

Executive summary

- 1 This is our second *Welfare trends report (WTR)*, in which we examine trends in public spending on different elements of the welfare system, including those items subject to the Government's 'welfare cap'. Reflecting the remit that we have been given by Parliament – to focus on the sustainability of the public finances – the report does not consider the impact of the welfare system on the income distribution or measures of poverty.
- 2 In our first *WTR*, we undertook a wide-ranging review of trends in welfare spending over the past 30 years, and in our latest medium-term forecasts and long-term projections. We focused on elements of spending delivered through the social security and tax credits systems. We do not believe there would be value in repeating such a comprehensive historical review on an annual basis, so will focus our coverage more narrowly in this and subsequent reports, repeating the comprehensive exercise later in this Parliament.
- 3 This year, we consider two main issues:
 - first, we revisit the conclusions we reached last year and discuss how the analysis of specific forecast risks identified in that report – and the further scrutiny we undertook in response – led us to revise our medium-term forecasts. We also summarise our latest long-term welfare spending projections, published alongside this report in our 2015 *Fiscal sustainability report*. And we have briefly reviewed some of the larger welfare policy measures implemented during the last Parliament, in order to learn any lessons that might be relevant to new measures in the forthcoming Budget or beyond; and
 - second, we present international comparisons of social protection spending – a broader definition of welfare spending than used in our forecasts and main *WTR* analysis – drawing on data published by the OECD and Eurostat.

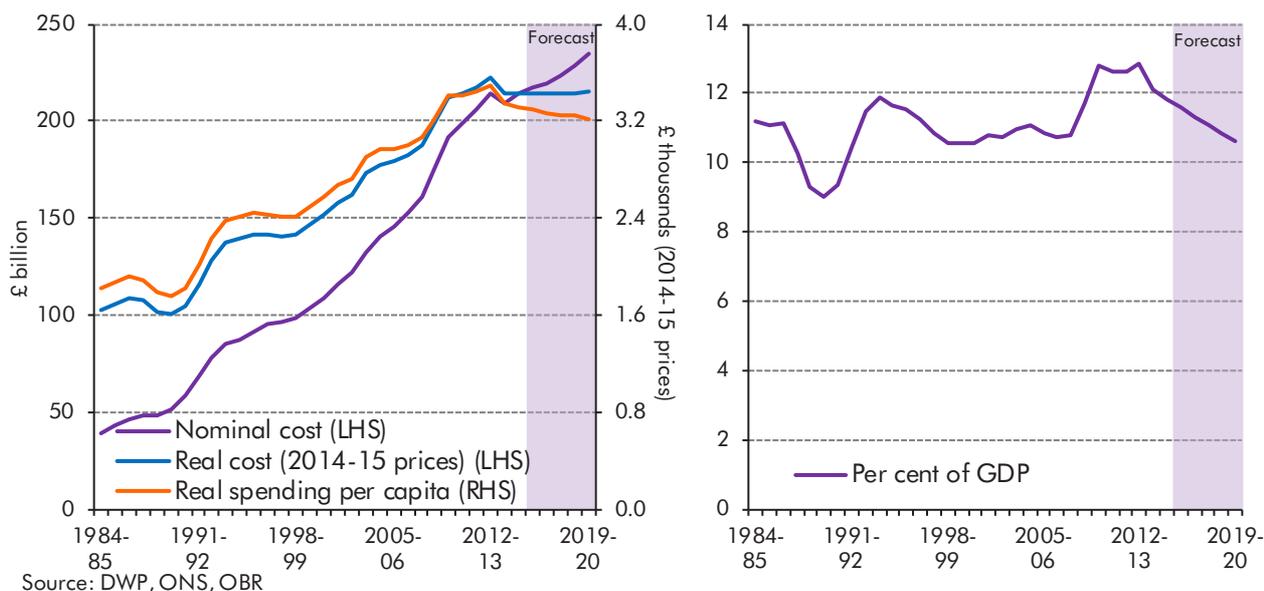
Trends in UK welfare spending

Historical trends

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

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

Chart 1: Total welfare spending in the UK



Medium-term welfare spending forecast

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

- we noted issues in the delivery of reforms to **incapacity benefits** – in particular, the backlog of work capability assessments for employment and support allowance (ESA) and the higher proportion of claimants in the more expensive support group. Our latest forecast shows incapacity benefits spending around £1 billion a year higher than our March 2014 forecast, with upward revisions to the support group caseload more than explaining the increase;
- similar issues arose in the delivery of reforms to **disability benefits** – with the transfer from disability living allowance (DLA) to the new personal independence payment (PIP) slower than planned and delivering smaller savings in the process. We revised up the expected proportion of new PIP claims that would be successful for the claimant, helping to explain around £1 billion a year higher spending relative to our March 2014 forecast;

