Forecast Evaluation Report / Welfare Trends Report 2014 Briefing

Robert Chote, Chairman, Office for Budget Responsibility

Good morning everyone.

My name is Robert Chote, Chairman of the OBR. And I would like to welcome you to this briefing on our fourth annual Forecast Evaluation Report and our first annual Welfare Trends Report.

The first is a look back at the performance of our economic and fiscal forecasts, in the light of the latest outturn data from the Office for National Statistics. The second is an analysis of trends in social security and tax credit spending over the past 30 years, plus a detailed look at our latest forecasts and the risks around them and the Government's welfare cap.

The two publications stretch to the best part of 300 pages between them, so my talk today will necessarily offer very heavily edited highlights. I will start with the FER and then turn to the WTR. The slides and my remarks will be available on our website.

[SLIDE] As you know, we produce two medium-term forecasts for the economy and public finances each year, at the time of the Budget and Autumn Statement. We take great pains to emphasise the uncertainty that lies around all such forecasts and quantify it as best we can. Reflecting that uncertainty, and the consequent likelihood of forecast errors, the purpose of the FER is to compare our past forecasts to the latest data from the ONS and explain the differences as best we can. This year we focus on our first forecast in June 2010 and the forecast we made in March 2013, just before the economy picked up speed.

[SLIDE] This year's report deals with two main issues:

First, up until early 2013, the real economy grew much less strongly than we forecast in June 2010. So why did the budget deficit – the gap between public spending and revenues – narrow very much as expected in the first two years of the Parliament, and only begin to overshoot in 2012-13? We asked this question last year, but we need to see if the answer still holds true after the big GDP revisions announced by the ONS late last month.

Second, why did the economy pick up much more rapidly over the last 18 months than we forecast in March 2013 – and yet the budget deficit was only slightly smaller than we expected in the latest fiscal year?

Let's start with the ONS revisions.

[SLIDE] This chart shows the outturn data and our forecasts for real GDP since the pre-recession peak in 2008. Real GDP is the estimated volume of goods and services produced in

the economy. You can see a big downward revision between our 2010 and 2013 Budget forecasts, with a stronger picture emerging in the 2014 forecast.

[SLIDE] Last month's revisions from the ONS suggest that the recession was shallower and the recovery stronger than it had previously thought. This lifts the estimated path of real GDP back towards the forecast that we made in June 2010. The picture for business investment was even more dramatic, with cumulative growth from the start of 2008 to the first quarter of 2014 revised from a fall of almost 15 per cent to a rise of almost 5 per cent. But it is worth bearing in mind that these revisions in part reflect changes in the scope and methods used to measure GDP, and so we are not exactly comparing like with like.

[SLIDE] This rewriting of history is not unusual. This chart shows the path of real GDP during the recession and recovery of the early 1990s. By 2013 the data showed a much shallower recession and a much sharper recovery than the data published 20 years previously – mirroring the impact that the latest revisions have had for the last few years.

[SLIDE] But, ironically, the latest revisions now show a significantly weaker recovery in the 1990s, with the economy 'flat-lining' for a protracted period. This only goes to show that you can never judge definitively how accurate a GDP forecast has been.

[SLIDE] The latest data show that by the end of 2012 the level of real GDP had fallen about 4 per cent short of our June 2010 forecast. The shortfall then stabilised over the subsequent 18 months as the economy started to grow at the sorts of rates that we predicted in June 2010 – just a couple of years too late.

But although most observers of macroeconomic forecasts focus on real GDP, it is the behaviour of nominal GDP – the cash value of spending and incomes in the economy – that matters much more for the public finances. And, as you can see, nominal GDP continued to fall further below the June 2010 forecast into 2013 and 2014.

[SLIDE] The performance of the public finances depends not just on the strength of nominal GDP, but also on its composition. That is because some components of nominal income and spending are taxed more heavily than others.

