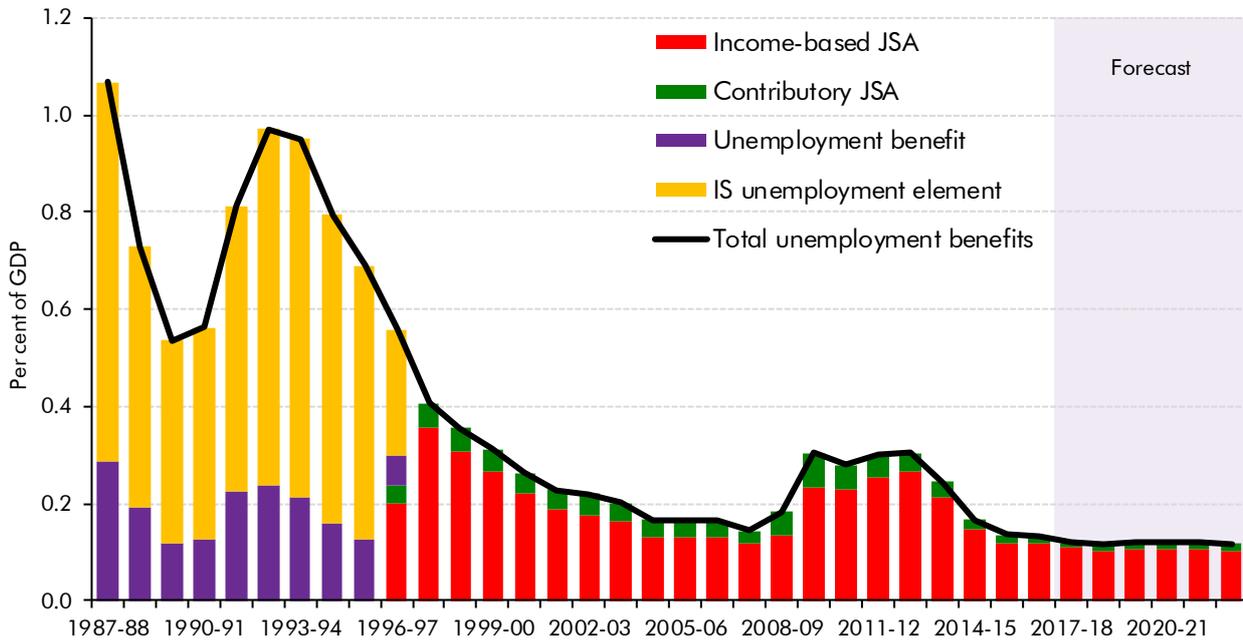
	November 2017 forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
	Caseloads ('000s)					
Total jobseeker's allowance	633	650	676	683	685	685
of which:						
Income-based JSA	552	563	586	592	595	595
Contributory JSA	81	87	90	92	90	90
	Average weekly award (£)					
Total jobseeker's allowance	75	73	74	75	77	78
of which:						
Income-based JSA	77	74	75	76	78	79
Contributory JSA	56	66	67	68	69	70
	Spending (£ million)					
Total jobseeker's allowance	2,462	2,489	2,601	2,672	2,738	2,783
of which:						
Income-based JSA	2,224	2,188	2,288	2,348	2,414	2,456
Contributory JSA	238	301	313	324	324	327
<i>Memo: JSA caseload/ILO unemployment</i>	<i>43.4</i>	<i>44.4</i>	<i>44.4</i>	<i>43.7</i>	<i>43.5</i>	<i>43.4</i>

Trends in spending on unemployment benefits

- 2.59 The economic and policy drivers of spending on the unemployed were reviewed in Chapter 8 of our 2014 *WTR*. Spending rises and falls in cash terms and as a share of GDP in a counter-cyclical manner with the ups and downs of the economy and unemployment. This contrasts with most other benefits, which exhibit mild counter-cyclicality in per cent of GDP terms due to a 'denominator effect' – when cash spending is relatively stable an economic downturn will push it up as a share of GDP.¹¹
- 2.60 Compared with more recent experience, spending on unemployment benefit and the unemployment element in income support was much higher as a share of GDP from the late-1980s to the mid-1990s (Chart 2.8). This was largely due to the higher levels of unemployment that followed the early-1980s recession and subsequent industrial restructuring, followed by the milder early-1990s recession. Between 1979-80 and 1986-87, the caseload almost trebled to peak at over three million. This rise was also influenced by a relaxation of the conditions attached to claiming unemployment benefit. The caseload then halved by 1990-91 as unemployment fell and conditions were tightened under the 'Restart' programme, before nearly doubling again to reach 2.6 million in 1992-93 at the end of that recession (Chart 2.9).
- 2.61 Spending then fell rapidly from 0.9 per cent of GDP in 1993-94 to 0.4 per cent of GDP in 1997-98 as the economy enjoyed a period of sustained growth. The switch from unemployment benefit and the income support unemployment element to JSA also led to some spending shifting within categories of welfare spending, as the child-related additions to unemployment benefit awards were transferred to the tax credits system.
- 2.62 The late-2000s recession was relatively severe in terms of the fall in GDP, but relatively mild in its effects on unemployment and JSA spending. The caseload peaked at 1.5 million in 2009-10 – roughly in line with the trough at the end of the late-1980s boom – and spending peaked at 0.3 per cent of GDP. This was partly because workers reduced their hours and accepted real pay cuts, cushioning the effects of falling output on employment. Tax credits also had an effect, reducing the relative attractiveness of JSA, particularly for those with an unemployed partner. As unemployment fell back from 2013-14 onwards, expenditure dropped to just 0.1 per cent of GDP by 2016-17.

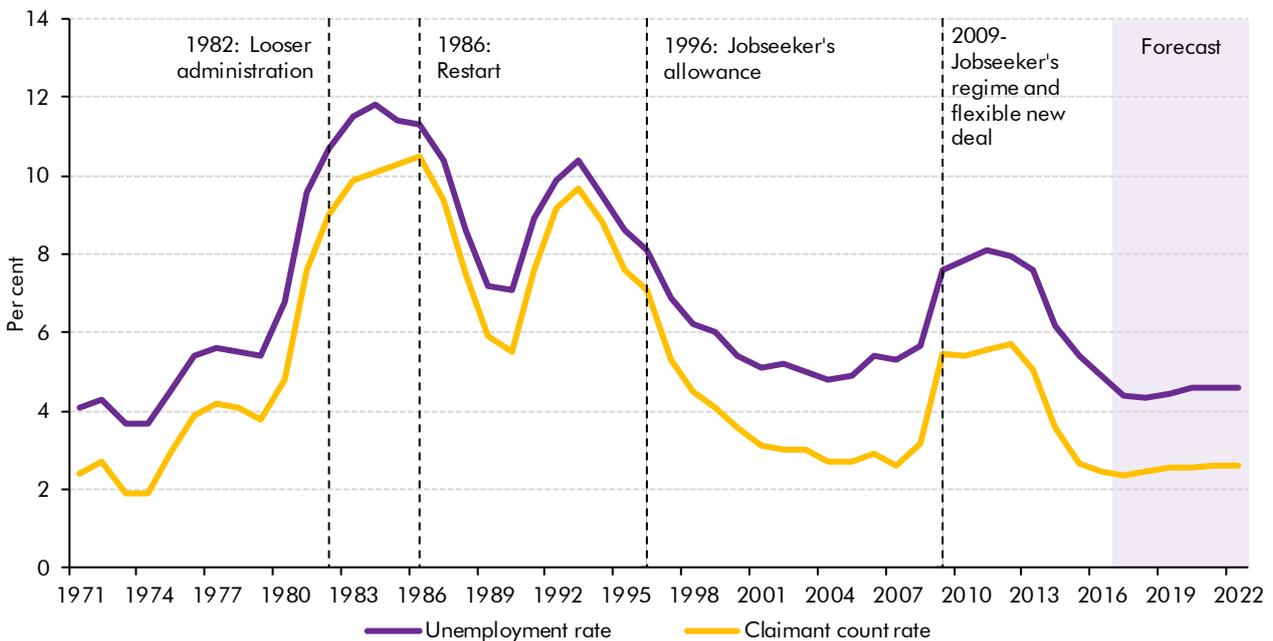
¹¹ See Box 4.1 of our 2014 *Welfare trends report* for analysis of the relative cyclicality of different benefits and tax credits.

Chart 2.8: Spending on unemployment benefits



Source: DWP, OBR

Chart 2.9: Measures of unemployment and associated policy interventions



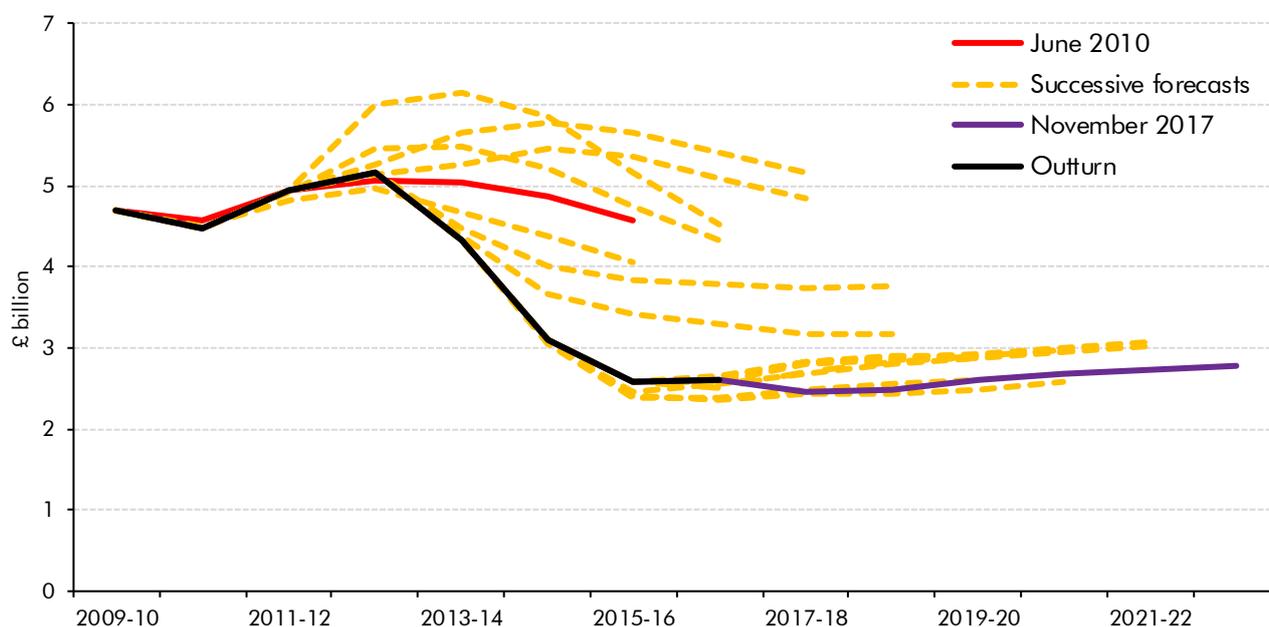
Source: ONS, OBR

2.63 Of all the legacy benefits, JSA is the most responsive to economic shocks. Under the stress test scenario in our July 2017 *Fiscal risks report (FRR)*, we assumed that a sharp downturn in GDP would lead to a trebling of the JSA caseload relative to our March 2017 forecast. This increased JSA and associated housing benefit spending by £8 billion in the short term, with it remaining £5 billion higher at the end of the scenario.

Historical forecast revisions

2.64 Our 2010 JSA spending forecasts were initially revised up as we revised down our wider GDP forecasts, but this proved not to be warranted as the weakness of GDP growth was concentrated in productivity growth rather than unemployment.¹² Unemployment started to fall in 2013 and fell further and faster than we anticipated in forecasts around that time. More recently, unemployment has continued to edge lower, but our JSA spending forecasts have been more stable and closer to outturns.

Chart 2.10: Successive OBR unemployment benefits forecasts since 2010



Source: DWP, OBR

Lessons for our UC forecast

2.65 A key lesson to draw from JSA forecasting is how the caseload varies with the broader LFS measure of unemployment. Both measures move with the economic cycle, but the relationship between them is not always stable. This can reflect changes in the composition of LFS unemployment, changes in eligibility criteria or the administration of the benefit system, or changes in take up among those who are eligible. In our 2014 WTR we discussed how the ratio of the claimant count to LFS unemployment had fluctuated as the JSA eligibility and sanctions regime caused the rate of flows into and out of the JSA caseload to differ from flows into and out of LFS unemployment. These factors are likely to be relevant under UC too.

2.66 The effects of conditionality and sanctions on spending to date appears mixed. Sanctions have reduced payments, but claimants' behavioural responses are less well understood.¹³

¹² As spending on jobseeker's allowance has already been significantly replaced by UC, Chart 2.10 adds back the expenditure lost from jobseeker's allowance to UC in outturn years in each of our forecasts that were affected by the UC rollout. All forecasts are therefore consistent with the 'no-UC' counterfactual.

¹³ *Benefit sanctions*, NAO (2016).

We have assumed that conditionality deters some eligible individuals from taking up their JSA entitlement, to avoid the condition-setting process, the conditions themselves and the possibility of sanctions. Extending conditionality to in-work claimants under UC appears without international precedent and the lack of evidence to date means that estimating its impact will be difficult. Earlier initiatives designed to increase work activity among the unemployed – such as ‘mandatory work activity’ and the ‘help to work’ scheme – provide mixed evidence.¹⁴ The Government closed these in 2015.

- 2.67 The history of unemployment benefits also highlights the fact that the pace of benefits reform can vary. The introduction of JSA in October 1996 was accompanied by a relatively swift migration of claimants from unemployment benefit and the unemployment element of income support. This was facilitated by the broad similarities between JSA and income support. This is also an element of the legacy system with relatively high levels of churn in the population, which means the natural flow of new claims flowing onto the new system leads to a relatively swift migration between the systems.

Income support

The legacy system

- 2.68 Income support is a means-tested benefit that was introduced in 1988 to support those on low incomes and not in full-time employment. Historically, income support covered a wide range of recipients – including the elderly and unemployed – but it is now mainly targeted at lone parents and carers as many of its original functions have been transferred to other benefits and tax credits. Of the legacy benefits replaced by UC, spending on income support is the lowest, fluctuating between £2.0 and £2.4 billion from 2017-18 to 2022-23.
- 2.69 Means-testing for income support considers both the household income and capital under the same rules as JSA. In addition to the earnings rise disregards in JSA, income support has an additional earnings disregard of £20 per week for lone parents.

Our November 2017 forecast

- 2.70 Spending on income support is expected to be broadly flat between 2017-18 and 2022-23. This reflects a fall in 2018-19, when the lone parent obligation is expected to move around 90,000 lone parents off income support and on to JSA and ESA, reducing spending by around £0.3 billion. From 2018-19 to 2022-23, spending is then expected to rise. This reflects an increase in the number of carers eligible for income support through carer’s allowance. The rising disability benefits caseload, which drives eligibility for carer’s allowance, and a backlog of carer’s allowance claims is expected to feed through to a 42 per cent increase in the carers caseload over the forecast period.

¹⁴ *Early impacts of mandatory work activity*, DWP (2012).

Table 2.9: Income support forecast: 'no-UC' counterfactual

	November 2017 forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
	Caseloads ('000s)					
Total income support (excluding incapacity element)	570	556	571	579	589	599
of which:						
Lone parents	370	320	321	320	321	322
Carers	174	207	221	230	239	248
Other	26	29	29	29	29	29
	Average weekly award (£)					
Total income support (excluding incapacity element)	78	70	70	72	73	76
of which:						
Lone parents	76	68	68	69	70	71
Carers	81	72	73	75	78	81
Other	82	75	75	77	78	80
	Spending (£ million)					
Total income support (excluding incapacity element)	2,320	2,019	2,085	2,159	2,247	2,362
of which:						
Lone parents	1,475	1,133	1,133	1,144	1,164	1,198
Carers	734	773	837	898	966	1,043
Other	111	113	114	116	118	121

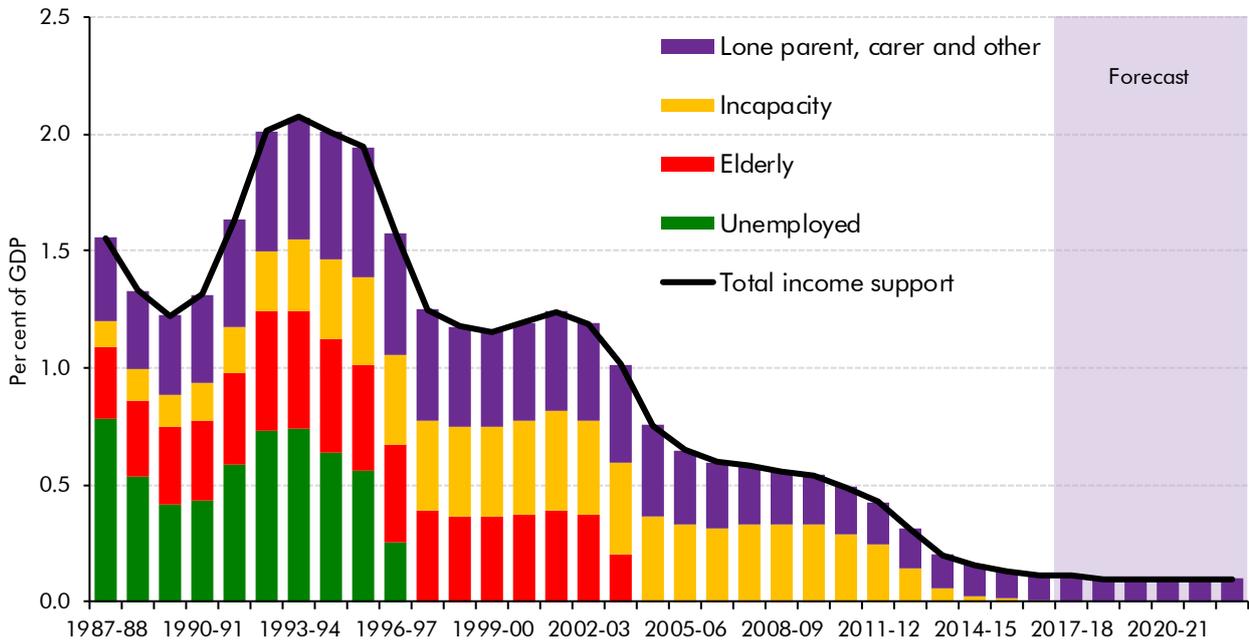
Trends in spending on income support

2.71 Spending on income support peaked at 2.1 per cent of GDP in 1993-94 following the early-1990s recession, which saw a big rise in unemployment (Chart 2.11). Expenditure then followed a downward trend to 1.1 per cent in 2016-17 as many of the original functions of income support were transferred to other parts of the welfare system:

- **jobseeker's allowance (JSA)** replaced income support for the unemployed in 1996;
- **pension credit** replaced income support for the over-60s in 2003-04;
- **child tax credit** subsumed the child addition paid out to new claimants under income support from 2003; and
- **employment and support allowance (ESA)** replaced new income support claims for those claiming on incapacity grounds in 2008. Migration of pre-existing claims on incapacity grounds to ESA began in 2011-12. This was originally due to be completed in 2015-16, but is now expected to conclude this year.

2.72 Changes in the income support caseload – typically in response to reforms – have been the main driver of trends in spending. Caseloads fell by 32 per cent between 1995-96 and 1998-99 (with the introduction of JSA) and by 45 per cent between 2002-03 and 2004-05 (following the transfer of over-60s cases to pension credit). The introduction of ESA and the lone parent obligation in 2008 caused a further steep fall in the caseload, with the number of claimants falling by 70 per cent between 2007-08 and 2016-17.

Chart 2.11: Spending on income support

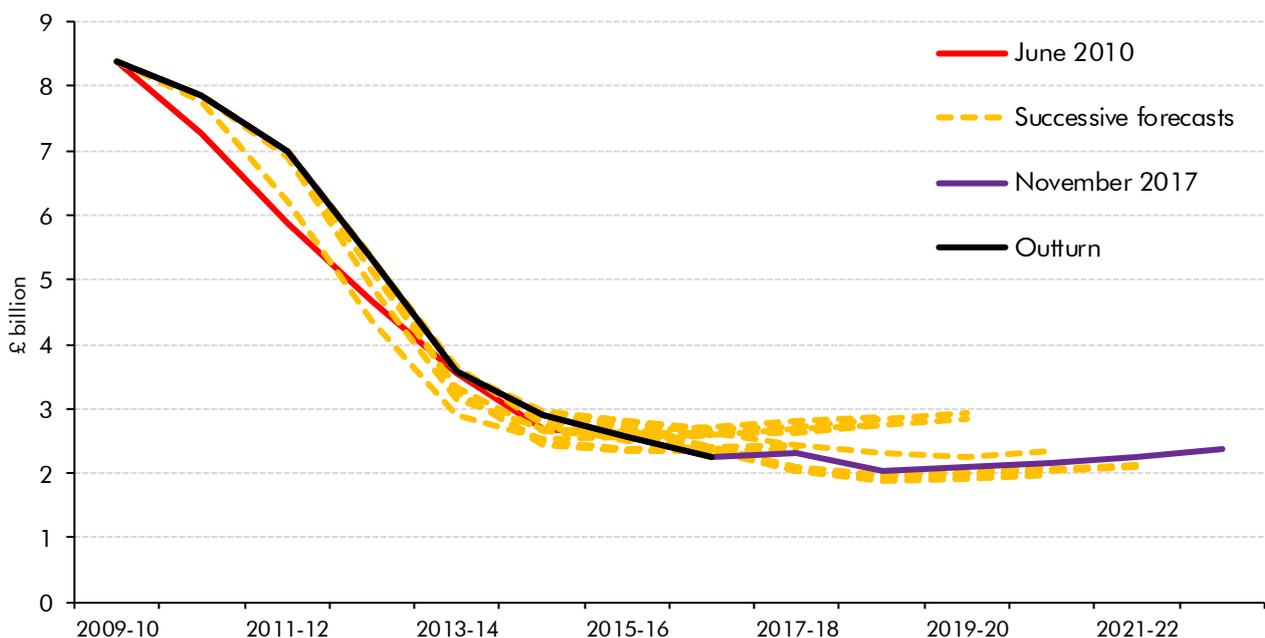


Source: DWP, OBR

Historical forecast revisions

2.73 Successive forecasts of income support spending have been reasonably accurate in capturing the effect of transferring many of its elements to other parts of the welfare system. The relatively small forecast revisions have mainly related to the pace at which these transfers feed through to the caseload and the knock-on effects on income support of the carer’s allowance caseload rising faster than expected.

Chart 2.12: Successive OBR income support forecasts since 2010



Source: DWP, OBR

Lessons learned for our UC forecast

- 2.74 The reforms to income support highlight the uncertainties associated with transferring types of support between different parts of the welfare system, albeit on a much smaller scale than will be the case with UC. The transfer of IS elements to JSA and pension credit was relatively quick, but the migration of child element cases to child tax credit has taken much longer than expected. The process began in 2003 and was originally planned to be complete by 2007-08, but even now it is still ongoing.
- 2.75 The reforms also illustrate the potential complexity of claimants' behavioural responses. For example, the lone parent obligation may have encouraged more lone parents to declare a caring responsibility in order to retain eligibility for income support as a carer rather than moving on to JSA or ESA. This type of behaviour may be relevant under UC for those seeking to avoid being subject to conditionality.
- 2.76 Recent income support trends show the effects of interactions between benefits, which cannot always be foreseen. The income support caseload is being supported by the rise in the number of carers eligible for carer's allowance and therefore income support whose ultimate eligibility stems from caring for someone in receipt of a disability benefit. The challenges we have had forecasting disability benefits as the new personal independence payment is rolled out in place of disability living allowance have been detailed in successive EFOs and in Chapter 5 of our 2016 WTR.

3 The design of universal credit

Introduction

3.1 This chapter discusses:

- the **scope of universal credit (UC)**;
- how someone's **UC entitlement** is assessed;
- legacy system **features that are not included in UC**;
- the implications of UC for **'passport benefits'**;
- the use of **conditionality and sanctions**; and
- the role of **UC work coaches**.

3.2 UC is being rolled out over several years. In some areas the Government has set out broad principles of the policy design and operational process, but not specific details. Where this is the case we have to make assumptions about the most likely end point – informed by the Government's latest stated intentions.

3.3 The main areas where design features have yet to be finalised include:

- **In-work conditionality:** the Government is currently trialling three variants, providing different degrees of support and conditionality. We have not assumed any effects from in-work conditionality in our forecast.
- **Managed migration:** the Government plans to transfer cases over a three-year period from July 2019. We assume a 6-month delay.
- **Minimum income floor:** the Government has set out broad guidelines and the policy is in place, but there is a large degree of discretion available to the work coach. We assume this will lead to significant savings relative to the legacy system, but the amount is highly uncertain.
- **Transitional protection:** the Government has set out broad principles but is still preparing the final legislation. We model the cost of this in our central forecast, but it is another significant source of uncertainty.

The scope of UC

- 3.4 As outlined in the introduction, UC is a single, means-tested working-age benefit that will replace child and working tax credit, the income-based components of jobseeker's allowance (JSA) and employment and support allowance (ESA), working-age housing benefit and income support.
- 3.5 The legacy system includes 'support for mortgage interest' (SMI) for people on low incomes. In Summer Budget 2015, the Government announced that these payments would be converted to loans from April 2018. It is not yet clear precisely how this will be delivered in UC. The cost of SMI is currently small (£0.2 billion in 2016-17) in the context of overall working-age welfare spending and UC. Converting conventional spending into loans means that the only effect on spending from SMI will come later, at the point when any of them are written off. We have not included SMI in the analysis in this report.
- 3.6 Child benefit, carer's allowance, disability benefits¹ and contributory benefits will remain outside the scope of UC. The latter includes £0.3 billion of (time-limited) contribution-based JSA (re-badged 'new-style JSA') paid to 100,000 claimants and £5 billion of contribution-based ESA (re-badged 'new-style ESA') paid to 900,000 claimants which will continue alongside UC. Local council tax support (formerly council tax benefit) is also excluded, as support is now paid at varying levels determined by local authorities.
- 3.7 Where couples have one adult over and one under the pension credit qualifying age for a single person, the household will be considered a working-age household and qualify for UC rather than pension credit. This feature has not yet been applied, with claimants currently free to choose between them.

Assessing UC entitlement

Key features

- 3.8 Entitlement to UC is assessed at 'benefit unit' level – as with most means-tested benefits and tax credits in the legacy system. A benefit unit can comprise a single person, a couple, a lone parent with dependent children, or a couple with dependent children. There can be more than one benefit unit in a household – for example a couple plus an adult, non-dependent son or daughter. In such cases, each benefit unit would receive a separate UC award if they met the eligibility criteria. Their awards would be adjusted to take into account the relevant household circumstances – e.g. only one award would cover housing costs.
- 3.9 Entitlement is assessed on a monthly basis and paid in arrears. Once fully rolled out, this will require monthly reporting of income and personal circumstances of 0.7 million claimants that would have received JSA in the legacy system, 3.5 million housing benefit claimants, 3.7 million tax credits claimants, 0.7 million income support claimants and 2.2 million ESA claimants. Among these will be 0.7 million self-employed. These caseloads

¹ For example, disability living allowance and personal independence payments.

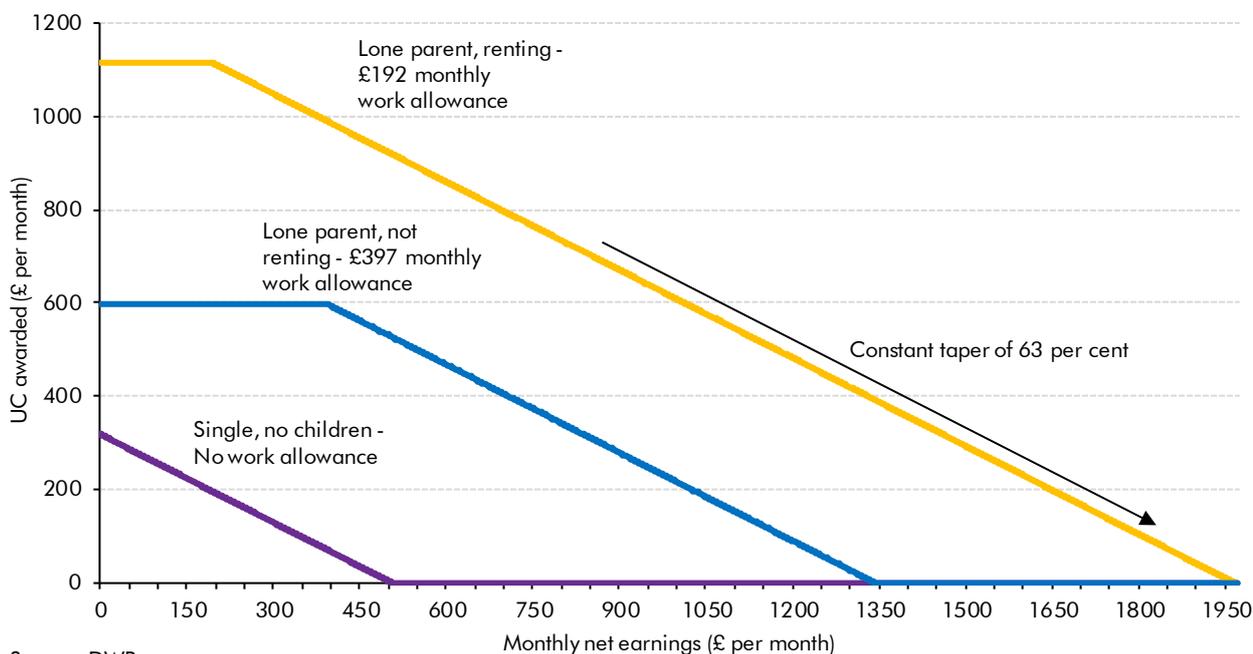
overlap – for example, where a working family is entitled to tax credits and housing benefit or an out-of-work individual to JSA and housing benefit.

- 3.10** Payments for housing support have been paid directly to the claimant rather than the landlord (as is currently the case for a significant proportion of housing benefit claimants). This changed in November 2017 with the announcement that claimants transferring to UC with housing support paid to the landlord will now be able to decide if they maintain the same arrangement.² In both Scotland and Northern Ireland, where aspects of the UC design have been devolved, the housing support element will continue to be paid directly to landlords.
- 3.11** Following the Autumn Budget 2017 decision to remove the initial 7-day wait before UC entitlement begins, most new claimants will be paid their first UC payment around 5 weeks after making a claim. Typically this includes a one-month assessment period (for which payment is calculated retrospectively) and up to seven days for the payment to reach the claimant's bank account.
- 3.12** During the assessment period claimants are eligible for short-term loans of their UC awards. These advances were increased in the Autumn Budget and are now worth up to 100 per cent of the assumed entitlement. Those taking them up will have their subsequent 12 monthly UC payments reduced until the value of the advance has been recovered. Take-up of these advances had been running at around 50 per cent when they were worth up to 50 per cent of the expected first UC award. The costing of the Autumn Budget increase in the maximum value of advances assumed that there would be a modest increase in take-up due to their higher value and to greater awareness among claimants following the publicity that surrounded the change.
- 3.13** Reassessments of entitlement following changes in personal circumstances (for example, a change in income or a partner joining the benefit unit) apply to the whole assessment period they are reported in, whatever the precise timing of the change. Those that increase people's entitlement are not backdated if reported late,³ but those that reduce it are recovered from future payments.
- 3.14** UC is made up of a number of different elements, each contingent on a claimant's personal circumstances. These elements are added to give the claimant's maximum potential award (discussed in the next section). This may then be adjusted downwards to reflect the claimant's income or other personal circumstances to give the claimant's actual award (discussed in the subsequent section). This structure is much like the current tax credits system.

² See Secretary of State for Work and Pensions, House of Commons debate on 'Universal Credit', 23 November 2017 (Hansard volume 631, column 1201).

³ Unless the claimant can persuade a decision-maker that there is good reason for the late notification.

