Executive summary

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

2 At any one time around half the UK population receives income from at least one social security benefit – and over the course of a lifetime most people will. So there is much that can be said about the way the welfare system operates and why it costs what it costs.

3 In this report we:

- focus on spending delivered through the benefits system (managed by the Department for Work and Pensions across Great Britain) and the tax credits and child benefit systems (managed by HM Revenue and Customs across the whole of the UK). We do not consider benefits-in-kind, for example social housing, education and healthcare;
- consider spending both in cash terms – as the welfare cap is a cash ceiling – and as a share of GDP – which is more relevant for the sustainability of the public finances. We say much less about real-terms spending and spending per head;
- look in detail at trends over the past 30 years and in the five-year forecast period of our March 2014 *Economic and fiscal outlook (EFO)*, as well as providing a summary of long-term prospects contained in our July 2014 *Fiscal sustainability report (FSR)*;
- provide greater detail about the judgements and assumptions that underpin our latest medium-term forecast and the risks and uncertainties to which they are subject; and
- draw out the broad themes that help explain fluctuations in welfare spending over the past and in our medium-term forecast and long-term projections.

4 Even having narrowed our focus to spending on social security benefits and tax credits, there remains considerable variety in the types of spending we examine. In our discussion, we have been guided by the Institute for Fiscal Studies' approach in its report *A survey of the UK benefit system* in grouping spending by the type of recipient.

5 One important new feature of the welfare system relevant to this report is the welfare cap. The Government announced in Autumn Statement 2013 that it would introduce a cap on certain items of welfare spending, excluding state pensions – which it argued are "*better planned and controlled over a longer time period*" – and jobseeker's allowance and

associated housing benefit payments – which it identified as "*the most cyclical elements of welfare*" in order "*to allow the automatic stabilisers to operate*".[1]

6 The cap was formally defined and initially set by the Government in Budget 2014. It will apply from 2015-16 – when it covers £119.5 billion of spending, around 55 per cent of total welfare spending – to the end of the forecast period, which was 2018-19 in Budget 2014.

Drivers of welfare spending

7 Trends in the number or proportion of the population eligible for many benefits reflect developments in the underlying drivers of individuals' circumstances. For example, the number of pensioners in part reflects trends in life expectancy at older ages, while the number of housing benefit recipients depends in part on the number of households renting rather than owning their home.

8 Some of the most important trends affecting welfare spending over the past 30 years and across our latest five-year forecast are related to demography, the labour market, inflation and earnings, and the housing market. In particular:

- **demographic trends:** the population has been ageing in recent decades, as fertility rates fell and life expectancy at older ages increased substantially. That led to a falling number of children until recently, while the size and proportion of the population aged over 65 has been rising steadily. Trends in family status and the availability of housing have meant the number of households has typically risen slightly faster than the population, reflecting a fall in the average household size;
- **labour market trends:** eligibility for a number of benefits depends on people's labour market status. Unemployment tends to follow a cyclical path, rising in recessions and falling in recoveries. It is expected to fall in our latest medium-term forecast. More people are inactive – neither working nor seeking work – than unemployed, and this can be for a variety of reasons. Among older people, labour market inactivity is generally due to retirement, so is influenced by demographic trends. Among working-age women, inactivity is most often due to family responsibilities. Inactivity in this group has been on a declining trend (with employment rates rising), which has implications for contributory benefits like state pensions. Among working-age men, inactivity increased from the 1970s until the mid-1990s, largely due to long-term sickness – a trend that subsequently reversed. For younger men and women, inactivity due to study has been rising. Self-employment and part-time work have also been on rising trends that accelerated through the late 2000s recession;
- **inflation and earnings growth:** most benefits are uprated each year in line with an official measure of inflation. Over the past few years, uprating by inflation has caused welfare spending to rise as a share of GDP because earnings growth – and productivity growth – has been very weak. An issue that we have not explored in detail

[1] HM Treasury (2013)

in this report – but to which we will return in the future – is differences in earnings developments across the income distribution. For example, in recent years it appears that much of the growth in self-employment has been at the lower end of the income distribution, which will have affected spending on tax credits; and

- **housing market trends**: housing benefit – support for people on low incomes who rent their homes – accounts for a significant share of welfare spending, so trends in the housing market are very important. The number of households living in the social-rented sector has been declining steadily for decades. Since the mid-2000s, the number of households living in the private-rented sector has been rising. That trend picked up in the late 2000s recession and in 2012-13 the number of private renters exceeded the number of social renters for the first time in almost 50 years. As private rents are on average higher than social rents, that shift puts upward pressure on welfare spending. Administrative data from the benefits system also suggests that rents have risen faster than earnings and inflation over the past decade.