This chart shows the total error in our June 2010 forecast for the level of nominal GDP in early 2012, based on the data available at the time of last year's FER. It shows that we overestimated the level of nominal GDP by almost 3 per cent and that this over-optimism was concentrated in profits and business investment – the blue bars – rather than in wages and household consumption. Profits and investment are taxed less heavily than wages and consumer spending – indeed most investment is tax deductible – so this helped explain why revenue held up and the deficit fell on schedule in 2010-11 and 2011-12.

[SLIDE] The ONS has now revised up its estimates of nominal GDP, so this year the shortfall in our forecast looks slightly smaller. The composition has also changed, but the basic story

remains intact: the deficit fell on schedule early in the Parliament in large part because the unexpected weakness of nominal GDP was focussed in those areas that are taxed less heavily – profits rather than wages, and stock-building plus business investment rather than consumer spending. Central and local government spending was also lower than expected.

[SLIDE] This chart illustrates how the headline measure of the budget deficit – public sector net borrowing – fell relatively rapidly in 2010-11 and 2011-12, but then more slowly over the subsequent two years. After a promising start, the deficit began to disappoint and overshot our forecast in 2012-13 for a number of reasons. Among them:

- nominal GDP fell further below forecast than in the previous two years;
- more of the weakness showed up in total wages and salaries;
- the housing market had not returned to normal;
- oil and gas production dropped sharply, reducing receipts from the North Sea; and
- high inflation in September 2011 pushed up welfare spending via benefit uprating.

The ONS has now aligned the public finance statistics with the new European System of Accounts, as well as implementing its own review of the statistics. Our forecasts will move to this basis at the Autumn Statement in December, but in this report we use the previous definitions - those for which the forecasts we are discussing were made.

So now let us turn to the performance of the economy and the public finances in the year and a half since our March 2013 forecast. In terms of real GDP growth, this was the 'darkest before the dawn' moment. At almost exactly this point, the economy gathered momentum much more strongly than we and other forecasters expected. Indeed, even as late as August 2013 none of the almost 40 forecasters polled monthly by the Treasury expected growth in calendar year 2013 to be as strong as the 1.7 per cent that the ONS now estimates.

[SLIDE] This chart shows our forecasts for cumulative real GDP growth between the second quarter of 2013 and the second quarter of 2014, plus the latest outturn data. As you can see the increase of 3.2 per cent is much stronger than the increase of 1.7 per cent that we forecast in March 2013 and stronger even than the rates we predicted in earlier years.

Explaining why growth should suddenly have picked up is not easy – and of course future vintages of ONS data may show a less abrupt transition. But – taking the existing data at face value – it may reflect the unusual absence of negative external shocks, the easing of credit conditions, the cumulative effect of loose monetary policy and an easing in the pace of fiscal consolidation. Some or all of these factors prompted a sharp pick-up in consumer

confidence and consumer spending, financed by lower savings rather than faster growth in earnings.

[SLIDE] So what did this mean for the public finances? This chart shows the forecasts we made for the budget deficit in 2013-14 in June 2010 and March 2013, plus the latest outturn estimate. It shows that the deficit is currently estimated at £108 billion, excluding transfers related to quantitative easing and the Royal Mail Pension Fund. This is £48 billion bigger than we forecast in June 2010 and £12 billion smaller than we forecast in March 2013.

So why the differences?

[SLIDE] Relative to the June 2010 forecast, the biggest shortfall came from income tax. This reflected lower-than-expected wages and salaries and a lower effective tax rate, due in large part to weak earnings growth and increases in low-paid self-employment. The next biggest shortfall was in corporation tax, reflecting lower-than-expected profits and the large accumulated losses of financial firms. And North Sea receipts were only half the level we expected, thanks to lower production and higher tax-deductible expenditure. The weakness in these and other tax receipts was slightly offset by lower public spending than expected, as very low government borrowing costs reduced the debt interest bill.

Relative to our March 2013 forecast, receipts came in £9 billion stronger than expected, with broadly similar contributions from income tax, VAT and corporation tax. These were partly offset by yet another disappointing year for oil and gas receipts. Public spending was about £3 billion lower than expected, as subdued RPI inflation reduced the interest paid to holders of index-linked gilts.

