IPPR

REPORT

ON THE FRONT FOOT

DESIGNING A WELFARE CAP THAT REFORMS SOCIAL SECURITY

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ABOUT IPPR

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for CHANGE

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EXECUTIVE SUMMARY

In this summer's public spending round, George Osborne announced his intention to introduce a new cap on a significant share of welfare spending, as a way of bringing greater planning and control to so-called 'annually managed expenditure' (AME). A few weeks earlier, Ed Miliband had pre-empted the government by making the case for controlling the welfare bill through deeper reforms which address the drivers of higher spending – and expressing support for a cap on 'structural' (as opposed to cyclical) welfare expenditure (Miliband 2013). Arguments about the nature and implications of the 'welfare cap' are set to play a central role in the debate about the public finances between now and the next election.

The backdrop to this issue is a significant shift in the balance of public spending towards AME – almost two-thirds of which is accounted for by social security and tax credits – and away from departmental expenditure levels (DEL), which has been cut heavily during the current parliament. Between 2007/08 and 2014/15 – from the start of the financial crisis to the end of the current parliament – AME is projected to rise by £77.4 billion overall (excluding locally financed expenditure). The higher cost of social security and tax credits is set to account for £52.7 billion (or 68 per cent) of that rise.

IPPR's analysis of Department for Work and Pensions (DWP) data shows that social security and tax credit expenditure is set to be almost £35 billion higher in real terms by 2017/18 than it was in 2010/11; this is despite a programme of cuts that will reduce welfare spending by over £21 billion a year relative to what it would otherwise have been by the end of this period. Even taking these unprecedented reductions into account, welfare spending is now expected to be £11.3 billion higher by the end of this parliament, in 2014/15, than the government was forecasting in its emergency budget of June 2010. Overall, AME in 2014/15 is now expected to be £15.1 billion higher than it was in projections made in June 2010.

However, these increases are not evenly distributed. Based on the latest estimates, over three-quarters (77 per cent) of the rise in welfare spending between 2010/11 and 2017/18 will come from higher spending on benefits for pensioners (a net rise of £27 billon). By contrast, less than a quarter (23 per cent) of this growth is set to come from extra spending on children and people of working age (a net rise of £8 billion). Other than the state pension, which dwarfs all other rises, spending on tax credits, housing benefit and disability benefits are set to rise by nearly £13 billion in cash terms between 2010/11 and 2017/18 – despite being the focus of considerable cuts.

Looking beyond the figures, the politics of the welfare cap are clear. In setting a cap in the 2014 budget for 2015/16 onwards, the chancellor will establish a baseline for public expenditure well into the next parliament. This will be based on his chosen path for deficit reduction, including a breakdown of overall DEL and overall AME allocations. He will then pledge that a future Conservative government would guide policy to hit those spending trajectories, probably including significant further welfare cuts. Finally, he will challenge Labour (and the Liberal Democrats) to either back those plans, or set out an alternative combination of higher taxes, extra cuts to departmental expenditure or greater borrowing.

Understanding trends in social security and tax credit expenditure

Political choices about the future of welfare spending should be based on a solid understanding of how it has evolved in the past. Therefore, before turning to arguments about the principle and design of a welfare cap, it is necessary to properly understand trends in social security and tax credit expenditure not just in the last few years, but also

over a longer timeframe. The main findings of new IPPR analysis of trends in welfare spending since the war can be summarised as follows:

- **Expenditure on social security and tax credits has increased substantially and steadily throughout the postwar period.** It is now more than three times larger as a share of national income than it was in the late 1940s, having grown from 4 per cent to 14 per cent of GDP over that period. It also rose from 19 per cent of total public spending in 1978/79 to an estimated 30 per cent in 2012/13. However, welfare spending remained broadly flat as a share of GDP from the late-1990s until the financial crisis. Across the postwar decades, spending has risen faster during recessions, but has fallen by far less – if at all – during recoveries.
- **The rise in spending on pensions in the coming years will consolidate its longstanding dominance of welfare spending:** it accounted for 55 per cent of welfare spending back in 1952. Expenditure on pensioners grew from 2.0 per cent of GDP in 1952 to 5.4 per cent in 1979, before reaching an estimated 7.1 per cent in 2012. As a share of all government spending, it has risen from 11 per cent in 1978/79 to 16 per cent in 2012/13. Between 1979 and 2013, real terms expenditure on pensioners has more than trebled, from £38 billion to £117 billion (in 2013/14 prices).
- **Expenditure on working-age social security rose gradually in real terms over the postwar decades, before spiking by almost £20 billion (in 2013/14 prices) between 1991 and 1996.** However, it then stayed virtually flat in real terms over the following decade: £51.6 billion in 1996 compared to £52 billion in 2007, just before the financial crisis. Working-age welfare spending then rose by a little under £10 billion in real terms over the next three years, following the recession.
- **The welfare system has grown significantly in scope and range since the late-1940s.** According to the latest figures, there were 31 separate benefits and payments in 2011/12, compared to just seven in 1948/49 – not including the numerous different rates and categories within many current benefits. The introduction of the universal credit will streamline the system, but even after its implementation (assuming this occurs) 20 different benefits will still remain.
- **Over the last two decades there has been a major decline in spending on the main income-replacement benefits for people who are out of work.** These comprised over a quarter (27 per cent) of the welfare budget in 1952, declining to just over a tenth (10.5 per cent) in 2012, despite the fact that unemployment is structurally far higher now than it was in the early 1950s. This is partly due to administrative changes that have stripped out 'extra costs' additions from the main income-replacement benefits (jobseeker's allowance, employment and support allowance and income support). However, it is also a result of steady declines in both caseloads (at least until the recession) and inflation – or sub-inflation – uprating.
- **The largest rises in welfare spending have been on the 'extra cost' payments for housing, disability and children**, which were created or extended in the 1970s and have since substantially expanded in cost and scope. Expenditure on housing benefit has risen five-fold in real terms over the last 30 years. Real spending on disability living allowance has risen four-fold in the last decade, and real-terms spending on cash benefits for families with children has more than doubled since the mid-1990s.

- **There has been a gradual – and not always explicit – expansion in spending on benefits for low-income working households in recent years.** For example, 72 per cent of tax credit expenditure (£21.1 billion a year) now goes to working families – a greater share than a decade earlier, despite the fact that unemployment is now significantly higher. Around £4.5 billion of housing benefit expenditure is paid to subsidise the rents of working households.
- **There has been a large decline in the share of welfare spending channelled through contribution-based benefits.** In 1979/80, 63 per cent of the total social security budget was accounted for by contributory benefits, compared to 21 per cent on universal payments and just 16 per cent on means-tested entitlements. However, by 2011/12 contributory benefits only accounted for 42 per cent of social security spending, compared to 18 per cent on universal payments and 39 per cent on means-tested entitlements.
- **Almost £9 in every £10 spent on contributory benefits (88 per cent) goes on the state pension**, which illustrates the decline in the role of contribution-based benefits is concentrated among working-age households. In 1979/80, 28 per cent of non-pensioner welfare went on contributory benefits, 38 per cent went on universal benefits, and 34 per cent was channeled through means-tested entitlements. By 2011/12, nearly two-thirds (65 per cent) of spending on working-age and children's benefits went on means-tested payments, compared to just over a quarter (26 per cent) on universal payments and less than one-tenth (9 per cent) on contributory benefits.
- **Expenditure on social security and tax credits, while progressive overall, reaches well into the top half of the income distribution.** Almost three-quarters (74 per cent) of households receive some income from the welfare system. Half of all households receive between £1 and £199 a week, a fifth receive between £200 and £399 a week, while just 1.3 per cent of households receive more than £500 a week from benefits, tax credits or pensions. This is the level of the government's 'benefit cap' for couple families and single parents with children. Means-tested payments are by far the most progressive, with contributory and universal entitlements more evenly distributed. Welfare reduces income inequality at the household level relative to original market incomes, but it has far less redistributive impact than taxation.
- **Expenditure on social security as a share of GDP is slightly lower in the UK than the OECD average.** Spending in this country is below that of a number of major European countries, including France, Austria, Italy, Belgium, Finland, Portugal, Spain, Germany, Denmark, Sweden and Ireland. However, it is higher than in Norway, the Netherlands, and the collection of liberal welfare regimes with which the UK is often grouped in the literature: the US, Canada, Australia and New Zealand.
- **Many OECD countries' welfare systems are dominated by pensioner spending to an even greater degree than the UK's.** In Italy, for example, 82 per cent of social security spending goes to pensioners. However, once spending on pensioners (and survivors) is stripped out, the UK rises in the OECD league table: in terms of the share of national income spent on family, incapacity, housing, unemployment and other social benefits, the UK – at 7.2 per cent of GDP – is surpassed only by Ireland (9.1 per cent), Denmark (8.6 per cent), Belgium (8.3 per cent) and Finland (7.6 per cent).
- While acknowledging the imperfections of OECD comparative data, it seems that **the UK is a relatively high spender on housing benefits and benefits for children**. Wider data on family-related spending suggests that the UK channels a much higher proportion of expenditure through cash benefits relative to 'benefits in kind' (mainly services like childcare and early-years education). According to the

OECD, two-thirds (66 per cent) of UK public spending on families goes on cash benefits – a higher share than in Germany (57 per cent), Finland (52 per cent), Italy (50 per cent), France (44 per cent), Norway (44 per cent), Sweden (43 per cent), Denmark (41 per cent) and Iceland (40 per cent).

- **However, the UK appears to be a comparatively low spender when it comes to unemployment benefit**, where expenditure is lower in the UK as a share of national income than in every other major European country except Norway. This is not due to unusually low unemployment, but to very low 'replacement rates': the proportion of previous earnings that households receive from the social security system upon becoming unemployed. A single person on the average wage, with no children and no housing support, could expect to receive just 13 per cent of their previous working income if they lost their job – compared to an OECD average of 56 per cent.
- **Social security and tax credit spending is driven by both *cyclical factors* related to the performance of the economy, and *structural factors* rooted in wider economic, social and demographic forces.** It is difficult to separate out the significance of each factor, but the rudimentary analysis presented in this paper suggests that expenditure on jobseeker's allowance is strongly cyclical, while spending on employment and support allowance (previously known as incapacity benefit) is largely unrelated to the economic cycle. There is a cyclical element to trends in housing benefit, but also an unrelenting structural rise. Much further analysis is needed to fully decompose the drivers of welfare spending, both overall and among its constituent parts.