Chart 3.1: UC award by income



Source: DWP

Calculating the maximum potential amount before adjustments

3.15 UC consists of a standard allowance that depends on whether the benefit unit is a single person or couple and whether at least one recipient is over 25. The following additional components are available to those that are eligible:

- **Child element:** this is available for up to two children, with some exceptions. Prior to April 2017, a higher rate was paid for the first child in a family. From April 2017 onwards, this higher rate will only be payable if the eldest child was born before 6 April 2017.
- **Disabled child addition:** this is payable for each disabled child in a benefit unit. Eligibility for the two rates is determined by the nature of each child's disability benefits claim.
- **Capability for work elements:** an addition is paid to claimants who have completed a work capability assessment and are deemed to have limited capability for work and work-related activity. For claims made on or before 3 April 2017, those deemed to have limited capability for work are eligible for a smaller addition. This is no longer available to new claims, but will not be withdrawn from continuing claims.
- **Carer element:** an addition paid where the claimant has regular and substantial caring responsibilities, in line with the terms of eligibility for carer's allowance.
- **Housing element:** support for housing costs is limited to the local housing allowance rate for those in the private-rented sector, while for those in the social-rented sector the

full amount is paid less any deduction due to the 'removal of the spare room subsidy' policy (often referred to as the 'bedroom tax').

- **Support for mortgage interest** for owner-occupier claimants not in work. The amount claimable is limited and is generally paid directly to the mortgage lender. From April 2018, it will take the form of a loan rather than a simple payment (see paragraph 3.5).
- **Childcare costs element:** for in-work claimants, 85 per cent of childcare costs will be met up to limits specified for one or more children in childcare.

3.16 As with most parameters in the working-age welfare system, the elements of UC will typically be uprated each year with CPI inflation, but from 2016-17 to 2019-20 all but the disability elements are frozen in cash-terms (Table 3.1).

Table 3.1: Elements in the UC award calculation

	Monthly (£)					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
	Maximum award elements					
Standard rate						
Single, under 25	252	252	252	257	262	267
Single, 25 or over	318	318	318	324	330	337
Joint claimants, both under 25	395	395	395	403	411	419
Joint claimants, one or both 25 or over	499	499	499	509	519	530
Child element						
First child ¹	277	277	277	281	286	292
Second/subsequent child	232	232	232	236	240	245
Disabled child additions						
Lower rate addition	126	126	126	129	131	134
Higher rate addition	372	382	391	400	409	417
Capability for work elements						
Limited capability for work element ²	126	126	126	129	131	134
Limited capability for work and work-related activity element	319	327	334	342	348	355
Carer element	152	156	159	163	166	169
Housing element	<i>varies depending on rent</i>					
	Childcare support					
Support for childcare costs (per cent)	85	85	85	85	85	85
Childcare support limits						
One child	646	646	646	646	646	646
Two or more children	1,108	1,108	1,108	1,108	1,108	1,108

¹ This higher amount only applies for first children born before 6 April 2017.

² Only available to the stock of claims made before 3 April 2017.

Calculating the actual award after adjustments

3.17 Once the maximum potential award has been calculated, adjustments are made in respect of the financial and other circumstances of the claimant. Each is discussed more fully below:

The design of universal credit

- **Financial assets:** for claimants with £6,000 to £16,000 of savings (or 'capital' in the terminology of UC), awards are tapered. Claimants with more than £16,000 in savings will not be entitled to UC at all;
- **Non-employment income:** for claimants with 'unearned income' – e.g. pensions – the award is withdrawn pound for pound with that income;
- **Employee or self-employment earnings:** to the extent that 'earned income' exceeds the claimant's work allowance UC is withdrawn at a rate of 63 per cent for each additional pound of net income. For the self-employed, the 'minimum income floor' applies, under which a claimant's earnings may be assumed to be significantly higher than their actual (reported) earnings for the purposes of the UC award calculation.
- **Benefit cap:** UC awards are subject to the Government's household benefit cap, with awards in excess of the cap withdrawn pound for pound.
- **Transitional protection:** for cases that are migrated from the legacy system to UC at DWP's discretion – i.e. subject to 'managed migration' – transitional protection will be paid where the UC award would otherwise have been lower than the legacy award.

3.18 Once the award has been calculated, further deductions can be made in respect of conditionality sanctions or to recover previous advances or overpayments. In some cases further deductions are made in respect of fraud sanctions or child support payments.

Capital rules

3.19 Under UC, capital rules will apply to all potential claimants. These broadly follow the rules for out-of-work income-related legacy benefits, thereby extending them to those who would have claimed an in-work benefit such as tax credits in the legacy system. The rules vary according to the value of a claimant's savings:

- **Less than £6,000:** no adjustment is made to the UC award.
- **Between £6,000 and £16,000:** awards will be reduced at a rate of £4.35 a month for each discrete £250 of savings. DWP refers to this as an 'assumed yield' but in reality is equivalent to the claimant drawing down around a fifth of their savings each year. Any excess of savings that does not make up a full £250 increment is disregarded.
- **Greater than £16,000:** entitlement to UC is removed entirely.

3.20 The definition of 'capital' for this purpose includes savings, stocks and shares, property and trusts. It does not include the value of the claimant's 'normal home' and any savings in a pension fund. Income derived from capital – interest on savings, rent payments from a second property or dividends from shares – is also treated as capital.

Unearned income

- 3.21 The definition of ‘unearned income’ for UC includes income from retirement pensions and annuities and most student loans and grants (with some of the latter disregarded). Some benefits are also counted as income, including carer’s allowance, contributory ESA and maternity allowance. The value of unearned income is collected via a central system and converted into a monthly amount that is deducted pound-for-pound from the maximum potential award.

Earned income

- 3.22 A claimant’s award is adjusted in accordance with their earnings (after income tax, National Insurance contributions (NICs) and contributions to a personal or occupational pension). In most cases, post-tax employee earnings will be reported through HMRC’s real-time information (RTI) system. DWP transfers this into a real-time earnings (RTE) system to adjust the monthly UC award.
- 3.23 Self-employed claimants have to report their earnings to DWP on a monthly basis. Claimants will have to report the total payments into and out of their businesses during each assessment period, including relievable pension contributions and any income tax and NICs paid in respect of these earnings. This gives a net profit figure, which is used in the UC calculation.
- 3.24 Awards are tapered at a rate of 63 pence in the pound for earned income. For some groups, this taper does not apply to an initial amount of earnings – a ‘work allowance’, as described in the next section.

Work allowances

- 3.25 Most benefit units – all those containing a child or an adult with limited capability to work – receive a ‘work allowance’ that means that up to that point they retain all their earnings without affecting their UC award. Beyond that their earnings are subject to the 63 per cent taper. There are two levels of work allowance depending whether the claimant is also in receipt of the housing element. One work allowance is allocated per benefit unit, regardless of the number of earners it contains. In 2017-18 the higher work allowance is equivalent to the wage from working around 12 hours a week at the National Living Wage (NLW). The lower allowance is equivalent to 6 hours a week at the NLW. Benefit units that contain neither a child nor an adult with limited capability to work do not receive a work allowance.
- 3.26 As Table 3.2 shows, the work allowances were frozen in cash terms up to 2017-18. From 2018-19 onwards, they will be uprated in line with CPI inflation (rounded to the nearest pound). They are therefore expected to fall relative to earnings and the NLW.

Table 3.2: Work allowances

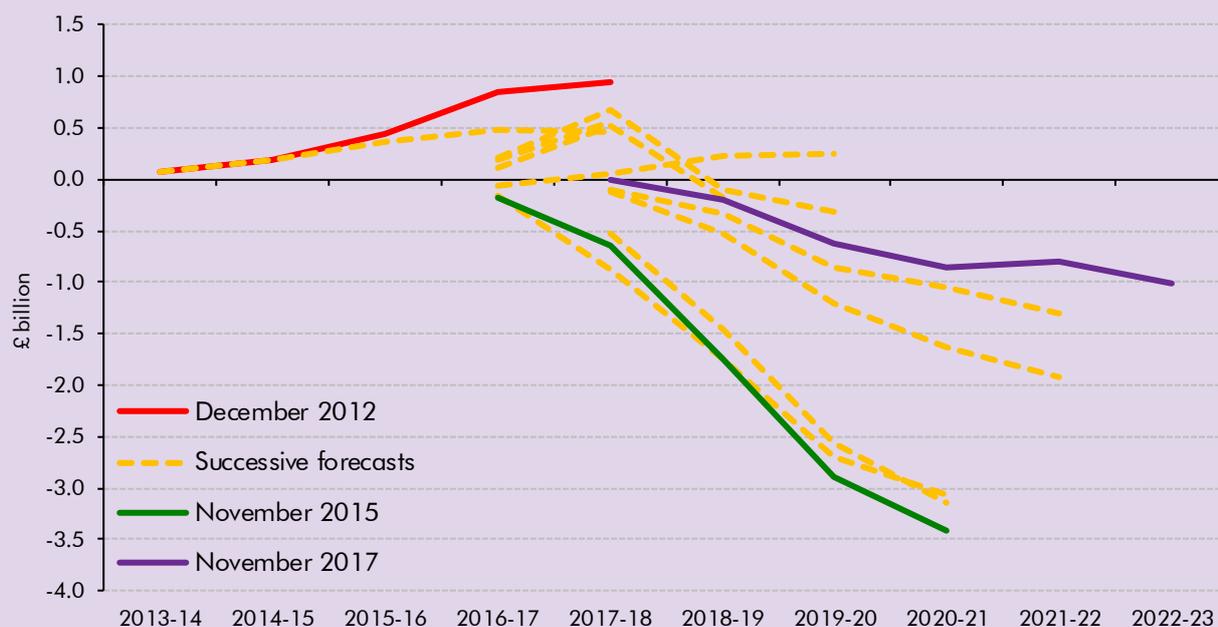
	Monthly (£)					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
No housing costs						
Single/couple, no children	0	0	0	0	0	0
Single/couple, with children	397	407	416	425	434	443
Single/couple, limited capability for work	397	407	416	425	434	443
With housing costs						
Single/couple, no children	0	0	0	0	0	0
Single/couple, with children	192	197	201	206	210	214
Single/couple, limited capability for work	192	197	201	206	210	214

Box 3.1: Work allowances and UC forecast revisions

Over time, our estimates of the net effect of UC on spending relative to the legacy system has moved from a net cost to a relatively large net saving and more recently to a smaller net saving (Chart A). The generosity of UC work allowances relative to the equivalents in the tax credits system were a key factor driving the initial swing from cost to saving.

When UC was first factored into our forecasts in December 2012, the final year of that forecast (2017-18) showed a net cost of £0.9 billion. In our November 2015 forecast, which reflected the cuts to the work allowances announced in Summer Budget 2015, and the reversal of the equivalent cuts announced for tax credits, the final year of the forecast (2020-21) showed a net saving of £3.4 billion. In our latest November 2017 forecast the final-year saving was £1.0 billion (in 2022-23). While the final year of each forecast is not identical to the ‘full-UC’ counterfactual given changes to the rollout schedule (see Chapter 6), it illustrates the pattern.

Chart A: Successive OBR forecasts for the marginal cost of UC

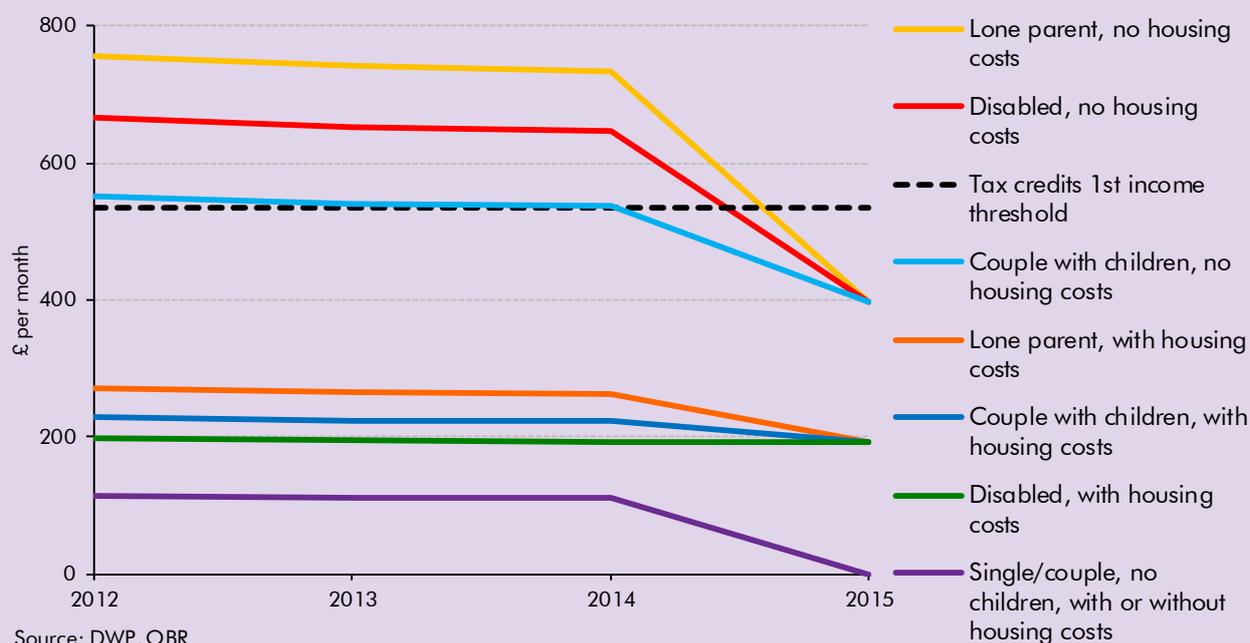


Source: OBR

The main explanation for the shift from net cost to net saving is that the Government cut the work allowances in UC and the income thresholds in tax credits sharply in Summer Budget 2015, but then reversed the tax credit cuts before implementing them in November 2015. Chart B shows how the UC work allowances have been cut across the board relative to the 'first tax credits income threshold', both in number and value. All are now worth less than the monthly equivalent of that threshold.

The estimated net saving was then reduced sharply in November 2016, reflecting modelling changes and policy changes, including the cut in the UC taper rate from 65 to 63 per cent.

Chart B: UC work allowances versus tax credits income threshold



Tapering to reflect earnings and self-employment profits

3.27 UC is tapered away at a single rate of 63 per cent. As UC is tapered against net income, take home pay is also affected by the income tax and National Insurance systems. This means that UC claimants take home the following amounts for every additional pound of gross earnings they earn above the relevant work allowance (if they receive one):

- 37 pence if they are **non-taxpayers, paying no NICs and making no private or occupational pension contributions;**
- 33 pence if they are **non-taxpayers that do pay NICs but make no other pension contributions;**
- 25 pence if they are **basic rate taxpayers paying NICs but making no other pension contributions;** and

- Less than 25 pence if they are **basic rate taxpayers paying NICs and receiving local council tax support** (formerly council tax benefit).⁴

3.28 For parents who need to pay for more childcare in order to increase their own pay, the gains in terms of disposable income after childcare costs would be lower still. This is despite UC meeting 85 per cent of childcare costs up to a specified maximum. This would also be the case if in-work claimants were sanctioned, due to not being deemed to be working enough hours or failing to meet another condition set by the work coach. For some claimants, disposable income after essential costs would be hit if the move into work or taking on more hours of work pushed their income beyond one or more of the income thresholds for passported benefits such as free school meals (see below).

Assumed self-employment income: the 'minimum income floor'

3.29 Where a self-employed person is classed as gainfully self-employed⁵ and their business is more than a year old, they will be subject to a 'minimum income floor' (MIF). This is an assumed level of earnings determined by DWP that replaces the claimant's reported earnings where the reported earnings are lower than the MIF set for the claimant. The Government says that this is "to encourage individuals to increase their earnings through developing their self-employment".⁶

3.30 A claimant's MIF is calculated as the expected number of hours worked per week multiplied by the National Living Wage rate (or relevant National Minimum Wage rate for the under-25s), which is then converted to a monthly figure and reduced in line with notional deductions for income tax and NICs payments. The expected number of hours worked in the MIF calculation match those across the 'claimant commitment' conditionality groups more widely (described in paragraph 3.48). The DWP work coach sets the level.

Benefit cap

3.31 The 'benefit cap' limits the total benefit payments that a household can receive, with different rates in London and the rest of the country and for single adults and couples or lone parents (Table 3.3). The cap applies to the combined income from 12 separate benefits including the main out-of-work benefits in the legacy system, child tax credit, housing benefit and UC. There are a number of exemptions for those in receipt of disability benefits, above the pension credit age or working enough hours to qualify for working tax credit. In terms of UC, claimants will be exempt from the cap where the limited capability for work-related activity element has been awarded or where the household is earning over £520 a month.

⁴ The local council tax support taper rate is applied sequentially after income tax, NICs and UC. There is no single deduction rate since all 326 local authorities in England are able to set their own individual LCTS system, while the Scottish and Welsh Governments have maintained a single system of support.

⁵ Claimants are subject to a 'gainful self-employment' test. This requires that self-employment should be the individual's main occupation and that it must also be organised, developed, regular, and carried out in expectation of profit. Among other things, work coaches will check tax records, business plans and marketing material as part of this test.

⁶ *Self-employment and the gig economy: Government Response to the Committee's Thirteenth Report of Session 2016–17*, House of Commons Work and Pensions Committee, December 2017.

Table 3.3: Benefit cap limits

	Monthly (£)					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
London						
Single adults	1,284	1,284	1,284	1,284	1,284	1,284
Couples and lone parents	1,917	1,917	1,917	1,917	1,917	1,917
Outside London						
Single adults	1,117	1,117	1,117	1,117	1,117	1,117
Couples and lone parents	1,667	1,667	1,667	1,667	1,667	1,667

Transitional protection

- 3.32** Under the current migration plan, approximately 1.9 million households will undergo a ‘managed migration’ to UC, with DWP at some point requiring them to give up their legacy benefit claim and make a UC claim instead. Some of these households will have lower entitlements under UC than they received in legacy benefits, in which case transitional protection (TP) will be awarded to make up the initial difference. In principle this means that most people that have been manage-migrated from legacy benefits to UC will be no worse off *at the point of transfer*. TP will not apply for the larger numbers of claims that are expected to move to UC ‘naturally’ as a result of a qualifying change in circumstances or the natural churn of caseloads due to exits and new claims.
- 3.33** The precise detail of the TP calculation is still being developed but at a high level it will be calculated by comparing the total monthly benefit and tax credit entitlement of a benefit unit at the point of migration with their total first UC entitlement. The comparison will be calculated after the benefit cap has been applied to both amounts. Where the UC entitlement is lower, TP will be awarded as an element of the initial UC award to make up the difference. The calculation will ignore any sanctions or deductions that the individual or family will be subject to in either system. This means that the TP amount will be based on the household entitlement at the point of transition rather than the actual payment received.
- 3.34** TP will not be offered to self-employed claimants against the effects of the MIF as it is calculated prior to the MIF being applied. But claimants with new businesses are granted a 12-month start-up period during which they are not subject to the MIF, while claimants who are manage-migrated are entitled to six months’ exemption from it – so the cost to them would occur after the point at which the TP calculation has been made.
- 3.35** TP is calculated on the basis of income as defined in UC, so tax credits claimants benefitting under the £2,500 income rise disregard may also be made worse off through the managed migration process without receiving TP.
- 3.36** TP awards will be fixed in cash terms, which means that – all else equal – anyone entitled to TP will become worse off than under the legacy systems from the following April, assuming that the parameters in the legacy system would have been updated. On current policy, this will be the case from April 2020 when the four-year cash freeze on most elements of the working-age welfare system comes to an end. For those whose legacy award includes

disability-related elements, this will be the case immediately as these elements are not subject to the uprating freeze.

3.37 TP will be provided until there is a 'significant change in circumstances' or the TP has been eroded to £0. The following changes in circumstances result in the withdrawal of TP:

- the **UC claim ends**;
- a **partner** leaves/joins the household;
- a sustained (three months) **drop in earnings** moves a claimant into a more intensive conditionality regime; and/or
- one or both members of the household **stop working**.

3.38 The cash value of TP is eroded if there is a change in circumstances that increases a claimant's UC entitlement, but does not trigger the end of TP. The following could increase the underlying UC entitlement and erode the TP award:

- **having a child** that creates an entitlement, or greater entitlement, for the child element;
- **a change of health status** that generates entitlement to a disability element;
- **a change of living circumstances** that creates or increases entitlement to a housing element; or
- **CPI uprating of UC** parameters from 2020-21 onwards.

In these cases the UC award will increase overall so long as the increase in UC entitlement exceeds the cash value of TP.

3.39 TP awards will not change for claimants whose UC award subsequently falls due to a change in circumstances that does not trigger the end of TP.

Legacy system features that do not feature in UC

3.40 When considering how UC will affect welfare spending, we also need to consider elements of the legacy system that will no longer feature under UC. Some of these are expected to have a significant effect on total welfare spending and on the incomes of particular groups.

Hours rules

3.41 Eligibility for UC is not affected by the number of hours that people work, removing the distinction made at 16, 24 and 30 hours in the legacy system. One consequence is that most single people and childless couples will no longer lose support when they work between 16 and 30 hours – too many hours to receive jobseeker's allowance and too few to

receive working tax credit. It also means that working small numbers of hours – what DWP terms ‘mini jobs’ – should be more attractive. The potential responses of claimants to these changes are discussed in Chapter 4.

Income rise/fall disregards

- 3.42 To limit the amount of overpayments and underpayments that must be recovered or repaid due to changes in earnings altering entitlement, the tax credits system includes an ‘income change disregard’. This means that while changes in earnings lead to changes in entitlement, so long as earnings change by less than £2,500 their effect is disregarded. This benefits those whose income rises by less than the threshold and costs those whose income falls by less. No such disregards exist under UC.

Run-ons

- 3.43 For claimants who move out of work and off working tax credits, HMRC operates a ‘run-on’ scheme that extends entitlement for four weeks to support their incomes until their first out-of-work benefits payment. Local authorities operate a similar scheme for housing benefit claimants who move into work and lose some housing benefit entitlement.⁷ UC removes these run-ons.
- 3.44 In Autumn Budget 2017 the Government introduced a two-week housing benefit run-on for claimants moving to UC who were previously entitled to housing benefit. This will pay two weeks of the full housing benefit entitlement for ‘natural migrations’ (negating the need for separate means-testing) and two weeks of the actual housing benefit payment for ‘managed migrations’, overlapping with their new UC entitlement for the period but paid more promptly. This will require DWP to work closely with local authorities to develop new procedures, particularly where migration is triggered by a change of address and the payment is to the landlord. The UC rollout was slowed by around three months in order to develop this capability, alongside the other UC measures that were announced.

Disability premia

- 3.45 Various disability premia exist in the legacy system, including two that can be paid with income-related ESA. Typically, people receiving income-related ESA in the support group are entitled to the enhanced disability premium (e.g. £15.90 a week for single claimants), while some may also qualify for the severe disability premium (e.g. £62.45 a week for single claimants). These premia do not exist in UC and represent one of the largest gross savings in UC relative to the legacy system. Some of those savings are offset by having a more generous basic UC allowance for those with higher levels of need due to their disability or health conditions via the ‘limited capability for work-related activity’ element.

⁷ These are known as ‘extended housing benefit payments’.

Passported benefits

- 3.46 Receipt of some legacy benefits automatically entitles ('passports') claimants onto various other benefits, including free school meals, free NHS prescriptions, eye tests and legal aid. The government department responsible for each passported benefit determines the eligibility criteria. Families eligible for passported benefits will face a 'cliff-edge' in their support, which means that some increases in work will result in disposable incomes actually falling once they have met the cost of the previously free item.
- 3.47 The largest of these is eligibility for free school meals (and, for the school in question, the pupil premium that is linked to free school meal receipt). The Government is consulting on setting a net income threshold of £7,400 a year before benefits are taken into account. Current eligibility is to be protected until "*the end of the rollout of Universal Credit, and then until the end of their phase of education*".⁸ The Resolution Foundation estimated that maintaining free school meals for all UC claimants – as has temporarily been the case since the UC rollout began – would cost around £0.6 billion a year.⁹

Conditionality and sanctions

Claimant commitment

- 3.48 All UC claimants are required to accept a 'claimant commitment'. In the cases of a joint claim, both members will need to accept individual commitments. The claimant commitment sets out the conditions that the claimant will meet in return for their UC award. It is shaped by the legal conditionality framework and then individually tailored to the claimant's circumstances by their work coaches. For example, out-of-work claimants will need to spend 35 hours seeking work (assuming they have no limitations on doing so) and to attend job interviews, while some in-work claimants will need to seek to increase their hours of work. The claimant commitment will be regularly reviewed and updated, and be signed by the claimant(s) each time.
- 3.49 Most decisions about the requirements imposed on claimants rest with each claimant's work coach (described later in this chapter). The work coach places each eligible adult into one of six labour market regimes, which map onto four conditionality groups based on the claimant's capability and circumstances:
- **Intensive work search:** for those who are able to work, but who are either not working at the moment or earning amounts below the 'administrative earnings threshold' set by DWP (currently £338 a month gross taxable pay for a single person and £541 for a couple). Claimants in this group are expected to take intensive action to secure work or more work, attending regular work-focused interviews, attending work search reviews (at least fortnightly) and undertaking work preparation, work search and other work-

⁸ *Eligibility for free school meals and the early years pupil premium under Universal Credit, Government consultation, Department for Education, November 2017.*

⁹ *Universal Remedy, Ensuring Universal Credit is fit for purpose, Resolution Foundation, October 2017.*

related activities. This might also apply to claimants in low-paid work, lone parents of school-age children, or claimants waiting for a work capability assessment.

- **Light touch:** for those whose earnings are above the *administrative* earnings threshold but insufficient to take them above the relevant individual or household *conditionality* earnings threshold. They are required to take actions to secure more or better paid work, but the contact and requirements that UC places on them is less frequent and lighter. The precise conditions have yet to be specified.
- **Work-focused interview requirements only:** for those expected to work in the future, but currently unable to because of childcare responsibilities. They are only required to attend a work-focused interview. People in this group include those named as the lead or responsible carer for a child or children aged 1 or 2 years old or others as defined in regulations, for example a lone parent/main carer in a couple whose youngest child is aged 3 or 4, and people with limited capability for work.
- **Work preparation:** for those who are expected to work in the future, but who are not required to look for work at this stage. These are claimants found to have limited capability for work at their work capability assessment or who are named as the lead or responsible carer of a child aged 3 or 4 years old. They are expected to attend periodic work-focused interviews and undertake work preparation activities. This might apply to lone parents and main carers whose youngest child is two, for example.
- **No work-related activity requirements:** claimants are not expected to attend work-focused interviews or undertake any work-related requirements. This might apply to claimants caring for a severely disabled person for 35 hours or more per week, pregnant women, or claimants with limited capability for work-related activity.
- **Working enough:** Claimants are not expected to attend work-focused interviews or undertake any work-related requirements. This might apply to those who are earning over the individual conditionality earnings threshold, in a household whose earnings are over the household conditionality earnings threshold, or self-employed and the MIF applies. This means that there will be some out-of-work claimants in this group.

3.50 If a claimant has characteristics that mean they could fall into more than one group, the one with the lowest conditionality intensity will always apply. DWP estimates that around a third of UC cases will be subject to work-related requirements when UC is fully rolled out, of which half will be full conditionality and half will be the various 'lighter touch' regimes.

3.51 Where claimants are placed into conditionality groups outside the no work-related requirements group, the work coach must decide the expected number of hours per week of required activity. This is based on each claimant's availability for work, taking into account any health conditions or caring responsibilities. For example, the lead carers for younger children in school (aged 5 to 12) will only be asked to look for a maximum of 25 hours work to fit with school hours. If a person has a health condition that means they can only

The design of universal credit

work 20 hours a week, their expected hours would be limited to 20. Where there are no other restrictions, the expectation is capped at 35 hours a week.

- 3.52 When self-employed claimants make a claim, 'enhanced capability work coaches' will decide if the claimant is 'gainfully self-employed' or not. This requires self-employment to be their main employment, that their earnings are self-employed earnings, and that the work is "organised, developed, regular and carried out in expectation of profit".
- 3.53 If claimants are deemed not to be gainfully self-employed, the minimum income floor (MIF) is not applied because claimants are required to meet work-search conditions and report any self-employed earnings. They receive support from the work coach with their job search. Their claimant commitment, including the expected hours of work-search, may be adapted to take account of their self-employment activity.
- 3.54 If claimants are deemed gainfully self-employed they are exempt from work search and work availability requirements. Those who have been self-employed for over a year are subject to a claimant-specific MIF as part of their claimant commitment (as described in paragraph 3.48). Those in the first year of self-employment, and taking active steps to increase their earnings, are eligible for a start-up period of one year during which the MIF is not applied and they are not required to look for or take up alternative employment. Claimants are allowed one new start-up period for a new business every five years. They are required to attend quarterly interviews with their work coach and agree the steps they are taking to increase their earnings towards at least MIF-levels. If a claimant fails to take active steps to increase their earnings, the start-up period may be ended before one year has passed and the MIF will be applied.

In-work conditionality

- 3.55 Conditionality has long been part of the legacy system for claimants that are not in work. A big difference in UC is the extension of conditionality to those already in work and to both members of a couple within a benefit unit, aiming to increase earnings to at least the equivalent of 35 hours a week at the NLW (or the relevant NMW for those aged under 25). For most claimants this will represent their 'conditionality earnings threshold', although others will have lower thresholds depending on circumstances.
- 3.56 DWP is currently running a randomised control trial (RCT) that started in April 2015 to see how the future design of in-work conditionality should evolve. Recruitment into the trial is ongoing. The RCT randomly assigned eligible claimants into one of three groups, providing different degrees of in-work support and conditionality:
- **Group 1** – claimants meet with their work coach every eight weeks to get support and review mandatory actions agreed in their claimant commitment. These claimants will have access to a flexible time bank of work coach support.
 - **Group 2** – claimants have the same set of requirements as group 1 and access to work coach support, but with a fortnightly review, rather than every eight weeks.

- **Group 3** – claimants receive DWP business-as-usual UC service for people in work. This is an initial telephone appointment to establish voluntary actions, and follow up telephone appointment eight weeks later to consider progress.

3.57 Participants in groups 1 and 2 agree mandatory actions to increase their earnings, whereas the actions of group 3 participants are voluntary. The interviews explore options for the claimant to increase their hours, take a second job, or secure a better paid job. Failure to meet mandatory actions may result in claimants losing their benefit payments.

Sanctions

3.58 Failure to comply with the requirements of the claimant commitment can result in the UC award being stopped or reduced ('sanctioned') for a set period, with the period of reduction increasing with repetition, up to a maximum of three years. Sanctions are capped at 50 per cent of the personal allowance.

3.59 All cases could theoretically be subject to sanction – if claimants do not report changes of circumstances as required under the claimant commitment – but in reality sanctions are only likely to affect claimants that face some form of work-related requirements.

3.60 There are four sanction levels – high, medium, low and lowest – depending on the severity of non-compliance. These sanctions are linked to the conditionality requirements, so those with the lowest conditionality (and therefore with the lowest capacity/capability) will not be sanctioned and the level of potential sanctions increases as claimants' deemed capacity, requirements and responsibilities increase.

3.61 **High-level sanctions** suspend or reduce entitlement for 91 days for the first higher level sanction in any 364-day period, 182 days for the second and 1,095 days for the third. These apply if the claimant:

- has to meet the '**work preparation requirement**' and fails to take part in 'mandatory work preparation activity';
- has to meet the '**work search requirement**' and fails to apply for a particular job when told to do so;
- has to meet the '**work availability requirement**' and refuses a job offer; or
- **leaves work or reduces hours of work**, whether voluntarily or due to 'misconduct' (while claiming UC or just before the claim).

3.62 **Medium-level sanctions** suspend or reduce entitlement for 28 days for the first sanction in any 364-day period or 91 days for the second. These apply if the claimant:

- has to meet the '**work search requirement**' and fails to take 'all reasonable actions to find paid work or increase earnings from work'; or

- has to meet the '**work availability requirement**' and is not available to start work or attend interviews.

3.63 Low-level sanctions suspend or reduce entitlement until the claimant meets the requirements, plus 7 days for the first sanction in any 364-day period, 14 days for the second or 28 days for the third. These apply if the claimant fails to:

- attend or take part in a **work-focused interview** and a lowest-level sanction does not apply;
- attend or take part in a **training course**; or
- **take a specified action** to get paid work or to increase earnings from work.