Trends in welfare spending

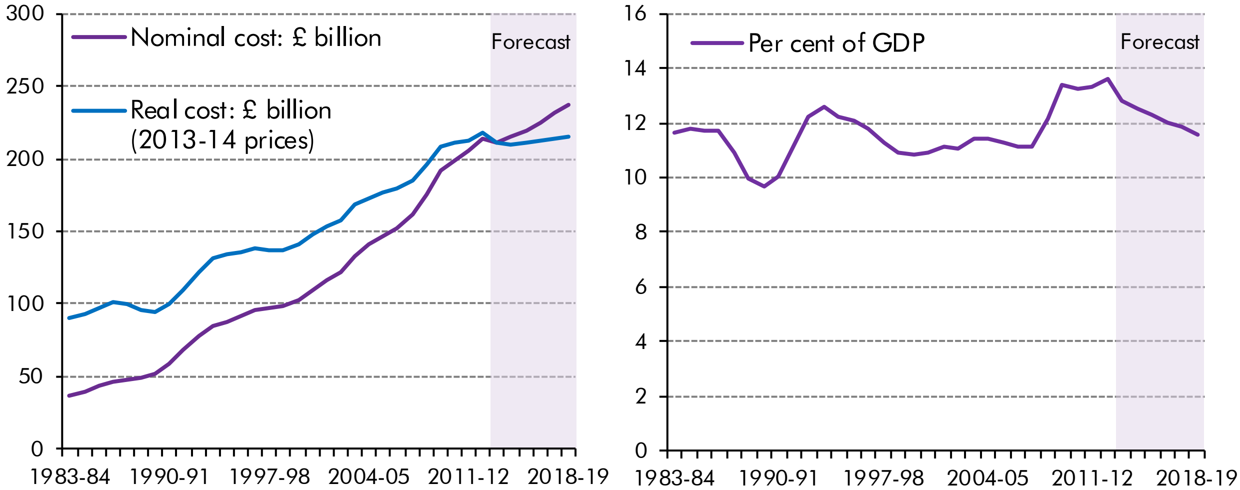
9 At a high level, trends in welfare spending reflect the underlying economic and social drivers set out above, together with Government decisions about the scope of support that it will provide to people through the welfare system. That is apparent in the rising share of welfare spending devoted to 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.

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

11 Welfare spending has, however, fluctuated significantly with the economic cycle. That has reflected two important features:

- first, the caseloads of small and highly counter-cyclical benefits (like jobseeker's allowance) rise significantly in recessions and fall significantly in recoveries. These elements of spending are excluded from the welfare cap; and
- second, the average awards of large and mildly counter-cyclical benefits (like state pensions or disability benefits) are more stable than GDP over the economic cycle, thereby fluctuating negatively with the cycle relative to GDP. With the exception of state pensions, these elements of spending are subject to the welfare cap.

Chart 1: Total welfare spending in the UK



Source: DWP, HMRC, OBR

Explaining trends in welfare spending in recent decades

12 We have looked at the factors that have explained the rises and falls in welfare spending as a share of GDP over the past 30 years. This report shows that:

- during the period of strong GDP growth **from 1983-84 to 1989-90**, spending fell by 2.0 per cent of GDP. The largest contributions to that fall were lower spending on unemployment benefits as the economy boomed and lower spending on state pensions as earnings growth outpaced uprating. The rising proportion of adults receiving incapacity benefits slightly offset those falls;

- **between 1989-90 and 1993-94**, a period that included the early 1990s recession, spending increased by 3.0 per cent of GDP. The largest contributions were caseload-driven increases in spending on unemployment and incapacity benefits, and average award-driven increases in spending on housing benefit, as the recession bit. Spending on state pensions was pushed up as a share of GDP thanks to the weakness of earnings growth relative to the amount by which they were uprated;

- **between 1993-94 and 2007-08**, a period of sustained economic growth, spending fell by 1.5 per cent of GDP. The largest contribution was the steady reduction in the unemployment rate. Spending on incapacity benefits also fell as uprating and other factors pulled average awards lower relative to earnings. This period also saw a big shift in spending from different parts of the benefits system to tax credits; and

- **between 2007-08 and 2012-13**, a period that spans the late 2000s recession and slow recovery that followed, spending increased by 2.5 per cent of GDP. The rise in the caseload for jobseeker's allowance made a surprisingly small contribution to the increase in spending. The largest contribution was from the uprating of state pensions as inflation outstripped growth in earnings and GDP. Spending on tax credits and housing benefit also increased significantly, the former reflecting generous discretionary uprating (especially of the child element) and the latter reflecting growth in the number of renters and rent inflation outstripping earnings growth.