To provide another perspective on these trends, we commissioned original polling from YouGov to find out what the public think about social security and tax credit spending:

- **Respondents massively underestimated the amount spent on pensioners, and substantially overestimated the amount spent on out-of-work benefits.** The average respondent thought that 20 per cent of the welfare budget goes to retired people, and that an equal share is spent on out-of-work benefits. In fact, a little under half (43 per cent) of expenditure is accounted for by pensioner benefits, while just a tenth (10 per cent) goes on the main income replacement benefits for people who are out of work.
- **Respondents were split on whether individual behaviour or structural factors are to blame for recent rises in the benefits bill.** When asked to pick two options from a longer list of potential causes of higher welfare spending, 39 per cent said they thought that greater numbers of immigrants coming to Britain was to blame, while 30 per cent thought that rising numbers of people choosing not to work was a key factor. By contrast, 37 per cent pinpointed rising unemployment and falling wages caused by the recession, and 34 per cent identified a greater number of people in retirement and living longer as the main explanations for the growth in social security expenditure.
- **Pensioners, disabled people and (to a much lesser extent) the recently unemployed were judged to be the most deserving of support from the welfare system.** Given three choices from a range of options, over three-quarters (76 per cent) of respondents to our poll singled out pensioners who have worked most or all of their lives as being among the most deserving, and over two-thirds (67 per cent) put people with a serious, long-term disability in that camp. The group considered the next most-deserving was people who have just lost their job (39 per cent).

- **Wealthy pensioners, large workless families, and in particular those deemed to be 'not trying hard enough to find work', garnered the least public sympathy.** Nearly three-quarters (74 per cent) of our respondents picked those who could work but are not making enough effort to secure a job as being among the least deserving of support from the welfare system. Almost two-thirds (63 per cent) put wealthy pensioners with other sources of income in this category, while a little under half (46 per cent) selected families with more than three children and no adult in work.
- **A substantial proportion of respondents thought that the welfare system provides too little financial protection when people fall on hard times.** Almost half (49 per cent) agreed with this statement, while less than a fifth (17 per cent) disagreed. This is consistent with the comparative analysis mentioned above, showing that the UK has low net replacement rates, relative to other major European countries, for the majority of family types when they are hit by unemployment. However, respondents were more evenly split when asked whether the system provides too little money to families with children in poverty. Over a third (37 per cent) agreed with this statement, but nearly a quarter (24 per cent) disagreed.
- **There was strong consensus that the welfare system does too little for people who have contributed to it, and is too soft on people who could work but don't.** Nearly eight in 10 respondents (78 per cent) agreed with the former proposition, while over three-quarters (76 per cent) backed the latter. Significantly, large majorities of Labour voters are part of this consensus (with 75 per cent and 65 per cent of them supporting these two positions respectively). Only 16 per cent of people who responded to our poll agreed that there are no fundamental problems with the welfare system.

The centre-left case for a welfare cap – and its strategic objectives

Given that the Coalition government has already taken over £21 billion out of social security spending, there are understandable fears about the prospect of a welfare cap. A range of fiscal choices are available to governments in order to make the public finances sustainable in the medium term – choices related to the pace of deficit reduction, the mix of spending cuts and tax rises, and priorities within both taxation and spending. However, the argument of this paper is not only that the risks associated with a welfare cap can be minimised through careful design, but that a positive case can be made for such a cap as a means of advancing strategic centre-left goals. There are five reasons for this:

1. The level of welfare spending is an unavoidable question that will continue to face policymakers in the coming years, and which will require its growth to be controlled. The centre-left should be wary of advocating higher social security spending as an indicator of greater social justice, and of appearing to deny the existence of trade-offs between different areas of public expenditure.
2. Even if current levels of spending were thought to be appropriate, there would still be a strong case for questioning where expenditure is directed, and for what purpose. Acknowledging this fact would enable the centre-left to avoid defending the current constellation of spending as the best possible embodiment of its values.
3. There are good reasons to worry about the relative drift from AME to DEL in recent years, which has shifted the balance of public spending away from avenues that tend to be more productive, efficient, resilient and solidaristic. In an era of fiscal constraint, the centre-left should be looking to maximise social

investment over what might be termed 'compensatory welfare' (or spending that results from social, economic or market failures).

4. Given this objective, the absence of an institutional mechanism for understanding and acting on the connections between AME and DEL is hugely problematic. It makes it hard for the centre-left, and others, to advance reforms that would reduce the demand for welfare spending and make better use of scarce resources.
5. Public confidence in the social security system is fragile, which is a major strategic concern for those committed to its health and strength. For this reason, it is essential for the centre-left to contest, not concede, the terrain of reform, while adopting an assertive rather than defensive political stance.

Building on these arguments, a plausible strategy for the centre-left would be to agree that it is necessary to control welfare spending, given the current pressures on the public finances and the importance of other areas of expenditure. However, it can offer a distinctive analysis of both why spending has been rising and how it can be controlled and better spent. Wherever possible, these positions should make common cause with broadly shared public sentiment. There should be three broad elements to such a strategy – which a welfare cap, if properly designed, could encourage and support.

1. Bring down cyclical welfare spending as quickly as possible, while enabling automatic stabilisers to support demand during economic downturns.

First and foremost, this involves reducing unemployment, which would reduce reliance on out-of-work benefits and other cash transfers. More broadly, a higher employment rate is essential for securing long-term fiscal sustainability and financing both the social security system and wider public services. New IPPR analysis has found that increasing the employment rate by 1.5 percentage points – from its current level of 71.5 per cent to 73 per cent – would reduce spending on tax credits and benefits by £2.4 billion. The overall fiscal gain from such a growth in the employment rate would be even higher, adding £3.1 billion in extra income tax and national insurance contributions (NICs). This would mean an overall net gain to the exchequer of £5.5 billion.

At the macro-level, key levers for pursuing this goal could include building on Mark Carney's recent 'forward guidance' by giving the Bank of England an explicit dual mandate in relation to employment as well as inflation. It could also involve orientating fiscal policy towards raising employment. In the short term, this might mean making fiscal contraction conditional on falling unemployment. It might also mean prioritising public spending that drives job creation – such as capital over current expenditure – and steering wider economic, labour market and taxation decisions towards those that are pro-employment.

Rising wages would also bring down cyclical welfare spending, particularly given the growth of expenditure on working households. This has been partly the result of deliberate decisions to improve work incentives, such as through tax credits, but also of the large number of households that have at least one adult in employment yet still have a low income. New modeling by the IPPR suggests that if real earnings were to grow by 2 per cent in 2013/14 then tax credit and benefit spending would be £1.1 billion lower, and income tax and NICs receipts £12.5 billion higher, than they would be if wages were to fall by 1.5 per cent in real terms this year as is projected by the Office for Budgetary Responsibility (OBR).

The causes of wage stagnation continue to be debated, and there are no guarantees that pre-recession rates of increase will be restored, or that rises in pay levels will be equitably shared. Perhaps the best prospect for securing rising wages for low- and middle-earners is a reduction in unemployment and a tighter labour market. Other possible strategies include reigning in excessive pay among top earners, improving intermediate-level technical skills (and demand for them among employers), a more assertive industrial policy, the development of stronger institutional arrangements to support 'high road' economic development, and increasing the bargaining power of ordinary workers (through trade unions or other labour market institutions).

Increasing the national minimum wage would reduce welfare spending, while previous analysis by IPPR and the Resolution Foundation found that if the living wage were paid to all workers whose earnings are currently below it, annual spending on tax credits and benefits would drop by £1.1 billion. Strategies for spreading the living wage include adopting it across the public sector and its supply chain (via procurement rules), requiring transparency about low pay in the private sector, and developing 'living wage zones' in which tax and benefit savings made from paying local government workers the living wage are drawn forward and devolved to support private-sector firms in making the transition away from low-pay business models.

It is vital that any welfare cap does not prevent the automatic stabilisers from fulfilling their role in maintaining demand during a downturn. If anything, their firepower should be strengthened to protect the economy from long-term damage during a recession: for example, a cut to employer NICs and extra funding to maintain adviser-claimant contact levels at JobCentre Plus could be automatically activated if unemployment hits a certain level. Similarly, the payment schedule for the Work Programme could be made more sensitive to the economic cycle, so it becomes a better measure of provider performance: maintaining cash flows during downturns, and preventing windfall gains when there is a labour-market upswing.

2. Advance reforms that reduce the costs of market failures and switch resources to social investments among the working-age population.

It is essential that welfare expenditure rises during a recession. The problem is that it does not fall – either at all, or in key areas – when the economy is growing. Spending is not entirely cyclical: it also reflects structural drivers such as rising rents, inadequate childcare, low skills, and worklessness among those on inactive benefits. These are often rooted in wider economic and social challenges, but public policy – and public spending – can make a difference.

This means that a premium must be placed on spending switches and institutional reforms that deliver better outcomes and greater value for money by reducing the demand for social security and tax credit expenditure (outside of variations in the economic cycle). In many areas, non-cyclical welfare spending is driven by irreducible demographic factors such as pensions, or is advancing important and chosen goals like meeting the extra costs of disability. Yet there is scope to reduce those costs that arise due to 'market failures', and to ensure that public money is spent in the most effective ways.

In some instances, putting cash in the pockets of individuals or households is essential or desirable. However, on the grounds of efficiency, resilience and solidarity – as well as supporting production over consumption – there are often reasons for preferring spending on services to spending on benefits. This is especially true in cases where the latter is

given principally to purchase the former. In areas like housing, childcare and social care, demand subsidies are often not the most effective or efficient means of developing high quality, reliable provision and, unless there is sufficient supply in a given market, they risk simply increasing prices.