- **universal credit** presents similar issues on an even larger scale, with the rollout repeatedly delayed. The implications of these delays for our forecast are limited, in part because universal credit is currently added into our forecast as a marginal cost relative to the legacy benefits system and in part because (unlike ESA and PIP) the reforms themselves are not associated with large expected cash savings. The Government pushed back its expected timetable for the rollout of universal credit, which we assume, for the purposes of our forecasts, will be delayed further still;
- due to the faster than expected fall in unemployment – and the additional fall in the claimant count relative to total unemployment – **jobseeker's allowance** was noted as an area where spending was likely to be revised down. In the event, we revised it down by between £0.6 billion and £1.0 billion a year relative to our March 2014 forecast. In relative terms, that was one of the largest revisions in any part of our fiscal forecasts – the biggest single year revision (in 2015-16) saw expected spending lowered by almost 30 per cent;
- we highlighted the uncertainty around our **housing benefit** forecast associated with trends in housing tenure (where owner occupation has fallen significantly in recent years) and rent inflation. In the end, we revised down our forecast for spending on housing benefit for other reasons, including slower expected growth in the number of households and the lower claimant count forecast; and
- we noted that **inflation** was potentially the most important general source of uncertainty in our welfare spending forecast. We pointed out that this represented a risk to the welfare cap, which is set in cash terms. Since our last *WTR* was published in October 2014, oil prices have fallen dramatically, pushing CPI inflation close to zero. The effect of lower inflation on the uprating of most benefits and tax credits saved over £3 billion in 2016-17, rising to around £5 billion by 2018-19.

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

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

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

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

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

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

Table 2: Medium-term forecast of welfare spending

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

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

- a 0.18 per cent of GDP fall in the cost of **tax credits** – the largest category of spending subject to the cap. This largely reflects the result of previously announced measures (uprating capped at 1 per cent in 2015-16) and operational changes targeting debt and error and fraud;
- smaller falls in **housing benefit** (0.13 per cent of GDP) and **incapacity benefits** (0.10 per cent of GDP) – the next largest spending lines. Spending on housing benefit falls as average awards grow more slowly than GDP-per-adult. Clearing the backlog of work capability assessments for incapacity benefits should reduce the overall caseload relative to the adult population;
- a substantial fall in spending on **disability benefits** (worth 0.18 per cent of GDP). This is driven by an assumed reduction in caseloads as people’s eligibility for support is reassessed when cases are migrated from the existing DLA to the new PIP; and
- falls in spending on **pension credit** (0.12 per cent of GDP) in part due to the rise in the state pension age and **child benefit** (0.10 per cent of GDP) due to uprating by less than earnings growth and a rise in the number of families opting out of payment as a result of the ‘high income child benefit charge’.

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

- a 0.22 per cent of GDP decline in spending on **state pensions** as the pressure from population ageing is more than offset by raising the state pension age, which leads to a decline in caseloads relative to the adult population. The ‘triple lock’ on uprating means that average awards rise broadly in line with earnings;
- spending on the unemployed – comprising **jobseeker’s allowance and housing benefit paid to jobseekers** – falls by 0.09 per cent of GDP, as caseloads fall further in 2015-16 and average awards rise more slowly than earnings over the forecast period; and
- a classification change means that spending on **war pensions** amounting to 0.05 per cent of GDP has moved from the definition of welfare spending used in our forecasts into the Ministry of Defence’s resource departmental expenditure limit.

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

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

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

- **errors in our economic forecasts** – which underpin the pre-measures forecasts to which policy costings are applied – **can be significant sources of error in costings themselves**. This has been particularly relevant to the major uprating policy measures: the ‘triple lock’ on state pension uprating; switching from RPI to CPI inflation uprating for most benefits and tax credits; and subsequently limiting the uprating of most working-age benefits to 1 per cent for three years; and
- **costings associated with structural changes to the welfare system** – e.g. the switch from incapacity benefit to the employment support allowance, from disability living allowance to the personal independence payment and the introduction of universal credit – **are subject to even greater uncertainty**. In some cases these require judgements about the proportion of the population that will claim a new benefit and at what rate, but they also typically require judgements about the capacity of departments or contractors to deliver the new policies.