But the surprise was not that last year's deficit came in lower than we expected in March 2013, but rather that the gap was not bigger - given the scale of the pick-up in real GDP growth and the continued dramatic improvement in employment. In part this was because the pick up in nominal GDP since mid 2013 has been less dramatic than the pick up in real GDP – and, as we have seen, this matters more. And, once again, earnings growth has been weaker than we expected, reducing the average effective rate of income tax.

[SLIDE] In each FER we try to identify lessons that we should learn for future forecasts. This FER has reinforced the importance of focusing on nominal rather than real GDP. It has also highlighted the importance of understanding changes in effective tax rates: for income tax, corporation tax, stamp duty, VAT and North Sea receipts. Forecasting contributions to the EU has emerged as another challenge, not least as they reflect the UK's economic performance relative to that of other EU members. So too has forecasting the welfare bill, which depends not just on economic developments but also on the way in which complex entitlement mechanisms operate and on the difficulty of implementing major reforms.

[SLIDE] That brings me neatly to the second half of today's double bill: our first annual Welfare Trends Report. In December last year the Chancellor announced that the

Government would set a cap on the overall cash amount that it would be willing to spend on a subset of social security benefits and tax credits. At the same time he asked us to assess the Government's performance against this cap and also to "prepare and publish information on the trends and drivers of welfare spending within the cap". This report is our first attempt to do that – and we have chosen to look not just at welfare spending within the cap, but also at how this fits in with broader trends in welfare spending. This morning I will focus on the broad historical overview and then on the risks to our medium-term forecast – and therefore to the Government's chances of remaining within the cap. What we do not discuss in the report – because it lies outside the remit that Parliament has given us – is the impact of welfare on the distribution of income or measures of poverty.

[SLIDE] Let me begin by setting out the scope of the report. Welfare spending can be defined in many different ways, but we focus here on social security benefits and tax credits – that is cash payments to individuals or families with low incomes or particular needs. These cost £210 billion in 2013-14, just under 13 per cent of national income. Around £3 billion of that was the negative tax element of tax credits. Within this total, the Government has chosen to exclude from the welfare cap state pensions and those benefits affected most directly by the ups and down of the economy, namely jobseeker's allowance and associated claims for housing benefit. The spending items within the cap cost £113 billion in 2013-14 – 55 per cent of the total, including negative tax. The largest elements are tax credits, the remainder (and bulk) of housing benefit, incapacity benefits and disability benefits.

[SLIDE] As you can see, total welfare spending on our definition has increased fourfold in cash terms over the past 30 years and has more than doubled in real terms, after adjusting for inflation.

[SLIDE] But, as a share of national income, there has been no clear trend over time. Welfare spending fluctuates with the ups and downs of the economy, averaging just over 11 per cent of GDP over the period as a whole. Spending has moved higher over the recession and recovery to date, reaching almost 14 per cent of GDP. But the increase was smaller than in the aftermath of the previous recession, in the early 1990s, even though the latest recession was deeper. Our March forecast shows spending falling back below 12 per cent of GDP by 2018-19.

[SLIDE] This slide shows the composition of welfare spending over the past 30 years and the next five. You can see that:

- State pensions have always been the largest component – and will be almost 45 per cent of the total by 2018-19;

- The biggest fall in spending has been on income replacement benefits for jobless people, reflecting lower caseloads and the removal of various additions for 'extra costs', while;

- The main rise in spending has been on 'extra cost' payments for housing, disability and families with children, with the last of these delivered primarily through tax credits.