This change in approach could have substantial implications for the direction and organisation of spending. In housing, it could mean creating the institutional conditions for a long-term shift towards capital expenditure to build homes, and away from subsidising rents through the benefit system. In childcare, it could mean shifting the balance of public spending away from cash benefits to families with children, and towards investing in the quality and availability of childcare services that enable parents to work and help overcome early childhood disadvantage. In social care, it could mean including attendance allowance (and DLA for the over 65s) in reforms to the funding and provision for those who have care and support needs in their later lives.

Reducing long-term unemployment and inactivity (plus low labour productivity) would also drive down social security and tax-credit costs. Over the last 25 years while significant advances have been made in 'supply-side' active labour-market policies, they have not solved this problem. Therefore, these traditional strategies could be complemented by 'demand-side' approaches such as wider use of intermediate labour-market programmes ('job guarantees'), or by boosting the 'incentive to hire' for employers through, for example, wider use of wage subsidies or lower labour taxes for those facing labour-market disadvantage. Alternatively, hiring could be 'de-risked' for employers – for example, the state could take on liability for sickness absence among workers with pre-existing health conditions.

One additional approach could involve forging closer connections across Whitehall so as to take account of the relationships between aspects of DEL and dimensions of AME. This is a necessary condition for driving more strategic, long term spending decisions in areas like childcare, housing and health. Another is that experiments in community budgets and the City Deals process could be expanded into more ambitious approaches with multi-year 'place-based budgets'. This would involve cities and combined authorities being given the ability to pool funding and make the trade-offs between AME and DEL that are most effective and offer the best value for money in their particular part of the country.

The original polling conducted for this report shows considerable public support for strategic spending switches such as these – particularly in relation to housing, job guarantees and the living wage (see page 49).

3. Defend the value and integrity of the state pension, while addressing the fiscal challenges of rising longevity.

Along with the NHS, the state pension is an enduring and resilient part of the postwar social democratic settlement. It plays a major role in ensuring dignity and security for people in retirement. To defend this achievement, however, the long-term affordability of the state pension must be secured. The chancellor has decided to keep the state pension out of the welfare cap, arguing that incremental increases in the state pension age provide a mechanism for responding to rising longevity. The current government's decisions to bring forward increases in the retirement age to 66 and 67 years old have delivered large savings – and it is likely that the rise to 68 (currently scheduled for 2046) will also be accelerated.

Another option would be to return to earnings-linked uprating – the longstanding goal of pension campaigners during the 1980s and 1990s. The OBR estimates that increasing the state pension in line with earnings would save 0.9 per cent of GDP – or £14 billion in 2013/2014 prices – by 2060 compared to maintaining the current 'triple lock'.[1] More radically, there may be a case for making the link between NICs and the financing of the state pension more explicit, such as through hypothecating revenues from the rest of the public finances, in order to entrench its contributory nature, protect it from political raids, and internalise the challenge of long-term affordability.

Not all social security spending which goes to older people is channelled through the state pension. In 2011/12, £8.4 billion was spent on pension credit, £2.2 billion on the winter fuel allowance and £600 million on free TV licences for the over-75s. Strategically, the defence of these more marginal benefits is not as important as that of the basic state pension, especially at a time when working-age households are facing numerous substantial hits to their income. For example, restricting the winter fuel allowance and free TV licences to households which receive pension credit would save £1.7 billion a year. Older people can also make a contribution to financing the welfare system by working longer, as many already do. The employment rate of those aged 50–64 rose from 56 to 66 per cent between 1992 and 2012, while among those aged over-65 it rose from 5.6 per cent to 9.0 per cent over the same period.

Maximising opportunities and limiting risks in designing the welfare cap

The key question about the design of the welfare cap is whether it helps to bring down the benefits bill by promoting genuine and enduring savings rather than short-term and short-lived cuts. Drawing on the analysis above, this means not inhibiting steps to reduce cyclical spending as quickly as possible; positively driving strategies for spending switches and institutional reforms; and contributing to measures necessary for managing the costs of an ageing society.

Decisions related to the cap must be rooted in a strong understanding of the drivers of AME and its sensitivity to other factors, including relevant aspects of DEL. Furthermore, it must enable more strategic decision-making and long-term planning in public expenditure. The government has acknowledged that further work is needed on the design and operation of the welfare cap. However, changes are needed to what it has proposed so far. To advance the objectives outlined above, the welfare cap needs the following features:

- **The cap should be inflation-proofed to focus on real-terms trends in spending, and to protect claimants against permanent erosions to their living standards.** In the government's current plans, any changes in inflation after the cap is set would not be adjusted for across the whole five-year period. This would mean that the cap could be breached – and reductions in support triggered – as a result of fluctuations in inflation rather than any underlying shift in spending pressures. This is contrary to the government's stated goal that the cap should protect against 'structural deterioration' in welfare. The cap should operate on a real-terms, rather than nominal, basis.
- **All contributory benefits, alongside the state pension, should be kept out of the cap, as these entitlements are based on the payment of NICs.** A better argument than the one given by the government for keeping the state pension out of the cap is that it is a contributory benefit, entitlement to which is earned

1 Assuming that earnings and inflation follow the same pattern as has been the case since 1993. The 'triple lock' is the Coalition government's guarantee that the state pension will rise every year in line with whichever increase is greatest between prices, earnings, or 2.5 per cent.

by paying NICs. This principle should be extended to working-age entitlements by keeping contributory job-seeker's allowance (JSA), employment and support allowance (ESA) and other contribution-based benefits outside the welfare cap. This would mark an important step towards reviving the contributory principle and recognising its unique status, distinct from means-tested and universal benefits. This would leave non-contributory pensioner benefits, such as pension credit and winter fuel allowance, and other benefits – like housing benefit and disability living allowance (and its successor, the personal independence payment) – that are paid to pensioners, within the welfare cap.

- **All non-contributory benefits should fall under the cap, but with a 'buffer' based on assessments of the sensitivity of welfare spending to cyclical fluctuations.** The government intends to preserve the automatic stabilisers by excluding JSA and 'passported benefits' from the cap. However, this is likely to prove crude and inaccurate. It is not only these benefits that are driven by the cycle, and not all JSA spending is cyclical (such as long-duration claims). The government has also said that 'there will be a margin above the cap to ensure policy action is not triggered by small fluctuations in the forecast' (HMT 2013a), and it would be better to preserve the automatic stabilisers through this provision. As such, when the cap is set, the scale of the 'buffer' within which spending could rise without the cap being breached should be identified. This should be consistent with an OBR assessment of the sensitivity of relevant expenditure to the cycle, based on historical data, contemporary modeling and the latest economic forecasts.
- **The OBR should conduct a detailed, annually updated analysis of what drives welfare spending, and its sensitivity to a range of factors, including DEL.** To ensure that the cap drives strategic decision-making, prior to its introduction the OBR should publish a detailed analysis of the factors driving different aspects of welfare spending, and its sensitivity to economic, social and demographic forces. This should explore the extent to which expenditure is the result of cyclical or structural factors, and quantify the relative importance of, for example, longevity, the labour market, family formation, benefit uprating and the housing market. This would greatly improve the evidence base for policymaking, helping to distinguish between desired and undesired spending. It would also highlight where and to what extent departmental spending or other policies might reduce the demand for welfare expenditure, and thus make best use of public money in the service of a given goal. Regularly updated, this analysis would also greatly enhance public awareness and media debates about welfare spending.
- **The cap should apply over a five-year time horizon, rather than biting annually, to allow space for genuine savings from reforms that address the structural drivers of welfare spending.** The other necessary condition for generating real savings, rather than short-term cuts, is a reasonable timeframe for reform. The government's plan is for a cap that bites on an annual basis. Initially set in the 2014 budget to apply just a few months later in the 2015/16 financial year, it would then be set for each subsequent year. This framework promotes the exact opposite of long-term, strategic decision-making. What the government should do instead is to set a rolling five-year cap, with the OBR responsible for judging whether or not spending will breach the cap by the end of the forecast horizon, based on current policy and forecasts. This would force the government to make active decisions for which they would be held to account. But, crucially, it would also provide a sufficient timeframe in which to plan medium-term spending switches and institutional reforms that are

capable of delivering genuine savings. This would fit well with a five-year spending plan set by the incoming government in 2015 which would cover the whole of the next parliament.

- **The introduction of the cap should be combined with experiments in DEL–AME switches, both between departments and through place-based budgeting.** To further drive strategic spending decisions that generate real savings, the cap should be used to launch a series of experiments and innovations in public spending. This should include multi-year place-based budgets for major cities and combined authorities that allow the pooling of public spending across existing departmental divides and between AME and DEL (such as housing, skills and welfare-to-work expenditure). Innovations should also be pursued across Whitehall, building on the precedent of the internal 'DEL–AME' switch at the recent spending round which allowed a series of labour-market interventions to be funded on the basis of OBR estimates of the likely benefit savings they would generate. This opens up the prospect of similar spending switches being made across Whitehall in areas where there is strong 'invest to save' evidence (which is likely to be the case in childcare and housing).
- **Personal tax reliefs – such as for pensions and childcare – should be included under the cap to promote a rounded view of public, private and employer spending on welfare.** Public expenditure on welfare sits alongside spending by individuals and contributions by employers. Therefore, the OBR should consider trends in private and employer spending on equivalent functions in its forecasts. This would highlight where public spending is supplemented or replicated by other parts of society, as well as where gaps exist in provision across all sectors. This should include 'fiscal welfare' – spending that serves the same or similar functions as social security and tax credits, but which is directed via the tax system. The largest item is pension tax relief, which disproportionately benefits the better-off. Such items, which mirror social security, should be included in the cap to encourage integrated policymaking and equitable burden sharing. Their inclusion is particularly necessary given that the government is extending the use of fiscal strategies to pursue welfare goals such as through 'tax-free childcare'.