3.64 Lowest-level sanctions apply only if the claimant has to meet the work-focused interview requirement and fails to attend or take part in a work-focused interview. They suspend or reduce entitlement until the claimant takes part in one.

3.65 When forecasting the effects of previous reforms – including to incapacity and disability benefits – one uncertainty has been the consequences of appeals processes. The precise nature of the process by which UC conditionality sanctions can be appealed has not been fully specified, but DWP expects it to be largely in line with the parts of the legacy system that are currently subject to such sanctions and appeals. To some extent this reduces the uncertainty associated with the marginal effect of UC relative to the legacy system, although conditionality and sanctions will apply to far more cases under UC.

Work coaches

3.66 The operation of the conditionality and sanctions regimes in UC will depend greatly on the work coaches that are expected to provide a personalised service to UC claimants, offering support and advice while wielding the stick of conditionality and sanctions. In some respects, the role of the work coaches is similar to the legacy benefits system – for example, the conditions and sanctions regime in jobseeker's allowance. But in others it represents a radical departure, most notably in-work conditionality and the role that they will play in determining whether self-employed claimants' work represents 'gainful self-employment' and support in boosting the profits of those passing that test. As Box 3.2 illustrates, these stretching roles are modestly remunerated.

Box 3.2: The role of UC work coaches

Each of the 13,000 work coaches required when UC is fully rolled out is expected to carry out a wide-ranging set of activities for both in- and out-of-work cases. According to DWP's 'candidate information pack' explaining the role to prospective job applicants, these activities include:^a

- *"hav[ing] an assigned caseload of UC, JSA, ESA and IS claimants for whom they will be responsible, providing consistency and continuity of service";*
- *"supporting UC customers to make the most of their work and earnings potential and become financially independent";*
- *"proactively develop[ing] in-depth knowledge of the local labour market and provision";*
- *"coach[ing] others to use digital job search methods i.e. job search websites, email, uploading documents, social media";*
- *"be accountable for the decisions made during interviews with claimants to help move them back into sustained employment or prepare for work"; and*
- *"a few roles involve home visits e.g. to help customers make applications for benefit or to obtain information".*

In carrying out these activities, the work coaches will need to:

- *"coach claimants to take responsibility for getting themselves into work, sustaining work and developing their career";*
- *"deliver a personalised service to claimants, identifying challenges to support them back into work within the guidance framework provided";*
- *"be responsible for identifying the range of provision available and referring claimants appropriately to relevant supportive provision";*
- *"coach claimants to develop the skills they need to look for and obtain sustained employment, or, for some claimants, move them closer to work";*
- *"review the claimants work plan or other documentation to confirm the claimant is available and actively seeking employment"; and*
- *"identify conditionality doubts; taking appropriate and timely action".*

At the same time, work coaches will be *"required to undertake a work based apprenticeship undertaken in work time"*.

Work coach positions have been advertised at salaries of between £24,000 and £26,000 a year.

Self-employed claimants will be served by 'enhanced capability work coaches' who will receive special training in order to carry out all the same activities but in respect of the viability of self-employed businesses.

^a Candidate information pack, Work Coach roles in Work Services Directorate, DWP, 2017.

4 How we forecast spending on universal credit

Introduction

4.1 This chapter describes:

- the **structure of our forecast** for the marginal impact of universal credit (UC) on welfare spending relative to the legacy benefits that it replaces;
- the **models we use** in estimating that marginal effect;
- how we produce an **in-year estimate** for UC and the legacy benefits; and
- the potential **indirect effects** of UC on the labour market and the wider economy.

4.2 We focus in this chapter on *how* we model the impact of UC on welfare spending. Chapter 5 presents the results for a steady-state counterfactual, as though UC were fully rolled out already, while Chapter 6 presents our forecast of actual spending in each year as UC is progressively rolled out. Chapter 7 reviews the uncertainties around these forecasts, which relate to both the modelling architecture and the assumptions and judgements we feed into it.

Overall structure of our UC forecast

Estimating the marginal effect of UC on welfare spending

4.3 As illustrated in Chapters 2 and 3, the welfare system and the various individual and family circumstances that it supports are highly complex and constantly evolving. This implies a trade-off when modelling the impact of UC. On the one hand, we need an approach that reflects the complexity of the real world, where this is material to the impact we are trying to measure. On the other hand, we need an approach that is not prohibitive in the time and resources it requires, both building and maintaining the models and generating and updating the assumptions and judgements required as inputs.

4.4 Where administrative data are comprehensive, it should be possible to build a model that fully reflects real-world complexity. But the gradual rollout of UC, and the relative scarcity of forecast-relevant management information on those already in the UC system, means that for now we have very little data upon which to base a bottom-up forecast. So the option of building a fully representative model is not available. We know most of the ways in which the entitlement of an individual or family of given circumstances to support would be

affected by UC, relative to the legacy benefits, but we do not yet have reliable information on the population that will ultimately claim UC or the amounts that they will actually receive.

- 4.5 Given these data limitations, for now we place more weight on the richer data that underpins the forecasts for spending on the legacy benefits (described in Chapter 2). So we prepare counterfactual legacy benefit forecasts as though UC did not exist and then use various models to estimate the marginal effect of UC relative to that counterfactual. This will reflect differences in entitlement, take-up, error and fraud, and other elements of policy design. This means, in effect, that we update a costing for the introduction of UC at each forecast, rather than directly forecasting the rise in total UC spending and the fall in spending on the legacy benefits and tax credits as they are replaced.
- 4.6 This counterfactual-plus-marginal-effect approach has advantages and disadvantages and the balance between them will shift as the UC caseload rises. In 2015-16, when the UC caseload averaged just 150,000, the current approach was clearly superior – it allowed us to scrutinise legacy benefit outturns against established forecast models in order to inform our forecast judgements. By 2016-17, with the caseload averaging 360,000, scrutinising outturns against a ‘no-UC’ counterfactual was becoming more challenging – for example, tax credits spending has been consistently lower than expected, but it has been difficult to pinpoint the extent to which that reflects more (or more expensive) cases migrating to UC than we had expected or other factors. We have faced similar issues with the in-work element of our housing benefit forecast. This issue has been more challenging again this year and will soon require us to move to a more conventional forecasting approach.
- 4.7 Table 4.1 summarises our November 2017 forecast for total spending on UC and the legacy benefits using the counterfactual-plus-marginal-effect approach. It shows that spending is currently forecast to be a little over £60 billion a year, with the marginal saving from UC building up over the forecast period as the caseload rises towards its steady-state level. The bottom line of this table represents our central forecast of actual spending on these benefits, but neither the ‘no-UC’ counterfactual for the legacy benefits nor the marginal saving from UC can be observed in the outturn administrative data.

Table 4.1: November 2017 forecast for spending on UC and legacy equivalents

	£ billion					
	Forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Legacy benefits: no UC counterfactual	59.9	60.4	60.3	60.8	62.0	63.2
<i>of which:</i>						
Tax credits	27.0	26.6	26.2	26.6	27.0	27.3
Housing benefit (working-age)	17.7	18.2	18.5	18.1	18.5	18.9
Income-based employment and support allowance	10.7	11.4	11.2	11.5	11.8	12.2
Income-based jobseeker's allowance	2.2	2.2	2.3	2.3	2.4	2.5
Income support (non-incapacity)	2.3	2.0	2.1	2.2	2.2	2.4
UC marginal savings	-0.1	-0.2	-0.6	-0.9	-0.8	-1.0
Actual spending	59.8	60.2	59.7	59.9	61.2	62.2

UC in steady-state and the transition period

- 4.8 Our modelling approach involves an important distinction between the effect of UC in so-called ‘steady-state’ and during the ‘transition period’. In the longer term – beyond the five-year horizon of our medium-term forecasts – UC will reach a true steady-state when all planned policy changes have been implemented and the rollout is complete (although even then, Governments are likely to continue to review and amend the design of UC). Until then, the marginal effects of UC in the transition period vary with Government policy in each year and – more significantly – the pace of the rollout.
- 4.9 Since the effects of UC vary so widely across different individual and family circumstances, assumptions about who moves onto UC and when are critical to the estimated effect of UC on spending in any given year. Differences in the assumed composition of the UC caseload can lead to very different estimated effects on spending. The interaction with the rollout profile – particularly the managed migration profile that is associated with transitional protection payments – can temporarily disguise the true underlying effects of UC, which in some cases may not be fully felt until beyond the forecast horizon.
- 4.10 To separate these effects, we model a ‘full-UC’ counterfactual for each year – reflecting the actual policy settings for that year, but an assumption that all relevant individuals and families receive UC rather than legacy benefits. We compare this with the ‘no-UC’ legacy benefits counterfactual to give a ‘steady-state’ marginal effect of UC. Finally, the effect in each year of the transition period is profiled according to the proportions of the various caseload groups that are expected to be in receipt of legacy benefits and of UC. The steady-state modelling estimates the degree to which UC is more or less generous than the legacy benefits that it replaces in each year, while the transition-period modelling estimates the actual effect on welfare spending in each year.
- 4.11 The components of the steady-state modelling are detailed in Chapter 5 while the transition-period modelling is described in Chapter 6.

Static, behavioural and indirect effects

- 4.12 When considering the effect of any policy change on the public finances, we split the calculations into different steps.¹ Having established the baseline – in this case the ‘no-UC’ counterfactual legacy benefits forecast – we first consider ‘static’ effects and then make adjustments for ‘behavioural’ effects, which we further split between those that are closely related to the tax or spending line in question and those that would affect many tax and spending lines by affecting the wider economy. This latter distinction is a practical one that allows us to estimate the effects on our forecast efficiently.
- 4.13 To estimate the effect of introducing UC we therefore start by considering static effects – i.e. an estimate of the cost or saving associated with a move to different entitlement rules. Most UC modelling work to-date has focused on these static effects, of which there are many to consider.

¹ Our general approach is described in detail in *Briefing Paper No.6: Policy costings and our forecast*, available on our website.

How we forecast spending on universal credit

- 4.14 In reality, differences in entitlement and other features of the UC system – such as changes in the conditionality and sanctions regime – are also likely to affect the size and composition of the caseload as actual or potential claimants change their behaviour. We have made relatively few adjustments for behavioural effects thus far, in part reflecting lack of information to base them on and frequent policy changes, and in part because there are likely to be effects working in both directions, so their omission would not predictably bias the estimates in one direction or another.
- 4.15 The main areas where behavioural assumptions are currently applied relate to take-up assumptions. UC is expected to raise take-up in some areas – particularly where the single UC award means that take-up of elements that would require separate claims in the legacy system becomes automatic. In other areas, UC is expected to deter take-up, for example among the group that will face greater conditionality than under the legacy system, especially for those whose UC awards would be relatively small.
- 4.16 One important area where we have not yet made any adjustments to our forecast, but where behavioural effects are possible, concerns the labour market. UC will affect individual and family labour supply decisions – i.e. whether to work and how much – in different ways to the legacy benefit system. The possible channels along which these effects could occur are discussed in the final section of this chapter, while the risks associated with them are discussed in Chapter 7. As with all aspects of our forecasts, if the available evidence suggested that factoring in further behavioural effects would deliver a more central forecast, we would do so.

UC in Northern Ireland

- 4.17 Welfare policy is devolved to Northern Ireland – including UC. We forecast welfare spending in Northern Ireland under a separate process. The equivalent spending on UC in Northern Ireland does not exceed £200 million in our medium-term forecast so for the purposes of the rest of this document we refer to UC spending in Great Britain only.

Our latest forecast for the effect of UC on welfare spending

- 4.18 Table 4.2 provides context for the modelling discussion in the rest of this chapter. It breaks down our forecast of the marginal effect of UC on welfare spending into its largest gross cost and saving elements relative to the 'no-UC' legacy benefits counterfactual. In our November 2017 *Economic and fiscal outlook (EFO)*, we projected the marginal effect of UC would reach a saving of £1.0 billion a year by 2022-23. This reflected £9.6 billion of gross costs in that year, more than offset by £10.7 billion of gross savings relative to the legacy system. We describe the methodologies used to generate these estimates in this chapter, while the amounts are discussed in Chapters 5 and 6.
- 4.19 The gross costs relative to the legacy counterfactual in 2022-23 arise from:
- **higher take-up**, driven mainly by automatic entitlement to legacy benefit equivalents that are currently not always claimed in full, costing £2.9 billion;

- **increased entitlement** where UC is more generous than the legacy benefits, costing £3.8 billion;
- **transitional protection** for claimants whose migration to UC is managed by DWP rather than resulting from a change in circumstances, and who would otherwise experience a cash loss on migration, costing £1.3 billion;
- **abolishing the tax credits income fall disregard** in UC, increasing UC awards relative to tax credits for affected claimants, costing £0.5 billion;
- **design changes that increase error and fraud**, costing £0.5 billion; and
- the gross costs of **other factors**, including many smaller differences in policy design, costing £0.7 billion.

4.20 The gross savings relative to the counterfactual in 2022-23 arise from:

- **lower take-up**, where we expect a small deterrent effect under UC, costing £0.4 billion;
- **lower entitlements**, where UC is less generous than the legacy benefits or removes some forms of support altogether, saving £5.5 billion;
- **abolishing the tax credits income rise disregard**, reducing UC awards relative to tax credits awards for affected claimants, saving £1.3 billion;
- **design changes that reduce error and fraud**, saving £1.9 billion;
- **the minimum income floor for the self-employed**, saving £1.2 billion; and
- **other factors**, again including many smaller differences in policy design, saving £0.2 billion.

Table 4.2: Breakdown of the marginal savings from UC

	£ billion unless otherwise stated					
	Forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Entitlement						
C1: Gross cost of entitlement differences where take-up rates are expected to rise	0.1	0.5	1.2	1.9	2.5	2.9
C2: Gross cost of higher entitlement where take-up rates are not expected to change	0.2	0.7	1.5	2.4	3.2	3.8
S1: Gross saving from lower entitlement where take-up rates are expected to rise	0.0	0.0	0.0	0.0	0.0	0.0
S2: Gross saving from lower entitlement, including where take-up rates are not expected to change	-0.2	-0.8	-2.2	-3.5	-4.7	-5.5
S3: Gross saving from lower entitlement where take-up rates are expected to fall	0.0	-0.1	-0.2	-0.3	-0.4	-0.4
Transitional protection						
C3: Gross costs from transitional protection	0.0	0.0	0.0	0.3	1.0	1.3
Minimum income floor						
S4: Gross saving from the minimum income floor	0.0	-0.2	-0.4	-0.7	-1.0	-1.2
Abolishing income disregards and run-ons						
C4: Gross cost from abolishing income disregards	0.0	0.1	0.2	0.3	0.4	0.5
S5: Gross saving from abolishing income disregards and run-ons	0.0	-0.2	-0.5	-0.9	-1.2	-1.3
Error and fraud						
C5: Gross cost from higher error and fraud	0.0	0.1	0.2	0.3	0.4	0.5
S6: Gross saving from lower error and fraud	-0.1	-0.3	-0.7	-1.1	-1.6	-1.9
Other factors						
C6: Gross cost from other factors	0.1	0.2	0.4	0.6	0.6	0.7
S7: Gross saving from other factors	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2
Net effect on welfare spending	-0.1	-0.2	-0.6	-0.9	-0.8	-1.0
<i>Memo: Gross cost</i>	0.4	1.6	3.5	5.7	8.2	9.6
<i>Memo: Gross saving</i>	-0.5	-1.8	-4.2	-6.6	-9.0	-10.7
<i>Memo: Net effect on welfare (2017-18 prices)</i>	-0.1	-0.2	-0.6	-0.8	-0.8	-0.9
<i>Memo: Net effect on welfare (per cent of GDP)</i>	0.00	-0.01	-0.03	-0.04	-0.04	-0.04

Modelling architecture

4.21 As with most of our fiscal forecasts, the models we use to estimate the marginal effect of UC on spending are physically operated by analysts in other departments – in this case DWP, with input from HMRC (whose analysts operate the tax credits forecast model). We work with those analysts to come up with the best approach, given the available resources. We draw on the analytical and modelling expertise of various analytical teams within DWP. But ultimately the OBR takes responsibility for the forecasts that result, with which the departments who help us may or may not agree.

4.22 We have set out elsewhere the principles that we apply when considering the appropriateness of a forecasting model: accuracy, plausibility, transparency, effectiveness

and efficiency. (Our first formal review of selected models against these principles was presented in our 2017 *Forecast evaluation report*.) These principles have guided our decision to use the counterfactual-plus-marginal-effect approach to date, as well as how to estimate the marginal effect. But this inevitably involves trade-offs. In particular, while an all-encompassing model would in principle deliver the most plausible results by consistently capturing all possible effects, it is unlikely to be transparent (making it hard to scrutinise effectively) or efficient (making it difficult to use in a time-pressured forecast process). Our forecast of UC therefore draws on several different models – including DWP’s policy simulation model (PSM) and integrated forecasting model (INFORM) – to produce the components of the forecast (Table 4.3). As far as possible, the same inputs are used in each model to ensure consistency across the forecast.

Table 4.3: Models used in estimating the marginal effect of UC

Component	Steady-state	Transition
Entitlement	Modelled in PSM controlled to DWP and HMRC forecasts	Profiled using INFORM volumes which are consistent with the DWP migration path
Take-up	Modelled in PSM	Profiled using INFORM volumes which are consistent with the DWP migration path
Transitional protection	N/A	Managed migrations modelled on INFORM. Average TP modelled on PSM
Abolishing the tax credits disregards	HMRC costing	Profiled using INFORM volumes which are consistent with the DWP migration path
Error and fraud	Analysis of impacts based on error and fraud data measured against DWP+HMRC baseline	Profiled using INFORM volumes which are consistent with DWP migration path. Lag built in to allow for learning effects
Minimum income floor	Modelled in PSM	Profiled using INFORM volumes which are consistent with the DWP migration path

Policy simulation model (PSM)

- 4.23 The bulk of the UC modelling is carried out in DWP’s PSM (described more fully in Box 4.1). This is a static micro-simulation model that calculates the effects of tax and benefit policy on a random sample of 21,000 households in Great Britain based on DWP’s annual Family Resources Survey (FRS, also described in Box 4.1). Future years are modelled by simulating announced policies consistent with growth in relevant variables from our economy forecast. Earnings in the UC population are assumed to rise at a rate 1 percentage point below our whole economy earnings forecast, except where they are determined by announced or forecast National Minimum Wage (NMW) or National Living Wage (NLW) rates.²
- 4.24 By modelling entitlement for each legacy benefit at the micro-level against entitlement under UC, the PSM calculates the gross costs and savings across different groups that would result from shifting entirely from one system to the other. It calculates this counterfactual for each year. The modelling is based on around 4,000 FRS sample cases that would be expected to

² The 1 percentage point adjustment is included to capture the effect of turnover at different ends of the earnings distribution that is expected to reduce average earnings growth among the UC population relative to whole economy average earnings growth. The same assumption is adopted in our tax credits forecasts.

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be eligible for UC in steady-state. This sample represents the full counterfactual UC caseload of around 7 million and counterfactual UC spending of around £60 billion.

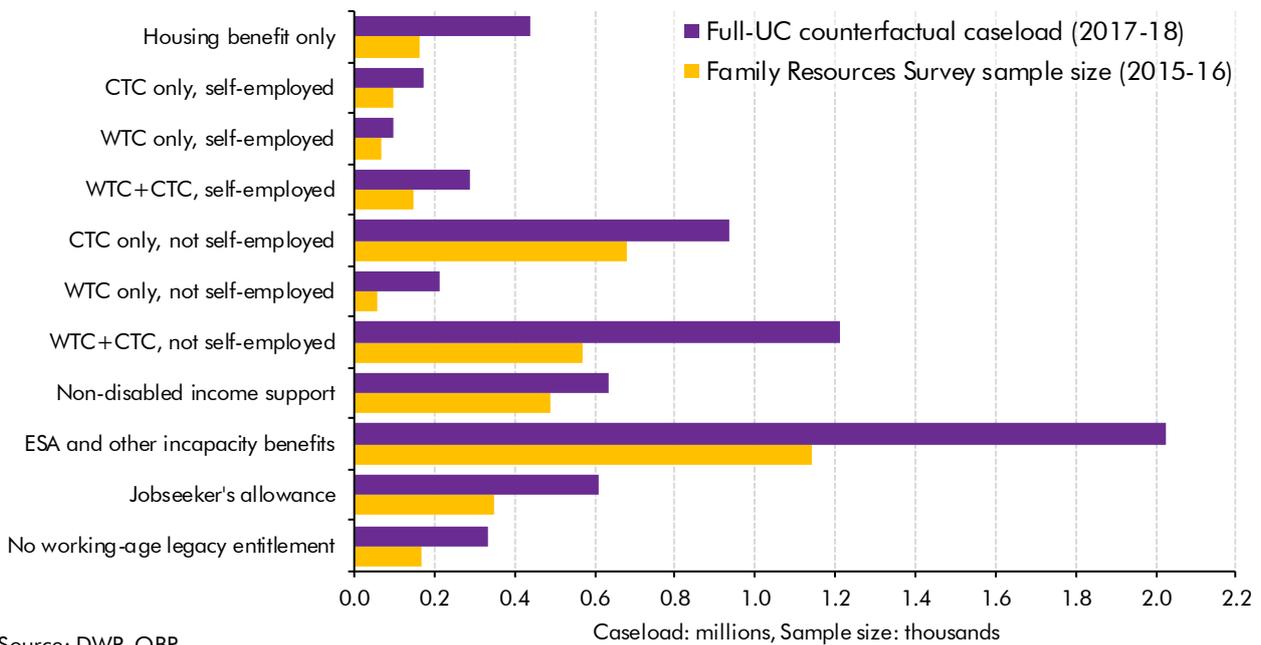
- 4.25** Most external commentators have focused on results by household type when analysing the effects of UC – e.g. lone parents, couples with or without children, etc. But in our forecasting approach legacy benefit status is the key building block in generating our estimates of the effects of UC and is therefore the one we use in this report. In the following chapters we split caseload and average award effects into the legacy benefit groupings used in the PSM. These groups are exclusive – a claimant cannot be in more than one – and hierarchical – claimants are allocated to the first group that is appropriate to their circumstances, even if a subsequent one would also be appropriate.
- 4.26** Table 4.4 shows how the ‘full-UC’ counterfactual UC caseload of 6.4 million in 2017-18 relates to the ‘no-UC’ counterfactual legacy caseloads that are used to calibrate it when presented on this basis. The exclusive and hierarchical nature of the groupings needs to be borne in mind when considering the breakdowns of the various gross costs and savings from UC split on this basis. For example, while the entire JSA caseload appears in the JSA group, 65 per cent of those cases are also in receipt of housing benefit and 19 per cent are also in receipt of child tax credit. By contrast 20 per cent of the tax credits caseload and 87 per cent of the housing benefit caseload are assigned to groups higher up the list.
- 4.27** Unfortunately DWP was not able to provide a breakdown of cases with a legacy benefit entitlement but no entitlement under UC. So while the table is complete from the perspective of the UC counterfactual caseload, it is incomplete from that of the ‘no-UC’ counterfactual legacy caseloads.

Table 4.4: Mapping legacy benefit caseloads to hierarchical groupings (2017-18)

	Benefit unit caseloads ('000s)						Total (net of overlaps)
	Legacy benefit (gross of overlaps)					Total number of separate claims	
	JSA	ESA	Income support (non-incapacity)	Tax credits	Housing benefit		
No working-age legacy entitlement							332
Jobseeker's allowance	612			117	374	1,102	612
ESA and other incapacity benefits		2,022		288	1,314	3,624	2,022
Income support (non-incapacity)			636	330	466	1,432	636
WTC+CTC, not self-employed				1,213	480	1,694	1,213
WTC only, not self-employed				215	17	232	215
CTC only, not self-employed				934	213	1,147	934
WTC+CTC, self-employed				290	71	362	290
WTC only, self-employed				101	7	108	101
CTC only, self-employed				174	18	192	174
Housing benefit only					439	439	439
No UC entitlement							-539
Total with UC entitlement	612	2,022	636	3,661	3,401	10,332	6,429

4.28 Chart 4.1 shows how the 4,000 UC-eligible FRS cases fit into the same 11 high-level groups shown in Table 4.4. These are built up from 67 lower-level calibration groups based on the characteristics of each benefit unit. These are known as ‘calibration groups’ because results for each sample case in the group are then scaled up – ‘calibrated’ – to match the caseloads and expenditure amounts derived from the legacy forecasts. This process of calibration stems from our decision to place most weight on the established forecast models when producing our overall welfare spending forecast. Modelling uncertainty is greatest where sample sizes are smallest – for example some of the self-employed groups.

Chart 4.1: FRS sample sizes by legacy benefit calibration group



4.29 The PSM is currently used to estimate the effect of UC on entitlement, take-up and the impact of the minimum income floor. Separately, it also calculates the average losses for managed-migration cases that feeds into our modelling of the cost of transitional protection. PSM modelling does not calculate the effects of all elements. It excludes:

- **some elements that reduce entitlement:** including the removal of the tax credits income rise disregard and design features that reduce error and fraud; and
- **some elements that increase entitlement:** including transitional protection for ‘managed migration’ cases, the removal of the tax credits income fall disregard and design features that increase error and fraud.

4.30 Ideally the PSM would include all these elements of the UC policy design to provide a comprehensive view of costs and savings across different groups, but that has not been possible. For some policies the resource cost of building the relevant features into the PSM outweighs any gains in accuracy or consistency. For others – mainly relating to flows – the estimated effects are heavily reliant on assumptions that mean sophisticated modelling would add little. There are also policies for which the cost base is not recorded in the FRS – for example, error and fraud – and so the PSM’s FRS-based approach is not appropriate.

Box 4.1: DWP's policy simulation model and the Family Resources Survey

The PSM is the main micro-simulation model used by DWP to analyse policy changes. It is based on the annual Family Resources Survey (FRS), which details benefit income streams alongside information about the circumstances of each 'benefit unit'.

The FRS is the best available source for modelling benefit entitlement, but has some limitations. As a self-reported survey, it relies on claimants (and interviewers) providing accurate responses. Several shortcuts are taken to reduce the burden on respondents, which might otherwise affect the sample size. For example, comparing FRS results with administrative data on welfare spending suggests that ESA, tax credits and housing benefit income tends to be under-reported. For broader earnings, the PSM uses an FRS variable that reflects claimants' interpretation of their 'usual pay', which is unlikely to be a perfect match for the earnings relevant to calculating UC awards. Net income is also required for the UC calculation and the reporting of tax and National Insurance payments are known to be less robust in the FRS.^a

FRS data are published with a lag of two to three years after collection. Incorporating new results into the PSM also takes time. The PSM underpinning our November 2017 forecast was based on data from the 2015-16 FRS that was published by DWP in June 2017. The survey is not therefore able to capture recent developments in the economy (e.g. further falls in unemployment since 2015-16) or policy (e.g. the progressive replacement of disability living allowance with the new personal independence payment). These effects have to be captured via other means – for example by aligning to alternative estimates or off-model adjustments. This adds further uncertainty to the PSM modelling.

The sample size relevant to the overall UC modelling is relatively large (around 4,000), but for some lower-level breakdowns it can be very small (e.g. around 25 benefit units for the 'WTC-only, non-self-employed, no housing benefit, single' calibration group, which is expected to account for just over 170,000 cases in the steady-state UC population). Conclusions drawn at these lower levels will be far less robust. But in the absence of administrative data, the FRS remains the best available source on which to base the PSM analysis.

Given some of the known issues with the FRS, and surveys in general, DWP's PSM team clean the raw FRS data (mainly earnings) and carry out some imputation (capital, income from tax credits, childcare costs) to generate the best possible input to the model. The FRS data are projected forward on a static basis – so that employment states in the base year are held constant, for example – but with sample weights adjusted through calibration to legacy benefit caseloads in each year (using either outturns or our forecasts, as appropriate). Entitlement rates are updated with announced policy while earnings and other incomes and outgoings (e.g. rents or mortgage interest) are grown in line with the relevant determinants from our latest forecast.

The PSM uses this information to model benefit entitlements under a base system and a proposed change (or 'scenario', in this case moving to UC). The difference in individual award between these two model runs is treated as the effect of the policy change.

^a *Family Resources Survey 2013-14, Methodology and standard error tables*, DWP, 2015.

Integrated forecasting model (INFORM)

- 4.31 INFORM is a dynamic micro-simulation model that generates estimates of *monthly* flows across and between the legacy benefits and UC (Box 4.2). These flows provide a picture of the build-up of the UC caseload (and associated rundown of legacy benefits) split by new starters, natural and managed migration and by legacy benefit. The monthly profile of flows is used to adjust the steady-state UC estimates generated under PSM to give us the expected actual savings in each year of the transition period.

Box 4.2: Integrated forecasting model (INFORM)

INFORM is a dynamic micro-simulation model that uses a 5 per cent sample of administrative data from DWP and HMRC systems that are merged on the basis of individuals' National Insurance numbers to identify the combination of benefits received in each household. As this involves confidential individual-level data, the raw inputs to the model are not seen by OBR staff or members of the Budget Responsibility Committee.

INFORM produces a monthly profile of benefits received in each household across the forecast period. These projections are estimated from transition probabilities – i.e. the likelihood of moving onto, off or between any given benefits in any given month – based on historical data. It aligns the caseload projections for each benefit to our forecasts for total caseloads across the legacy benefits and tax credits. Finally, it applies the transition and migration rules to the monthly profiles to estimate the build-up of the UC caseload and the associated rundown of the legacy benefit caseloads. The scenario-based model then converts these INFORM caseloads into the hierarchical legacy benefit breakdown used to calibrate PSM outputs.

But INFORM has some disadvantages. Relying on historical data to model transition rates means that when the past is not a good representation of the future, outturns will deviate from forecasts. INFORM is based on data relating to the period from 2009-10 to November 2015. The divergence in recent years from the transition probabilities during that period mean that INFORM is no longer used in forecasting legacy benefit caseloads. We also cannot use it to model newly eligible cases. That said, it remains the best available source of information on receipt of more than one benefit by individual benefit units, and on the flows in, out and between them. By calibrating the INFORM outputs to our legacy benefit forecasts, we can reduce the forecast risk associated with the transition-probability inputs diverging from actual experience. The marginal savings approach also means that the data problems that led us to stop using INFORM for the legacy forecasts have less impact as they would affect both legacy and UC estimates, but would have little effect on the difference between them.

Other bespoke models

4.32 We use a number of separate bespoke models to estimate the remaining elements of gross costs and savings from UC:

- **Transitional protection model:** this uses outputs from the PSM and INFORM modelling to calculate the cost of transitional protection on a basis that is consistent with both.
- **Removing the tax credits income fall/rise disregards:** this spreadsheet-based model uses data supplied by HMRC to estimate the net effect of removing the disregards.
- **Changes in error and fraud:** several spreadsheet-based models based on elements of the legacy benefit system are used to estimate the savings from elements of error and fraud that are either designed out or reduced via administrative changes.
- **Other policies modelled separately as individual policy costings:** further spreadsheet-based models estimate the effect of policies and UC design elements not included in the main PSM modelling.