[SLIDE] The drivers of welfare spending can be divided into those that affect the caseload – the number of people receiving each benefit – and those that affect the average amount that each recipient is paid. We discuss these drivers benefit by benefit in the report, but there are some common themes:

- First, demographic and economic trends can cause significant changes in the cost of different benefits. Most obviously, the ageing of the population has increased the proportion of adults over the state pension age from 21 per cent in 1983 to 25 per cent today, while the ups and downs of the economy have seen the cost of unemployment benefits rise and fall. Greater female labour market participation has made more women eligible for the full state pension. And recent increases in the share of the population renting rather than owning their home has increased the housing benefit caseload, while the shift in renting from the social- to the private-rented sector has raised the cost per claimant. Most importantly for the system as a whole, changes in inflation feed through to the cost of most benefits and tax credits when their values are uprated each year. When inflation is higher than earnings growth, as it has been in recent years, that tends to push the welfare bill higher relative to GDP;

- Second, we see that major reforms to the welfare system often lead to large and sometimes unexpected changes in spending. For example, the cost of tax credits rose faster than expected after they were introduced and expanded in the mid-2000s, as earnings grew more slowly in the tax credit population than in the wider economy and as childcare costs increased significantly. The system also had to be rejigged to address unexpectedly high levels of overpayments. The introduction of disability living allowance in 1992 led to rapid growth in caseloads as a result of widening eligibility, allowing claimants to self-assess their needs, and a rise in take-up. And reforms to unemployment benefits in the second half of the 1980s, designed to reduce their cost after the recession of the early 1980s, led to sharp increases in the incapacity benefits caseload. This in turn prompted major reform of incapacity benefits in 1995;

- Third, welfare spending can change significantly in response to changes in take-up rates – the proportion of people eligible for a benefit who claim it. The introduction of pension credit in 2003 was accompanied by a deliberate Government campaign to raise take-up – and the caseload rose by more than 50 per cent between 2002 and 2005. In the case of support for families with children, take up among low-income families on the highest awards has increased from around 60 per cent for the family income supplement to 90 per cent for the current system of tax credits; and

- Fourth, welfare spending can be affected by wider public policy decisions. For example, cutting spending on social housing may have had a significant impact on the housing benefit bill, by increasing the proportion of recipients paying higher rents in the private-rented sector.

[SLIDE] We can see the impact of some of these factors by looking at how the welfare bill changed over the 25 years or so running up to the financial crisis – and then over the subsequent five years. As we saw in the chart I showed earlier, relative to the size of the economy welfare spending was much the same in 2007 as it had been in 1983 at just over 11 per cent of GDP. Spending on tax credits increased significantly over this period, as they absorbed other benefits and were used by the last Government as its main policy lever to reduce child poverty. There was a flow of people from unemployment benefits and a flow onto disability benefits, reducing the cost of the former and increasing the cost of the latter. And there were falls in the share of GDP spent on state pensions and child benefit, as they were generally uprated in line with inflation at a time when prices were rising less quickly than nominal GDP.

Having been stable on average over this earlier period, the welfare bill jumped by 2.5 per cent of GDP between 2007 and 2012. Uprating the state pension, tax credits and child benefit in line with – or by more than – inflation now had a very different effect. It protected the purchasing power of these benefits, but it substantially increased their generosity relative to the earnings of people in work and to the size of the economy. Meanwhile higher unemployment and weak earnings growth increased the number of people claiming jobseeker's allowance and housing benefit, and thus the cost of them both.

[SLIDE] So what of the next five years? This table shows our latest forecasts for the change in welfare spending as a share of GDP between 2013-14 and 2018-19, dividing the total into those benefits inside and outside the welfare cap.

Spending inside the welfare cap is expected to fall by almost 1 per cent of GDP or about £16 billion a year in today's terms by 2018-19. About a fifth of this reduction comes from tax credits, largely reflecting the Government's 1 per cent cap on uprating through to 2015-16 and other policy measures. We also assume a significant fall in spending on disability benefits, as people's eligibility is reassessed as they move from disability living allowance to the new personal independence payment or 'PIP'. And there are smaller falls in spending on housing benefit – as claims linked to other benefits decline – and on incapacity benefits – as people's claims for the new employment and support allowance or ESA are assessed.

Spending outside the welfare cap is expected to fall much more modestly, by 0.3 per cent of GDP or roughly £5 billion a year in today's terms. More than half of this will come from a fall in spending on jobseeker's allowance and associated housing benefit claims, as the dole queue continues to shrink and as average awards rise less quickly than earnings. And less

than half will come from the state pension, as the increase in the state pension age more than offsets the impact of the ageing of the population, while uprating by the 'triple lock' keeps average awards rising broadly in line with earnings growth.