Future prospects for welfare spending

March 2014 *Economic and fiscal outlook* central forecast

13 Our latest medium-term forecast shows welfare spending rising by 12.5 per cent in cash terms between 2013-14 and 2018-19. We expect the cash size of the economy to grow significantly more quickly, so this reduces expected welfare spending by 1.2 per cent of GDP between 2013-14 and 2018-19, from 12.8 per cent to 11.6 per cent.

Table 1: Medium-term forecast of welfare spending

	Outturn	Forecast					
	2012-13	2013-14	2014-15	2015-16	2016-17	2017-18	2018-19
£ billion							
Total welfare spending	212.9	210.1	213.9	218.8	224.5	230.6	236.3
of which:							
Welfare spending subject to the welfare cap	116.5	116.4	117.8	119.5	122.0	124.6	126.7
Welfare spending outside the welfare cap	96.4	93.8	96.1	99.3	102.5	106.0	109.6
Per cent of GDP							
Total welfare spending	13.6	12.8	12.4	12.2	12.0	11.8	11.6
of which:							
Welfare spending subject to the welfare cap	7.4	7.1	6.8	6.7	6.5	6.4	6.2
Welfare spending outside the welfare cap	6.1	5.7	5.6	5.6	5.5	5.4	5.4

14 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. This is driven by:

- a 0.2 per cent of GDP drop in the cost of tax credits – the largest category of spending subject to the cap. This reflects a number of policy measures designed to cut spending, including uprating by 1 per cent for three years from 2013-14;

- falls of 0.1 per cent of GDP in spending on both housing benefit and incapacity benefits – the next largest spending items. Housing benefit falls as caseloads linked to other benefits decline relative to the adult population, partly offset by growth in the 'housing benefit only'[2] caseload of those in work. The expected fall in spending on incapacity benefits is partly driven by our assumption that the reassessment of employment and support allowance claims will reduce the overall caseload;

- a substantial fall in spending on disability benefits (worth 0.2 per cent of GDP) that is driven by the assumed reduction in caseloads as people's eligibility for support is reassessed when cases are migrated from the existing disability living allowance to the new personal independence payment; and

[2] This 'housing benefit only' caseload is described as 'only' in DWP data because recipients are not also in receipt of another DWP benefit. From the broader perspective of welfare spending, such claimants will typically receive some income from tax credits and, if they have children, will also receive income from child benefit.

- falls in spending on a number of other benefits, including pension credit (as the qualifying age is raised and the single tier pension is introduced), child benefit (due to uprating) and income support (as incapacity-related claims are migrated to employment and support allowance).

15 Spending outside the welfare cap is expected to fall by around a third as much – 0.3 per cent of GDP – as spending subject to the cap. That reflects:

- a 0.1 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, while the triple lock on uprating sees average awards rise broadly in line with earnings; and

- a 0.2 per cent of GDP fall in spending on the unemployed – comprising jobseeker's allowance and housing benefit paid to jobseekers. Spending on state pensions was around 12 times higher than spending on these benefits in 2013-14, so this represents a much larger proportional fall. Lower spending is driven both by lower cyclical caseloads and by average awards rising more slowly than earnings.

Key risks to the forecast

16 Our forecast for welfare spending is subject to a number of important risks and uncertainties. In particular:

- the three largest sources of uncertainty – and risks to the forecast – probably relate to housing benefit, incapacity benefits and disability benefits. In the case of housing benefit, this relates to the underlying economic drivers of both the caseload and the implied average award per claim. For incapacity and disability benefits, the major uncertainties are associated with ongoing policy reforms – the effect on caseloads and average awards as systems are changed, as existing caseloads are migrated from old to new benefits, and as savings are assumed to flow from the associated reassessment process. In both cases there have been delays to delivery of these reforms that have affected the timing and scale of expected savings. We will revisit our assumptions on these key areas ahead of our December 2014 forecast;