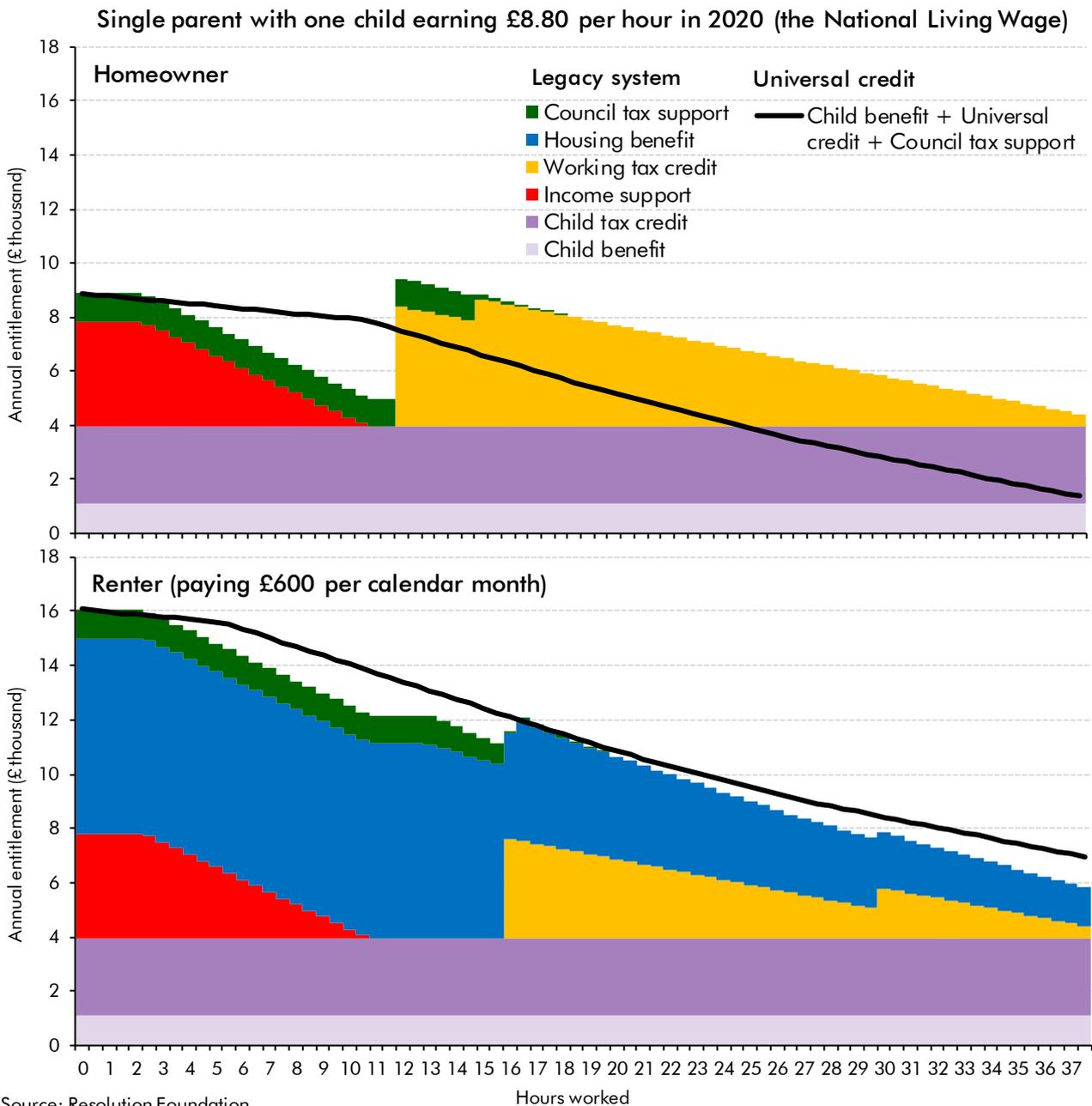
Modelling the static and claim-specific behavioural effects

Differences in entitlement

4.33 The static impact of changes in entitlement (i.e. assuming no changes in behaviour) can be calculated within the PSM by modelling entitlement to the legacy benefits and to UC using the FRS-based micro-simulation of each benefit unit's reported circumstances. Building and maintaining the PSM is complex and resource intensive, but once the necessary assumptions have been made the modelling involves aggregating a large number of relatively simple calculations. Differences in entitlement between UC and the legacy benefits generate differences in average awards, but also in caseloads if entitlement moves from or to zero.

4.34 Chart 4.2 illustrates how entitlement under UC and the legacy system would vary by the number of hours worked at the National Living Wage for two hypothetical lone parents with one child – one a homeowner and one a renter with housing costs of £7,200 a year. It shows how the single UC taper and absence of hours rules creates a much smoother profile of entitlement by hours of work for both households. In particular the absence of the 16-hours rules means that UC is considerably more generous than the legacy system for lone parents working fewer than 16 hours.

Chart 4.2: Entitlement: UC versus and the legacy system



Source: Resolution Foundation

4.35 Entitlement modelling also estimates the static effect of extending capital limits to those who would have been tax credits claimants in the legacy system. Comparing FRS data to administrative data on income support claimants, where capital limits already apply, suggests that reported capital is typically higher in the FRS. Capital held by out-of-work individuals in the FRS sample is therefore scaled to levels consistent with the administrative data. The same scaling factor is applied to the FRS-reported capital of in-work claimants.

4.36 While uncertain, other evidence suggests that this assumption is probably central. ONS estimates in its *Effects of taxes and benefits on household income* publication suggest that tax credit claimants are concentrated in the bottom half of the disposable income distribution. The 2015 ONS *Wealth and assets survey* suggests that median net financial

wealth³ only exceeds the £6,000 capital limit in the top half of the net income distribution. But this masks considerable variation within each part of the income distribution. For example, net financial wealth is reported to exceed £6,000 for at least a quarter of those in the bottom half of the net income distribution.

Differences in take-up rates

4.37 Simple static entitlement modelling estimates the cost or saving from UC assuming full take-up of both UC and the legacy benefits – i.e. a world in which spending equals entitlement. In practice, of course, not everyone takes up their entitlement. This may be because:

- people are **not aware** of or do not understand what they are entitled to;
- they are aware, but **deem the value of the entitlement too low** to make applying worthwhile;
- they are aware of their entitlement, but are **unwilling to meet the conditionality requirements**; or
- the individual or household is **averse in principle to claiming benefits**, regardless of their value – e.g. if they perceive there to be stigma attached to doing so.

4.38 To reflect this incomplete take-up, the FRS data are adjusted to scale down legacy benefit entitlement within PSM based on historical rates of take-up by benefit combinations. The choice of which units have scaled-down JSA/ESA and/or pension credit entitlements is randomised, informed by ‘logistic’ modelling of the conditional probabilities. The marginal effect of UC is estimated against these scaled-down take-up rates, reflecting actual take-up.

4.39 For some cases, UC is expected to result in a net increase in take-up against these historical take-up rates of legacy benefits because of:

- **greater transparency** over entitlement under UC; and
- the **merging of several benefits into a single claim**, creating automatic take-up gains in some cases where it does not exist under the disaggregated legacy system.

4.40 For other cases we expect take-up to fall slightly due to various deterrent effects – such as the increased conditionality associated with claiming UC – putting some people off claiming lower-value awards. Some households may also attach more stigma to claiming a benefit from DWP that involves engaging with Jobcentre Plus than claiming tax credits from HMRC.

³ Including savings and investments, which are in scope of the UC capital limits, but also assets in private pension schemes, which are not.

- 4.41 To estimate the likelihood that individuals or families (as proxied by the FRS sample cases) will take up their entitlement under UC, benefit units with a modelled entitlement under the legacy system are split into groups:
- **full legacy claimers:** where a case has modelled entitlement and receives the income to which they are entitled under the legacy system;
 - **partial legacy claimers:** where a case reports receipt of some but not all the benefits to which the model calculated them to be entitled – e.g. a tax credit recipient who would be entitled to housing benefit but does not report receiving such payments;
 - **legacy non-claimers:** where a case has modelled entitlement but receives none of the income to which they are entitled; and
 - **newly entitled claimants:** where a case has no entitlement, and therefore no benefit income under the legacy system, but would be entitled to an award under UC.
- 4.42 All else equal, it seems unlikely that existing full legacy claimers would claim less under UC. Partial legacy claimers – who have taken the time to complete at least one (but not all) the application processes in the legacy system – are also expected to receive the full amount to which they are entitled by virtue of the single application and award (assuming that they know what they are entitled to and provide the relevant evidence to qualify). This automatic uplift in entitlement is included in the model in its entirety, assuming that DWP has the necessary procedures in place to pick up undeclared entitlements.
- 4.43 But ‘all else equal’ takes no account of the increased burden of (and financial risks associated with) making a UC claim, including potentially being subject to conditionality or sanctions. That might deter some from claiming. This seems most likely for in-work claimants and partners who are not subject to conditionality in the current system. There may also be a shorter-term deterrent effect whereby claimants delay moving onto UC due to the 5-week minimum gap in payment built into moving onto UC and recent negative press coverage. With average awards that are relatively high – around £8,000 to £9,000 – we would expect any deterrent effect to be concentrated among those that would receive lower awards.
- 4.44 For both groups we have assumed historical benefit take-up rates (conditioned on the value of the award) for UC awards worth less than £4,000. This simplification implies that claimants face the take-up decision afresh – this time under UC – and decide not to claim lower-value UC awards even when they are currently claiming legacy benefit entitlements. Assuming such an effect reduces take-up for these two groups by around 3 percentage points. The true effect will depend on the final design of the in-work conditionality regime and the degree to which work coaches have discretion over its severity.
- 4.45 For legacy non-claimers we need to judge whether the introduction of UC would lead to any take-up at all. We split these cases by employment status:

How we forecast spending on universal credit

- **Employees:** some of these individuals will be better off under UC and will not need to make a new claim if they move from being out-of-work into low-paid work under UC. We assume a take-up rate for those who stand to gain from UC informed by existing rates for tax credits. This is equivalent to a UC take-up rate of 20 per cent.
- **Self-employed:** we assume that some self-employed legacy non-claimers will also be better off under UC but less likely to take it up than employees due to the additional reporting requirements and minimum income floor. We therefore assume a UC take-up rate of 10 per cent.
- **Out of work:** given the similar value of UC and legacy entitlements for those that are out of work, we assume no additional take-up of UC.

4.46 These assumptions are subject to significant uncertainty – relatively large entitlements like those under UC would typically be associated with significantly higher take-up rates, but this group must have reasons for choosing not to claim anything under the legacy system.

4.47 Newly entitled claimants move into entitlement under the new rules for UC. We assume that these cases are similar to those in the legacy benefit population, so we use take-up rates derived from estimates relating to the legacy benefits.

4.48 Where take-up is assumed to be higher under UC, the effects are calculated within the PSM by ‘switching on’ the missing entitlements at the micro-level for all partial legacy claimers and by random selection for the legacy non-claimers and newly entitled claimants where assumed take-up rates are less than 100 per cent. The lower take-up effects for partial legacy claimers and legacy claimers that would be entitled to awards of less than £4,000 are estimated separately as an off-model adjustment. Simulated entitlements under the revised take-up assumptions are then compared against entitlement without those assumptions to estimate the cost of these take-up assumptions.

Minimum income floor (MIF)

4.49 The minimum income floor for the self-employed sets a claimant-specific level below which any reported earnings are ignored and replaced in the UC award calculation with a higher amount determined by the work coach. The static effect of the MIF is calculated within PSM, adjusting self-employed claimants’ reported earnings in the FRS micro-data where they are affected. Ideally we would model a claimant-specific MIF for each sample case simulating the likely choice of the work coach depending on various circumstances (plus an element of discretion), but that is not possible using the FRS data. We could alternatively assume a distribution of MIF levels, but this is not feasible without any administrative data on which to base the assumption.

4.50 Where we can quantify it, we assume maximum MIF levels for a given group depending on the circumstances available in the FRS. For example:

- for a claimant that is **single and has no mitigating circumstances** (e.g. children or a disability), conditionality would normally be equal to 35 hours a week so we model the highest MIF level (around £1,050 a month for claimants aged over 25); and
- for a claimant that is **a lone parent with a child aged 8 and no other mitigating circumstances**, conditionality would normally be equal to 25 hours a week so we model the highest possible MIF corresponding to this number of hours (around £780 a month for claimants aged over 25).

4.51 Choosing the maximum possible MIF for each set of circumstances means that risks associated with this set of assumptions are only in one direction. But very early outturns suggest that DWP's work coaches are choosing conditionality thresholds for the self-employed clustered around these maximums. We shall monitor this carefully. These risks are likely to be small relative to the broader uncertainty about the self-employed UC population that comes from small FRS sample sizes and from uncertainty about how claimants will respond in the real world to the large income losses the MIF imposes.

4.52 Our modelling assumes that claimants comply with the MIF and simply accept the lower UC award. But in the real world, there are at least three alternative behavioural responses:

- **Claimants accept the loss but increase their earnings by making their business more profitable or changing occupation** (thus increasing the savings achieved by the MIF): This assumes that self-employed businesses are not maximising their opportunities for profits in the absence of the MIF, that the loss of UC entitlement alone is sufficient to overcome that, and that any change in occupation does not displace other workers.
- **Claimants cease to claim as self-employed and claim UC as unemployed jobseekers instead** (either by ceasing their activities or by fraudulently failing to report their self-employed earnings, reducing the savings achieved by the MIF): this assumes that some claimants stand to gain in this way, that they are willing to commit fraud, and that UC's compliance activities do not pick up the fraudulent activity.
- **Claimants seek other work as an employee**, either replacing or supplementing their self-employment income: this assumes that additional employment is available and that the claimant can secure and sustain it.

4.53 Given the lack of administrative data and the fact that these highly uncertain risks could push in both directions, we do not assume behavioural responses to the MIF in our forecast.

Transitional protection

4.54 Transitional protection (TP) is modelled separately in a bespoke stock-flow model with inputs consistent with the rest of the forecast. The methodology involves the following steps:

- **INFORM caseload projections** provide volumes of managed migrants by legacy benefit by applying a set of migration rules as the UC caseload builds up and the legacy caseloads run down;

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- **transition rates** derived from HMRC and DWP administrative data reduce the caseload stock as annual uprating erodes TP and as changes in circumstances trigger moves off TP; and
- the PSM provides **average losses** per UC case split by legacy benefit.

4.55 This means that we do not model the cost of TP directly – forecasting the number of cases that will receive TP and then multiplying by the average value of TP per case. This is not possible under the current modelling architecture since that would require INFORM to calculate entitlement gains/losses (but it does not model UC entitlement) or the PSM to model the likelihood of being manage-migrated (but it cannot generate flows). DWP is unable to tell us the number of cases it expects to benefit from transitional protection.

4.56 So instead we forecast the cost of TP indirectly by a method that should produce a broadly equivalent result. We estimate the number of cases that are manage-migrated (via INFORM) that would be eligible for TP if they faced a loss in moving to UC, apply TP erosion rates to this pool of manage-migrated cases and then multiply the resulting caseload by the average loss for all UC cases for each legacy benefit. This is not a solution, since the decision about which cases are to be manage-migrated is independent of whether cases gain or lose, but this simplification should produce a similar result. We will continue to review this methodology and work with DWP to provide direct estimates of numbers affected before the managed migration process begins, so that we can compare forecasts to outturns in order to understand whether forecast judgements are being borne out by reality.

Abolition of the tax credits income disregards

4.57 To model the effect of abolishing the tax credits disregards we use HMRC estimates of the effect of abolishing the disregards on tax credits in a no-UC world. These are modelled using detailed tax credits administrative data grown in line with population projections, tax credits policy and earnings growth.

4.58 Abolishing the income rise disregard would have two main effects on tax credits spending:

- a **reduction in entitlement** as rises in income below the thresholds now feed through to lower awards on the tax credits taper; and
- an **increase in the level of overpayments at finalisation**, some of which would be recovered in future years and some of which would eventually be written off.

The net effect on spending would be the reduction in entitlement minus any additional overpayments that were not recovered.

4.59 When abolishing the disregards in UC we assume that the bulk of the rise in overpayments will be recovered thanks to RTI data on earnings provided ahead of the UC payment. Overpayments for those with non-PAYE earnings (and therefore not subject to RTI reporting) still arise, so we factor in a cost from these not being recovered in full.

Error and fraud

4.60 Most error and fraud across the legacy benefits and tax credits is categorised as error. Where UC has been designed to screen out error and fraud, and succeeds in doing so, savings will arise. To estimate this we:

- **Identify the volume of error, fraud and overpayments in the legacy benefits:** this is largely derived from DWP's 2014-15 fraud and error statistics and HMRC forecasting models. To convert these into effects on spending, we apply existing recovery rates for over- and underpayments.
- **Identify UC design features** that are likely to alter the propensity for claimants to make errors or commit fraud.
- **Estimate the impact of these design features** on steady-state error and fraud and then adjust for the transition.

4.61 These effects are based solely on changes in the design of UC. They do not include any behavioural effects on the underlying rates of error and fraud.

Establishing the relevant level of error and fraud in the legacy system

4.62 The estimated level of error and fraud and overpayments for housing benefit and tax credits are relevant in the legacy benefits (Table 4.5).

Table 4.5: Fraud, error and overpayments

	£ million					
	Forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
DWP housing benefit						
Fraud and error overpayments	+1,404	+1,410	+1,413	+1,442	+1,442	+1,442
Fraud and error underpayments	-610	-609	-613	-626	-626	-626
HMRC tax credits						
Error and fraud in favour of the claimant	+1,243	+1,301	+1,314	+1,291	+1,291	+1,291
Error and fraud in favour of HMRC	-187	-186	-184	-187	-187	-187
Overpayments	+1,136	+1,101	+1,068	+1,096	+1,096	+1,096
Net effect on spending	+2,986	+3,016	+2,998	+3,017	+3,017	+3,017

Design features generating savings

4.63 The following design features are expected to generate savings:

- **Real-time information (RTI):** UC generates savings from identifying incorrectly reported earnings by exploiting an automatic data feed of actual PAYE earnings recorded in HMRC's RTI system for that month. Assuming RTI is accurate, we assume that all losses resulting from incorrect PAYE earnings in the legacy system would be saved under UC. These savings are over and above those currently expected from use of RTI in the tax

credits system and are additional because of the monthly assessment period, paid in arrears (compared to the tax credits annual assessment paid in advance).

- **No hours rules:** reporting more hours worked than actually worked generates no benefit under UC since entitlement is based only on earnings not hours. We assume that all error and fraud due to 'work and hours' is saved under UC.
- **Terminations:** in tax credits the annual renewal process means that overpayments arise for cases that are no longer entitled to tax credits but fail to renew by the renewal deadline. The monthly assessment period in UC, paid in arrears, should remove these and we assume that the savings in UC equal the overpayments that HMRC would not expect to recover.
- **No disability premia:** UC will not pay any disability premia for adults. Instead, it will provide an extra 'limited capability for work' element based solely on the work capability assessment carried out as part of the UC claim. We assume that this will save the error and fraud associated with tax credits disability premiums.
- **Merging in- and out-of-work benefits:** bringing together the legacy benefits for in- and out-of-work claimants means less error and fraud when claimants in work wrongly receive out-of-work benefits. It also prevents the error and fraud that arises in the legacy system when housing benefit awards are based on incorrect reporting of tax credits and other benefits received.
- **Childcare:** tax credits claimants have relatively high levels of error in reporting childcare costs. UC supports childcare costs based on actual costs of childcare and paid in arrears. We assume some but not all the cost of childcare-related error in tax credits will be saved under UC, so use an estimate based on half being saved.
- **Self-employed earnings:** in tax credits, annual reporting of self-employed earnings leading to finalisation the following year results in errors. Under UC the self-employed will report earnings on a monthly basis in advance of the UC payment for the relevant period, removing the need for any reconciliation. We assume that this saves the loss that currently occurs in tax credits due to unrecovered overpayments in respect of self-employed earnings. There remains considerable uncertainty in this area, though, given the prospect for greater volatility in after-tax monthly earnings of the self-employed.
- **Changes to rules for paying back underpayments:** tax credits allow repayment of underpayments on entitlement backdated several months; UC only allows it for the month in which the change is reported. We assume that this saves half the cost of error and fraud arising in tax credits in this way, since other UC design features will reduce the rate of underpayments.
- **Change in the taper rate:** the difference in the taper rate between UC and the legacy benefits means that the same error will generate different costs under the two systems. Modelling this difference results in a small saving under UC.

Design features generating costs

- 4.64 The following design features are expected to generate costs in our forecast:
- **Sensitivity to changes in income:** abolishing the tax credits income disregards makes the UC award more sensitive to changes in income. For non-PAYE incomes (not captured by RTI) this will increase the error and fraud associated with income changes.
 - **Capital limit:** introducing capital limits to tax credits claimants is expected to increase error and fraud associated with reporting capital. This is captured in the main modelling of the capital limit.
 - **Late RTI:** 3½ per cent of RTI returns from employers come in later than required. The resulting net effect on the overlapping assessment period is a cost that partly offsets the gains from using RTI.
- 4.65 There may also be behavioural effects associated with error and fraud in UC compared to the legacy system. Given the lack of outturn evidence to date we have not included any.

Off-model costings

Other bespoke models

- 4.66 Around 50 further adjustments are taken from a variety of bespoke models. These include costings of recent budget measures, ready-reckoned estimates of changes in our economic forecast (that fluctuate) and other smaller effects. No individual impact is greater than £50 million in any year, but they could sum to more significant amounts.

In-year modelling

- 4.67 In most of our spending and receipts forecasts, the estimate for the year in progress plays an important role, because forecast models are specified in terms of growth rates from this starting point. For UC, the in-year modelling is much more complicated because outturn data reflect the real-world 'actual costs' of UC and the legacy benefits, not the counterfactuals that we use to forecast them. We cannot know in real time whether the monthly path of spending on UC and the legacy benefits reflects underlying trends in eligibility and take-up or the rollout of UC and how much it is saving or costing relative to the benefits and tax credits it is replacing.
- 4.68 We use the in-year modelling to generate estimates of the actual costs presentation. This involves an iterative process between the DWP team that leads on UC and the forecasters in DWP and HMRC that lead on the legacy benefits and tax credits. We draw on the various forecasters' judgements about how the spending they monitor is being affected by the rollout of UC and on DWP's UC team that brings these estimates together. We scrutinise these estimates from different perspectives: How do the forecasts for the remaining months of the year compare to the latest outturns? How does the implied UC rollout profile compare with DWP's latest plans and with progress reported in the administrative data?

What do the various estimates imply for the marginal saving from UC per case that has moved between the two systems? The results are highly uncertain.

4.69 Table 4.6 shows our November 2017 forecast for 2017-18 on both the ‘counterfactual plus marginal cost’ basis and the real world ‘actual cost’ basis. The actual cost of legacy benefits is lower in the real world than the counterfactual because the full cost of cases now in receipt of UC is allocated to UC. The difference between the two presentations gives an indication of the progress of the UC rollout – for example, the 39 per cent difference between the marginal and actual cost presentations of JSA spending in 2017-18 reflects the relatively advanced UC rollout for this group of claimants.

Table 4.6: Universal credit and the legacy benefits (2017-18)

	£ billion		Difference (per cent)
	Marginal cost presentation ¹	Actual costs presentation ²	
Legacy benefits			
Income-based jobseeker's allowance	2.2	1.4	-38.7
Income-based employment and support allowance	10.7	10.2	-4.4
Income support (non-incapacity)	2.3	2.2	-7.3
Tax credits	27.0	26.1	-3.2
Housing benefit	17.7	16.4	-7.8
Universal credit	-0.1	3.7	
Total	59.8	59.8	

¹ Marginal cost presentation: legacy benefits on a 'no-UC' counterfactual basis with the marginal saving from UC subtracted.

² Actual costs presentation: actual payments on each welfare item.

4.70 Although UC outturn spending is recorded, it is categorised according to UC claimant groupings, which do not correspond one-for-one with legacy benefit groupings. This hampers analysis of trends in the outturn data. In addition, DWP is not currently equipped to calculate what counterfactual legacy benefit awards would have been for existing UC claims, which means we cannot estimate the marginal cost or saving for those cases that are now in receipt of UC. This lack of information about the effect of UC on spending now is a matter of significant concern, especially when UC spending is set to rise significantly.

4.71 The in-year forecast for UC spending is estimated using DWP's in-year model. Initial estimates are produced by multiplying the monthly forecast for the build-up of the UC caseload by legacy benefit from INFORM by average award assumptions for each legacy benefit in the no-UC counterfactual. Adjustments are then made to:

- **The pace at which the UC caseload builds up** to reflect any differences between the INFORM projection and how the UC rollout is actually progressing. This adjustment is done on a legacy-benefit-by-legacy-benefit basis, using DWP operational information on the rollout and administrative data. Given the difficulties in comparing UC claimants to legacy benefit claimants, this adjustment is primarily judgement-based. It can be more precise for groups of claimants where the UC and legacy groupings are more closely aligned – for example, those in receipt of the UC housing element or legacy housing benefit.

- **The average award assumptions**, as the average legacy benefit awards of those claimants migrating to UC are likely to differ from the overall average awards in the no-UC counterfactual scenario. These differences largely reflect how UC is being rolled out – for example, the early stages concentrated on simple JSA cases while the cost of housing support is affected by the geography of the rollout. Again, these adjustments are primarily judgement-based and can be more precise for some groups of claimants than for others.

4.72 By definition, actual spending on the legacy benefits plus UC must equal spending in the no-UC legacy counterfactual less the marginal saving from UC. But since the latter cannot be observed, modelling the two approaches invariably generates an unexplained residual. We typically assume this will remain constant across the rest of the year and apportion it across the estimates for each legacy benefit. Persistent or large residuals point to the need to review forecasting models.

4.73 We have raised our concerns about the lack of forecast-relevant in-year information for UC with the Treasury and DWP. This information gap raises the possibility of material forecast errors because we do not know what effects UC is having on spending now. DWP is in the process of developing the administrative data in order to provide a firmer basis for monitoring UC spending, which should provide us with better information for forecasting it. Evaluating the true effect of UC relative to the legacy system will always be difficult due to the many factors that can affect claimants' circumstances (including differences between what is reported and reality), but we remain concerned about the inability to monitor even the static effect of UC relative to the legacy system.

Potential indirect effects on the economy

4.74 So far in this chapter we have described the approaches taken to estimate the effects of UC in our central forecast. In this section we set out the framework within which we (and others) think about an issue that we have not yet factored into our central forecast: any wider economic effects from the way UC changes incentives to work.

4.75 DWP has released estimates of the employment effect it expects UC to deliver (most recently in October 2017 via a response to a Parliamentary Question).⁴ The Institute for Fiscal Studies and the Resolution Foundation have published detailed analyses of the ways that UC is expected to alter financial incentives for those out of work to move into work and for those already in work to increase their hours and earnings.⁵ We draw on this and other information in deciding whether and how to factor any effects into our forecasts.

⁴ See, for example, *Impact Assessment: Universal Credit*, Department for Work and Pensions, December 2012 and House of Lords written Parliamentary Question HL2020, 'Universal Credit', Department for Work and Pensions, 16 October 2017.

⁵ See, for example, *IFS Green Budget 2016* (Chapter 10: The (changing) effects of universal credit, Browne, Hood and Joyce), Institute for Fiscal Studies, February 2016, and *Universal Remedy: Ensuring Universal Credit is fit for purpose*, Brewer, Finch and Tomlinson, Resolution Foundation, October 2017.

Labour market reforms and potential output

- 4.76 UC will alter the incentives individuals face when choosing whether to seek work and, if already in work, how many hours to work. These labour supply decisions can be important drivers of the level of activity in an economy. As they affect the supply of labour, they can permanently affect the sustainable level of employment and output – i.e. change potential output. For example, the labour market reforms of the 1980s are widely assumed to have helped reduce the UK's sustainable unemployment rate. This is not directly observable, but according to OECD estimates it fell from 10.0 per cent in 1985 to 8.2 per cent in 1995, with further larger falls taking it to 5.7 per cent in 2005. While many other factors will have contributed over those 20 years, all else equal it would have been equivalent to raising potential output by 4.5 per cent (around £92 billion in today's terms).
- 4.77 Differences between UC and the legacy benefits system include both financial elements – stemming from the relative generosity of UC and the legacy benefits across their out-of-work and in-work elements – and non-financial elements – including the different conditionality regimes and the reduced complexity that comes with UC being a single system with a single means test applying across in-work and out-of-work claimants.
- 4.78 The Government believes that the combined effects of these features will boost employment relative to where it would stand if the legacy systems continued. DWP's latest published estimate of a 250,000 boost to employment once UC has been fully rolled out would be equivalent to around $\frac{3}{4}$ per cent of employment in the final year of our latest forecast. In terms of GDP and potential output, the effect would be smaller if the average productivity across the additional employment were lower than the average across existing employment, as would seem likely given the characteristics of the population affected by UC.
- 4.79 As this section describes, to date we have not made any adjustments to our labour market or productivity forecasts in respect of UC. We do not normally make bottom-up policy-related adjustments to our assumptions about potential output and its components as they are generally small relative to the uncertainty around the estimate itself and also uncertain themselves. We made an exception for the introduction of the National Living Wage (NLW), which we deemed sufficiently material to warrant an adjustment in our July 2015 *Economic and fiscal outlook*. We estimated that it would add around 0.2 percentage points to the sustainable unemployment rate between 2016 and 2020. Since this effect was concentrated at the bottom of the earnings distribution, we assumed that average productivity among those in employment would be slightly higher.⁶
- 4.80 Given the scale of UC once fully rolled out, affecting around a third of all working-age households at any time, it is important to consider how its introduction could affect the labour market and to monitor those potential channels as the UC caseload builds. This will be challenging given the uncertainty around the reasons for the current historically high employment rate and what that means for the sustainable unemployment rate, and the

⁶ See Annex B of our July 2015 *Economic and fiscal outlook* for a description of the methodology we used to estimate the effects on our economy forecast of introducing the National Living Wage.

(perhaps related) ongoing puzzle around the weakness of productivity growth. This is also made more difficult still by the different rates at which cases from the different legacy benefits are migrating to UC. In the event that clear evidence were to emerge, we would reflect it in our forecasts accordingly.

- 4.81 In the rest of this section we consider differences in financial and non-financial incentives between UC and the legacy benefits for three types of labour market decision: the choice between working or not (known as the ‘extensive margin’), the choice over how many hours to work (known as the ‘intensive margin’) and the particular set of incentives facing those in low-income self-employment. We consider the early evidence where it is available.

Choices about moving into work

- 4.82 UC is intended to increase the rate at which out-of-work claimants move into employment – to ‘make work pay’.⁷ The channels through which this might operate include:

- direct changes to the **financial incentives** to work;
- **removal of complexity and the continuation of support** once claimants move from being out of work to in work; and
- the use of **conditionality and intensive coaching**.

Financial incentives: the participation tax rate

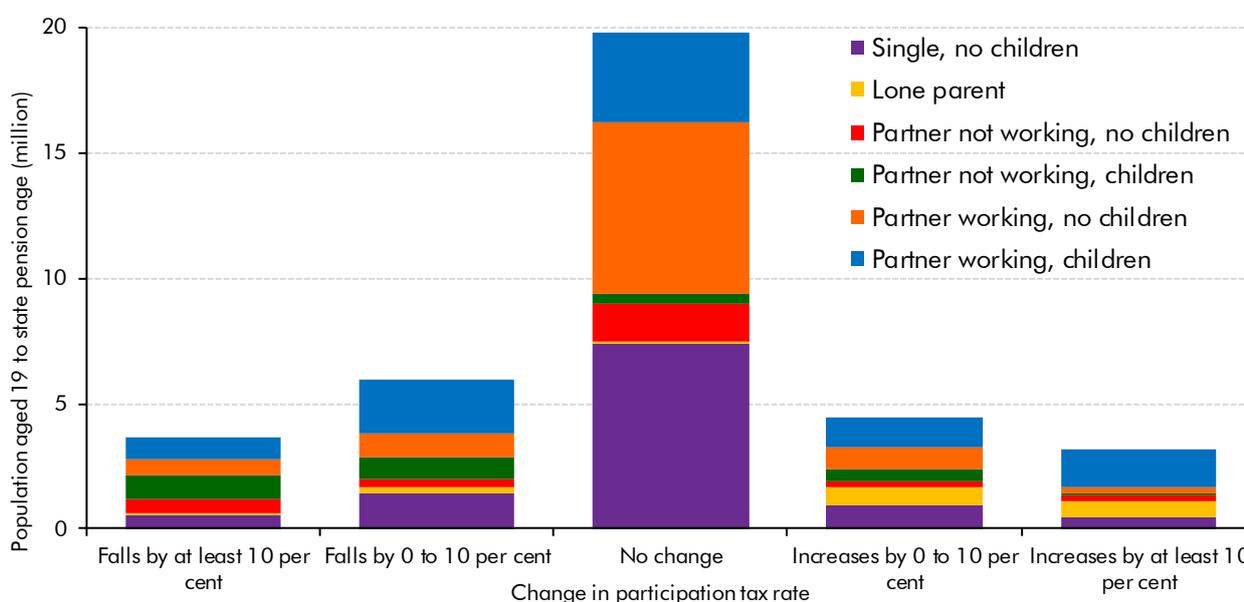
- 4.83 When someone moves from receiving out-of-work benefits to less generous in-work benefits, the reduction in their benefit award is equivalent to losing some of their employment income through tax. This reduces the financial gain from entering work. This can be measured by estimating ‘participation tax rates’ (PTRs) for individuals in different circumstances. This represents the proportion of earnings that an individual loses in either higher taxes or withdrawn benefits when they enter work.
- 4.84 What matters for the effect of UC on employment is how PTRs under UC differ from PTRs under the legacy system. This is complicated, in part because of the many factors entering into the UC award calculation, but more importantly because of the many overlapping means tests and hours rules within the legacy system. Out-of-work benefits are withdrawn pound-for-pound in the legacy system, while income tapers in tax credits and housing benefit are applied simultaneously. Under UC, a single taper of 63 per cent applies at all times. Smoothing out the resulting PTR wrinkles in the legacy system means the differences between UC and legacy PTRs vary significantly. Support for childcare costs is also more generous under UC than tax credits (up to 85 per cent versus up to 70 per cent).
- 4.85 In its February 2016 Green Budget, the IFS estimated – on the basis of UC policy as it stood at the time – that the move to UC would slightly reduce the average PTR across all working-

⁷ For example, in the November 2010 white paper that introduced UC, the Government stated that: “Universal Credit will mean that people will be consistently and transparently better off for each hour they work and every pound they earn.”