[SLIDE] As with any forecast, there is considerable uncertainty around all these spending projections. In the report we discuss the risks in greater detail than we would in our usual Economic and fiscal outlook publications – and we identify which are most pertinent to the welfare cap. Let me briefly discuss some of the key risks specific to particular benefits – namely jobseeker's allowance, housing benefit, incapacity benefits and disability benefits – before turning to a couple of the general risks that apply across all or most of them.

[SLIDE] First, jobseeker's allowance. Our March forecast showed spending falling from £4.4 billion to £3.2 billion over the next five years, almost halving as a share of GDP. This largely reflects an expected drop in the caseload as claimant count unemployment continues to fall.

[SLIDE] It is almost certain that we will have to revise this forecast down in December, at least in the near term, as we and others have once again been surprised at the rapid fall in claimant count unemployment. Over the past year, the claimant count has fallen at its fastest rate since 1973. It has fallen by more than 17 per cent since March alone, moving below 1 million in August and reaching a level that we did not expect until 2017.

[SLIDE] Second, housing benefit. Spending on housing benefit is forecast to rise from around £24 billion last year to £27½ billion in 2018-19, with an increase in spending within the welfare cap outweighing a fall in spending outside the cap.

[SLIDE] As this chart shows, our four Budget forecasts to date for housing benefit in 2012-13 underestimated spending by an average of £1 billion or more than 4 per cent – and we have revised our forecast significantly higher. These errors reflect three main factors:

- First, the share of the population renting has continued to rise more quickly than we expected. House prices have remained high relative to incomes and high loan-to-value and loan-to-income mortgages are still hard to come by;

- Second, employment growth has been stronger than expected, while earnings growth has been weaker. So the number of people in work but earning sums small enough to entitle them to housing benefit has been bigger than we expected, and;

- Third, rents have been rising more rapidly than we expected.

We have revised our forecasts to reflect this evidence, but significant uncertainties remain. We assume that the proportion of households renting will rise more slowly and then stabilise – but there are risks on both sides of this assumption. We assume that faster

earnings growth and slower employment growth will limit the increase in housing benefit eligibility, but earnings growth continues to disappoint and employment growth continues to overachieve. And there is considerable uncertainty in both directions around our forecast for rent inflation, partly because the official rents data are being reviewed.

[SLIDES] Turning to incapacity benefits – which are income-replacement benefits for people unable to work as a result of sickness or disability – we forecast in March that spending would rise from £13.4 billion to £14.5 billion over the next five years.

[SLIDE] As you can see, this is very different from the shape of our previous forecasts, where we assumed a significant drop in spending. We have concluded that the move from incapacity benefit to the employment and support allowance (or ESA) is likely to generate much smaller savings over this horizon than we previously assumed. This reflects evidence from work capability assessments that more people are being put into the so-called 'support group' and that fewer are being declared fit for work than we originally assumed. We also assume that there will be fewer assessments taking place over this horizon, as the number taking place has dropped and as the growing backlog is likely to take a long time to clear.

But there remain lots of uncertainties around the latest forecast.

- We assume that the migration from incapacity benefit to ESA will be complete by 2015-16. But this remains highly uncertain – especially while the Department for Work and Pensions looks for a delivery partner to replace ATOS Healthcare;

- We assume that assessments will save more money over time, and that the rates of appeal against them will settle down. But in both cases the performance of the new contractor will be crucial;

- We assume that flows off ESA reduce overall welfare spending. But there is evidence that some people declared fit for work are moving onto JSA and then returning to ESA again, and;

- We assume that inflow rates are stable going forward. But the rise in the state pension age and cohort effects may increase the number of older-age working people for whom the risks of illness are higher.

Parliament's Work and Pensions Committee has recommended a complete redesign of ESA processes. This could reduce these risks, but the history of major benefit reform programmes suggests that they are often rolled out more slowly and with greater difficulty than governments initially expect. We have underestimated this in the past, so we will review our assumptions carefully in December and take a close look at the implications of the Government's new contractual arrangements, when they have been awarded.