The decision about the level at which the cap should be set will depend on circumstances – and will be a highly political judgment. But its design is crucial too, particularly if it is to act as an institutional force for shifting the focus of spending towards social investments and reducing the demands placed on the welfare system. Getting this design right could help to offer a plausible strategy for maintaining fiscal responsibility while advancing distinctively centre-left objectives, and for promoting an assertive prospectus for welfare reform that taps into broadly shared public sentiment. Such an approach is essential for securing the future of an effective and resilient welfare state.

1. THE CONTEXT AND POLITICS OF THE 'WELFARE CAP'

In this summer's public spending round, George Osborne announced his intention to introduce a new cap on a significant share of welfare spending as a means of establishing greater planning of and control over so-called annually managed expenditure (HMT 2013a: 26–27). A few weeks earlier, Ed Miliband had pre-empted the government by making the case for controlling the welfare bill through deeper reforms that address the drivers of higher spending – and expressing support for a cap on 'structural' (as opposed to cyclical) welfare expenditure (Miliband 2013). Arguments about the nature and implications of the 'welfare cap' are set to play a central role in the debate about the public finances between now and the next election.

With that as its context, this paper aims to provide a fuller understanding of the trends and drivers of the expenditure which will fall under the scope of the proposed 'welfare cap' (as well as the important aspects of social security spending which will not). Based on this analysis, it then discusses how the cap should be designed so that it can drive the generation of real savings – through spending switches and institutional reforms – rather than simply as a mechanism for delivering short-term, short-lived cuts. This report's central conclusion is that fiscal constraints must be taken seriously, and therefore the balance of spending must be shifted away from compensatory welfare and towards social investment. The paper also presents results from original polling, commissioned by IPPR and conducted by YouGov, which tests the public's understanding of welfare spending, explores their priorities, and gauges their reactions to a series of new strategic policy directions.

To begin with, some definitions are necessary. 'Annually managed expenditure' (AME) is the part of public spending that is not allocated in fixed budgets to departments (which are collectively known as departmental expenditure limits, or 'DEL'). The rules governing specific aspects of AME are set out by the government in policy or statute. However, the level of spending in any given year is responsive to variable factors that are related to the economic cycle, demographic trends and household circumstances – the Office for Budget Responsibility (OBR) sets out projections for AME based on current policy. However, there is not a fixed AME budget, as is the case for, say, the NHS, where fiscal pressures are also to some degree affected by levels of demand. The objective of a welfare cap is to bring a greater proportion of AME more firmly within the government's control.

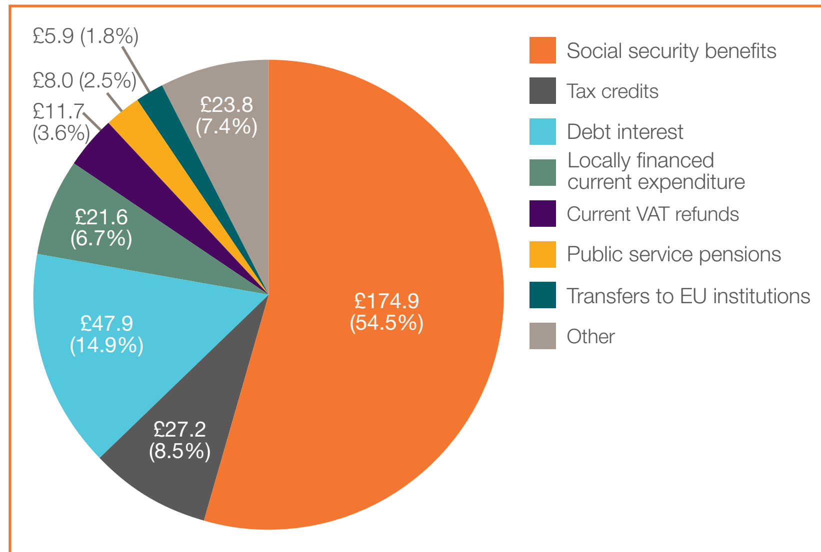
To understand why this has become an issue of political concern, it is necessary to explore trends in the balance of the public finances in recent years – and in the years immediately ahead.

1.1 The balance of public spending has shifted from DEL to AME

During the last full financial year (2011/12) overall public expenditure was £693.6 billion (HMT 2013b: 103).[2] Just under half (48 per cent) of this total (£336.2 billion) was accounted for as AME, with just over half (52 per cent) accounted for as DEL (£357.4 billion). Figure 1.1 below breaks down AME expenditure in 2011/12 into its component parts, showing that almost two-thirds (63 per cent) comprised spending on social security and tax credits. Together, these two categories accounted for £3 in every £10 of all public expenditure. The other large item of AME is debt interest, which accounted for £47.9 billion in 2011/12. The level of these payments depends on both the stock of debt issued by the government and the cost of borrowing to the exchequer.

2 This figure includes both capital and current expenditure.

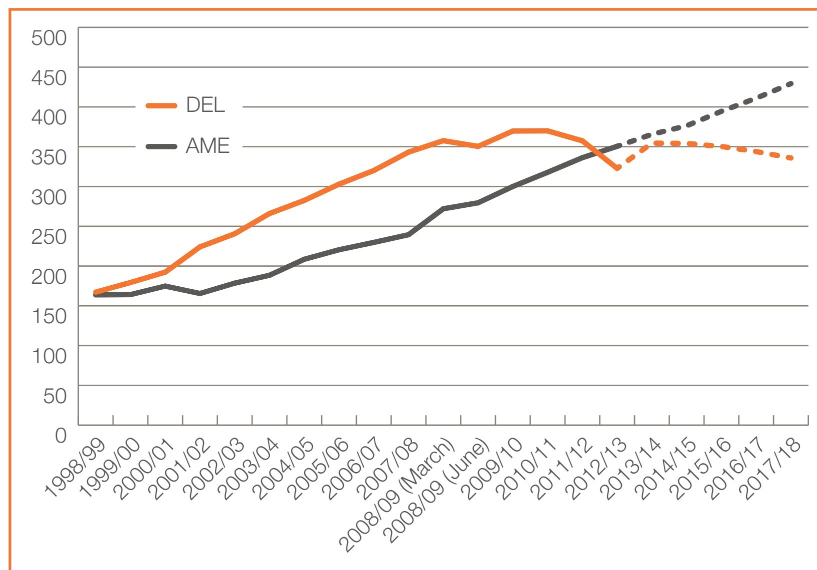
Figure 1.1
Breakdown of AME, 2011/12



Source: HMT 2013b: 103

Public expenditure has been divided between DEL and AME since 1998.[3] In the following year, total managed expenditure (TME) was split fairly evenly: £167.2 billion on DEL and £163.8 billion on AME (1998/99).[4] Figure 1.2 shows how the balance of spending has evolved since then, and includes projections out to 2017/18 based on the latest OBR forecasts. The accentuated drop in DEL for 2012/13 is caused by the transfer of Royal Mail assets onto the government's balance sheet, which counted as negative capital spending and so artificially pulled the figure down.

Figure 1.2
Recent trends in DEL and AME, in cash terms, 1998/99–2017/18



Source: Treasury budget documents back to 2000; latest data, including future projections, from HMT 2013b
Note: Figures from 2012/13–2017/18 are projections only.

3 For more information, see http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/newsroom_and_speeches/press/1998/press_100_98.cfm

4 Source: Treasury budget documents 2000–2013; latest data from HMT 2013b.

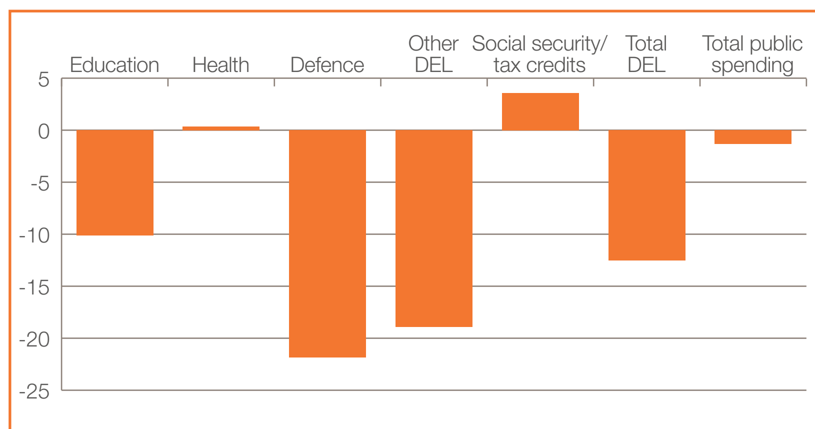
This data shows that DEL grew strongly from the turn of the century until the financial crisis, reflecting the substantial increases in spending on public services made by the last Labour government (after the fiscal restraint of its first two years in office). After 2010, however, DEL flattens and then falls, consistent with the Coalition government's squeeze on public spending, which has heavily targeted departmental expenditure and which is scheduled to continue well into the next parliament.

The chart also demonstrates that AME has risen consistently and substantially for the last decade. Between 2001/02 and 2006/07, a period marked by strong economic growth and high employment, it rose by £73.9 billion. It then spiked by almost £100 billion in just the four years between 2007/08 and 2011/12, as the financial crisis sparked a deep recession and put upward pressure on cyclically sensitive spending. However, looking at the period as a whole, trends in AME do not appear to be straightforwardly cyclical. This is underlined by future projections, which forecast that AME will rise on a consistent basis until 2017/18, despite the expectation that economic growth will return – not to mention the government's programme of welfare cuts and below-inflation benefit uprating.

Between 2007/08 and 2014/15, from the start of the financial crisis to the end of the current parliament, AME is projected to rise by £77.4 billion overall (excluding locally financed expenditure) (HMT 2012a: table 1.1). The higher cost of social security and tax credits is set to account for £52.7 billion (or 68 per cent) of that rise. The other substantial factor is increasing debt interest payments, which are set to increase by £23.7 billion over this period (and projected to account for 30 per cent of the rise in AME). Other factors, such as public sector pensions, the National Lottery, the BBC and contributions to the EU, make up the remaining 2 per cent of the rise in AME over this period.