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age individuals, but that more importantly it will reduce the numbers where incentives to enter work are currently very low by a lot more. For example, the numbers facing PTRs of greater than 70 per cent were estimated to fall by around two thirds. The incentive for couples with children to have at least one adult in work improve significantly under UC – in the legacy system, couples’ entitlement to out-of-work benefits is relatively more generous than their entitlement to working tax credit. This is not the case under UC, making a move into work more attractive. However, as Chart 4.3 shows, the improvement is far from uniform. The IFS estimated that PTRs under UC would increase for almost three quarters of lone parents (as their in-work support is reduced by more than their out-of-work support, partly due to UC work allowances being less generous than the equivalent tax credits income thresholds) and almost a third of second earners in families with children (due to the UC work allowance being eroded by their partner’s earnings).

Chart 4.3: Changes in participation tax rates: UC versus the legacy system



Source: IFS, Green Budget 2016

Note: these estimates are based on the UC and legacy policy settings as known at the time of the IFS analysis.

4.86 The removal of the hours rules in the jobseeker’s allowance and tax credits systems will significantly reduce PTRs faced by those choosing to work small numbers of hours a week. The 16-hour rule has a particularly strong effect on the choices made by lower-paid lone parents, where the Resolution Foundation notes that 14 per cent report working precisely 16 hours a week – roughly twice as many as the next most popular choices (20 and 30 hours a week).⁸ As described later in this chapter, incentivising single parents and others to take up these ‘mini-jobs’ is a key element of DWP’s estimate of the positive employment effects it expects from UC.

⁸ See Figure 10 in *Universal Remedy: Ensuring Universal Credit is fit for purpose*, Brewer, Finch and Tomlinson, Resolution Foundation, October 2017.

Non-financial incentives: simplicity and a smoother transition into work

- 4.87 In the legacy system, the move from receiving out-of-work benefits into work that is eligible for in-work benefits can involve dealing with three separate government agencies (DWP, HMRC and, for housing benefit, local authorities) and calculating multiple different entitlements. One of the main benefits of UC will be to reduce both aspects of this complexity. To the extent that either factor currently deters people from moving into work, particularly short-term or less certain positions, this could boost total employment.
- 4.88 UC does not remove these issues entirely – means-tested council tax support will still be administered by local authorities, while issues such as childcare costs and eligibility for free school meals, or the risk of failing to meet conditions attached to a UC award and being sanctioned will continue to present challenges in understanding the effect of moving into work on a household’s disposable income. And of course it is possible that making the financial implications of a move into work clearer could discourage some from doing so if the increase in their disposable income for a given increase in earnings is revealed to be smaller than they would otherwise have expected.

Non-financial incentives: conditionality and coaching

- 4.89 Some UC awards will come with many conditions attached, as described in Chapter 3. This conditionality regime will apply to more claimants under UC than under the legacy system. In steady-state this is expected to impose conditionality – either for the first time or to a greater extent – on significant numbers of claimants, including partners:
- JSA-style conditionality extended to around 300,000 **claimants that would otherwise have received child tax credits and housing benefit** and that do not face any conditionality under the legacy system;
 - additional conditionality applied to **claimants that would otherwise have received ESA**, with around 150,000 moving into full conditionality and 300,000 experiencing additional work-preparation requirements; and
 - a range of **additional conditionality regimes** for around 450,000 claimants that become newly eligible to means-tested benefits under UC.
- 4.90 These conditions require claimants to alter their behaviour in order to meet them, with the threat of sanctioning their UC award if they fail to do so. Assuming this can be delivered, there are several possible outcomes for affected claimants. These include:
- **responding successfully to the conditions set**, usually by moving into work;
 - **reporting different circumstances that remove or reduce conditionality**, for example by declaring a disability or caring responsibility;
 - **not being able to meet the conditions set** and thereby losing income via sanctions; or
 - **choosing not to engage with UC** – a deterrence effect reducing take-up among the eligible population.

4.91 The effects of conditionality under UC on wider labour market outcomes are very difficult to estimate because they depend crucially on how successfully the regime is delivered. The OECD has assessed various active labour market policies across advanced economies, noting that the effectiveness of these can vary considerably due to differences in detailed implementation and the country-specific context.⁹ Under UC, the role of the work coach is critical to delivering the programme of conditionality. As Box 3.2 in Chapter 3 illustrated, DWP expects a lot of the modestly paid work coaches it is recruiting in terms of tailoring interventions to the needs of individuals and families in the context of local labour markets, setting conditions and monitoring compliance with them.

Choices about how many hours to work

4.92 As well as improving the incentive to enter work at all, UC is also intended to incentivise claimants already in work to increase the number of hours that they choose to work. The channels through which this might operate are:

- direct changes to the **financial incentives** to work;
- **removal of complexity**; and
- in-work **conditionality and intensive coaching**.

Financial incentives

4.93 When claimants of means-tested benefits increase their hours of work or their earnings, they may face a cut in their benefits as well as having to pay tax on their higher earnings. The rate at which claimants' awards are reduced as they earn more can be combined with the rate at which they pay tax on their additional income to give their 'effective marginal tax rate' (EMTR). The EMTR measures how much of an additional pound of earned income the claimant loses in terms of higher taxes and lower benefits.

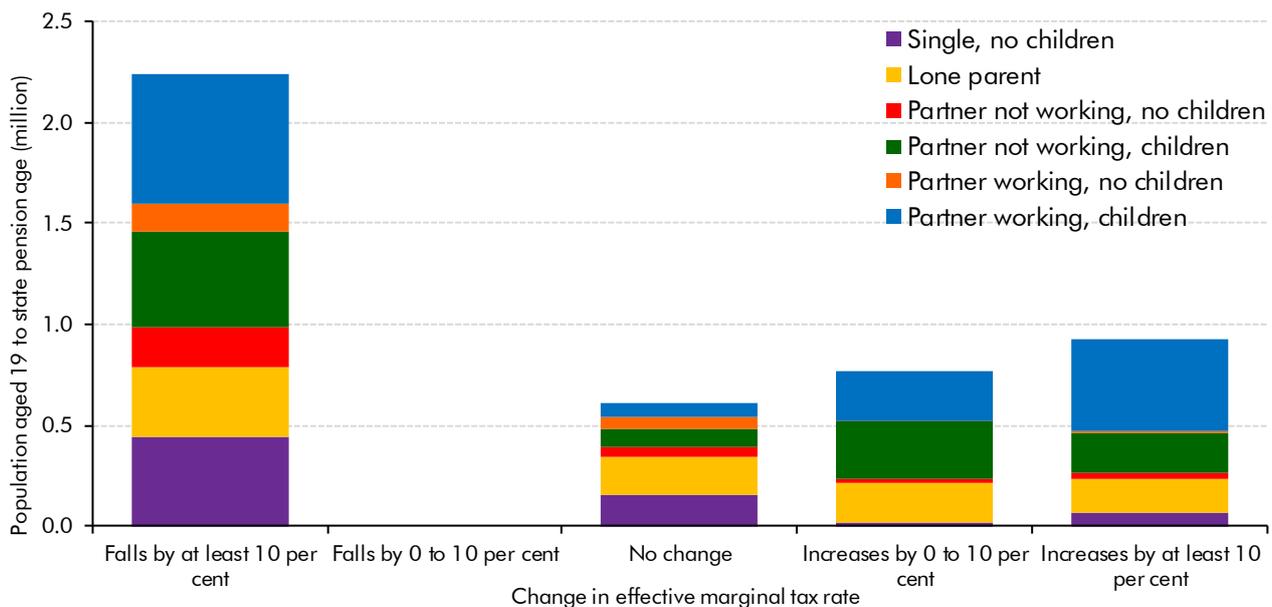
4.94 As with the assessment of PTRs, what matters here is how EMTRs under UC differ from those under the legacy system. Again, this is complicated by the fact that the relatively simple UC taper is being compared with the overlapping means tests in the legacy system, in particular those applying to tax credits and housing benefit awards. For families with children, the extent to which additional childcare costs are met by the benefits system and the implications for free school meals will also affect choices over how many hours to work. Both differ under UC and the legacy system, with childcare support more generous under UC (lowering the EMTR relative to the legacy system) while the Government is consulting on introducing an income threshold in UC to determine eligibility for free school meals.¹⁰ Under both systems, withdrawal of local council tax support will also affect EMTRs.

⁹ See Chapter 3 'Activating jobseekers: Evidence from seven OECD countries' in the *OECD Employment Outlook 2013*.

¹⁰ *Eligibility for free school meals and the early years pupil premium under Universal Credit: Government consultation*, Department for Education, November 2017.

- 4.95 In its 2016 Green Budget, the IFS estimated that the move to UC will reduce the average EMTR across those workers who are entitled to one or more of the means-tested benefits and tax credits that are being replaced by UC, but noted that the average disguises significant variation among those affected. Their analysis pre-dated the Autumn Statement 2016 decision to reduce the UC taper from 65 to 63 per cent, reducing EMTRs under UC, but the broad conclusions would not be too sensitive to a change of this magnitude.
- 4.96 As Chart 4.4 shows, the IFS analysis showed that EMTRs under UC are lower than under the legacy system for about half the 4.5 million workers that they estimated would be affected, but higher for around a third of them. For those facing the highest EMTRs under the legacy system, almost all will face a lower EMTR under UC – and for those that face either pound-for-pound withdrawal of out-of-work benefits or the combined housing benefit and tax credit tapers, EMTRs will be significantly lower. The opposite is also true, with those facing the lowest legacy system EMTRs often seeing higher ones as they move onto the UC taper.
- 4.97 Claimants without children are most likely to see the greatest falls in EMTRs under UC, but mainly because they are most likely to lose entitlement to means-tested benefits entirely under UC so will have no award to be withdrawn. Second-earners in households with children are most likely to see the greatest rises in EMTRs as many in this group do not earn enough to pay income tax and are entitled to tax credits but not housing benefit. So they face just the tax credits taper in the legacy system instead of the higher UC taper. Lone parents and couples with children are more likely to see smaller falls in EMTRs, notably where they move from facing the combined tax credits and housing benefit tapers to the single UC taper.

Chart 4.4: Changes in effective marginal tax rates: UC versus the legacy system



Source: IFS, Green Budget 2016

Note: these estimates are based on the UC and legacy policy settings as known at the time of the IFS analysis.

- 4.98 It is also worth noting how EMTRs under UC interact with changes in the work allowances – the lower the work allowance, the fewer hours can be worked at a given hourly wage before EMTRs rise due to the taper. In 2017-18 the higher work allowance is equivalent to working around 12 hours a week at the NLW while the lower work allowance is equivalent to working just 6 hours a week. The tax credits income threshold for in-work claimants is equivalent to 16 hours, but below this level claimants receive out-of-work benefits that are withdrawn pound for pound with higher earnings rather than being tapered. Lone parents, disabled claimants and those aged over 60 also have their award tapered at lower levels of earnings under UC than the legacy system. If work allowances are increased more slowly than the NLW (as will be the case until at least 2020 on current policy), the number of hours that can be worked before EMTRs rise due to the UC taper will continue to fall, reducing the financial incentive to increase hours worked.
- 4.99 The Resolution Foundation notes that one possible implication of relatively high EMTRs for UC claimants earning enough to pay income tax and NICs is that the financial loss from reducing hours can be relatively small: *“a worker on the [NLW] could earn £60 less when dropping an eight hour shift, but lose only £15 of net income as they give up only 25 pence for every pound of earnings forsaken.”* It notes that *“The risk therefore is not that those who would currently choose full-time work may now go part-time, but rather that the increasing numbers going part-time are incentivised to do so at lower hours.”*¹¹
- 4.100 These analyses focus on workers’ decisions in light of changed financial incentives. The ability to act on such incentives will also be affected by the decisions of employers. The Institute for Government has noted that some employers – particularly in the retail and hospitality sectors – appear to have internalised the 16 hours rule in the legacy benefits system. With the abolition of hours rules, it asks *“So how will employers react? By asking existing employees if they want more hours? Or by creating more ‘mini-jobs’? Or with more ‘zero hours’ contracts?”*¹²

Non-financial incentives: removal of complexity

- 4.101 While less significant than the simplification under UC of the move into work, it is possible that the clarity of the single UC taper could affect decisions about the number of hours to work or whether to take up a higher paid employment opportunity. This effect may not only be in one direction though, as the Resolution Foundation has suggested via its example of the modest net income loss for taxpaying claimants from working slightly shorter hours.

Non-financial incentives: conditionality and coaching

- 4.102 As noted in Chapter 3 and above, conditionality is a key feature of UC – and the extension of it to in-work claimants is a new feature of the welfare system. The precise form that the conditionality will take has yet to be decided. Several variants are being trialled in a pilot programme that began in April 2015. These seek to encourage claimants to increase their working hours and/or obtain better paying or additional employment by imposing financial sanctions for failure to comply with conditions set by UC work coaches.

¹¹ *Universal Remedy: Ensuring Universal Credit is fit for purpose*, Brewer, Finch and Tomlinson, Resolution Foundation, October 2017.

¹² *Universal Credit: From disaster to recovery?*, Timmins, Institute for Government, September 2016.

4.103 The role of the UC work coach will be critical. In terms of in-work claimants, it will involve providing support with a broad range of activities and setting, monitoring and policing the conditions of their award. The effectiveness with which UC can deliver in-work conditionality depends on the extent to which work coaches can provide high quality coaching while also delivering their other responsibilities. Ensuring that coaches receive the correct training and that there are enough of them will also be important. In its 2016 review of in-work progression under UC, the Work and Pensions Select Committee concluded the following on the role of personalised work coaching:

“For in-work progression to succeed, Jobcentre Plus (JCP) Work Coaches will need to be a new kind of public servant, possessing new skills and operating on a new agenda. They will need to address structural barriers to progression, such as access to childcare, skills development and job opportunities, on a personalised basis. They will also need to understand local labour markets and engage with employers to a far greater extent than they have done before. Compared to the existing role of moving people out of work into employment, this will require the DWP to nurture Work Coaches with a substantially expanded set of skills. Should a full service be delivered in-house by JCP, supporting an estimated one million in-work claimants will also entail a sharp increase in JCP workload.”¹³

4.104 Given the lack of a defined policy and these uncertainties, we have not yet included an impact of in-work conditionality in our forecast. We will review this as the policy firms up and further evidence becomes available – for example, DWP’s large-scale randomised control trial that began in December 2015 and will ultimately cover 15,000 claimants. It has not yet reached that target; once it does, the trial will run for a further 12 months.¹⁴

4.105 The ability of workers and firms to adjust working hours, wages and employment patterns is not just a matter for the individual. The state of the labour market will also play a role in determining what is feasible. Failing to take this into account when setting conditions could result in claimants facing unavoidable financial sanctions that would lower awards and therefore expenditure. A particular issue may be the trend towards low-wage work. Raising earnings to meet in-work conditionality requirements in a low-wage economy may put a disproportionate burden on adjustments to working hours.

The self-employed

4.106 Low-income self-employed individuals will face a much tougher benefits system under UC thanks to the introduction of the minimum income floor (MIF). They will also face in-work conditionality for the first time as well as experiencing the potential benefits of a less complex system of support.

Financial incentives

4.107 There has been little specific analysis to date of how UC will affect the financial incentives faced by affected self-employed individuals. For those subject to the MIF, participation tax

¹³ *In-work progression in Universal Credit*, House of Commons Work and Pensions Committee, May 2016.

¹⁴ *Universal Credit: In Work Progression Randomised Control Trial*, DWP, 21 December 2017.

rates could be high since in-work UC awards will assume they are earning more than is actually the case, whereas their out-of-work UC awards would be the same as for any other claimant. By contrast, effective marginal tax rates for those under the MIF would be low – so long as their earnings did not rise beyond the MIF, their UC award would not fall at all with higher earnings.

- 4.108 The significant difference in treatment of the same level of employee earnings and self-employment income under UC due to the MIF will encourage people to take up employee jobs – particularly at low hours – rather than self-employment.

Non-financial incentives: conditionality and coaching

- 4.109 The first condition that must be met for a self-employed individual to receive in-work support under UC is to prove to DWP's work coaches that they are 'gainfully self-employed'. This requires that self-employment should be the individual's main occupation and that it must be organised, developed, regular, and carried out in expectation of profit. Among other things, work coaches will check tax records, business plans and marketing material. If the work coach decides that a claimant is not gainfully self-employed, they will become subject to out-of-work conditionality. If they are deemed gainfully self-employed, they become subject to the MIF and eligible for in-work coaching support.
- 4.110 As with other aspects of the UC conditionality regime, the effectiveness of work coaches will be central to its success in raising the earnings of self-employed claimants. Recognising the greater challenge in this area, self-employed claimants will be served by 'enhanced capability' work coaches with special training. The challenge of providing transformational advice to individuals running their own business is not new to Government – the Department for Business, Energy and Industrial Strategy and its many predecessors have been engaged in such support for decades. Whether DWP's work coaches will have greater economy-wide success with the MIF, conditionality and personalised coaching than has been the case with previous interventions is something that we will keep under review as UC is rolled out and evidence is gathered.

DWP estimates of the steady-state effects of UC on labour market outcomes

- 4.111 DWP has released estimates of the effects of the main elements of UC on employment, but not productivity or GDP. Table 4.7 reports two of these estimates. The latest was summarised in response to a Parliamentary Question tabled in the House of Lords by the Bishop of Durham in October 2017, itself in response to a statement made by the then Secretary of State for Work and Pensions in the House of Commons. The first was included in the impact assessment that followed the 2012 Welfare Reform Act and was accompanied by greater detail on methodologies and uncertainties. DWP will include an updated estimate in the full UC business case that is currently scheduled for publication later this year.
- 4.112 These estimates are built up from the various changes in financial and non-financial incentives and are subject to varying degrees of uncertainty:

- In both cases, the largest effect comes from the **financial incentives to move into work**. This is estimated by combining changes in participation tax rates across different individuals with FRS data on their weight in total employment and academic evidence on the responsiveness of different groups to these financial incentives. While subject to considerable uncertainty, the methodology is standard. The analysis does not capture all factors affecting the participation tax rate – e.g. childcare costs (where UC is more generous), free school meals (where a new income threshold in UC is currently subject to consultation) and local council tax support (which would be common to both UC and the legacy systems). This effect represents three-fifths of the total employment effect in DWP’s latest estimate. It would be equivalent to raising total employment in 2022-23 by 0.5 per cent relative to our latest forecast.
- DWP’s latest estimate did not refer to the effect of **financial incentives to increase hours worked** since it was in response to a question about an employment figure, but the 2012 impact assessment did. The methodology used is similar to that above, but focuses on effective marginal tax rates and hours worked. The impact assessment results, which pre-date a number of significant changes to the UC policy, would be equivalent to raising total hours worked in 2022-23 by 0.1 to 0.2 per cent relative to our latest forecast.
- The effect of **conditionality** is expected to be material – equivalent to raising total employment in 2022-23 by around 0.2 per cent relative to our latest forecast. The 2012 impact assessment cited evaluations of jobseeker’s allowance interventions published in 2000 and 2006 as the source of the range that it presented. The latest estimate was less specific on the basis, stating that it was based on “*evidence of the employment impacts from trials of labour market interventions*”.
- The effect of **greater simplicity and smoother transitions into work** are also expected to be material – again equivalent to around 0.2 per cent of total employment in 2022-23. DWP has drawn on less closely related evidence to produce these estimates – in particular evaluations of the in-work credit (until October 2013 available to lone parents taking up employment of more than 16 hours a week) and mandatory work-focused interviews (an element of the income support regime for lone parents). The 2012 impact assessment noted that “*This impact is very difficult to measure and should be regarded as indicative.*” The latest estimate was not caveated.

4.113 The table also shows that the latest estimates in respect of each aspect are at or towards the lower end of the ranges presented in the 2012 impact assessment. In the case of financial incentives to enter work, this will partly reflect the less generous UC work allowances following the Summer Budget 2015 cuts, which increase participation tax rates for those affected. DWP has informed us that the 250,000 employment estimate that was conveyed to Parliament does not reflect the November 2015 reversal of equivalent cuts in tax credits. This means that the relative change in participation tax rates between UC and the legacy system underpinning this estimate is more favourable in terms of the employment effect of UC than will be the case in reality. This is one of the factors that will be addressed when

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DWP updates its analysis in the full UC business case it presents to the Treasury and the Cabinet Office later this year.

- 4.114 Despite the lower estimates across individual components, the headline figure has only fallen from 300,000 to 250,000. These figures are not directly comparable. In 2012, DWP focused on the top end of the participation tax rate analysis, noting in the impact assessment that the various effects may overlap – e.g. when describing the gains from conditionality, it noted that it was “difficult to assess the extent to which this impact would be additional to the response to other financial and non-financial incentives under Universal Credit.” The latest figure is the sum of all the parts. It is not clear from the material published in support of this figure whether DWP has made adjustments that overcome its original concerns over whether these impacts are all additional when considered together.

Table 4.7: DWP estimates of the employment effect of UC (2012 and 2017)

	October 2017 Lords PQ response ¹	December 2012 Impact Assessment ²
Financial incentives to enter work (participation tax rates)	150,000	100,000 to 300,000
Financial incentives to work more (effective marginal tax rates)	n/a	1.0 to 2.5 million hours a week
Non-financial incentives: conditionality and sanctions	50,000	50,000 to 100,000
Non-financial incentives: greater simplicity and smoother transitions into work	60,000	50,000 to 100,000
Presentation of a headline figure	"In total, it is estimated that Universal Credit will help more than 250,000 people move into employment."	"Overall this could lead to the equivalent of up to 300,000 additional people in work from improved financial incentives."
Caveats	None	"It is very difficult to estimate the dynamic impacts of Universal Credit due to the radical nature of the reform. As such, estimated employment impacts should be treated with caution."

¹ 16 October 2017, Department for Work and Pensions, Universal Credit, House of Lords written Parliamentary Question HL2020.

² Impact Assessment: Universal Credit, Department for Work and Pensions, December 2012.

DWP's published evidence on the effects of UC on labour market outcomes

- 4.115 DWP presented early estimates of the impact of UC relative to jobseeker's allowance on selected claimants' labour market activity in two reports published in 2015.¹⁵ The analyses considered a sample of around 8,000 single, unemployed individuals who claimed UC between July 2013 and September 2014 in the first ten jobcentres that offered UC. The experience of these claimants was compared with a sample of jobseeker's allowance claimants for which as many other circumstances as possible were matched. The study found that:

¹⁵ See *Universal Credit: estimating the early labour market impacts*, DWP, February 2015, and *Universal Credit: estimating the early labour market impacts: updated analysis*, DWP, December 2015.

- New UC claimants were about 8 percentage points **more likely to have been employed at some point within 270 days of making their claim** than the comparable jobseeker's allowance claimants (71 per cent versus 63 per cent).
- The proportion of UC claimants **in employment 270 days after making a claim** was 3 percentage points higher than the proportion of the matched sample of jobseeker's allowance claimants at the same time (51 per cent versus 48 per cent). DWP noted that one reason why the chance of being in work after nine months may be significantly lower than the chance of having been in work at any point during those nine months may be due to UC making it more worthwhile and easier for people to accept short-term temporary work.
- UC claimants had **worked 12 days more** than jobseeker's allowance claimants in the comparable sample (109 versus 97 days). DWP warned that this figure is less robust than the estimates above because it relies on further assumptions about the start and end dates of employment periods reported in HMRC's real-time information (RTI) system.
- **Earnings** were only marginally higher than for the JSA equivalents. At the 270-day horizon, the estimated effect on cumulative earnings to that point was just £60 and not significantly different from zero. Again, DWP warned that the RTI data underpinning this estimate made it less reliable than the employment estimates. But this does provide further evidence that UC encourages claimants to take up small amounts of additional work – taking the 12 days and £60 estimates implies working less than 1 hour at the National Minimum Wage during those extra days in employment. As DWP put it *“the relatively modest impact on earnings suggests that whilst UC claimants are more likely to have some work it appears that this additional work probably involves relatively few hours at relatively low wages”*.

4.116 The latest update to this evidence covered three times as many JSA-equivalent claims made between July 2014 and April 2015.¹⁶ It focused on claimants' status six months after their initial claim rather than nine months, reporting that UC claimants were 4 percentage points more likely to have been in work at any point (63 per cent versus 59 per cent) and 3 percentage points more likely to be in work at the six-month horizon (56 per cent versus 53 per cent). Both were slightly lower than the results of the 2015 studies. The 2017 publication did not update the estimated number of days in employment or the resulting effect on earnings.

4.117 One conclusion that can be drawn from these early results is that while there may be positive effects from UC on employment outcomes, they may mean little for GDP or for tax revenues because they appear to involve small numbers of hours (reducing average hours worked at the whole economy level) at low pay (reducing average productivity per hour worked). Were we to factor in any wider economic effects of UC in our forecast, we would need to take all these components into account.

¹⁶ See *Universal Credit Employment Impact Analysis Update*, DWP, September 2017.

4.118 But the bigger question is whether the results will be a good guide to labour market outcomes across out-of-work cases in general as UC is rolled out fully. On this we are cautious. DWP's studies have focused on a sample of UC claimants whose circumstances are relatively simple and whose cases have been administered in a small number of geographically clustered job centres at a very early point in the UC rollout. This raises several concerns:

- **Simple cases are unlikely to be representative of the overall caseload:** the evaluation compares single, unemployed claims across UC and jobseeker's allowance. Most cases will have more complex circumstances. The extent to which observed effects on simple cases will be replicated in more complex ones is subject to considerable uncertainty.
- **Operational choices and resources available per case may not be representative of the policy when scaled up:** as the UC caseload builds up through the rollout phase, there are likely to be greater strains on resources that make aspects of the UC programme harder to deliver – as noted in Chapter 7, it is being delivered against significant real-terms cuts in DWP's resource budget. In particular, the personalised work coaching is cited as an important driver of improved labour market outcomes. This will be harder to deliver as many more complex cases enter the UC caseload.

4.119 Finally the generosity of the UC system has been significantly reduced since these trials, with large cuts to work allowances taking effect in 2016-17. This will have raised participation tax rates and lowered the level of earnings at which effective marginal tax rates rise. The extent to which this would have affected the results is uncertain.

Conclusion

4.120 Given the number of people that will see their financial and non-financial incentives to work changed by the rollout of UC, it is clearly important to keep its potential labour market effects under review. As this section has illustrated, while UC itself involves a simpler set of work incentives than the legacy systems it is replacing, the difference between the two – which matters when considering the labour market effects of the rollout – is highly complex.

4.121 DWP's estimates of the steady-state employment effects and its evidence on effects for specific groups in the early days of the rollout are subject to a range of uncertainties that mean we have chosen not to factor them into our forecasts at this stage. We will consider the updated estimates that are due to be published in the full UC business case later this year, but do not expect to make any new forecast judgements until UC is operating at greater scale across all types of claimant and for a sufficiently long period for robust evidence of any labour market effects to emerge.

4.122 It is worth noting that it will never be straightforward to isolate the effects of UC on labour market outcomes given the need to generate a counterfactual for what those outcomes would have been had the legacy system remained in place and to control for the many other factors that affect individual's employment and earnings.

5 The full spending effects of universal credit

Introduction

5.1 In Chapter 2 we described our ‘no-UC’ counterfactual forecast for spending on legacy benefits and tax credits that provides the baseline for our estimates of the effect of universal credit (UC) on welfare spending. Based on the policy design described in Chapter 3 and the modelling approaches described in Chapter 4, the next step is to estimate the effect of UC on spending in the ‘full-UC’ counterfactual – as though UC were rolled out in full from day one. The final step – estimating the actual effect on spending in line with the gradual rollout that is now underway – is described in Chapter 6.

5.2 This chapter:

- summarises **the gross costs and gross savings of UC relative to the legacy benefits** in the counterfactual ‘full-UC’ world where it has already been fully rolled out;
- examines **the main elements that contribute to the overall costs and savings**, focusing on the breakdown by legacy benefit group; and
- summarises **the overall effect of UC by legacy benefit group**.

Summary of the ‘full-UC’ counterfactual

5.3 Table 5.1 shows the net effect of a fully rolled out UC on welfare spending, relative to the legacy benefits in the ‘no-UC’ counterfactual. Unlike the actual costs presented in Chapter 6, this does not include the cost of transitional protection, which is a feature of the rollout rather than the steady state.

5.4 The table shows that if UC were to be fully rolled out this year, we estimate that it would save £2.1 billion relative to the legacy system. By 2022-23 the net saving would be £2.4 billion a year, with the difference reflecting the inflation-linked uprating of UC thresholds from April 2020 onwards and various compositional and other factors.

5.5 This 4 per cent saving in 2022-23 is the net effect of a gross saving of £10.9 billion (or 18 per cent) less a gross cost of £8.5 billion a year (or 13 per cent). The majority of the gross saving comes from elements of UC that are less generous than the legacy system – notably the work allowances relative to the equivalent income thresholds in tax credits. Some cost reflects elements of UC that are more generous than the legacy system – including payments to those working fewer than 16 hours, who in the legacy system are only eligible

for out-of-work benefits. And some reflects elements where take-up is expected to be boosted by ‘automaticity’ in UC, since it is not possible to claim only part of a UC award if a claimant provides all the relevant information when applying.

Table 5.1: Net effect of UC on welfare spending: ‘full-UC’ counterfactual

	£ billion, unless otherwise stated					
	Forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Entitlement						
C1: Gross cost of entitlement differences where take-up rates are expected to rise	3.1	3.0	3.0	2.9	2.9	2.9
C2: Gross cost of higher entitlement where take-up rates are not expected to change	3.3	3.4	3.3	3.5	3.7	3.9
S1: Gross saving from lower entitlement where take-up rates are expected to rise	0.0	0.0	0.0	0.0	0.0	0.0
S2: Gross saving from lower entitlement, including where take-up rates are not expected to change	-5.1	-5.3	-5.8	-5.9	-5.7	-5.6
S3: Gross saving from lower entitlement where take-up rates are expected to fall	-0.4	-0.4	-0.4	-0.4	-0.4	-0.4
Minimum income floor						
S4: Gross saving from the minimum income floor	-1.1	-1.1	-1.1	-1.2	-1.2	-1.3
Abolishing income disregards and run-ons						
C3: Gross cost from abolishing income disregards	0.5	0.5	0.5	0.5	0.5	0.5
S5: Gross saving from abolishing income disregards and run-ons	-1.4	-1.3	-1.3	-1.3	-1.3	-1.3
Error and fraud						
C4: Gross cost from higher error and fraud	0.5	0.5	0.5	0.5	0.5	0.5
S6: Gross saving from lower error and fraud	-1.9	-1.9	-1.9	-1.9	-2.0	-2.0
Other factors						
C5: Gross cost from other factors	0.7	0.7	0.7	0.7	0.7	0.7
S7: Gross saving from other factors	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2
Net effect on welfare spending	-2.1	-2.2	-2.7	-2.8	-2.5	-2.4
<i>Memo: Gross cost</i>	8.0	8.0	8.0	8.1	8.3	8.5
<i>Memo: Gross saving</i>	-10.1	-10.2	-10.7	-10.9	-10.8	-10.9
<i>Memo: Net effect on welfare (2017-18 prices)</i>	-2.1	-2.2	-2.6	-2.7	-2.3	-2.1
<i>Memo: Net effect on welfare (per cent of GDP)</i>	-0.10	-0.11	-0.13	-0.13	-0.11	-0.10

Breakdown of the ‘full-UC’ counterfactual

5.6 In this section we decompose each gross cost and gross saving reported in Table 5.1. We focus on a single year (2022-23), but the breakdowns would be similar for earlier years of the forecast. Drawing on the modelling approaches used, we show how the costs and savings arise from the different groups of claimants who would be eligible for different legacy benefits and tax credits were UC not to exist. This breakdown is more approximate in some places than others, depending on how the estimates are modelled. But it allows us to build up an overall picture of where the gains and losses from UC relative to the legacy

system are greatest – and the extent to which they are likely to net off within specific groups of claimants and across the system as a whole.