- the migration from six existing benefits to the single universal credit that is planned to take place over the coming years will pose many of the same problems, often to an even greater degree. But, quantitatively, this is not as large a risk to the forecast over the next five years as the reforms described above; and

- we have been surprised at the speed with which claimant count unemployment has fallen – not just because the broader survey measure of unemployment has fallen unexpectedly rapidly, but because the claimant count has fallen unexpectedly rapidly relative to that survey measure. The claimant count moved below 1 million in August 2014 – a level we not expect it to reach until 2017 in our latest forecast in March. It has fallen at a faster rate over the past year than at any time since 1973. This suggests that in our December 2014 forecast we will need to revise down our forecast of spending on jobseeker's allowance significantly. Some of the fall may reflect claimants moving onto other benefits, such as employment and support allowance.

17 So how do these risks affect the Government's welfare cap? The cap was formally defined and initially set in line with our Budget 2014 forecasts (Table 2). It will apply from 2015-16 to the end of the forecast period, which was 2018-19 in Budget 2014. The Government has set a forecast margin above the cap of 2 per cent in each year. In our December EFO, we will have to assess whether spending is likely to exceed the cap for discretionary policy reasons or the cap-plus-forecast-margin due to changes in our forecast assumptions.

Table 2: The level of the welfare cap and the forecast margin

	£ billion			
	2015-16	2016-17	2017-18	2018-19
Welfare cap	**119.5**	**122.0**	**124.6**	**126.7**
2 per cent forecast margin	2.4	2.4	2.5	2.5

18 The downside risks we have identified to our forecasts for jobseeker's allowance and associated payments of housing benefit lie outside the cap, whereas the significant upside risks on incapacity and disability benefits lie within it. The 'housing benefit only' group that has been the source of recent upward revisions to spending also lies within the cap.

19 More generally, with the welfare cap having been set in cash terms, inflation surprises are a key risk – especially if there is an upside surprise that comes after the period over which the uprating of most working-age benefits is being capped at 1 per cent. (Our central forecast implies that this cap will be binding and we assume that throughout the report.) An upside inflation surprise that occurred during the period of 1 per cent uprating would reduce the real value of most working-age benefits, rather than feeding through to higher spending.

July 2014 *Fiscal sustainability report* projections

20 Our 2014 *FSR* contained long-term projections of welfare spending. These projections capture the effects of demographic change on spending, with neutral assumptions in most other areas. An important difference from our medium-term forecasts is that we assume that benefits are uprated in line with earnings rather than inflation, which means that we do not allow spending to fall in our projections due to an ever-widening divergence between the living standards of those in work and those receiving income from the welfare system.

21 Our long-term projections show total welfare spending rising by 2.5 per cent of GDP between 2018-19 – the end of our medium-term forecast – and 2063-64, with almost all of 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. (This is based on the principle set out by the Government that people should expect to spend a third of their adult life in receipt of the state pension.) 'Triple lock' uprating is assumed to put further upward pressure on state pensions spending as a share of GDP over the long term.

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

- spending on incapacity and disability benefits rises, in large part due to the ageing of the population, because we assume constant age-specific shares of the population in receipt of incapacity benefits. Cohort effects raise the caseload as a share of the adult population as the population ages. For disability benefits, even though we assume 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 2.3 per cent of the population in 2014 to 7.7 per cent in 2064; and

- spending on housing benefit falls, due in large part to assumed higher home-ownership rates for pensioners. This reflects cohort effects – newly-retired pensioners have higher home-ownership rates than the oldest pensioners, which all else equal means fewer newly-retired pensioners are eligible for housing benefit.

Table 3: Long-term projections of welfare spending

	Forecast		Projections				
	2013-14	2018-19	2023-24	2033-34	2043-44	2053-54	2063-64
Per cent of GDP							
Total welfare spending	12.6	11.6	11.8	12.9	13.6	13.9	14.1
of which:							
State pensions[1]	5.8	5.5	5.7	6.7	7.4	7.6	7.9
Other welfare spending	6.8	6.1	6.1	6.1	6.2	6.3	6.2
Per cent of total welfare spending							
State pensions[1]	46.0	47.7	48.1	52.2	54.3	54.8	56.0
Other welfare spending	54.0	52.3	51.9	47.8	45.7	45.2	44.0

Note: Figures for 2013-14 and 2018-19 presented on a UK-basis, consistent with our 2014 *Fiscal sustainability report* projections.
[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