These figures need to be understood in the context of wider trends in public expenditure. Figure 1.3 below shows that social security and tax credits stand out (along with health, but only just) as the only major area of public spending that has grown in real terms during the period of the current spending review (including the latest 2015/16 allocations). Over this six-year period, welfare is set to rise by 3.6 per cent in real terms, compared to a 12.5 per cent drop in real departmental spending (and even larger reductions outside of the ringfenced NHS and schools budgets).

Figure 1.3
Changes in real spending (%), 2010/11–2015/16



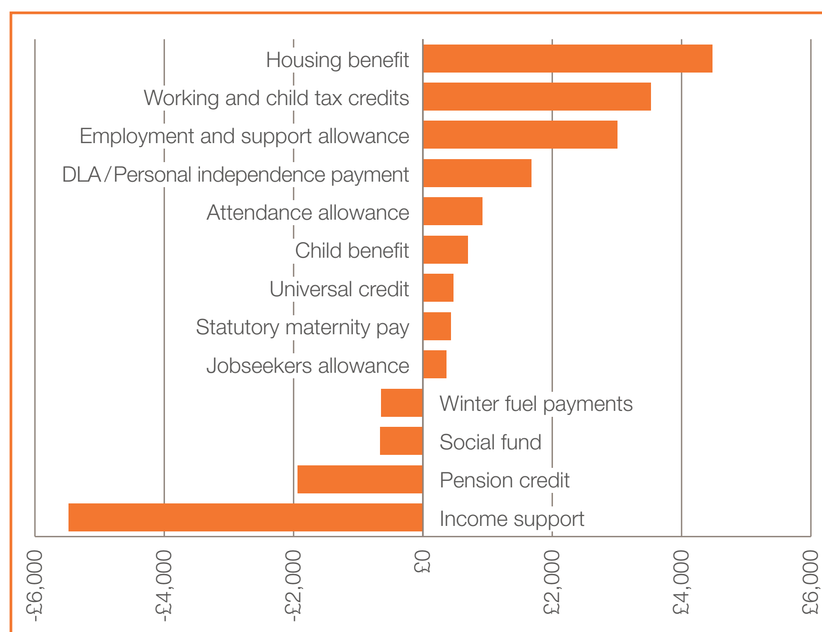
Sources: HMT 2011, 2012b and 2013b

1.2 Pensions are set to dominate rising welfare spending out to 2017/18

Analysis of more detailed DWP data shows that social security and tax credit expenditure is set to be almost £35 billion higher in real terms by 2017/18 than it was in 2010/11.[5] This is despite the Coalition government implementing a programme of cuts that will reduce welfare spending by over £21 billion a year relative to what would otherwise have been spent by 2017/18. Even taking these unprecedented reductions into account, social security and tax credit spending is now expected to be £11.3 billion higher by the end of the current parliament, at the close of the 2014/15 financial year, than the government was forecasting in its emergency budget of June 2010. Overall, AME is now expected to be £15.1 billion higher in 2014/15 than it was projected to be in June 2010.[6]

Significantly, these increases are not evenly distributed. Based on the latest estimates, over three-quarters (77 per cent) of the rise in social security and tax-credit spending between 2010/11 and 2017/18 is projected to come from higher spending on benefits for pensioners – a net rise of £27 billon.[7] By contrast, less than a quarter of the growth (23 per cent) is set to come from extra spending on children and people of working age (a net rise of £8 billion).[8] Figure 1.4 disaggregates the projected trends in benefit expenditure between 2010/11 and 2017/18. However it does not include the state pension because its projected rise of £28.7 billion over this period would overwhelm the rest of the data.

Figure 1.4
Changes in spending in cash terms (£), excluding the state pension, 2010/11–2017/18



Source: DWP 2013a: table 1a and 'Tax Credits and Child Benefit' table.
Note: This chart does not include council tax benefit, which from 2013/14 is a local government responsibility and so has transferred from DWP expenditure data to the Department for Communities and Local Government's DEL allocation.

5 DWP 2013a. From 2013/14 onwards, council tax benefit is no longer included in these figures, as from this point it becomes a local authority responsibility.
6 Based on a comparison of future spending projections published alongside the June 2010 and March 2013 budgets.
7 This is a net figure: spending on the state pension is set to rise by £28.2 billion over this period, slightly offset by a £1.9 billion drop in spending on pension credit.
8 DWP 2013a: table 1a

Setting aside the state pension, this chart shows that expenditure on tax credits, housing benefit and disability benefits is set to rise substantially – by a total of nearly £13 billion in cash terms – between 2010/11 and 2017/18. This is despite each – and particularly tax credits – being the focus of cuts. Expenditure on ESA is set to rise in large part because of the switch of claimants with a disability who currently receive income support (thus offsetting the reduction in cost that will result from the time-limiting of contributory ESA). Spending on income support is also set to fall as lone parents on benefits continue to be transferred to jobseeker's allowance (and, eventually, universal credit). These projections take all announced policy changes into account, including the three-year, 1-per-cent uprating of benefits and tax credits (as well as economic forecasts which point to a recovery in output and employment over this period).

1.3 The terms and politics of the 'welfare cap'

The shift in recent years from fixed departmental budgets to demand-led expenditure is not surprising given the combination of fiscal consolidation and economic stagnation (in addition to rising longevity). However, it would not be unreasonable for any government to be concerned about the fact that less than half of public spending is currently being channeled through fixed budgets: this seriously impedes the planning and sound management of the public finances. Furthermore, within this government's overall fiscal consolidation plans, the growth in social security and tax credit spending has loaded larger cuts onto public services and capital spending.

It is in this context that George Osborne announced the introduction of a new cap on welfare spending, with the following details:

- The aim of the cap is to prompt action to prevent structural deterioration in welfare spending, while enabling the automatic stabilisers to operate. The cap will apply to all social security and tax credit spending, except the basic and additional state pensions (soon to be merged into a 'single tier' state pension) and jobseeker's allowance, as well as those 'passported benefits' to which households with no other income are automatically entitled along with JSA, which often include housing benefit and child tax credit.
- The OBR will be charged with monitoring compliance with the welfare cap. They will provide an assessment of whether the government is set to meet or breach it. If the cap is on course to be breached, the government will either have to change policy or report to parliament on why it is allowing spending to overshoot. A small margin above the cap will be permitted to ensure that policy changes are not triggered by small fluctuations in the forecast. The cap will be set in cash terms, with no inflation adjustments during the five-year period.
- The cap will operate on an annual basis, with limits for each year of a rolling five-year period. The first cap will be set in the 2014 budget for the financial year 2015/16, on the basis of policy and financial projections at that point. The 2014 autumn statement will then present the opportunity for the OBR to pronounce on whether the caps for the first and subsequent years is set to be breached or not, with scope for action at that point in order to increase the chances of the government keeping within the limit. (HMT 2013a: 26–27)

The final section of this paper discusses the operation of the welfare cap, and the ways in which it could be better designed to drive strategic spending decisions rather than crude cuts, in more depth. What is, of course, immediately striking is that the cap will not apply to the one area of spending – the state pension – that is set to grow most strongly.

The chancellor's rationale for this is that incremental increases in the state pension age serve as a separate mechanism for ensuring its affordability.

However, looking beyond the policy detail, the politics of the welfare cap are clear. Between now and the general election the Conservatives are likely to use the introduction of a cap to pose a trade-off about the future of the public finances – setting further reductions in the profile of working-age benefit and tax credit spending on the one hand against some combination of extra cuts to departmental expenditure, higher taxes or more borrowing on the other.

In the 2014 budget, the chancellor is likely to use the setting of the cap for 2015/16 onwards to establish a baseline for public expenditure totals well into the next parliament. This will be based on his chosen path for deficit reduction, including a breakdown of overall DEL and overall AME allocations. He'll then pledge that a future Conservative government would guide policy to hit those spending trajectories, including any consequential welfare cuts, before challenging Labour (and the Liberal Democrats) to back those plans – or set out their alternative.

Having seen the chancellor signal his intention to introduce some form of welfare cap in the budget, Ed Miliband has set out his case for reducing the drivers of higher social security spending which are rooted in wider market failures (Miliband 2013). He framed this with support, in principle, for a limit on 'structural' (non-cyclical) social security spending.

Public hostility towards those in receipt of benefits, and a perceived 'crisis of legitimacy' in the welfare system, are borne out in repeated surveys of public opinion.[9] There are also major, long-term pressures on the public finances that cannot be ignored (OBR 2013). In this context, a welfare cap that helps to control rising in social security and tax-credit spending, and that drives strategic policymaking and genuine savings, would have considerable merit. However, to get its design right, it is first necessary to interrogate social security and tax credit spending in more depth.

9 See for example http://www.jrf.org.uk/media-centre/tough-attitudes-poverty and http://www.natcen.ac.uk/study/public-attitudes-to-poverty-and-welfare.

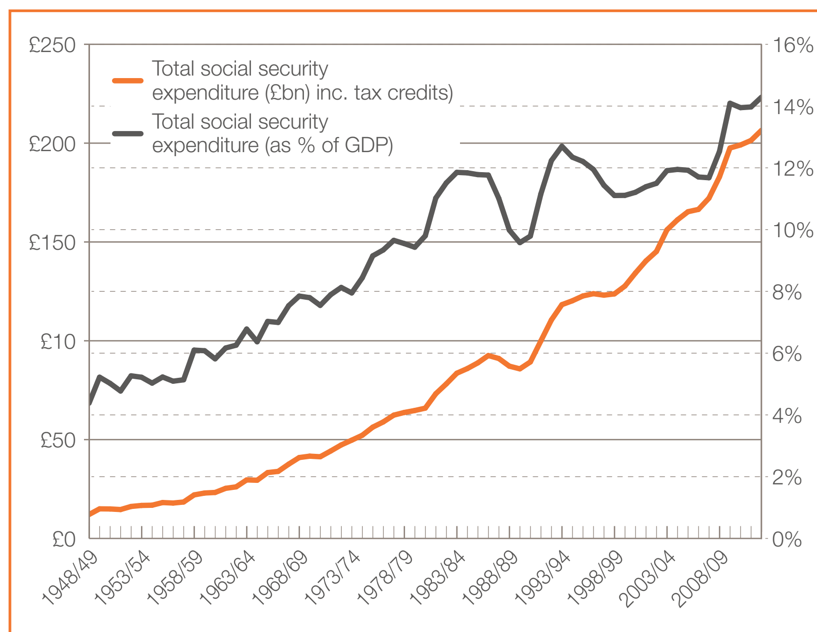
2. TRENDS IN SOCIAL SECURITY AND TAX-CREDIT EXPENDITURE

Political choices about the future of welfare spending should be based on a strong understanding of how it has evolved in the past. Therefore, the following new IPPR analysis of published benefit expenditure data sheds light on the major patterns of social security and tax-credit expenditure across the postwar period, both in aggregate and among its different categories and component parts.