5.7 Some of the largest effects of UC relative to the legacy system relate to recipients who would otherwise be getting tax credits. Our modelling approach splits these into six groups based on whether they claim only working tax credit, only child tax credit or both, and for each of those three categories whether they are self-employed or not. Where possible we have grouped these into three larger groups as follows:

- **‘In-work employees receiving tax credits’**: this group includes non-self-employed recipients of both elements or working tax credit only. But it will not include some recipients of child tax credit only that are in employment, but whose working tax credit award has been tapered to zero. This group is a reasonable, but not precise, proxy for those in work and employed but not self-employed.
- **‘In-work self-employed tax credits recipients’**: this group includes self-employed recipients of any combination of child and working tax credits.
- **‘Child tax credits only, including out-of-work recipients’**: this includes all recipients of child tax credit only. It will therefore include those in employment (or self-employment) whose working tax credit award has been tapered to zero. HMRC reports that 59 per cent of tax credits recipients in April 2017 who received child tax credit only were out of work, so this group is only an approximation for out-of-work recipients.¹

Gross costs and savings related to entitlement differences

Gross costs where take-up rates are expected to rise

5.8 The gross cost of entitlement differences and higher take-up in cases where we expect take-up rates to increase (line C1 in Table 5.1) is expected to be £2.9 billion in 2022-23. It has not been possible to split the entitlement and take-up elements of this cost. As Table 5.2 shows, most of it relates to individuals and families who make claims for some, but not all, the payments to which they are entitled in the legacy system (‘partial legacy claimers’). We assume that they will take up their UC award in full. This assumption reflects the fact that people can only claim for their full entitlement in UC, assuming the claimant provides all the required evidence. For example, so long as information on rent payments is provided, it is not possible to claim the tax credits equivalent within UC without also claiming the housing benefit equivalent. We also assume there will be some take-up among those who have an entitlement in the legacy system, but currently do not claim at all (‘legacy non-claimers’). But the cost here is small by comparison with the ‘partial legacy claimers’ effect.

¹ In- and out-of-work here relates to working 16 hours or more under the tax credits system. *Child and working tax credits statistics: Provisional awards April 2017*, HMRC, May 2017.

Table 5.2: Take-up costs by legacy system claim behaviour: 'full-UC' counterfactual

	£ billion					
	Forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
C1: Gross cost of entitlement differences where take-up rates are expected to rise of which:	3.1	3.0	3.0	2.9	2.9	2.9
Partial legacy claimers	2.7	2.6	2.6	2.6	2.5	2.6
Legacy non-claimers	0.4	0.4	0.3	0.3	0.3	0.3

5.9 Table 5.3 breaks down the cost in 2022-23 between the different legacy-benefit groupings that are used when this effect is modelled in the policy simulation model (PSM). It shows that the average awards of 'partial legacy claimers' are boosted by around £4,000 a year (£78 a week) by receiving all that they are entitled to, rather than just those bits they apply for in the legacy system. The 631,000 cases affected represents 9 per cent of the UC caseload in the full-UC counterfactual for 2022-23, but the caseload shares are proportionately greater for the tax credits groups (14 per cent) and for those claiming housing benefit only (24 per cent). It is important to bear in mind that these figures are affected by the hierarchical nature of the groups (as detailed in Chapter 4). But it is notable that the proportion of gainers is highest for those receiving income from schemes administered by HMRC and by local authorities, but not receiving income from benefits administered by DWP.

Table 5.3: Cost of higher take-up (2022-23): 'full-UC' counterfactual

Calibration group (hierarchical)	Partial legacy claimers			Legacy non-claimers			Total
	Caseload ('000s)	Average change in award (£)	Spending (£ billion)	Caseload ('000s)	Average change in award (£)	Spending (£ billion)	Spending (£ billion)
New claimants				80	3,946	0.3	0.3
Jobseeker's allowance	26	3,844	0.1				0.1
Employment and support allowance	84	3,420	0.3				0.3
Income support (non-incapacity)	15	5,655	0.1				0.1
Tax credits (employees)	201	3,692	0.7				0.7
Tax credits (self-employed)	48	5,050	0.2				0.2
Child tax credit only ¹	149	4,959	0.7				0.7
Housing benefit only	108	3,481	0.4				0.4
Total	631	4,075	2.6	80	3,946	0.3	2.9

¹ Includes some in-work claimants with WTC tapered to zero.

Gross costs where take-up rates are not expected to change

5.10 The gross cost associated with entitlement changes where we have not assumed changes in take-up (line C2 in Table 5.1) is expected to be £3.9 billion in 2022-23. Unfortunately it has not been possible to decompose this modelling on a sequential basis, so Table 5.4 reports indicative estimates to give a sense of scale. This includes:

- **Newly entitled claimants:** cases that are entitled to UC but not to any legacy benefits or tax credits cost £0.3 billion.

- **Costs associated with removing hours rules:** UC removes the legacy system's distinction at 16 hours a week of work, so that entitlement varies exclusively with income rather than with both income and hours worked. This generates a cost of £1.4 billion from more generous treatment of claimants working fewer than 16 hours, who are only entitled to out-of-work benefits in the legacy system.
- **Costs associated with restricting the child element to two children and cutting the family premium:** these Summer Budget 2015 measures apply in the legacy system and in UC with slightly different effects. The measures cut spending in both systems, but they generate a £0.5 billion cost in UC *relative* to the legacy system. Limiting the child element to two children applies to new births in the legacy system but to both new births and new claims in UC. But the net saving from this wider scope in UC is more than offset by lower savings per case resulting from other elements of the UC design that reduce entitlement or remove it altogether.
- **More generous childcare support:** UC pays 85 per cent of eligible childcare costs up to a limit, compared with 70 per cent under tax credits. This costs £0.3 billion.
- **Other factors:** the remaining £1.5 billion of costs are wrapped up in the results of PSM modelling and could not be unpicked for this report. Some will reflect interactions across the other elements described above, but a significant proportion is likely to be the effect of the limited capability for work related activity (LCWRA) element. UC changes the way additional support is provided to disabled claimants, including a higher LCWRA element than the legacy system equivalent, but removing various disability premia that exist in the legacy system. The savings associated with the removal of disability premia are accounted for separately below.

Table 5.4: Main sources of gross entitlement cost: 'full-UC' counterfactual

	£ billion					
	Forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
C2: Gross cost of higher entitlement where take-up rates are not expected to change of which:	3.3	3.4	3.3	3.5	3.7	3.9
Newly entitleds	0.3	0.3	0.3	0.3	0.3	0.3
Gains to those working less than 16 hours	1.1	1.2	1.2	1.2	1.3	1.4
Child-limiting support	0.5	0.5	0.5	0.5	0.5	0.5
More generous childcare support	0.2	0.2	0.2	0.2	0.2	0.3
Other (including interactions)	1.1	1.2	1.1	1.3	1.4	1.5

5.11 Table 5.5 breaks down the cost in 2022-23 into the legacy-benefit groupings that are used in the PSM. It shows that the largest effects relate to the groups whose legacy system entitlement would have been to:

- **Tax credits for those in employment:** a cost of £1.9 billion is attributed to this group, reflecting factors that include gains for those working fewer than 16 hours a week

The full spending effects of universal credit

(who are not eligible for working tax credit in the legacy system) and more generous childcare support.

- **Income-based ESA:** a cost of £1.0 billion is attributed to this group. This includes the effect of introducing the limited capability for work element in UC, although the cost is lower than the saving from removing the disability premia payable with ESA. Some in this group will also benefit from UC's more generous support for low-hours work.
- **Housing benefit only:** a cost of £0.6 billion is attributed to this group, which is largely made up of low-income in-work claimants, some of whom will gain because they work fewer than 16 hours a week or because they become eligible for childcare support that is only available with tax credits in the legacy system.

Table 5.5: Entitlement costs by legacy group (2022-23): 'full-UC' counterfactual

	Caseload ('000s)	Change in annual average awards (£)	Spending (£ billion)
Newly eligible	183	1,674	0.3
Jobseeker's allowance	28	1,768	0.0
Employment and support allowance	871	1,121	1.0
Income support (non-incapacity part)	26	1,891	0.0
Tax credits (employees)	514	1,149	0.6
Tax credits (self-employed)	103	1,335	0.1
Child tax credit only ¹	444	2,676	1.2
Housing benefit only	232	2,542	0.6
Total	2,399	1,625	3.9

¹ Includes some in-work claimants with working tax credit tapered to zero.

Gross savings where entitlement is lower (net of take-up effects)

5.12 Almost all the gross costs associated with UC are modelled within the PSM, but less than two thirds of the total gross savings are. Other than the minimum income floor (described later in this section), £5.6 billion of the gross savings from UC arise where entitlement is lower, take-up is not expected to change and the impact is modelled through the PSM (line S2 in Table 5.1). As with the gross costs modelled in the PSM, Table 5.6 shows indicative estimates of individual elements rather than sequential components of the PSM modelling. The largest factors include:

- **Savings associated with less generous work allowances:** the July 2015 Budget cuts to the UC work allowances significantly reduced the level of earnings at which UC awards begin to taper. If the tax credits income threshold cuts announced at the same time had been implemented, this would not have represented a saving in UC *relative to tax credits*. But because the tax credits cuts were reversed, the UC work allowance is less generous than tax credits for most cases that would be entitled to tax credits in the legacy benefit system. This saves £2.4 billion for cases where take-up is not expected to rise. Once higher take-up assumptions are factored in, the saving associated with the work allowances would reach £2.7 billion. The latter effect is captured within the costs shown in Table 5.3.

- **Savings associated with the removal of disability premia:** UC includes a limited capacity for work element, but removes the enhanced disability and severe disability premia currently payable in ESA, the disability premia in income support and jobseeker’s allowance, and the disability elements in tax credits. The gross cost associated with the former was shown in Table 5.4. The estimated gross saving from removing the disability premia is £2.2 billion.
- **Savings associated with extending capital limits:** UC extends the capital limits applied to out-of-work legacy benefits to all claimants, thereby bringing tax credits equivalent cases within scope of these limits. This reduces entitlement for those with savings of £6,000 or more and is estimated to save £0.2 billion.

Table 5.6: Non-take-up related entitlement savings: ‘full-UC’ counterfactual

	£ billion					
	Forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
S2: Gross saving from lower entitlement, including where take-up rates are not expected to change	-5.1	-5.3	-5.8	-5.9	-5.7	-5.6
of which:						
Less generous work allowances	-2.3	-2.3	-2.3	-2.4	-2.4	-2.4
Removal of the disability premia	-1.7	-1.9	-2.1	-2.2	-2.2	-2.2
Wider application of capital limits	-0.2	-0.2	-0.2	-0.2	-0.3	-0.2
Other (including interactions)	-0.8	-0.8	-1.1	-1.0	-0.8	-0.8

5.13 Table 5.7 breaks down the saving in 2022-23 into the legacy-benefit groupings that are used in the PSM. It shows that the largest relate to those who would have received ESA or tax credits in the legacy system. For the ESA group the saving is dominated by removal of the disability premia in the legacy system. This saving should be considered alongside the entitlement-related cost for ESA recipients shown in Table 5.5, which includes the cost of the limited capability for work-related activity element in UC. For the tax credits groups the savings are dominated by the less generous UC work allowances, with a smaller effect from imposing capital limits where they do not exist in tax credits.

Table 5.7: Entitlement savings by legacy group (2022-23): ‘full-UC’ counterfactual

	Caseload ('000s)	Change in annual average awards (£)	Spending (£ billion)
Newly eligible	-	-	-
Jobseeker's allowance	73	-1,117	-0.1
Employment and support allowance	950	-2,608	-2.5
Income support (non-incapacity)	159	-1,248	-0.2
Tax credits (employees)	756	-1,927	-1.5
Tax credits (self-employed)	197	-2,138	-0.4
Child tax credit only ¹	473	-1,855	-0.9
Housing benefit only	55	-1,728	-0.1
Total	2,664	-2,106	-5.6

¹ Includes some in-work claimants with working tax credit tapered to zero.

Gross savings where take-up rates are expected to fall

- 5.14 We assume that some cases currently claiming all their legacy benefit entitlement, but who would receive UC awards of less than £4,000 a year, will be deterred from claiming UC by the greater requirements to meet conditions under the UC ‘claimant commitment’ and the associated risk of being sanctioned. For example, those who would otherwise have received relatively small tax credits awards, but would not have engaged with DWP or jobcentres. This saves around £0.4 billion in 2022-23.

Gross savings where take-up rates are expected to rise

- 5.15 Higher take-up among partial legacy claimers results in higher spending under UC in almost all cases, but in a small number (up to 10,000) entitlement differences are sufficient to offset the effect on spending of assumed rises in take-up. The associated savings are around £15 million in 2022-23 (line S1 in Table 5.1).

Gross saving from the self-employed minimum income floor

- 5.16 The imposition of the minimum income floor (MIF) on self-employed UC claimants is assumed to generate significant savings relative to the legacy system. As described in Chapter 4, the modelling that underpins our estimate of these savings is only an approximation of what will be seen in the real world. Estimating the proportion of self-employed claimants that will be affected by the MIF is necessarily simplified because we are not yet able to model how the MIF will interact with changes in the self-employed earnings distribution. And the self-employed caseload itself is projected on the basis of trends in the equivalent tax credits caseload, which has not moved closely with growth in self-employment more broadly. Table 5.8 sets out our November 2017 forecast assumptions.

Table 5.8: Self-employment and UC claimants: ‘full-UC’ counterfactual

	Thousands					
	Forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
OBR economic forecast						
Total employment	32,148	32,338	32,451	32,544	32,643	32,741
Self-employment	4,831	4,900	4,957	5,011	5,067	5,122
UC modelling						
Self-employed claimants on UC	709	673	664	664	645	642
Share of total self-employed (per cent)	15	14	13	13	13	13
Self-employed claimants affected by the MIF	458	436	429	444	428	432
Share of self-employed claimants (per cent)	65	65	65	67	66	67

- 5.17 In 2022-23, 430,000 benefit units (two thirds of all self-employed UC claimants) are assumed to lose from the MIF, meaning that their award will be lower than it would be if it reflected their reported earnings. On average, those affected are assumed to lose around £3,000 relative to what they would receive if the MIF were not in place. These are overwhelmingly claimants who would have been entitled to tax credits or housing benefit in the legacy system. Given the large per-case effects of the MIF, this area of our modelling

will be prioritised for development as more information becomes available. But data on self-employment earnings are limited and this is an area that has also generated challenges in forecasting self-assessment income tax receipts.

Table 5.9: MIF savings by legacy group (2022-23): 'full-UC' counterfactual

Calibration group (hierarchical)	Losers		Spending (£ billion)
	Caseload ('000s)	Average change (£)	
Newly eligible	7	-4,530	0.0
Jobseeker's allowance			0.0
Employment and support allowance	10	-2,626	0.0
Income support (non-incapacity part)	2	-6,236	0.0
Tax credits (employees)			0.0
Tax credits (self-employed)	302	-3,070	-0.9
Child tax credit only, not self-employed, tax credits ¹			0.0
Child tax credit only, self-employed, tax credits	67	-1,816	-0.1
Housing benefit only	43	-3,332	-0.1
Total	432	-2,927	-1.3

¹ Includes some in-work claimants with working tax credit tapered to zero.

Net saving from abolishing income disregards and run-ons

5.18 The tax credits system disregards income rises or falls within year of less than £2,500. These 'income disregards' will not feature in UC, which we estimate would generate a net saving of £0.8 billion in 2022-23 if UC were fully rolled out. This reflects a gross saving of £1.2 billion from removing the income *rise* disregard (line S5 in Table 5.1) and a gross cost of £0.5 billion from removing the income *fall* disregard (line C3).

5.19 Tax credits and housing benefit both have four-week 'run-on' periods, where payments are continued for four weeks after a change that would otherwise cease the award. These will not feature in UC either, which we estimate would save around £0.1 billion a year (also in line S5 of Table 5.1), split roughly evenly between housing benefit and tax credits.

Table 5.10: Income disregards and run-ons: 'full-UC' counterfactual

	£ billion					
	Forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Net saving of abolishing the disregards	-1.0	-0.8	-0.8	-0.8	-0.8	-0.9
<i>of which:</i>						
S5: Gross savings from abolishing tax credits income rise disregard	-1.3	-1.2	-1.2	-1.2	-1.2	-1.2
S5: Gross savings from abolishing 4-week run-ons	-0.1	-0.1	-0.1	-0.1	-0.1	-0.1
C3: Gross cost of abolishing tax credits income fall disregard	0.5	0.5	0.5	0.5	0.5	0.5

5.20 The latest published information on those affected by the income disregards reports that, of around 3 million in-work tax credit recipients in 2015-16, the incomes of around 1.7 million were either unchanged or changed by less than the disregard limits so did not affect their award, the incomes of around 0.7 million changed by more than the limits but did not affect their award because they were not on the taper, and the incomes of around 0.7 million changed by more than the limits and did affect their award.² We cannot split the effect of these changes down further, but all the disregards savings will accrue from the various in-work tax credits groups, while the savings from abolishing the 4-week housing benefit run on would be spread across groups since the housing benefit only group contains only a small proportion of the total caseload that would receive housing benefit in the legacy system.

Net savings from reduced error and fraud

5.21 Various elements of the UC design are expected to affect error and fraud. The majority, though not all, are expected to reduce costs relative to the legacy system. If UC were fully rolled out, we estimate that the net saving in 2022-23 would be £1.5 billion, made up of a gross saving of £2.0 billion partly offset by gross costs of £0.5 billion.

5.22 As Table 5.11 shows, the main sources of net savings include:

- The use of HMRC's **real-time information (RTI)** in the earnings calculation for employees is expected to reduce error and fraud relative to end-of-year reporting in the legacy system. This saves around £0.8 billion a year, with around two-thirds derived from employees who would have been entitled to tax credits in the legacy system and a third from those who would have been entitled to housing benefit. It is also assumed that late submission of RTI will generate £0.1 billion of offsetting costs.
- **The removal of hours rules** means that there is no need to report hours worked to calculate eligibility and awards, which removes this as a source of error and fraud. This saves around £0.5 billion a year from claimants who would have been entitled to tax credits in the legacy system.
- The **lack of 'terminations'** in UC saves around £0.2 billion a year from claimants that would have received tax credits in the legacy system. While the termination of tax credit claims from those who fail to meet the requirements of end-of-year finalisation means that awards are no longer made to those who are assumed no longer to be entitled, it also means that past payments are difficult to recover, as they cannot be clawed back from ongoing awards. The saving reflects the fact that more of these debts are assumed to be collected under UC and that some will not arise in the first place.
- **Removing disability premia** from UC means that error and fraud in respect of those premia will be designed out of the system. This is expected to save £0.1 billion a year.

² Child and Working Tax Credits statistics: finalised annual awards - 2015 to 2016, HMRC, 2017.

5.23 In preparing this report, one error and fraud saving of around £0.2 billion in our November 2017 forecast was revealed to reflect a modelling error. This is included in Table 5.11, but will be corrected in our March 2018 forecast.

5.24 Altogether this means that around £1.6 billion (almost 80 per cent) of the £2.0 billion gross savings from reduced fraud and error are expected to come from claimants that would have received tax credits in the legacy system. This equates to around half the projected cost of error and fraud in the tax credits system in 2022-23 on a legacy counterfactual basis.

Table 5.11: Changes in error and fraud costs (2022-23): 'full-UC' counterfactual

	£ billion			Total
	Legacy benefit group affected			
	Tax credits	Housing benefit	Other	
Net savings from error and fraud	-1.1	-0.3	-0.1	-1.5
<i>of which:</i>				
Gross savings from error and fraud	-1.6	-0.3	-0.1	-2.0
Real-time information	-0.5	-0.3	0.0	-0.8
No hours rule	-0.5		0.0	-0.5
Terminations	-0.2		0.0	-0.2
No disability premia	-0.1		0.0	-0.1
Merging benefits		0.0	-0.1	-0.1
Childcare	-0.1		0.0	-0.1
Self-employed earnings	-0.1		0.0	-0.1
Modelling error	-0.2			-0.2
Other	0.0		0.0	-0.1
Gross costs from error and fraud	0.5	0.0	0.0	0.5
Error due to sensitivity to earnings	0.5		0.0	0.5
Late RTI	0.0	0.0	0.0	0.1

Net savings from other factors

5.25 A variety of smaller sources of costs and savings complete our estimate of the 'full-UC' counterfactual (lines S7 and C5 in Table 5.1). Nearly 50 different factors are covered and we estimate that together they add around £0.5 billion in 2022-23 to the cost of UC relative to the legacy system.

Table 5.12: Other sources of net savings: 'full-UC' counterfactual

	£ billion					
	Forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Net savings from other factors	0.5	0.5	0.5	0.5	0.5	0.5
<i>of which:</i>						
Gross costs	0.7	0.7	0.7	0.7	0.7	0.7
Gross savings	-0.2	-0.2	-0.2	-0.2	-0.2	-0.2

Where would the full costs and savings of UC arise?

- 5.26 In a world in which UC was fully rolled out in 2022-23, and any costs of transitional protection had already passed, the breakdowns in the previous section allow us to illustrate where the various costs and savings would arise relative to a world in which the legacy system was still in place. It is important to stress that this is only an illustration and is influenced by the way in which various effects are modelled or estimated. Each step is subject to varying degrees of uncertainty. And the hierarchical groups mean that some costs or savings – notably those related to housing support in UC and housing benefit in the legacy system – will be accounted for in groups further up the table.
- 5.27 With those caveats in mind, Table 5.13 aggregates the overall effects of UC on spending in 2022-23 in the ‘full-UC’ counterfactual, broken down into the legacy groups. In terms of savings from losers and costs from gainers, it is not possible to aggregate caseload effects as we cannot say where individual effects overlap i.e. how many cases affected by less generous work allowances will also be affected by abolition of income disregards or designing out scope for error or fraud. We therefore present only the spending effect.
- 5.28 The breakdown shows that newly eligible claimants benefit by £0.7 billion. Among cases that would have been eligible for one or more benefits or tax credits in the legacy system, those who would have been entitled to:
- **Jobseeker’s allowance and income support** see relatively small gross gains and losses that broadly offset.
 - **Employment and support allowance** see net losses of £1.4 billion. This reflects the removal of disability premia, which more than outweighs introducing a ‘limited capability for work’ element in UC and gains for those working fewer than 16 hours.
 - **Tax credits** see net losses of £2.2 billion. This reflects the reduced error and fraud in favour of claimants’ incomes, abolition of the income disregards, imposition of the MIF on self-employed claimants, and the less generous work allowances for those working 16 hours or more. These more than outweigh the extra support for claimants working fewer than 16 hours and the more generous childcare support.
 - **Housing benefit only** see a net gain of around £0.7 billion. This reflects gross gains from various entitlement and take-up effects being partly offset by losses associated with reduced error and fraud in favour of claimants and the removal of the run-on.

Table 5.13: Total effects of UC by legacy group (2022-23): ‘full-UC’ counterfactual

	£ billion		
	Gross losses	Gross gains	Net effect
Newly eligible	0.0	0.7	0.7
Jobseeker’s allowance	-0.2	0.2	0.0
Employment support allowance	-2.8	1.4	-1.4
Income support	-0.3	0.2	-0.1
Tax credits	-7.2	5.0	-2.2
Housing benefit only	-0.4	1.1	0.7
Total effect	-10.9	8.5	-2.4

6 The actual effects of universal credit on spending

Introduction

6.1 In Chapter 5 we set out our latest estimate of the net effect of universal credit (UC) on welfare spending in the 'full-UC' counterfactual – a hypothetical world in which UC has been rolled out in full from day one. To forecast the effect of UC in the real world we then make further adjustments that are described in this chapter. It sets out:

- our assumption about **the pace of the UC rollout** and how that relates to DWP's UC migration plans;
- what that means for the **size and composition of the UC caseload** in each year;
- how we factor in the rollout profile and the costs of transitional protection to generate **our central forecast for the net effect of UC** on welfare spending in each year; and
- **where the effects of UC are expected to be felt** in each year as UC is rolled out.

The pace of the UC rollout

6.2 Parliament requires us to base our forecasts on current Government policy. Where that relates to the parameters of a system like UC – e.g. the work allowances or taper rate – we can simply plug the relevant numbers into our modelling. But where 'current policy' relates to the planned timetable for achieving something like the UC rollout, we have to judge whether those plans will actually be achieved, as this is not entirely in the Government's control. To do this we revisit the Government's latest plans (e.g. DWP's UC business case) and informed assessments of those plans (e.g. reviews carried out by the Infrastructure and Projects Authority) when preparing each forecast.

6.3 What matters for our forecast is the number of cases of different types that are expected to move from the legacy system to UC in a given period. This is combined with the per-case costs and savings taken from the 'full-UC' counterfactual to estimate the actual effect of UC on welfare spending in each year. Our forecast is also affected by the transitional protection regime, which applies to cases shifting to UC at DWP's discretion during the 'managed migration' process. In the real world, these will affect the actual amounts spent on the legacy benefits and on UC, with the underlying net effect of UC relative to the legacy system impossible to observe in real-time and challenging to infer even after the event.

The actual effects of universal credit on spending

6.4 As of November 2017, UC was being received by 660,000 claimants across the country via two systems:

- **Live service:** this is an early version of the UC system that has been used with the simplest cases while the Government has been developing UC policy and operational delivery. Claimants have mainly been single, unemployed and without children, so generally younger than average and with relatively simple circumstances from the perspective of their UC claim. DWP is in the process of transferring live service claims to the full service. The live service was closed to new claims in December 2017.
- **Full service:** this builds on the live service and includes features that allow a broader claimant base to apply. This includes more complicated cases – e.g. families with childcare costs or self-employed claimants subject to the MIF – where the larger costs and savings from UC are expected. The availability of the full service, and the extent to which it is dealing with such cases, are important drivers of our forecast and key factors in the judgements we make.

6.5 The pace and extent of the UC rollout will depend on DWP's decisions about how quickly to move to 'full service' in different areas and, given those decisions, how many cases will enter the UC system in those areas. The latter is largely beyond DWP's direct control, since it reflects the underlying drivers of means-tested welfare spending more generally. Given the cautious 'test and learn' approach that DWP is taking to the UC rollout, there is considerable uncertainty over the migration plan. This overlays the usual uncertainties around drivers of eligibility for different types of means-tested support.

How the migration plan has evolved

6.6 The Coalition Government's November 2010 White Paper set out a provisional timetable that would have seen the rollout completed by October 2017. But the parameters of UC were not sufficiently firmly established to be able to include its effects in our forecast fully until December 2012. At that point the rollout was still expected to be "*almost complete by 2017-18*". Since then, as Chart 6.1 shows, the schedule has been pushed back repeatedly. The Institute for Government reviewed the reasons behind these delays, citing various problems in the early years of the project including unrealistic timetables and optimism bias, departmental overload, a lack of technical capability and governance deficiencies.¹

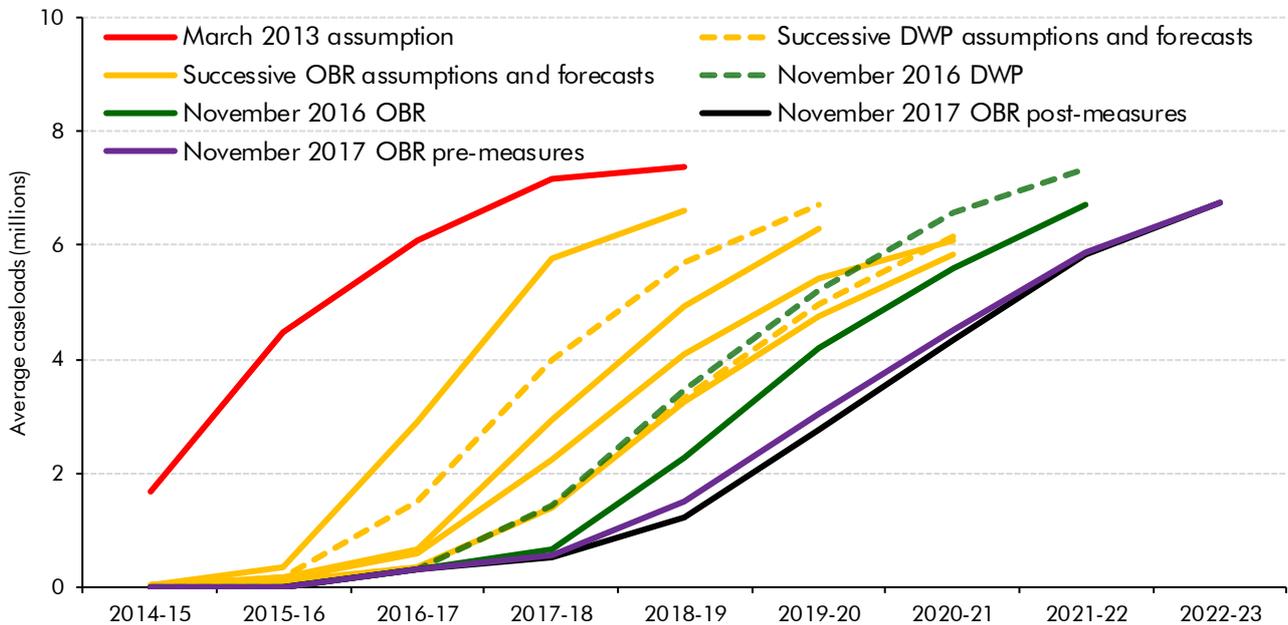
6.7 More recent delays have largely been due to changes in the design of UC itself. For example, the migration plan was pushed back once it became apparent that DWP was unable to deliver the Conservative Government's July 2015 Budget policy to restrict support to families with more than two children without slowing the pace of the UC rollout. Most recently, in Autumn Budget 2017, the migration plan was moved back by three months and the decision taken to close the live service and to re-open the gateway to new jobseeker's claims in order to deliver the UC policy package.

¹ See pages 65 to 73 in *Universal Credit - From disaster to recovery?*, Institute for Government, September 2016.

6.8 The latest DWP migration plan involves:

- **New claims** to the legacy benefits ceasing on a rolling geographical basis from May 2016 to December 2018. Five jobcentres a month have switched to UC for new claims since May 2016, rising to around 50 a month from October 2017. This will be reduced to 10 jobcentres a month from February 2018, increasing again to around 40 in May and then to around 60 a month thereafter. National coverage is expected to be completed by the end of December 2018.
- **Managed migration** beginning in July 2018 with a controlled test before full managed migration starts in July 2019 and is completed by March 2022.

Chart 6.1: Successive UC migration profiles



Source: DWP, OBR

6.9 Even abstracting from the possibility of future policy changes, there are many uncertainties around the rollout timetable. They include:

- development of **IT**, including the ‘Verify’ online security system and the linking of HMRC’s real-time information on earnings with UC;
- integrating **administration** that currently spans DWP, HMRC and local authorities; and
- addressing any **unforeseen issues**.