Long-term welfare spending projection

- 12 Our 2015 *Fiscal sustainability report (FSR)* contains long-term projections of welfare spending. These largely capture the effects of demographic change, with neutral assumptions in most other areas. An important difference from our medium-term forecasts is that we assume benefits are uprated with earnings rather than inflation, which effectively switches off the fiscal drag effect of average awards rising more slowly than GDP-per-adult.
- 13 Since last year, we have changed the migration assumption underpinning our medium-term forecasts and long-term projections from the ONS low migration variant to its principal projections. This raises population growth and reduces the old-age dependency ratio, since migrants to the UK are more likely to be of working age than the native population.
- 14 Our projections show total welfare spending rising by 2.2 per cent of GDP between 2019-20 – the end of our medium-term forecast – and 2064-65, with almost all the rise accounted for by benefits paid to the elderly. This is largely driven by demographic trends, which are partly offset by further expected increases in the state pension age – based on the principle set out by the Government that people should expect to spend up to a third of their adult life in receipt of the state pension. The triple lock on uprating is assumed to put further upward pressure on state pensions spending as a share of GDP over the long term.
- 15 Among other benefits, the main projected changes over the long term are:
 - spending on incapacity and disability benefits rises in large part due to the ageing of the population. We assume constant age-specific shares of the population in receipt of incapacity benefits, which means that cohort effects raise the caseload as a share of the adult population as the population ages. For disability benefits, even assuming

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

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

Table 3: Long-term projections of welfare spending

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

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

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

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

⁴ Jobseeker's allowance.

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

International comparisons of social protection spending

Comparing welfare spending across countries

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

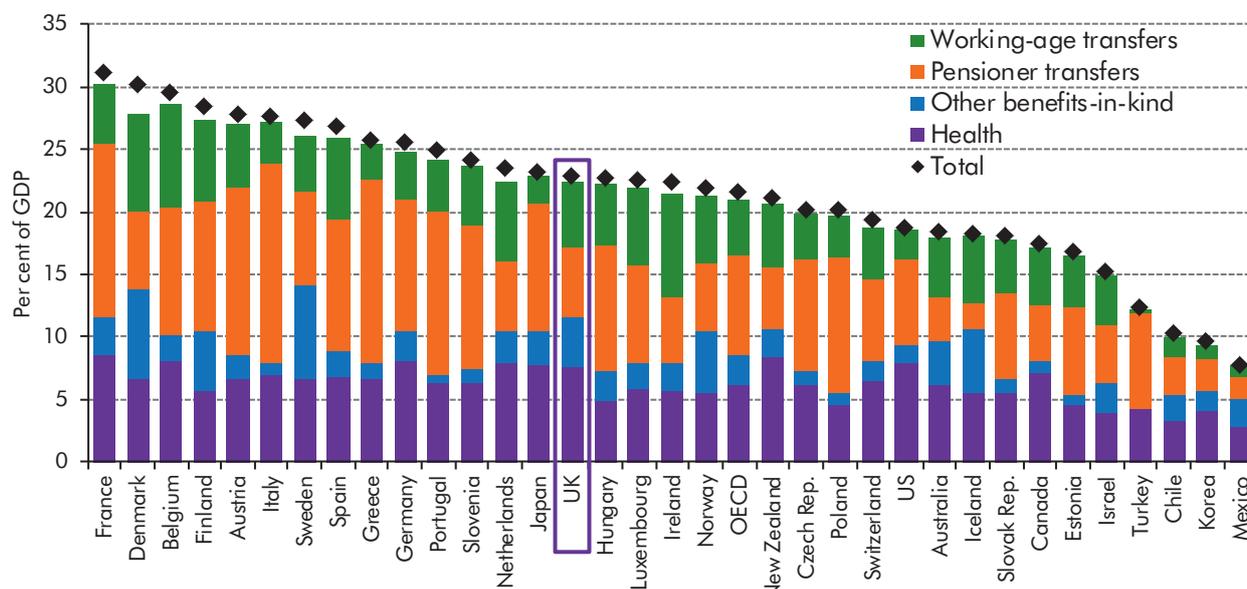
involved." That includes health care and other goods and services provided as benefits in kind, as well as the transfers that are the focus of our *WTRs*.

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

Total expenditure on social protection

- 18 The OECD collects data that allow us to consider how different countries' welfare systems deliver social protection to their populations. This shows the importance of comparing not just the gross amount of public spending on social protection, but also the degree to which the private sector is incentivised or mandated to deliver the equivalent support and interactions with the tax system. Taking those factors into account can significantly alter our understanding of the share of national income a country devotes to social protection.
- 19 Looking first at the gross measure of public spending on social protection, the UK is estimated by the OECD to have spent 21.7 per cent of GDP in 2014. That was very close to the OECD average, lower than in Nordic and Continental European systems and the third lowest in the G7 (after Canada and the US). On this definition (as shown in Chart 2), UK public spending is roughly evenly split between cash transfers and the provision of benefits in kind, with pensioner benefits accounting for around half of cash transfers and health spending for two-thirds of benefits in kind.