[SLIDE] Spending on disability benefits – which are designed to provide help with additional costs, rather than to replace income – is forecast to fall very slightly over the next five years, reaching £13.6 billion by 2018-19. [SLIDE] Our forecasts have been more accurate to date than for incapacity benefits, but the disability benefits regime is now embarking on a period of major reform as claims migrate from disability living allowance to the personal independence payment. This transition from DLA to PIP involves challenges very similar to those that have forced us to increase our forecasts for spending on incapacity benefits.

The roll out of PIP has been delayed, but we assumed in March – on the basis of the limited available data – that 63 per cent of the caseload would be on PIP by 2018-19. As fresh evidence comes in, we will need to consider again if this is achievable. As with ESA, the volume of savings depends not just on the pace of the rollout, but also on the outcome of the claim reassessments and the results of subsequent appeals. This is hard to predict, but the experience with ESA suggests that we should be wary of early optimism. As with ESA, the key question is whether delivery challenges are likely to be temporary or persistent. The roll-out to PIP is at a much earlier stage than for ESA, so the uncertainties are even greater.

The delivery problems with incapacity and disability benefits are of course mirrored in the Government's repeatedly delayed plans to combine most working age benefits into universal credit (UC). Our March forecast was based on the Government's then plan to migrate most recipients of the current benefits onto UC in 2016-17 and 2017-18. Last month the Government announced that more simple cases would be brought forward, but it has yet to say publicly what will happen to the remainder of the timetable. For the time being our forecast is relatively insensitive to the speed at which UC is rolled out, but we will nonetheless revisit our assumptions in December and keep them closely under review.

[SLIDE] So what does all this mean for the welfare cap? The cap was formally set by the Government in line with our Budget 2014 forecasts, with an additional 2 per cent margin for error that can be used to absorb forecasting changes - but not to pay for policy changes. Of the specific risks that I have just discussed, the downside risk to spending on JSA and associated payments of housing benefit is of no help as these lie outside the cap. But the significant upside risks on incapacity benefit and disability benefits lie within it, as does the category of housing benefit spending where our recent forecasts have been revised higher.

[SLIDE] In addition to these risks, specific to particular benefits, there are broader risks that reflect our need to predict inherently uncertain demographic and economic determinants. This table shows how sensitive welfare spending is to a number of these determinants.

For example, a 5 per cent rise in the number of private renters – about half that seen between 2007-08 and 2009-10 – would add about £1 billion to the cost of housing benefit. The most obvious risk is an upward surprise on inflation, especially if it occurs after the period during which the uprating of most working-age benefits is being capped at 1 per

cent. If CPI inflation was to be 1 percentage point higher than we currently forecast in 2016-17, this would increase welfare spending by £1.7 billion a year later, of which roughly £1.3 billion would lie within the welfare cap.

The ONS announced earlier this week that CPI inflation was 1.2 per cent in September, which is 0.6 percentage points lower than our March forecast for the third quarter as a whole. In normal times, lower inflation in September saves money on the following year's welfare bill, due to uprating. But because most working-age benefits are to be uprated by no more than 1% next year, and the basic state pension has to rise by at least 2.5 per cent under the 'triple lock', the savings will probably be less than £½ billion, with much of that coming from lower awards to those receiving disability-related benefits. Uprating the basic state pension by 2.5 per cent will cost around £¾ billion more than if it had been uprated by CPI inflation and more still than if it had been uprated in line with average earnings.

So, to conclude, forecasting welfare spending is far from easy. Like most of our tax and spending forecasts, those for welfare spending are subject to significant uncertainty as a result of their dependence on different economic and demographic trends. But the outlook for welfare spending – and especially those parts of it that lie within the welfare cap – is also clouded by the uncertain impact of significant reform programmes for incapacity benefits, disability benefits and (someway further off) universal credit. Alas recent and more distant history suggests that these are rarely as swift or as straightforward as governments hope.