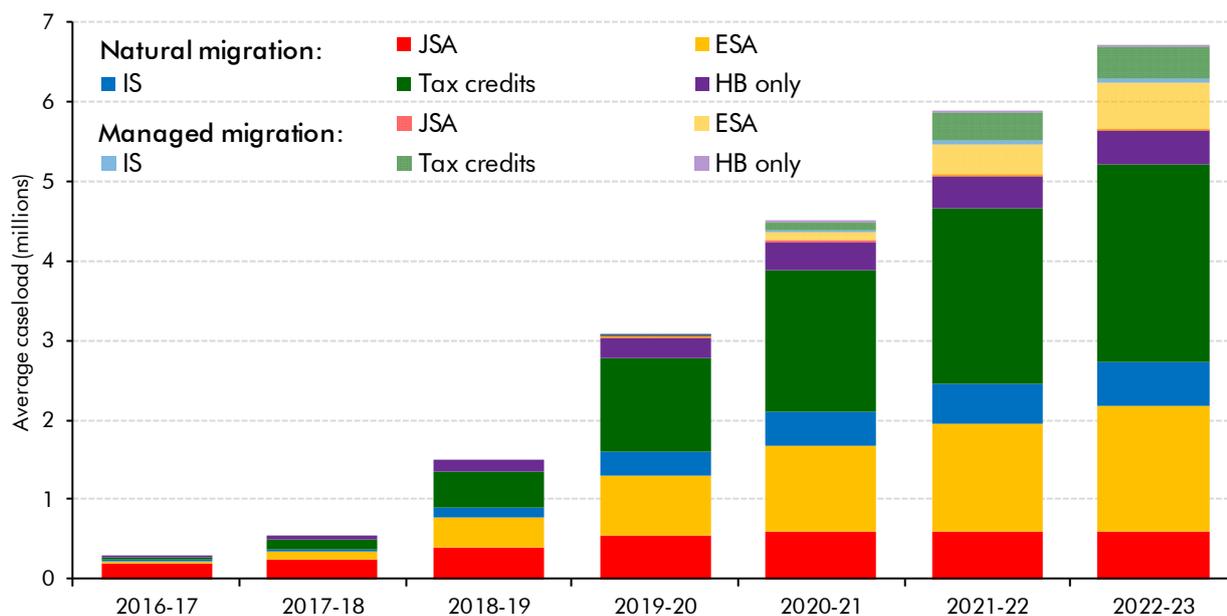
6.10 On the basis of the evidence available to us when we prepared our November 2017 forecast, we assumed that the new claims element of the rollout would proceed according to DWP’s plans, but that the managed migration element would take place six months later than planned. We discuss the risks around the rollout timetable in Chapter 7.

Implications of our rollout assumptions for the UC caseload

The volume of UC cases

6.11 Given the assumptions set out above, and the underlying ‘no-UC’ counterfactual forecasts described in Chapter 2, we expect the UC caseload to reach 6.7 million by 2022-23.² Having risen by an average of 0.3 million a year in 2016-17 and 2017-18, the increase is expected to average 1.2 million a year from 2018-19 to 2022-23, with the largest absolute rise in 2020-21 (1.6 million) and the largest proportionate rise in 2018-19 (when the caseload more than doubles relative to 2017-18). The vast majority of this comes from ‘natural migration’, as cases either flow from legacy benefits to UC due to a change in circumstances or through the natural churn from new claims coming from outside the welfare system and existing cases exiting it altogether. Numbers affected by the managed migration are negligible in 2019-20, but rise to 0.3 million in 2020-21 and 1.1 million by 2022-23, the forecast horizon in our most recent forecast. These are shown at the top of each column in Chart 6.2.

Chart 6.2: UC caseload forecast



Source: DWP, OBR

The proportion of legacy cases that have migrated

6.12 For the calculations underpinning our spending forecast, the proportion of specific legacy groups migrated is key. These are used to convert the ‘full-UC’ counterfactual costs and savings set out in Chapter 5 into a central forecast for the actual path of these effects.

² This excludes around 300,000 cases where UC entitlement is tapered to zero. Including these cases formally on UC means around 7 million cases in the PSM for 2022-23.

Weighted averages of the ‘calibration groups’ described in Chapter 4 are used to derive these forecasts. In Table 6.1 these are shown for the groups discussed in Chapter 5.

Table 6.1: Proportions of legacy caseloads rolled out into UC

Calibration group (hierarchical)	Per cent					
	Forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Newly eligible	4	21	48	74	86	95
Jobseeker's allowance	40	65	87	96	97	98
Employment and support allowance	4	16	34	53	78	97
Income support	6	23	51	74	92	99
WTC and CTC, not self-employed	4	17	42	66	87	99
WTC only, not self-employed	6	21	44	65	85	96
CTC only, not self-employed	3	15	40	66	88	96
WTC and CTC, self-employed	2	12	34	58	83	97
WTC only, self-employed	2	10	23	42	74	96
CTC only, self-employed	2	9	28	52	77	96
Housing benefit only	12	32	60	78	91	99

Our forecast for the net effect of UC on welfare spending

6.13 Table 6.2 sets out our November 2017 forecast for the net effect of UC on welfare spending. It is the equivalent in ‘actual’ terms to the ‘full-UC’ counterfactual costs and savings shown in Table 5.1, with the addition of transitional protection (TP) costs (line C3), which are a feature of the transition only.

6.14 Other than TP, each line is produced by multiplying the disaggregated estimates underpinning Table 5.1 by the relevant percentage of the caseload that has been subject to the UC rollout:

- **for those items modelled in the PSM** – take-up (C1), entitlement changes (C2, S1 and S2), and the minimum income floor (S3) – all groups’ profiles are used;
- **for the abolition of income disregards and run-ons** (C4 and S4) the profiles for tax credits cases are used;
- **for error and fraud** (C5 and S5) the profiles for tax credits and housing benefit only cases are used for in-work elements, the DWP out-of-work benefits profiles are used for the out-of-work elements; and
- **for other factors** (C6 and S6) the most closely matched groups to the effects being estimated are used.

Transitional protection is modelled separately and is described in the next section.

6.15 The results of this modelling are shown in Table 6.2. On this basis, the expected net effect of UC is to reduce spending relative to the legacy system in every year. The net saving rises

The actual effects of universal credit on spending

from £0.1 billion in 2017-18 to £1.0 billion in 2022-23, at which point it is made up of £10.7 billion of gross savings that are largely offset by £9.6 billion of gross costs. Despite 98 per cent of the overall rollout being complete by 2022-23, only 45 per cent of the £2.3 billion 'full-UC' counterfactual saving is expected to be realised in that year. This is primarily because of the £1.3 billion cost of transitional protection.

Table 6.2: Components of our forecast of the marginal savings from UC

	£ billion unless otherwise stated					
	Forecast					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Entitlement						
C1: Gross cost of entitlement differences where take-up rates are expected to rise	0.1	0.5	1.2	1.9	2.5	2.9
C2: Gross cost of higher entitlement where take-up rates are not expected to change	0.2	0.7	1.5	2.4	3.2	3.8
S1: Gross saving from lower entitlement where take-up rates are expected to rise	0.0	0.0	0.0	0.0	0.0	0.0
S2: Gross saving from lower entitlement, including where take-up rates are not expected to change	-0.2	-0.8	-2.2	-3.5	-4.7	-5.5
S3: Gross saving from lower entitlement where take-up rates are expected to fall	0.0	-0.1	-0.2	-0.3	-0.4	-0.4
Transitional protection						
C3: Gross costs from transitional protection	0.0	0.0	0.0	0.3	1.0	1.3
Minimum income floor						
S4: Gross saving from the minimum income floor	0.0	-0.2	-0.4	-0.7	-1.0	-1.2
Abolishing income disregards and run-ons						
C4: Gross cost from abolishing income disregards	0.0	0.1	0.2	0.3	0.4	0.5
S5: Gross saving from abolishing income disregards and run-ons	0.0	-0.2	-0.5	-0.9	-1.2	-1.3
Error and fraud						
C5: Gross cost from higher error and fraud	0.0	0.1	0.2	0.3	0.4	0.5
S6: Gross saving from lower error and fraud	-0.1	-0.3	-0.7	-1.1	-1.6	-1.9
Other factors						
C6: Gross cost from other factors	0.1	0.2	0.4	0.6	0.6	0.7
S7: Gross saving from other factors	-0.1	-0.2	-0.2	-0.2	-0.2	-0.2
Net effect on welfare spending	-0.1	-0.2	-0.6	-0.9	-0.8	-1.0
<i>Memo: Gross cost</i>	0.4	1.6	3.5	5.7	8.2	9.6
<i>Memo: Gross saving</i>	-0.5	-1.8	-4.2	-6.6	-9.0	-10.7
<i>Memo: Net effect on welfare (2017-18 prices)</i>	-0.1	-0.2	-0.6	-0.8	-0.8	-0.9
<i>Memo: Net effect on welfare (per cent of GDP)</i>	0.00	-0.01	-0.03	-0.04	-0.04	-0.04

Estimating the gross cost of transitional protection

6.16 We assume that 1.9 million cases will be moved onto UC between 2019-20 and 2022-23 through the managed migration process. We cannot estimate directly how many of these will receive transitional protection (TP) because their UC award would be lower than their legacy system award. Instead, we estimate the costs of TP indirectly using the process described in Chapter 4. Over the same period, 590,000 TP awards are assumed to come to

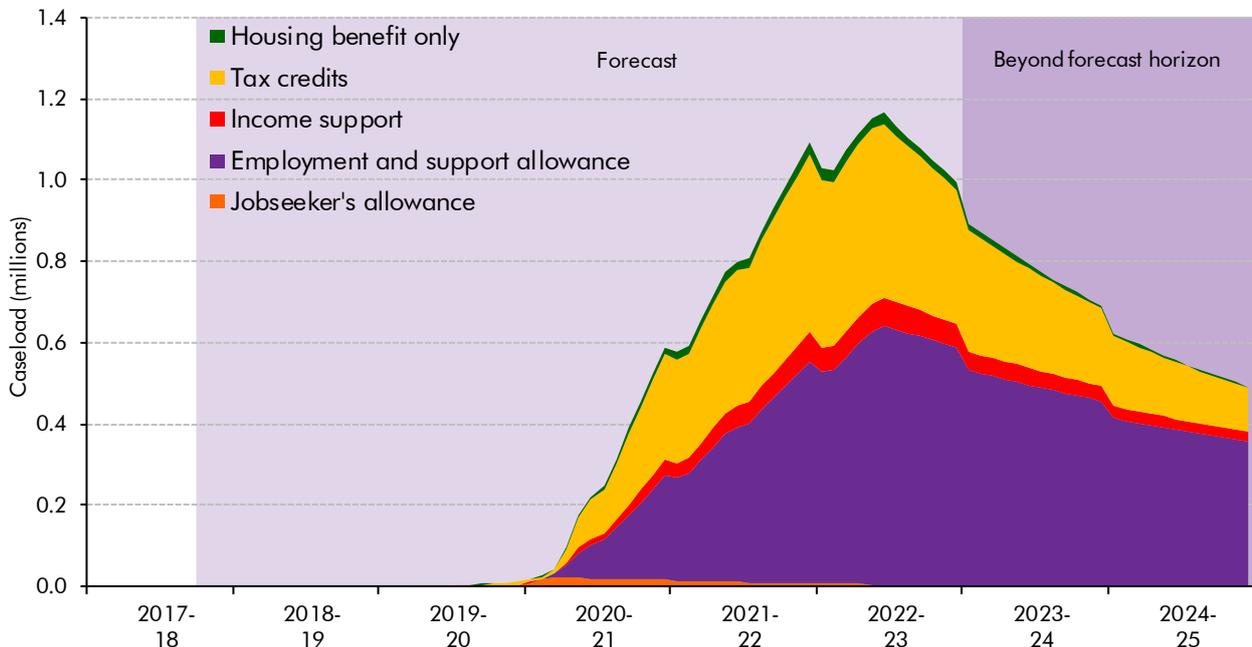
an end as a result of qualifying changes in circumstances while 280,000 are assumed to be eroded to zero due to uprating and other factors.

Table 6.3: Managed migration cases in UC

	Thousands			
	2019-20	2020-21	2021-22	2022-23
Stock at start of period	0	12	590	1,092
Inflow during period	13	657	818	370
Outflow during period	-1	-79	-316	-469
of which:				
Due to change of circumstances	-1	-62	-214	-312
Due to award erosion	0	-17	-102	-157
Stock at end of period	12	590	1,092	993

6.17 Chart 6.3 shows how the stock of managed-migrated cases in UC evolves through to the end of our forecast period and beyond. The peak is close to the end of our five-year forecast period, so the full savings from UC (and full losses to claimants relative to what they would have received under the legacy system) are obscured by the cost of TP even at the end of our forecast. The chart also shows how tax credits and ESA cases (in the hierarchical breakdown) consistently make up around 90 per cent of cases undergoing managed migration.

Chart 6.3: Managed migration cases by legacy benefit



Source: DWP, OBR

6.18 To estimate the cost of TP, the caseload forecast is multiplied by an estimated average cost per case derived from the PSM (as described in Chapter 4). Table 6.4 reports the assumed weighted-average amounts by legacy group, with or without support for housing costs, that are used in these calculations. It shows that the cost is highest for tax credits cases that are not eligible for housing support. As noted in Chapter 4, these are costs per managed

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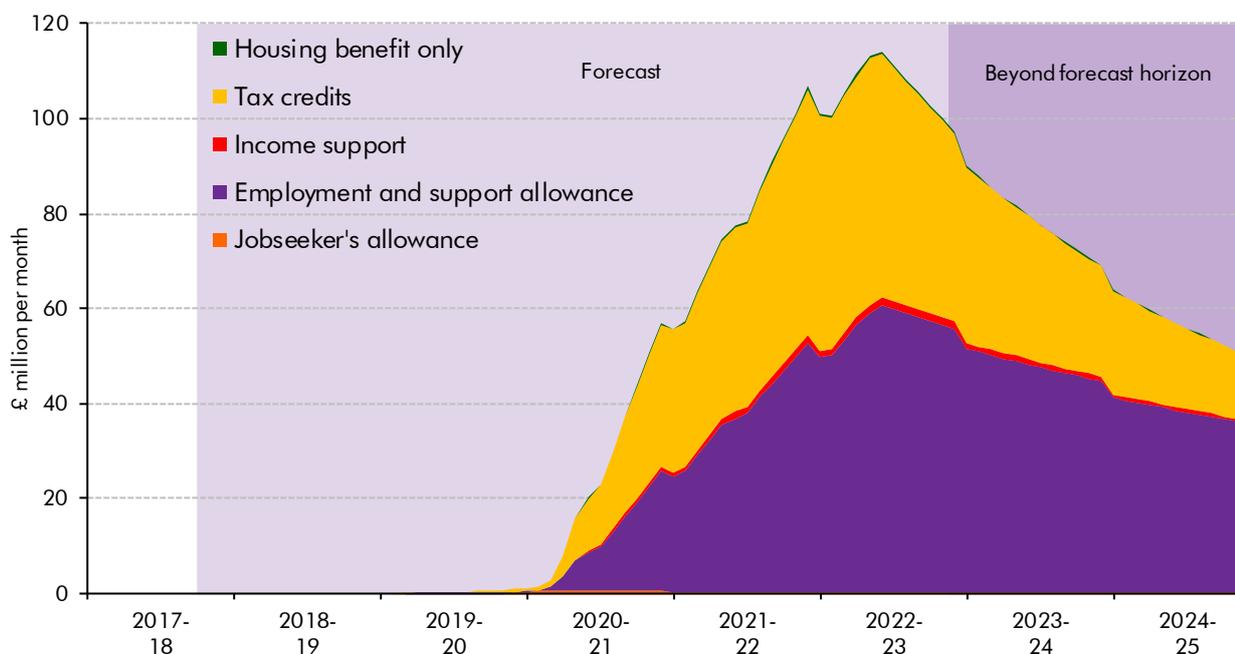
migration case as opposed to average costs of TP for the subset of those cases that will receive TP. This is a modelling simplification that we will seek to refine over time.

Table 6.4: Average transitional protection cost per managed migration case by legacy group

	£ per month							
	With housing benefit				Without housing benefit			
	2019-20	2020-21	2021-22	2022-23	2019-20	2020-21	2021-22	2022-23
Jobseeker's allowance	36	34	25	24	4	4	5	5
Employment and support allowance	120	121	115	112	46	51	53	57
Income support	29	29	28	28	19	17	17	17
Working tax credit only	44	70	72	70	108	137	138	128
Working and child tax credits	35	36	33	34	140	146	150	151
Child tax credit only	11	11	11	11	116	120	119	123
Housing benefit only	31	22	18	18				

6.19 Chart 6.4 shows the total monthly cost of TP broken down by hierarchical legacy benefit group. These costs are dominated by the tax credits and ESA groups. The 45 per cent share of the cost of TP in 2022-23 that is accounted for by those moved from tax credits to UC is higher than the 37 per cent share of the managed migration caseload accounted for by tax credits cases because they face a higher-than-average loss of entitlement and would therefore be expected to receive higher-than-average amounts of TP.

Chart 6.4: Transitional protection cost



Source: DWP, OBR

Breakdown of the costs and savings from UC

6.20 By applying the rollout profile and TP estimates described in this chapter to the breakdowns of the 'full-UC' counterfactual, we can illustrate where and when the gross costs and savings associated with the transition to UC are expected to arise. As Table 6.5 shows, the largest gross costs and savings relate to the tax credits group, reflecting more generous treatment of those working fewer than 16 hours or receiving support for childcare costs but less generous UC work allowances than the equivalent income thresholds in tax credits. There are also substantial gross costs and savings in respect of the ESA group, in part reflecting the change in how additional support for those with disabilities will be provided through UC, which is accounted for as a gross cost from introducing the limited capability for work element in UC and a gross saving from removing various disability premia that exist in the legacy system. The net effect is to lower spending at the cost of claimants in this group.

Table 6.5: Actual costs and savings from transition to UC by legacy group

		£ billion					
		2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Newly eligible	Gains	0.0	0.1	0.3	0.4	0.6	0.7
	Losses	0.0	0.0	0.0	0.0	0.0	0.0
	Net effect	0.0	0.1	0.3	0.4	0.6	0.6
Jobseeker's allowance	Gains	0.1	0.1	0.1	0.2	0.2	0.2
	Losses	0.0	0.0	-0.2	-0.2	-0.2	-0.2
	Net effect	0.0	0.1	0.0	0.0	0.0	0.0
Incapacity benefits	Gains	0.1	0.2	0.5	0.9	1.5	2.0
	Losses	-0.2	-0.5	-1.0	-1.6	-2.3	-2.8
	Net effect	-0.1	-0.3	-0.6	-0.8	-0.7	-0.7
Income support	Gains	0.0	0.1	0.1	0.1	0.2	0.2
	Losses	0.0	-0.1	-0.2	-0.2	-0.2	-0.3
	Net effect	0.0	0.0	-0.1	-0.1	-0.1	-0.1
Tax credits	Gains	0.2	0.8	1.9	3.3	4.8	5.5
	Losses	-0.3	-1.0	-2.5	-4.3	-6.0	-7.0
	Net effect	-0.1	-0.2	-0.6	-0.9	-1.2	-1.5
Housing benefit only	Gains	0.1	0.3	0.6	0.8	1.0	1.1
	Losses	0.0	-0.1	-0.3	-0.3	-0.3	-0.4
	Net effect	0.1	0.2	0.3	0.5	0.6	0.7
Total effect	Gains	0.4	1.6	3.5	5.7	8.2	9.6
	Losses	-0.5	-1.8	-4.2	-6.6	-9.0	-10.7
	Net effect	-0.1	-0.2	-0.6	-0.9	-0.8	-1.0

Legacy and UC spending in gross terms

6.21 While our focus remains on estimating the cost of UC relative to the legacy system, the figures we produce allow us to infer an illustrative path for the levels of spending on UC and the legacy equivalents in each year – as they will be seen in the real world. We present a bottom-up version of this calculation in Chapter 4. Table 6.6 contains a simplified top-down extension of those calculations for the entire forecast period. As this presentation cannot be derived simply from the modelling that underpins the marginal cost approach, we have approached it from different perspectives relating to the cumulative share of the caseload

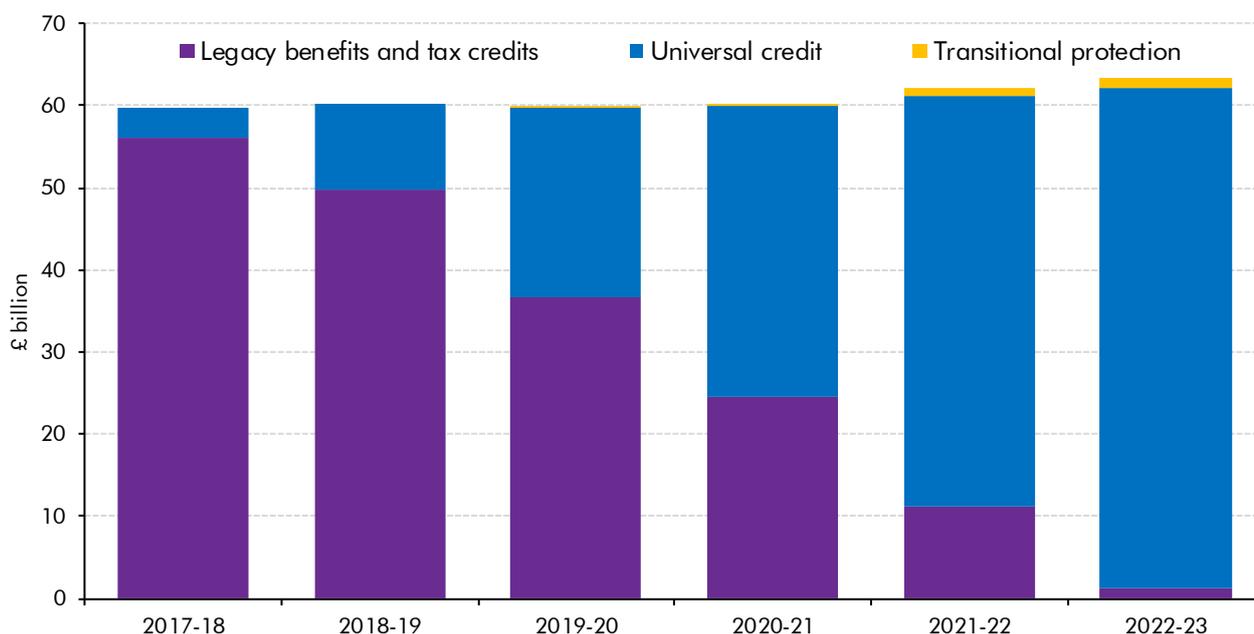
The actual effects of universal credit on spending

that is assumed to have migrated, the cumulative share of the marginal saving that has accrued and the effects of transitional protection. The results of these different approaches have been averaged to generate the illustrative paths in Table 6.6. On this basis, spending on UC would rise from £3.7 billion this year to more than £10 billion next year and is set to reach £50 billion in 2021-22.

Table 6.6: Marginal and actual cost estimates for UC spending

	£ billion					
	2017-18	2018-19	2019-20	2020-21	2021-22	2022-23
Legacy counterfactual plus marginal cost presentation						
Legacy benefits and tax credits	59.9	60.4	60.3	60.8	62.0	63.2
Universal credit	-0.1	-0.2	-0.6	-0.9	-0.8	-1.0
Total	59.8	60.2	59.7	59.9	61.2	62.2
Actual costs presentation						
Legacy benefits and tax credits	56.2	49.7	36.6	24.5	11.2	1.2
Universal credit	3.7	10.5	23.1	35.3	50.0	60.9
of which:						
Transitional protection	0.0	0.0	0.0	0.3	1.0	1.3
Total	59.8	60.2	59.7	59.9	61.2	62.2

Chart 6.5: UC and the legacy benefits: illustrative path of actual costs



Source: DWP, OBR

7 Risks and uncertainties

Introduction

7.1 In all our forecasts we aim to present a central view of the outlook for the public finances, based on stated Government policy and the best available information. Estimating the effect on the public finances of the move to universal credit (UC) involves the use of many models and requires us to make a large number of assumptions and judgements, so our estimates are inevitably subject to a wide range of risks and uncertainties.

7.2 In this chapter, we first consider uncertainties around the ‘full-UC’ counterfactual described in Chapter 5, many of which would be common to forecasts for both UC and the legacy systems. We then consider the additional uncertainties associated with the real-world transition from the legacy system to UC described in Chapter 6. For each we consider:

- **Forecast risks:** in particular the judgements in our economy and fiscal forecasts that determine the size and composition of the eligible population over the forecast period.
- **Static modelling risks:** in particular the reliance on the Family Resources Survey to underpin the key models and the lack of evidence to inform some key judgements.
- **Behavioural risks:** with UC awards and the conditions attached to them differing significantly from the legacy system in some areas, there is considerable uncertainty around the effects that UC will have on claimant behaviour.
- **Policy-related risks:** successive Governments have changed aspects of the UC policy design in recent years, which adds to the complexity of modelling its effects on spending and has sometimes led to delays in the rollout schedule.

7.3 In order to illustrate the likely importance of different sources of risk, we note the amount of steady-state spending that is affected by different assumptions or areas of modelling. Where possible we have also included indicative estimates of the effect of varying key assumptions – known as ‘ready reckoners’. These have to be treated as illustrative as they typically quantify the effect of changing a particular assumption as though it applied equally to all members of the relevant group, each with an average effect. That would not of course be the case in the real world, where household circumstances vary. Running the full UC modelling on different assumptions to generate firmer estimates of these sensitivities would be a very resource-intensive exercise.

The 'full-UC' counterfactual

Underlying forecast-related risks

- 7.4 Eligibility for the many elements of UC is determined by the specific circumstances of millions of individuals and families, so there are many determinants of working-age welfare spending that could evolve in different ways to those assumed in our central forecast. Of particular importance are those relating to the labour market (employment and earnings), the housing market and inflation.
- 7.5 Many risks would affect spending under both the legacy and UC systems, with little consequence for the marginal effect of UC *relative to* the legacy system. But some would affect the cost or saving associated with UC. This section groups forecast-related risks into those that could be considered structural – i.e. with permanent effects – and those that could be considered cyclical – i.e. with temporary effects. In reality this distinction is never clear cut, with the persistence of different effects varying.

Structural factors

- 7.6 Our assumptions about the economy's underlying growth potential are built up from assumptions about the potential path for participation in the labour market (driven by demographics and trends in age-specific activity rates), the sustainable level of unemployment (thereby giving a potential path for the employment rate), average hours worked and growth in output per hour worked. All have implications for spending on UC and the legacy benefits. For example, they determine our medium-term forecasts for employment, unemployment and average earnings. These are important determinants of our 'no-UC' legacy benefits counterfactual and, since UC-related costs and savings vary across groups, our estimate of the marginal effect of UC.
- 7.7 We discussed risks to our potential output assumptions in Chapter 3 of our 2017 *Fiscal risks report*. Key among them was the outlook for trend productivity growth, which has repeatedly disappointed in recent years. Having reviewed the hypotheses put forward to explain this weakness, and whether it was likely to reverse itself soon, we revised down our assumption for annual trend productivity growth by 0.6 percentage points in our November 2017 *Economic and fiscal outlook (EFO)* relative to our previous forecast from March. We now expect it to average 1.0 per cent a year over the next five years. We also revised other components of potential output, no longer assuming that average hours worked will revert to their long-term downward trend over the next five years and lowering our assumption for the sustainable unemployment rate. The net effect was to reduce potential output growth in the economy by 0.4 percentage points a year on average.
- 7.8 The overall fiscal effects of these changes were dominated by weaker tax receipts, due to slower growth in the tax base. But the effects on UC and the legacy benefits illustrates the sensitivity of working-age welfare spending to developments in the labour market:

- **Earnings growth:** we revised down cumulative average earnings growth in the five years to 2021-22 by 3.2 percentage points to 13.4 per cent. In real terms, relative to CPI inflation, the downward revision was 2.9 percentage points, leaving an increase of just 1.8 per cent. The effect of this on our forecast – on the ‘no-UC’ legacy counterfactual plus the marginal effect of UC – was to add £0.7 billion (1.1 per cent) to spending in 2021-22. The largest effects were on the counterfactual forecasts for tax credits and housing benefit, where awards are tapered away with income. This effect is offset slightly by the transition to UC because of the saving associated with the less generous ‘work allowance’ in UC relative to the ‘income threshold’ in tax credits.
- **Employment:** we revised employment in 2017-18 up by 198,000 to 32.1 million, largely reflecting stronger outturns in the year to date. Thereafter the cut in our assumption for the sustainable unemployment rate meant that employment remained higher in every year (by 161,000 in 2021-22) than in March. Employment *growth* from the higher starting point was slightly lower in our November forecast than it was in March. The effects of this were on the counterfactual forecasts for jobseeker’s allowance and associated housing benefit and the out-of-work tax credits caseload. These were offset slightly by in-work caseloads for tax credits and housing benefit. The marginal saving from UC was also fractionally greater, again due to the less generous work allowances.

7.9 Other structural changes in the labour market could also affect our UC forecast. In Chapter 5 of our *Fiscal risks report*, we noted the rise in the proportion of self-employed workers at the bottom of the earnings distribution and the effect that has had on tax receipts. That trend does not appear to have affected the self-employed tax credits caseload, which has been relatively flat in recent years. Our welfare spending forecast assumes that the self-employed caseload will continue its recent trend (and in fact fall in the UC forecast) rather than following our broader assumptions about self-employment. If the caseload were to rise in line with our assumption that self-employment growth will average 1.2 per cent a year in the six years to 2022-23, the counterfactual UC caseload would be 110,000 higher but the estimated saving from the minimum income floor in UC would also be higher.

7.10 The housing market is another area where structural changes pose a risk to our UC forecast. Increased levels of renting and higher proportions of renters in the more expensive private sector have been key drivers of changes in our housing benefit forecast since 2010 as they have increased caseloads and average awards. Housing support in UC would also be sensitive to such changes and to the extent that take-up of housing support is expected to be higher than for housing benefit in the legacy system, spending would be more sensitive to such changes.

7.11 Our counterfactual housing benefit forecast assumes that 33 per cent of the caseload in 2022-23 will be in the private-rented sector – representing 1.5 million cases and £9.2 billion of spending. Average awards in the private-rented sector in 2022-23 are assumed to be 23 per cent higher than in the social-rented sector, so a 1 percentage point shift from social to private renting would, all else equal, add around £50 million to the counterfactual housing benefit bill.

Cyclical factors

7.12 Our latest forecast envisages little cyclical fluctuation in growth and employment over the five-year forecast period, with the economy judged to be operating a little below its potential level in mid-2017 and remaining relatively close to potential thereafter. This means that any cyclical shock – large or small – would represent a surprise relative to our forecast. The main effect of such a shock would be on working-age welfare spending in general rather than on the effect of UC relative to the legacy system.

7.13 The most important cyclical factors that affect spending on UC and the legacy benefits are:

- **Unemployment:** this is, of course, a key driver of many out-of-work caseload forecasts – not just jobseeker’s allowance. While there is some variation over time in the relationship between jobseeker’s allowance caseloads and the Labour Force Survey (LFS) measure of unemployment, they are closely linked.¹ Housing benefit and out-of-work child tax credit caseloads also rise and fall with unemployment, while the working tax credit caseload moves in the opposite direction. Spending on out-of-work cases across the legacy benefits and tax credits in our forecast – on a legacy counterfactual basis – amounts to £13.2 billion in 2022-23, so a 5 per cent rise in the caseload would, all else equal, add £660 million to spending. A 5 per cent increase in LFS unemployment would be equivalent to the unemployment rate being 0.2 percentage points higher than in our central forecast, at 4.8 per cent rather than 4.6 per cent.
- **Earnings and inflation:** spending is sensitive to earnings growth because individual earnings influence entitlement in both UC and the legacy system – higher earnings growth reduces spending. Spending is also sensitive to inflation, because it determines award levels via uprating policy (outside periods such as the currently ongoing cash freeze) – higher inflation increases spending. Since these effects work in opposite directions, spending is sensitive to fluctuations in earnings growth *relative to* inflation – it will be pushed higher if real earnings growth is weak and vice versa. Spending is also sensitive to changes in the distribution of earnings – if earnings growth were to be weaker or employment growth stronger at the bottom of the earnings distribution, the number of individuals and families eligible for in-work support would increase. Spending on in-work cases across the six legacy benefits and tax credits in our central forecast amounts to £39.7 billion, so a 5 per cent rise in the caseload would, all else equal, add £2.0 billion to spending.
- **National Living Wage and National Minimum Wage:** these rates set floors for employee earnings and so are key to modelling entitlement under both systems. For those years where the Low Pay Commission (LPC) has not yet recommended statutory rates to the Government, we assume that the NMW rises in line with our average earnings forecast and that the NLW rises in a straight line until it reaches 60 per cent of median earnings for the over-25s (as required by the remit the Government has set for the LPC). If the NMW and NLW were to rise faster relative to average earnings than

¹ See Box 8.1 of our 2014 *Welfare trends report* for a discussion of how the jobseeker’s allowance caseload has varied relative to LFS unemployment since 2000.

we have assumed, which would be consistent with the earnings distribution evolving more favourably for those on lower earnings, spending would be lower.