2.1 Substantial rises in welfare spending since the Beveridge era

As figure 2.1 shows, welfare spending – excluding the relatively recent addition of tax credits – has risen substantially over the last six decades both in real terms and as a share of national income. Despite coming under a series of political attacks, the social security system has proven remarkably resilient: it is over three times larger as a share of national income now than it was in the late 1940s, and has grown over that period from 4 to 14 per cent of GDP. In real terms, welfare spending is now fourteen times greater than in 1948/9; over the same period GDP has grown only five-fold (ONS 2012).

Figure 2.1
Trends in welfare expenditure (including tax credits), 1948/49–2012/13



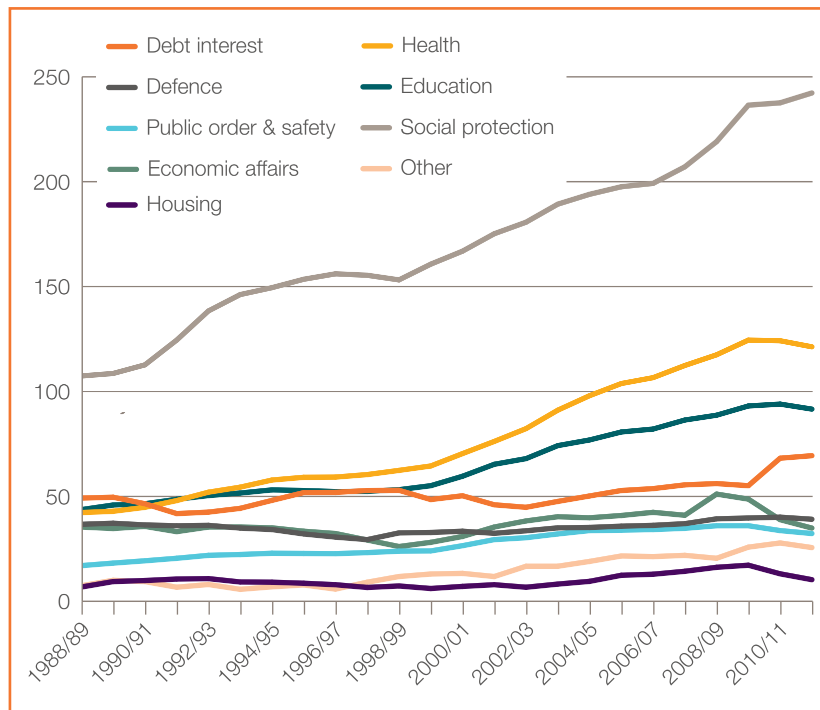
Sources: DWP 2013a and ONS 2012.

As this chart makes clear, there was a consistent rise in welfare spending as a share of GDP from the late 1940s until the end of the 1970s, despite this being a period marked by very low levels of unemployment. Expenditure as a share of GDP then spiked twice during the early 1980s and the early 1990s, thanks to higher spending and lower output as a result of recessions. The dip in between reflects the impact of the 'Lawson boom' and Peter Lilley's social security reforms.

Looking through the ups and downs, the legacy of the Thatcher and Major years was that expenditure continued up its steadily rising path. Under Blair and Brown, welfare expenditure flattened as a share of national income as the fiscal dividend from rising employment was offset by political choices to tackle child and pensioner poverty. Spending continued to rise sharply in real terms over this period. As previously discussed, welfare expenditure shot up both in real terms and as a share of GDP after the financial crisis, as the benefits bill rose and output fell sharply.

To put these trends in a wider context, figure 2.2 shows how spending on the major areas of government activity has evolved since the late 1980s (as far back as this data series goes). It demonstrates that welfare spending, defined here as 'social protection', has long represented a large share of public expenditure, but also that it has risen strongly across the last two decades in relative as well as real terms. It grew, for instance, on a similar trajectory to the historic and high-profile rises in health spending under the Blair government, though with far less public or political discussion. Expenditure on social security and tax credits has risen from 19.3 per cent of total public spending in 1978/79 to an estimated 30 per cent this year (2012/13), and is set to remain at around this level until 2017/18.[10]

Figure 2.2
Trends in major areas of public spending in real terms (£bn, in 2011/12 prices)



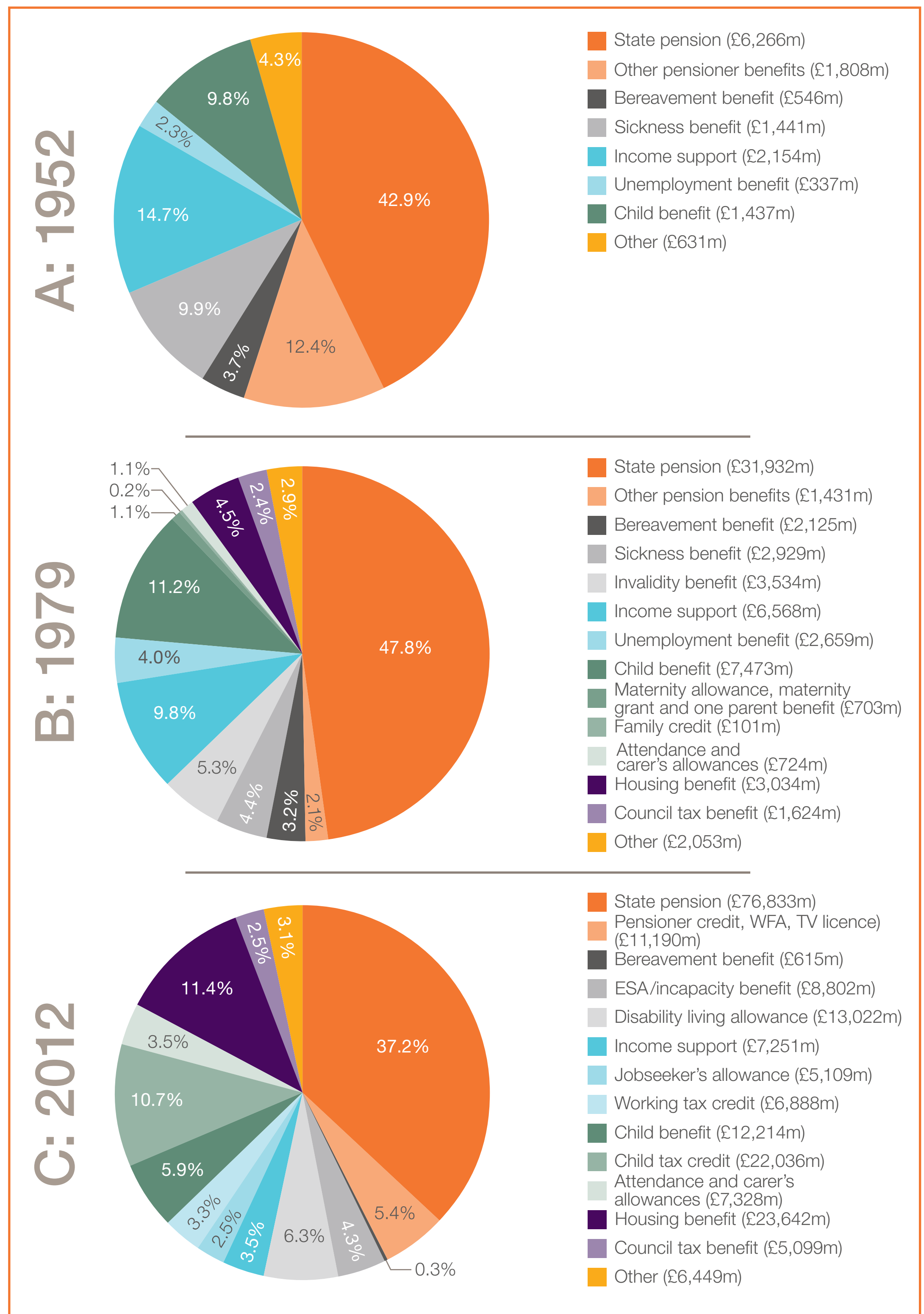
Source: HMT 2012: table 4.3

2.2 Shifts in the functions of welfare spending across the postwar decades

Beneath the headline rises in welfare spending over the last six decades, there have been significant shifts in where expenditure has been directed, on what basis and for what purpose. To give a snapshot of these changes, figures 2.3A, 2.3B and 2.3C show breakdowns of expenditure on different benefits in 1952, 1979 and 2012 respectively. 1952 represents the foundation of postwar social security, once the Beveridge system was fully up-and-running, while 1979 marks the beginning of the Thatcher era. The final chart brings the analysis up to date with the latest available figures.

10 DWP 2013a: 'GB Benefits and Tax Credits' table

Figure 2.3A, 2.3B and 2.3C
Breakdown of social security expenditure in 1952, 1979 and 2012 (in 2013/14 prices)



Source: DWP 2013a: table 1b.