Chart 2: Estimated gross public expenditure on social protection



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

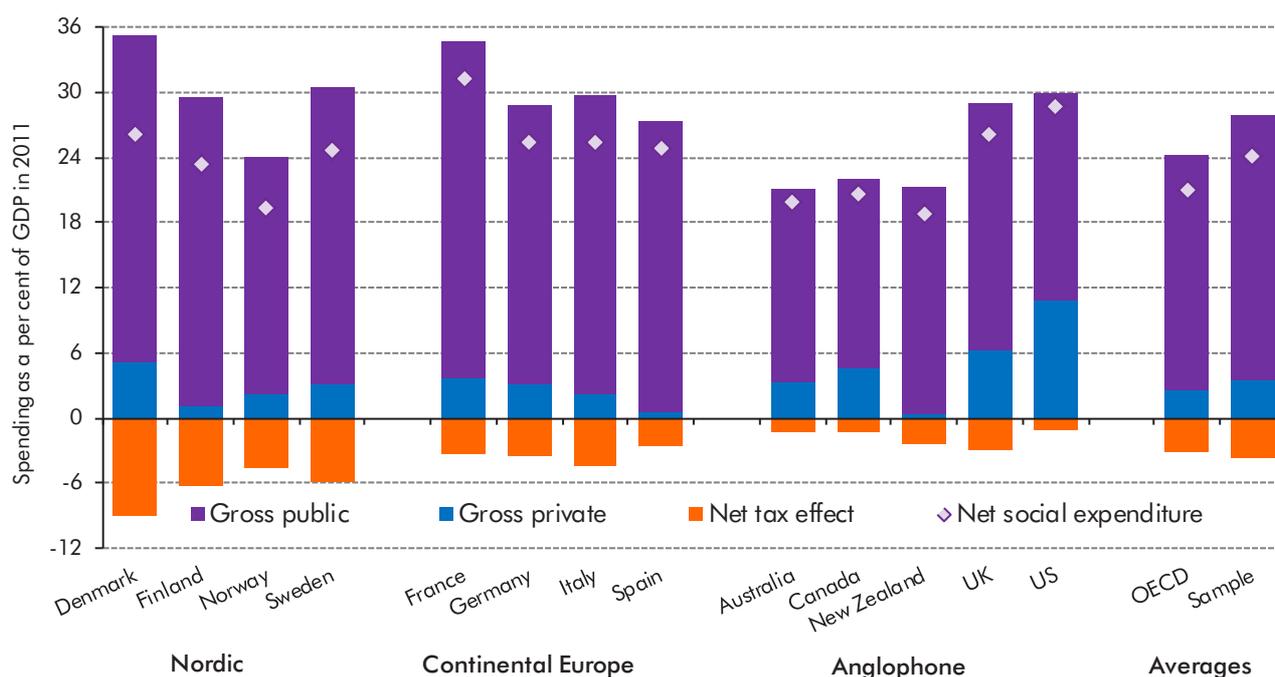
20 To move from gross public expenditure on social protection to a measure of net total expenditure, we need to consider two other methods of delivering on social objectives:

- **gross private social expenditure** amounted to 2.7 per cent of GDP in 2011 across the OECD. The main components were incapacity spending (e.g. sickness-related payments), old-age spending (e.g. employer-based pension schemes) and health spending. There is considerable variation in the extent to which countries incentivise or mandate the private sector to provide social protection. That said, two countries with high private sector spending on social welfare provision are Anglophone countries: the US (due to high levels of private spending on health care and private pensions) and the UK (due to extensive private pension spending); and
- the **effects of the tax system** on the overall fiscal cost of social protection. Countries can levy income tax on cash transfers to individuals – the UK does so on pensions and some other benefits, while Nordic countries tend to on most benefits. Consumption taxes are levied on spending out of income from cash transfers – the effect of this is much larger in European countries (where gross benefit income and indirect tax rates are often relatively high) than in Australia, Canada, and the US (where both are relatively low). These effects reduce the net fiscal cost of social protection. Countries can also use tax incentives for social purposes – for example by tax relief for collective health insurance (as in the US) or pension saving (as in the UK). The OECD database does not include tax incentives for pension saving, which can have a significant cost in foregone revenue.