- **Rents:** the assumptions we make about rent inflation are key determinants of our forecasts for housing benefit and UC. In terms of our no-UC counterfactual housing benefit forecast, a 1 per cent increase in rents in 2022-23 would increase total spending on housing benefit by £250 million. Given our assumption that take-up of the housing element of UC will be higher than for housing benefit in the legacy system, this would add to the gross cost of shifting to UC.

7.14 Given the way the Government's inflation target works, asking the Bank of England to aim for CPI inflation of 2 per cent, but not to recoup past deviations from target, inflation shocks typically feed through to the price level. As a result, temporarily higher inflation that is not accompanied by higher earnings would permanently raise inflation-linked award levels relative to average earnings. This would happen, to take a recent example, if a fall in the value of the pound raised import costs. If CPI inflation-uprating in 2020-21 (after the cash-freeze has ended) were 1 percentage point higher than our November forecast, but fell back in line with our forecast thereafter, total spending on UC and the legacy equivalents would be £0.4 billion higher from 2020-21 onwards – i.e. a persistent effect rather than a one-off in 2020-21.

7.15 In the event of an economic downturn, the working-age welfare system is a key element of the so-called 'automatic stabilisers' that increase public spending and provide automatic support to household incomes and the wider economy. In the legacy benefits system, jobseeker's allowance (and associated housing benefit) and tax credits have been the main shock absorbers, with caseloads increasing in response to higher unemployment and weak earnings growth.² In the early-1980s and early-1990s recessions, before the current tax credits system was in place, it was unemployment benefit that played the largest role (with incapacity benefits affected too). During the late-2000s recession, the burden shifted to tax credits as earnings growth and working hours fell while unemployment increased much less than in the preceding recessions. The tax credits system may have facilitated this different pattern of labour market adjustment to the economic downturn.

7.16 It is not clear how different the response of spending to a similar shock would be under the UC system. There are some features that would be likely to increase the amount spent during a downturn – e.g. the greater automaticity in entitlement to all elements of UC when a claim is made, whereas those engaging with the legacy system during a downturn may only engage with parts of it, and may stop claiming earlier than they would under UC. But other features could have the opposite effect – e.g. UC is less generous to the unemployed than the legacy system and introduces capital limits to former tax credits claimants. UC also involves greater use of work coaches and conditionality, which could act as a deterrent to some potential claimants and could affect the time spent out of work by those who do claim.

² See Box 4.1 of our 2014 *Welfare trends report* for a discussion of the cyclicity of spending on different benefits and tax credits.

Risks from the static modelling

7.17 In this section we consider the risks around the static modelling, which at present accounts for the majority of the estimated effects of UC relative to the legacy system. To a large extent this rests on whether the available survey data and the assumptions we need to make to fill the gaps provide a reasonable representation of the real world. Calculating different eligible amounts under the two systems for an individual of given circumstances is a matter of arithmetic, but estimating how many individuals will exhibit those circumstances in a given state of the economy – i.e. ignoring the forecast risks already discussed – is not.

Is the modelling representative of the true UC-eligible population?

7.18 UC entitlement is more sensitive to claimants' circumstances than entitlement to the legacy benefits. Entitlement can vary greatly across benefit units, even among cases that are similar across many characteristics. This means that large sample sizes are required to ensure that inferences from sample data will be sufficiently representative of the true eligible population.

7.19 The Family Resources Survey (FRS) sample that underpins the UC modelling is relatively large (around 4,300 observations from the more than 19,000 households in the full FRS sample), but sample sizes for some relevant groups are small. For example, elements of the minimum income floor modelling, which affects low-income self-employed individuals in different ways according to age and family circumstances, rely on single-figure samples. It is much less likely that small samples will represent the true population accurately, which creates greater uncertainty around estimated UC effects in these areas. It also means that they can vary considerably when the FRS is updated. The main way that this risk is managed is by calibrating spending to the legacy forecasts, but these too are subject to uncertainty.

7.20 As described in Box 4.1 in Chapter 4, there are other limitations to the FRS that create uncertainty for modelling based on it. As a self-reported survey, it relies on claimants (and interviewers) providing accurate responses. Comparison with other sources suggests that this is not always the case, with the apparent variation from reality greater in some areas than others. The FRS is also published with a lag of two to three years after collection and incorporating new results into models takes time. The survey is not therefore able to capture recent developments in the economy or policy.

The minimum income floor

7.21 The minimum income floor (MIF) is the third largest source of gross savings from UC, with savings forecast to reach £1.2 billion by 2022-23. Unfortunately, the FRS sample is not large enough to provide robust samples at the highly disaggregated level necessary to model the static impact on self-employed claimants. The 2015-16 sample includes 365 data points relating to the self-employed, of which 250 relate to cases that would see their UC award reduced by the MIF. But because the MIF itself varies for different age groups (because of different National Minimum Wage (NMW) and National Living Wage (NLW) rates) and different family circumstances (for single people and couples, and whether they have children and the youngest age of the child), there are many possible MIFs that could

be applied. The FRS sample for some of these can be very small, with no observations at all for some potential family circumstances.

- 7.22 On top of these sample-size uncertainties, the measurement of self-employed incomes in general is subject to a number of challenges.³ For individuals and families responding to the FRS, self-reporting will be more challenging if their net incomes follow an irregular pattern due to fluctuations in gross earnings and the business costs they incur, including any tax due. These factors are likely to affect many self-employed businesses. As well as being a source of greater variance in net income over time, this means that the distribution of self-employed incomes – a key determinant of how many people will be affected by the MIF – is highly uncertain. Differing definitions of self-employment in the benefits and tax systems point to further risks in terms of numbers potentially affected.
- 7.23 Our modelling of the MIF itself is a simplification relative to its real-world application. The UC policy design allows work coaches to vary the MIF applied to different claimants according to their circumstances. For the forecast, we assume the MIF is set at the maximum level for the various different single and couple family types given the difficulty in modelling a distribution of mandated earnings using the FRS sample data. To the extent that work coaches set reduced MIFs for some claimants, this represents an upside risk to spending – i.e. the saving from the MIF would be smaller. DWP's early analysis of administrative data suggests that the scale of this risk is likely to be small. We consider it a second-order issue relative to the other uncertainties in the MIF modelling. These include uncertainties around the behavioural response of claimants to potentially large monetary losses from the application of the MIF, none of which are currently factored into the forecast. The net effect of the various possible responses could be positive or negative for spending on UC.

The effect of capital limits

- 7.24 Millions of claimants – mainly those who would receive tax credits but no DWP benefits in the legacy system – will be subject to capital reporting for the first time under UC in 2022-23. Few of them are expected to have sufficient savings for the capital limits to apply, so this is expected to save around £250 million in that year – a small but highly uncertain saving.
- 7.25 There is uncertainty around the adjustments we make for the under-reporting of capital in the FRS, which can only be approximate. For example, it may not be appropriate to apply a scaling factor derived from out-of-work households to the full tax credits caseload, around 70 per cent of whom are in work. It would, however, require a large error in that adjustment to have a significant effect on the saving from this element of UC.
- 7.26 The withdrawal of the UC award pound-for-pound against the assumed drawdown of savings will reduce the incentive to save among those who would have been, or might have expected to be, tax credits claimants in the legacy system. But any reduction in saving behaviour by this group would need to be very large to have a material effect on UC spending or on the wider public finances given their relatively low initial levels of saving.

³ For example, see *Why is measuring self-employed income so hard?*, Jonathan Athow, ONS, 14 August 2017.

Risks from behavioural responses

7.27 Several potentially important behavioural responses could pose risks to our estimates of the effect of UC – some relative to assumptions that we have made and some because we have not yet made any assumptions pending greater clarity about policy design or implementation or firmer evidence on the possible effects. This is particularly true of the various forms of conditionality in UC, which the Government expects to improve labour market outcomes but where to date we have not adjusted our forecasts.

Take-up rates

7.28 On a like-for-like basis, across all the elements being combined in UC, we expect a greater proportion of the eligible population to take up UC than under the legacy system. It is not possible to decompose the effects of take-up assumptions from entitlement changes, as they are modelled together and to split them would be too resource intensive, but it is clear that they are a significant source of the gross costs associated with moving to UC.

7.29 As described in Chapter 5, most of this is not a behavioural response – rather it is the mechanical result of greater automaticity in taking up all elements of UC. We introduced more refined take-up assumptions in our latest forecast in order to capture deterrent effects – for example, not wishing to submit to conditionality rules – that are likely to reduce take-up for those entitled to relatively small awards. Further refinements are likely as more outturn data become available and actual take-up rates can be estimated.

7.30 One set of take-up uncertainties lies around the assumptions we have made about the various categories of individuals and families, split according to their eligibility and take-up characteristics under the legacy system:

- **Full legacy claimers:** For UC awards greater than £4,000 a year, we assume that 100 per cent of those currently claiming all their entitlement in the legacy system will take up UC. In practice, this means the same take-up rates under the legacy and UC systems for these cases rather than full take-up. For every 1 percentage point rise or fall in take-up spread evenly across this group, the steady-state effect of UC on spending in 2022-23 would rise or fall by around £20 million. As with the overall net effect of UC itself, this relatively small net effect masks larger gross costs associated with those who gain from the shift to UC and gross savings associated with those who lose.
- **Partial legacy claimers:** For UC awards greater than £4,000 a year, we assume full take-up across all elements of UC for those currently only partly claiming their legacy benefits entitlement. For smaller awards, we assume lower take-up rates. For every 1 percentage point rise or fall in take-up spread evenly across this group, the steady-state effect of UC on spending in 2022-23 would rise or fall by around £30 million.
- **Legacy non-claimers:** We have assumed that employees increase take-up from zero to 20 per cent and the self-employed from zero to 10 per cent, but no rise among the

unemployed. A further 10 percentage point rise in take-up among this group would add around £30 million to steady-state gross costs from UC in 2022-23.

- **Newly entitled claimants:** For those entitled to UC with no entitlement under the legacy system we have assumed take-up rates in line with historical averages in relevant parts of the legacy system, varying by employment status, rent payments, and receipt of contributory ESA. For every 1 percentage point rise or fall in take-up spread evenly across all claim types within this group, the steady-state effect of UC on spending in 2022-23 would rise or fall by just £5 million.

7.31 A second set of take-up uncertainties relates to groups for which we have not tried to model specific responses at this stage, although our top-down adjustments to reflect lower take-up for those eligible to smaller awards may capture some of these effects. They include:

- **In-work claimants:** UC will introduce greater conditionality to in-work claimants, although the Government is yet to finalise its precise design. Some may decide to end their claims rather than subject themselves to these conditions.
- **Self-employed claimants:** UC's combination of the gainful self-employment test, the MIF, and the requirement for monthly reporting of profits are all new. So is the role of work coaches in setting requirements to increase profits and/or seek alternative employment. Under current plans, 0.6 million self-employed claimants will be newly subject to the self-employed requirements by 2022-23. The average annual UC award among this group is estimated at around £5,600 in 2022-23, so if 5 per cent of these cases chose not to take up UC it would generate a steady-state UC saving of around £180 million in that year.

7.32 Social attitudes may also play a role in suppressing take-up. Claimants often associate 'rightful' claims with claimants' work ethic or working status.⁴ Introducing procedures – such as signing-on – that are culturally associated with out-of-work benefits may result in lower levels of take-up among in-work claimants, who often consider themselves in a more socially acceptable position given their work status – particularly at lower awards. This may be true particularly for those eligible for working tax credit who do not currently claim DWP-administered benefits and therefore have not experienced its existing conditionality regimes.

The effectiveness of conditionality on those who are out of work

7.33 UC aims to improve incentives for the out of work to move into work. The channels include conditionality, coaching and the lowering of 'participation tax rates' (as described in Chapter 5). We have not made any adjustments to our labour market forecasts for such effects since some policy detail is yet to be finalised and, more importantly, it is unclear whether the goals of the policy will be achievable when delivered at the whole economy level. If UC does encourage more claimants into work – and this does not simply displace other employment activity – it would imply greater savings from the switch to UC and also wider fiscal benefits through higher tax receipts.

⁴ *Making a claim: Entitlement to working age social security money from the perspectives of recipients* (Summers, 2017), presented at the Foundation for International Studies on Social Security Research conference, June 2017.

Risks and uncertainties

- 7.34 The scale of this risk in terms of our UC forecast would depend crucially on whether any reduction in the out-of-work caseload was assumed to lead to a reduction in the total UC caseload or a shift into the in-work UC caseload (i.e. assuming that the additional employment was relatively low paid). In reality we might expect some of both to happen.
- 7.35 Any broader implications for our labour market and productivity forecasts would have larger fiscal effects. Such labour supply effects would reduce the sustainable rate of unemployment and so raise potential output. The extent to which output increased would also depend on how productive out-of-work claimants were upon moving into employment, which in turn depends on factors such as skill levels and broader labour market conditions.
- 7.36 To the extent that the average productivity of those moving into work was lower than the average across the whole economy (as would seem plausible), the boost to output would be proportionately less than the boost to employment and average productivity would be lower. By way of illustration, if employment were 100,000 higher in 2022 and average productivity were unchanged, GDP would be 0.3 per cent higher. But if the average productivity of those 100,000 extra workers were proxied by working 35 hours a week at the National Living Wage, the boost to GDP would be around half as much.⁵

The effectiveness of conditionality on employees

- 7.37 The hours requirements for working tax credits – and the boost to awards at 16 and 30 hours a week in particular – encourage claimants to work (or report that they work) specific numbers of hours defined by the system. Employers are also likely to have been influenced by these features when structuring the weekly hours that they offer, in the knowledge that it maximises the take-home earnings of their employees for a given cost to them.
- 7.38 One intention of the UC design is to remove this ‘bunching’ by focusing on earnings rather than hours worked. This design feature has been somewhat reversed by the introduction of new thresholds for eligibility for some passported benefits – for example, free school meals. Even so, the removal of the main hours rules could result in some claimants choosing to work fewer hours than under the legacy system while others could choose to work more. The net effect on total hours worked – i.e. on labour supply and potential output – would depend on which effect dominated.
- 7.39 UC is designed to increase work participation through use of conditionality for those in work, supported by reduced complexity and lower effective marginal tax rates. If this were to lead those affected to work more hours – and did not simply displace the hours worked by others – it would (as with out-of-work conditionality) imply greater savings from the switch to UC. It would also have wider fiscal benefits through higher potential output – along similar channels to those outlined in paragraph 7.33 – and therefore higher tax receipts.

⁵ This illustrative calculation implicitly assumes that the NLW rate would be a reasonable proxy for productivity, but it is likely that since the NLW is set above where the market would be expected to set hourly pay that it is somewhat higher than the relevant individuals’ productivity. It is this logic that drives our assumption that the NLW will raise unemployment modestly over time.

- 7.40 In principle, conditionality increases the variability of in-work claimants' awards as their entitlement is to some extent at the discretion of the work coach through the use of sanctions according to criteria that evolve over time. The application of conditionality to employees means that, in principle, a claimant could experience no material change in their underlying circumstances but still see their UC award change. This increases uncertainty around the impact of conditionality on the spending forecast. The effectiveness of work coaches' interventions in raising hours worked and earnings in a way that is additional rather than simply displacing the work of others is a key source of uncertainty around any wider labour supply effects. The ability of work coaches to deliver such a step-change in active labour market policy outcomes is yet to be demonstrated at the whole economy level.

The effectiveness of conditionality on the self-employed

- 7.41 Conditionality is applied to the self-employed in two stages. Work coaches must first assess whether a claimant is 'gainfully self-employed'. Where a claimant is deemed not to meet this standard, they are then classified as unemployed for the purposes of UC and pass into the unemployed conditionality group. In our central forecast, average awards for unemployed UC claimants are higher than for self-employed UC claimants, so the proportion of prospective self-employed cases deemed gainfully self-employed represents one source of forecast uncertainty. Those deemed gainfully self-employed are then assessed as to whether they should be subject to the minimum income floor (risks to which are discussed next) and may also receive coaching that attempts to ensure that they reach target levels of profits determined by the work coach.
- 7.42 In assessing whether a claimant is gainfully self-employed, work coaches have even more discretion than in setting conditions for employees. At present this judgement is based on broad guidelines, but is not subject to standard criteria. The target profit levels are also, in principle, at the discretion of work coaches rather than centralised criteria. This makes conditionality a source of considerable uncertainty in our forecast. As with employee conditionality, it also gives work coaches greater discretion over claimants' awards.

Responses to the minimum income floor

- 7.43 As noted above, the FRS sample is not rich enough to provide a robust basis for even the static modelling of the minimum income floor (MIF). What that modelling implies is that for some individuals and families, the MIF will reduce their UC award by very large amounts. The estimated MIF saving assumes that all claimants with lower entitlement due to the MIF accept the loss of income. But this is largely due to a lack of evidence with which to estimate the effect on spending of the various possible behavioural responses, rather than a confident expectation that there will be no behavioural responses.
- 7.44 Claimants could respond to the MIF-related loss of income in ways that increase spending on UC (e.g. if self-employed people became unemployed or moved into low-paid employee jobs where the MIF does not apply) or ways that reduce spending on UC (e.g. if they were able to raise their self-employed earnings or chose not to engage with the welfare system at all). This is not an exhaustive list of possible responses, but it illustrates their range and the fact that they could affect UC spending in both directions.

- 7.45 The estimated gross saving from the MIF rises to £1.2 billion in 2021-22, slightly more than the overall net saving from UC of £1.0 billion in that year. If the gross saving from the MIF were half as big as currently estimated, the net effect of UC relative to the legacy system would be to raise welfare spending rather than reduce it. We will continue to work with DWP to refine these estimates and to learn what we can from outturn data. But estimates are likely to change significantly from forecast to forecast.

Differences in error and fraud rates relative to the legacy system

- 7.46 Error and fraud are driven by the behaviour of claimants. However, for this report, we have treated our fraud and error modelling to date as static because it has simply involved mapping known fraud and errors rates from the legacy system onto groups within the UC caseload. Where the design of UC reduces the scope for error or opportunity for fraud, assumed rates are reduced accordingly. Where it creates new scope, assumed rates have been selected from legacy areas that most closely resemble them. In that sense, our error and fraud modelling does not assume any behavioural response to UC. The mapping and the various assumptions are clearly subject to uncertainty.
- 7.47 A number of factors influence fraud and error in the welfare system. The size of awards determines the potential gain from fraud and the range of penalties and perceived likelihood of getting caught determine the extent to which this gain looks likely to be realised. The complexity of the system – both understanding eligibility and making a claim – is a key driver of error, and also provides opportunities for fraudulent activity.
- 7.48 The extent to which fraud and error rates will differ between the legacy and UC systems is not clear. The large UC awards and material changes to entitlement rules could increase fraud and error. Against that, many features of UC are designed to reduce the channels through which fraud and error can take place. While underlying fraud and error rates could differ across the systems, the specific features designed to reduce error and fraud look a greater source of uncertainty. The largest of these relates to the use of real-time information (RTI), which is expected to deliver a £0.7 billion net reduction in the cost of fraud and error in 2022-23. This is predicated on the IT systems underpinning RTI (operated by HMRC) and UC (operated by DWP) working together effectively. As with any IT-based approach to resolving public finance issues, experience suggests that the benefits may be lower than expected or take longer than expected to accrue as unanticipated delivery problems are addressed. There is also uncertainty about the extent of earnings-related fraud and error to be tackled by RTI and its effectiveness in doing so.
- 7.49 Our spending forecast is also influenced by the number of fraud and error cases that are processed and the extent to which the associated over-payments are recovered. This depends on staff numbers and their productivity, which in turn is affected by the complexity of cases, the effectiveness of the IT they work with and so on. These are subject to uncertainty in both our legacy and UC forecasts, with the potential for problems such as those seen recently with the outsourcing of tax credits recovery under the ‘error and fraud additional capacity’ measure (described in Annex A of our November 2016 EFO) and

longer ago when online tax credits claims were rolled out between 2004 and 2006 before being withdrawn (described in Chapter 2).

- 7.50 There are several potential behavioural changes for which we have made no specific forecast adjustments, but that could ultimately affect UC spending. Among them:
- **Online servicing:** allowing claimants to view their accounts and report changes of circumstances online could encourage more claimants to report such changes more promptly, leading to fewer incorrect payments that need to be recovered through debt collection processes. This would only be of benefit to those with ready access to and familiarity with online procedures. But to the extent that face-to-face prompting to declare changes of circumstances is a driver for some, the effect could be negative. And online servicing also opens the system to the risk of fraudulent cyber-attacks and reduced verification of claimants' information.
 - **System-learning and legal challenges:** new systems that include discretionary application of rules can be subject to both system-learning – e.g. websites advising how best to navigate the system to maximum gain for claimants – and legal challenge – e.g. recent challenges to the interpretation of guidance on personal independence payment assessments. UC includes work capability assessments in respect of the incapacity benefits element, while work coaches are set to have considerable discretion in a number of areas. It remains to be seen whether this will generate system-learning and legal challenges that ultimately lead to higher spending.

Policy-related risks

- 7.51 Parliament requires us to forecast on the basis of current Government policy. So possible future policy changes will always be a source of risk to our forecasts. UC policy has been changed frequently since it was originally conceived, with different aspects becoming more or less generous – both in absolute terms and relative to the legacy system. It is highly likely that Governments will continue to change the policy design as it is rolled out. This could be to address unforeseen consequences, in response to pressure from individuals and families set to lose, or simply because of changing preferences over what the Government wishes the working-age welfare system to do.
- 7.52 In terms of policy changes that result from political pressure to reduce the losses for those that would be adversely affected by a policy change, there are a number of recent examples: cuts to tax credits that were announced in July 2015 and reversed before implementation in November 2015; cuts to disability benefits announced in March 2016 but dropped soon after; and the increases to National Insurance contributions paid by the self-employed that were announced in March 2017 but also dropped soon after.
- 7.53 In terms of UC itself, the Government announced modest changes in Autumn Budget 2017 that alleviated some of the concerns that had been raised in Parliament in recent months.

- 7.54 It is not for us to predict future policy changes, but this report underlines the fact that the relatively small net effect of UC relative to the legacy system is made up of some large gross costs and savings – and that for some individuals and families UC is much less generous than the legacy system, notably for the low-income self-employed due to the minimum income floor. The UC ‘work allowances’ are also less generous than the tax credits ‘income threshold’, because they are in effect aligned to tax credit threshold cuts that were announced in July 2015 rather than the thresholds that actually exist after those cuts were reversed. The November 2015 costing of this measure assumed that the UC element would ultimately save £3.0 billion. These effects build up slowly, partly because of transitional protection, rather than happening overnight to all claimants, as would have been the case with the reversed tax credit cuts.
- 7.55 As well as these entitlement-related policy risks, work coaches in UC have considerably more discretion in the conditions they can impose on both in-work and out-of-work claimants and in the sanctions that they can impose for failure to meet those conditions than exists in the legacy system. Delivering the underpinning IT systems is also challenging, due to the scale of UC and the need to rewrite elements of the IT when entitlement policy settings change. The volume of policy changes after the 2015 General Election contributed to DWP’s decision to delay the rollout of UC again in 2016, while the more modest Autumn Budget changes led to another three-month delay in the rollout.
- 7.56 Frequent policy changes also generate modelling and forecasting complexity, with some initially estimated outside the main policy simulation model. Interactions between different forecast and costing models also become more important – and difficult to manage. These factors have led to frequent forecast revisions as the underlying models catch up with the latest policy and the modelling of interactions is refined.

Wider effects on the public finances

- 7.57 Our forecasts do not make specific adjustments for the potential knock-on effects from the shift to UC for other parts of the public finances. For example, local authorities are likely to face additional costs as social sector landlords experience higher rent arrears under UC than under housing benefit and as they have to fund more budgeting advice and access to social funds and hardship payments. In our forecasts, these potential costs to local authorities are wrapped up in broader top-down judgements about pressures on their budgets – e.g. from adult and children’s social care responsibilities – and what that means for their decisions to draw down reserves to meet existing spending commitments.

The ‘real world’ transition from legacy to UC systems

Underlying forecast-related risks

- 7.58 Even in the absence of UC, our forecasts for the legacy benefits and tax credits would be subject to significant uncertainty. As described in Chapter 2, the largest absolute sources of forecast errors in recent years have been incapacity benefits (to the upside) and housing benefit (in both directions), while the largest percentage errors have been for jobseeker’s

allowance (to the downside, as unemployment has fallen more sharply than expected since 2013). More recently – and particularly over the past 18 months – tax credits spending has surprised us significantly on the downside. It is not clear to what extent factors relating to UC might have contributed to these surprises.

- 7.59 As the UC caseload builds, further uncertainty arises because the administrative data across the legacy and UC systems permit only broad-brush assessments of the marginal effects of moving from one system to the other. They cannot be mapped onto the forecast easily. This makes it difficult to determine whether the inevitable differences between forecast and outturn are related to underlying movements in the eligible population or estimates of the effect of UC on spending for a given eligible population.
- 7.60 Some sources of surprise relative to our forecasts will always have offsetting effects, at least in part, because they affect both gross costs and gross savings driven by the size of the UC caseload. But others need not be offsetting, which could lead to large revisions to total welfare spending in future forecasts as we learn more about how the real-world rollout of UC matches the huge number of assumptions necessary to produce the forecast. This includes potential behavioural effects in the labour market, described above.
- 7.61 In our November 2017 *EFO* we highlighted a number of issues in the underlying modelling that had caused concern when preparing the forecast and that we are working with DWP to address. These included the complexity of the modelling and the time that it takes to process. We will need to be able to revise forecast judgements in light of emerging evidence as UC is rolled out, and its rising share in actual spending will only make this more important over time. At present, neither the in-year administrative data nor the forecasting infrastructure allow us to do this efficiently. For such a large programme, that creates serious risks to our overall public spending forecast.

Risks from the static modelling

Estimating the cost of transitional protection

- 7.62 Transitional protection is expected to cost £1.3 billion in 2022-23. Alongside the MIF, this is potentially one of the most uncertain aspects of the UC forecast as it is contingent on various other factors that are themselves subject to a range of risks. Among them are:
- **The rollout schedule:** transitional protection is only paid to claimants that would otherwise lose out as a result of being migrated to UC at DWP's discretion ('managed migration'). These risks are therefore largely down to policy and operational decisions.
 - **The rate at which claimants experience qualifying changes of circumstances:** transitional protection is reduced or ceases altogether when certain events occur – such as a change of work status or the number of people in a household. There is considerable uncertainty around the proportion of the relevant caseload that will experience such an event each period following the award of transitional protection.

Risks and uncertainties

- **Modelling issues:** it has not yet been possible to model precisely the transitional protection calculations, because some elements of the UC modelling are being estimated outside the main policy simulation model. This could result in the average amounts of transitional protection being under- or overestimated for some cases.

7.63 Delays to the UC rollout schedule increase the likelihood that claimants migrate ‘naturally’ to UC (therefore without transitional protection) when otherwise they would have been moved on by DWP (with transitional protection). This makes forecast expenditure on transitional protection sensitive to the UC rollout assumption. The precise sensitivity depends on the composition of such a rollout delay – if it were focused among those expected to lose most from the shift to UC (e.g. working tax credits claimants with earnings that exceed the UC work allowance but not the tax credits income threshold), then transitional protection costs could even be higher as a result of a slower rollout schedule.

Risks from behavioural responses

7.64 As Chapter 3 describes, certain changes in claimants’ circumstances will trigger an end to transitional protection. So claimants might alter their behaviour to avoid the loss of income that would follow such a change. For example, some UC claimants migrated from the legacy system may be discouraged from taking up short-term employment because they would know that when that period of work came to an end their benefit entitlement would be lower as their transitional protection would cease.⁶ It could also encourage claimants to delay reporting changes in circumstances – for example, a partner joining the household. More generally, claimants might be deterred from reporting changes that could cause them to move to UC – either to retain their legacy entitlement or in the hope of getting into the transitional protection regime by being subject to managed rather than natural migration. For the low-income self-employed, there would be a considerable benefit to remaining within the tax credits regime rather than moving to UC and being subject to the MIF.

Policy-related risks

The planned pace of the rollout

7.65 The key policy decision relevant to the transition-period modelling is the pace at which UC will be rolled out across the country. The latest profile and changes to it over time are described in Chapter 6 (for example, see Chart 6.1). Our forecast assumes that natural migration will occur in line with DWP’s plans and that managed migration will be completed six months later than DWP’s plans. Past delays to the rollout have reflected various factors, with those in the past couple of years largely the knock-on consequence of other policy changes that require delivery systems to be reviewed and changed. There is clearly a risk that this could be repeated in the future.

⁶ Keen, Kennedy and Apostolova, *Universal Credit changes from April 2016*, House of Commons Briefing Paper, November 2016.

Wider delivery risks

- 7.66 The rollout schedule and the various possible effects of UC on spending and the labour market – both those currently factored into our forecast and those that are not – need to be viewed in the context of DWP’s resources and other calls on them. Between 2011-12 and 2019-20, the Government plans to cut DWP’s DEL budget by around a third in real terms (excluding the effect of transferring the cost of council tax benefit to local authorities).
- 7.67 While UC is the largest spending reform that DWP has to deliver within this falling budget, it is far from the only one. For example: the full transition from disability living allowance to personal independence payment is not due to be completed until 2019-20; the new single-tier state pension will only cover around a quarter of the total state pension caseload by 2022-23; auto-enrolment policy changes are expected to continue well into the next decade; and limiting eligibility for various benefits, including UC, to the first two children in families has only started to take effect this year.

Conclusions

- 7.68 The discussion in this chapter illustrates how each step in estimating the effect of UC on working-age welfare spending is subject to a variety of real-world and modelling risks and uncertainties:
- **Forecast risks:** these include both the underlying uncertainty about how the eligible population will evolve (due to changes in the labour market, housing market and other factors), but also our ability to model the eligible population using FRS data and calibrating to legacy forecasts. These risks are exacerbated because the available in-year administrative data only allow broad-brush analysis of forecast errors.
 - **Static modelling:** calculating entitlements under UC and the legacy systems may only be a matter of arithmetic, but some elements are challenging because the FRS and other sources provide only limited information about the affected population. The minimum income floor and transitional protection – each responsible for around £1 billion of spending by 2022-23, in opposite directions – are particularly uncertain.
 - **Behavioural responses:** we have factored relatively few potential behavioural responses into our forecasts to date, mostly with respect to take-up rates. Introducing conditionality to far larger numbers of claimants than in the legacy system creates the potential for claimants’ behaviour to change, perhaps materially. Similarly, large potential financial losses for particular groups – notably low-income self-employed individuals and families – are likely to prompt a variety of responses. Take-up rates and rates of fraud and error are also sources of uncertainty.
 - **Policy risks:** if recent years are any guide, our current UC estimates and the pace at which UC is rolled out are subject to significant risk from future policy changes. The context in which UC is being delivered, with DWP’s departmental budget being cut

progressively and several major policy reforms ongoing, could present further risks to the delivery timetable beyond the six-month margin already factored into our forecast.

- 7.69 The prospect of future forecast revisions – potentially significant ones – is something that we have stressed in recent *EFOs* and that is worth repeating. In previous *Welfare trends reports* we have reviewed various significant spending surprises that followed major reforms – to unemployment benefits, incapacity benefits, disability benefits and tax credits. None of these reforms were as large as the introduction of UC.

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