Comparing spending between specific years has obvious limitations, and runs the risk of allowing particular factors or circumstances to distort longer-term trends. However, some headline points stand out:

- The state pension has always accounted for a substantial share of social security spending: even in 1952 it made up 43 per cent of overall expenditure, and if war pensions are included then spending on older people overall accounted for more than 55 per cent of all welfare spending in that year. At this time, the system had three basic functions: to compensate people for periods without work, to offset the costs of having children, and to provide security in retirement.
- There were fewer different benefits in the early 1950s – in addition to pensions, there were only payments for unemployment, children, sickness and low income. However, by the late 1970s, provision for disability (as opposed to absence from work on the grounds of poor health), rent subsidy, council tax rebates and in-work support for low-income families had been introduced, significantly widening the range of functions served by the welfare system.
- Over the three decades that followed, these new areas of provision grew substantially in cost, and have come to account for significant shares of welfare spending. This was spurred on by the introduction of new benefits – such as DLA, housing benefit and council tax benefit – and later by the creation of tax credits. Over the last 15 years, these have involved major increases in spending on families with children, the 'extra costs' of disability, housing costs and topping-up low pay.
- Overall, there has been a marked decline in the share of social security spending devoted to income replacement benefits, of different kinds, for people out of work. While this comprised just over a quarter (27 per cent) of the budget in 1952,[11] it had declined to just over a tenth (10.5 per cent) by 2012,[12] despite unemployment now being structurally far higher than in early 1950s.[13]
- By 2012 a set of smaller pensioner benefits, such as pension credit and the winter fuel allowance, had been newly created. However, bereavement benefit, which was significant in 1952, has become much more marginal over the intervening years – and others, such as war pensions, no longer exist.

The subsequent sections of this report explore the most significant of these trends in the composition of social security and tax-credit expenditure in greater depth, before putting current spending in a comparative context. What follows is largely a descriptive rather than explanatory story. There are a range of complex factors which have driven expenditure in certain directions over given periods. While some are specific to particular benefits, other are reflective of more general trends. For example, since the postwar era there have been major social, economic, cultural and demographic changes.

These include: an ageing population; deindustrialisation and a more flexible labour market; a rise in single-person households; a declining supply of housing relative to demand; greater recognition of the additional costs related to disability, and many more disabled people living into adulthood; increases in female employment and significant declines in male employment; and a polarisation between two-earner and zero-earner households. Such trends must be borne in mind when considering the data on changing social security and tax-credit expenditure in recent decades.

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11 Unemployment benefit, income support and sickness benefit.

12 Jobseekers allowance, income support and ESA.

13 DWP 2013a: table 1b

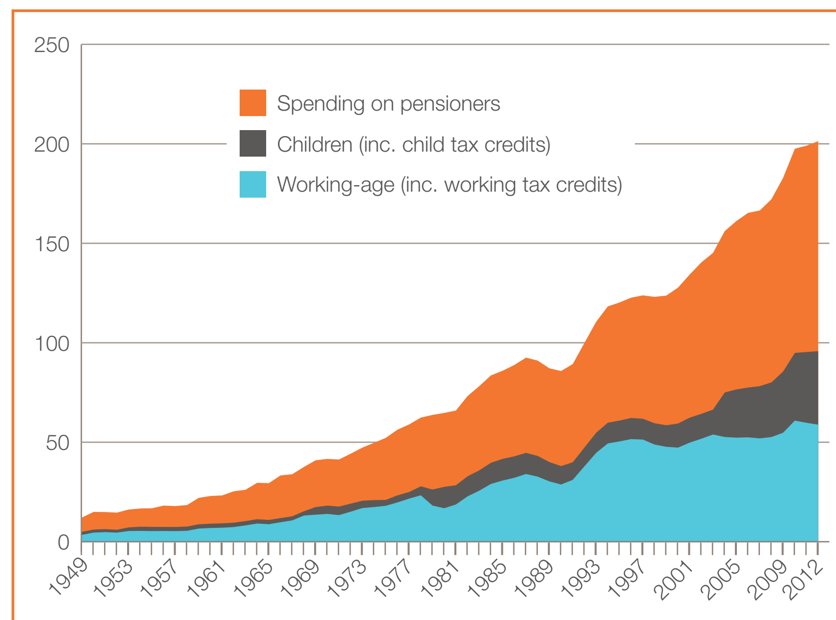
2.3 The longstanding and growing dominance of spending on pensioners

Expenditure on pensioners has grown substantially as a share of national income throughout the postwar era, having risen from 2 per cent of GDP in 1952 to 5.4 per cent in 1979, before reaching an estimated 7.1 per cent in 2012. As a share of all government spending, it has risen from 11.3 per cent in 1978/79 to 16 per cent in 2012/13. Over the period 1979 to 2013, real-terms expenditure on pensioners has more than trebled, from £37.5 billion to £116.9 billion (in 2013/14 prices).[14]

As shown above, growth in expenditure on pensioners is the single most important explanation for the rise in the benefits bill in recent years. This growth is set to continue, with the government forecasting that spending on pensioner benefits will rise to 8.1 per cent of GDP by 2061 (DWP 2013b). This is slightly lower than it would have been otherwise as a result of the single-tier pension, which will reduce expenditure on the state pension and other pensioner benefits by the middle of the century (as people are prevented from accruing much higher entitlements through the second state pension).

Figure 2.4 illustrates the pattern of rising expenditure on pensioners over the last three decades, and its dominance of the overall welfare budget (accounting for 52 per cent in 2012). Real-terms welfare spending on pensioners has doubled in the two decades since 1992, from £52.6 billion to £105.6 billion (in 2013/14 prices). This rising share is illustrated more clearly in this graph than in figure 2.3C, which does not separate out spending on those over the retirement age on benefits such as attendance allowance, DLA for over-65s and housing benefit.

Figure 2.4
Trends in social security spending, including tax credits, by demographic group (£bn, in 2013/14 prices)



Sources: DWP 2013a, and Treasury weighted working and child tax credit estimates.[15]

14 DWP 2013a: 'GB Benefits and Tax Credits' table

15 http://www.hmrc.gov.uk/statistics/fin-main-stats/cwtc-awards.pdf. Until 2008, tax credit expenditure figures could not be split between child tax credit and working tax credit. Therefore, the numbers given in figure 2.5 for the period 2003–2008 are based on the average ratio for the years 2008–2012 (70 per cent child tax credit, 30 per cent working tax credit).

Expenditure on working-age social security gradually rose in real terms over the postwar decades, before spiking by almost £20 billion between 1991 and 1996, in today's prices, as a result of the early-1990s recession. However, it then remained virtually flat in real terms over the following two decades: £51.6 billion in 1996 compared to £52 billion in 2007, just before the financial crisis, in 2013/14 prices. (This fact is striking, given claims that welfare bills were 'out of control' during the Labour era.) Working-age welfare did then rise by slightly less than £10 billion in real terms over the next three years, before beginning to fall back as a result of the Coalition's cuts.

Spending on families with children was a relatively minor – and flat – element of the welfare budget right up until the late 1970s, when child benefit replaced family allowance. In real terms, expenditure on distinct children's benefits then also remained relatively stable until the early 2000s. However, this underestimates child-related spending overall during this period, given that child premiums were paid through the main income-replacement benefits.

From the turn of this century, Labour began to substantially expand financial support for families with children in pursuit of its goal of ending child poverty. The 'jump' in spending between 2003 and 2004 shown in the data reflects the introduction of the current tax credit arrangements, under which all child-related spending was drawn together. However, even accounting for this administrative change, a rise in the recorded expenditure on child-specific entitlement of more than a third in real terms – from £22.4 billion to £37.0 billion in 2012 (in 2013/14 prices) – represents substantial growth.[16]

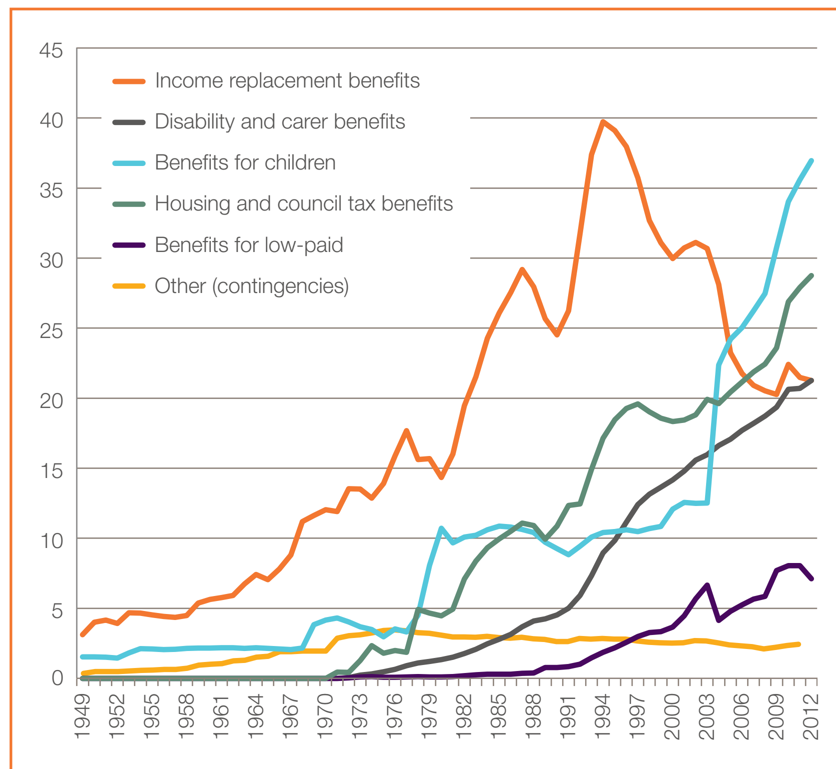
2.4 Shifts in the balance of spending in response to changing needs and demands

As noted above, the extent to which the welfare system has grown in scope and range since the late 1940s is striking. New benefits have been created in response to either new needs or new demands. According to the latest DWP data, there were 31 separate benefits and payments in 2011/12 (not including all the different rates and categories within many of the current benefits), compared to just seven in 1948/49.[17] The introduction of the universal credit may streamline the system, but 20 different benefits will still remain after its full implementation. Figure 2.5 illustrates the impact of these expansions of the system by analysing spending by benefit category, excluding pensions and focusing on the working-age population.