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

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

Chart 3: Net total expenditure on social protection



Expenditure on selected social protection programmes

Support for the elderly

- 22 Payments to pensioners are mainly driven by demographic trends, so they tend to be less sensitive to the economic cycle than social spending on the working-age population. Thanks to the ageing of the population and the maturation of pension systems, public pension spending has been rising as a share of GDP in most advanced economies (including the UK). Many OECD countries are reforming their pension systems to limit the growth of spending, with the goal of achieving long-term financial sustainability of pension systems.
- 23 In the UK, spending on pensioners is the largest category of social spending, with gross public spending at 6.1 per cent of GDP in 2010 (slightly below the OECD average of 7.3 per cent) and gross private spending at 5.2 per cent (significantly higher than the OECD average of 2.4 per cent). Among the countries we focus on, Italy has the highest public spending on pensioners (at 13.3 per cent of GDP) and New Zealand the lowest (at 4.5 per cent).
- 24 Putting the UK in international context, a number of features are apparent:

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

Support for sick and disabled people

- 25 In advanced economies, income support for those unable to work due to sickness or disability is common. Spending on such benefits is driven both by underlying factors (such as demographics and age-specific health status) and by policy decisions (such as eligibility rules, benefit replacement rates and access to other social programmes). These factors determine the proportion of populations in receipt of sickness and disability transfers and the relative generosity of the benefits they receive.
- 26 In the UK, public spending on sick and disabled people in 2011 – the latest year for which detailed OECD data are available – stood at 2.5 per cent of GDP, slightly above the OECD average of 2.2 per cent. Most was spent on cash transfers. Private spending was 0.5 per cent of GDP – slightly below the OECD average of 0.7 per cent. This was mostly sickness payments made by employers.
- 27 Putting the UK in international context, we note a number of features:
- the UK spends somewhat less on benefits-in-kind (i.e. goods and services) for disabled people, particularly compared to the Nordic countries. Overall spending is similar to Nordic levels, with the UK delivering more help through cash benefits. This includes the additional costs support of DLA that is closely linked to the cost of providing necessary goods and services for disabled people – a model unusual among OECD countries;
 - the UK spends less on sickness payments (private spending) than Continental European and Nordic countries. One reason for this is the lower generosity relative to previous earnings of such payments in the UK;

- the UK is estimated to have a lower self-reported prevalence of disability than the Nordic countries, but higher than most Anglophone and Continental European countries. In the late 2000s, just under 1 in 5 working-age people in the UK were self-reported as having a long-standing health problem that limited daily activity; and
- the UK has a slightly lower than average net replacement rate (a proxy for relative generosity) for disability-related benefits, whereas Nordic countries have higher replacement rates.

Support for unemployed people

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

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

- the unemployment rate – which fluctuates with the economic cycle. In 2011, the unemployment rate in the UK was close to the OECD average, so this factor did not explain the UK's relatively low spending on unemployment benefits. Spain saw the highest unemployment rate among the countries we consider, having been hit particularly hard by the late 2000s recession, which caused unemployment to rise above the internationally high levels seen in Spain in the mid-1990s;
- the ratio of the unemployment benefit caseload to total unemployment – this is a proxy for a more structural element that is influenced by the conditions determining eligibility for the benefit. In 2011, the jobseeker's allowance caseload in the UK was around half the level of unemployment as reported in the Labour Force Survey. That too was close to the OECD average. In Spain, eligibility is tighter than in many countries, so only a small proportion of the large number of unemployed people receive the primary unemployment benefit; and
- the generosity of those benefits – this contains a structural element determined by policy, but can also be varied in response to the economic cycle. This factor explains the UK's relatively low spending, with the replacement rate associated with jobseeker's allowance low by international comparisons. It appears that much of this is explained by the UK delivering support for housing costs via a separate scheme – housing benefit – whereas most systems set benefit awards at levels that reflect housing costs.

Support for people on low incomes

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

- 31 Tax credits are the largest component of spending on families in the UK. Spending on them has doubled as a proportion of national income since 2002-03, in particular reflecting the expansion of tax credits in 2003-04 – when child tax credits in particular became the Labour Government’s preferred policy tool to try to meet its child poverty targets. More recently, during the late 2000s recession, spending increased because of generous discretionary uprating (especially of the child element).
- 32 As noted above, the UK’s **housing benefit** system is relatively unusual in providing support for housing costs via a separate benefit rather than factoring those costs into the generosity of other benefits. OECD data show that the UK spends more subsidising housing costs as a share of GDP than any other country in the OECD. At 1.5 per cent of GDP, this figure is more than three times the OECD average of 0.4 per cent. We have not been able to determine whether, if the difference of approach could be appropriately adjusted for, the cost of subsidised rent in the UK was genuinely higher than in the other countries. But this might be possible given the high cost of housing in general. It is a subject we may return to in future WTRs.