These categories must be treated with some caution given the number of changes over the years to how benefits for different functions are structured. Certain benefits, in particular incarnations, straddle the categories used in some of the charts in this report. For example, for many years income support included additional premiums for children and disability, in addition to providing a basic out-of-work income. Similarly, a number of benefits, such as housing benefit and council tax benefit, are claimed by those in low-paid work, as well as boosting the incomes of people who are out of work. Shifts in the nature and definition of tax credits, following their introduction in the late 1990s, also create some discontinuities in the data. See the footnote to figure 2.5 for a further explanation of how the categories have been constructed.

16 http://www.hmrc.gov.uk/statistics/fin-main-stats/cwtc-awards.pdf
17 DWP 2013a: table 1a

Figure 2.5
Trends in real terms working-age social security expenditure by benefit type, 1949–2012 (£bn)



Sources: DWP 2013a, HMRC 2009, 2010, 2011 and 2012, and HMRC tax credit and equivalent expenditure figures.[18]

However, while recognising that these kinks in the charts represent administrative rather than actual changes in spending, some broad expenditure trends stand out:

- **Since the 1970s, there has been substantial growth in spending on benefits to help people meet the extra costs of living with a disability.** It was not until payment of attendance allowance and invalidity benefit started in 1971–72 that there was any specific financial support for people with a disability (other than sickness benefit for absence from work, and war injury compensation). Within five years, in response to pressure from disability campaigners, carer's allowance, mobility allowance and severe disablement allowance were also established to provide extra help for disabled people and those who cared for them. Over the next two decades the value of these payments doubled as a share of the non-pensioner welfare budget, rising from 9 per cent in 1972 to 18 per cent in 1992. Subsequently, in the early 1990s, disability living allowance was created, expenditure on which rose from £3.1 billion in 1992 to £13.0 billion in 2012 (in 2013/14 prices).

18 'Pensioner benefits' includes the basic state pension, pension credit, winter fuel allowance, TV licences, over-65s and over-70s payments and war pensions. 'Income replacement benefits' includes JSA/unemployment benefit, income support/supplementary benefit/national assistance, and ESA/incapacity benefit/invalidity benefit. 'Benefits for children' includes child benefit/family allowance and child tax credit. 'Housing and council tax benefit' includes housing benefit and council tax benefit (and predecessor rent/rate rebates). 'Benefits for low-paid' includes working tax credit/family credit/family income supplement, in-work credit, job grant and working families' tax credit. 'Disability and career's benefits' includes disability living allowance, attendance allowance, carer's allowance, statutory sick pay, sickness benefit, the Independent Living Fund, mobility allowance and severe disablement allowance. 'Other benefits' includes bereavement benefit, industrial injuries disablement benefit, death grant and the Social Fund.

- **There has been a rapid rise in expenditure on support with housing and council tax costs since the early 1980s.** A national system of rebates for rents and local rates was not established until the early 1970s. As figure 2.6 shows, these remained a relatively minor aspect of social security expenditure until the early 1980s, when spending on rent subsidies in particular started to rise rapidly; this growth was checked in the late 1980s by the creation of housing benefit, which acted to restrain spending. However, expenditure soon resumed its sharp upward trend, flattening somewhat in real terms around the millennium before spiking after the recession.[19] Spending on council tax benefit also rose by two-thirds in real terms in the decade to 2012, from £3.5 billion to £5.1 billion (in 2013/14 prices) – but since then payment of the benefit has been devolved to local authorities (and its budget cut by 10 per cent). In 2012, housing and council tax benefit accounted for a quarter of all non-pensioner welfare spending.
- **In the last fifteen years, there has been a large rise in spending on children, in particular through the introduction of tax credits.** Financial support for families with children was part of the initial Beveridge system, though family allowance was initially only available for second and subsequent children. This accounted for only a small share of spending until the introduction of the more generous child benefit, which replaced family allowance from the mid-to-late 1970s. Trends in expenditure on children during the 1980s and early 1990s are hard to discern because support was channeled through premiums in the main income replacement benefits. However, there was undoubtedly a large increase in financial support for children under the last Labour government.

  Looking at specifically child-related benefits, spending rose from £10.5bn in 1997 to £22.4bn in 2004 after the introduction of tax credits, and reached almost £37bn by 2012 (in 2013/14 prices).[20] They now account for nearly a third (32 per cent) of all non-pensioner welfare spending. These growth figures are somewhat inflated by the gradual transfer of child-related premiums from out-of-work benefits into child tax credit. To put the numbers in context, recent analysis by John Hills (2013) found that spending on cash benefits directed to families with children rose from £16 billion in 1995/6 to nearly £40 billion in 2010/11. These numbers are calculated on a slightly different basis than ours, as they take account of the child-related premiums in the main income-replacement benefits prior to the introduction of tax credits. However, they confirm that the rise in non-pensioner social security expenditure under the last Labour government was concentrated on families with children.
- **In-work support has emerged as a core feature of the social security system, expanding considerably in recent years.** Financial support for low-income working families dates back to the early 1970s, though it remained a relatively small element in the welfare system until the mid-1990s. Spending on such areas then grew rapidly, first through family credit and then, under Labour, through a series of tax credits. From 2003, the current split between working tax credit and child tax credit was established, with the former focused on topping up the wages of low-income working households. Financial support for low-income working households is actually far higher than figure 2.6 suggests, given that payments in other categories – notably child tax credit, housing benefit and council tax benefit – are also available to households with adults in employment (though still on a low income). Seventy-two

19 See Hull and Cooke 2012 for a more detailed analysis of trends in housing benefit spending.

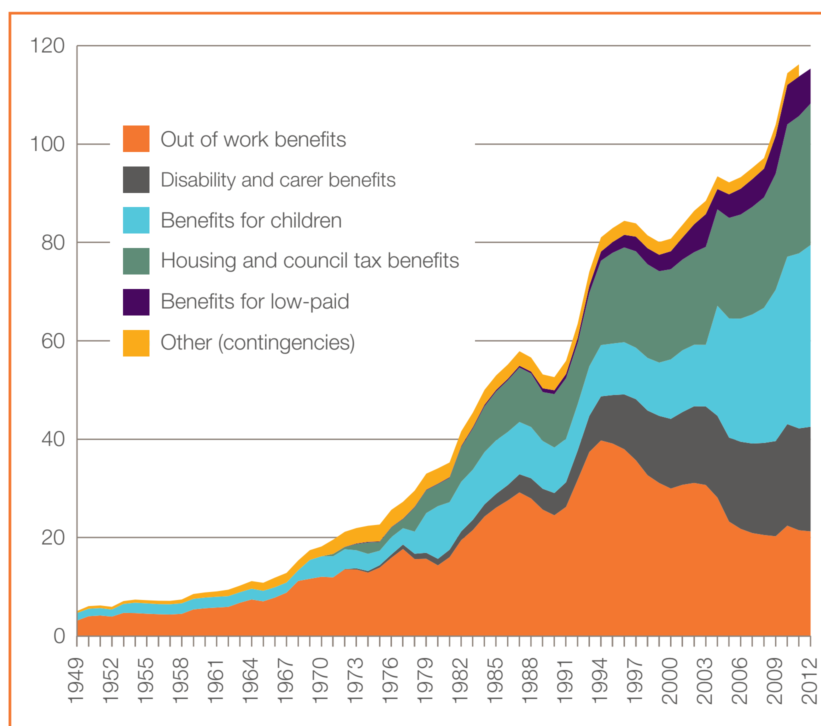
20 Spending on children between 2003 and 2008 is based on an estimate for child tax credit spending derived from the average ratio of child tax credit to working tax credit over the period 2008–2012.

per cent of tax credit expenditure (£21.1 billion a year) now goes to working families – a greater share than a decade earlier despite unemployment being significantly higher[21] – and around £4.5 billion of housing benefit expenditure is paid to subsidise the rents of working households.[22]

- **Spending on bereavement and industrial injuries benefits has declined in relative terms, and these are now marginal parts of welfare expenditure.** In the late 1940s, bereavement benefit accounted for a significant share of social security spending, but its relative value has since declined substantially. Industrial injuries disablement benefit was introduced in the early 1970s, but never became a large line of expenditure (and indeed has been falling in real terms since the turn of the century). By contrast, the Social Fund – which provides emergency assistance to people on low incomes, and was established in its current form in the late 1980s – saw its cost rise significantly to £800m by 2011 (in 2013/14 prices), before being sharply reduced when responsibility for it was transferred to local authorities.

Drawing these trends together, figure 2.6 illustrates how the different categories of benefits (as classified for the purposes of this report) have contributed to the growth in non-pension social security expenditure since the late 1940s.

Figure 2.6
Trends in social security expenditure by benefit type (excluding pensions), 1949–2012 (£bn, in 2013/14 prices)



Sources: DWP 2013a, HMRC 2009, 2010, 2011 and 2012, and HMRC tax credit and equivalent expenditure figures.

21 http://www.hmrc.gov.uk/statistics/fin-main-stats/cwtc-awards.pdf
22 Author calculation based on Stat Xplore, https://stat-xplore.dwp.gov.uk/

2.5 Declining spending on contributory benefits alongside a rise in means testing

Since the last election there has been a revival of interest in the role of the contributory principle, especially within the Labour party (Cooke 2012). This marks a major break with more than two decades of mainstream political thinking, during which time it was largely rejected for being too expensive (in not targeting resources on those in greatest need) and too exclusive (in not assisting those who have not, for whatever reason, made financial contributions). In response, universal and means-tested entitlements have been preferred across the political spectrum (albeit often for different reasons).

Figures 2.7 and 2.8 illustrate trends in social security and tax credit expenditure across the three entitlement principles (contributory, universal and means-tested) over the last six decades. Figure 2.7 shows data across all households, showing the initial dominance of contributory benefits and the growth in spending on means-tested and universal benefits since the 1970s. For example, in 1979/80, 63 per cent of the social security budget was channelled through contributory benefits, compared to 21 per cent on universal payments and just 16 per cent on means tested entitlements. However, as the Thatcher–Major era drew to a close in 1996/97, the share of spending accounted for by contributory benefits had fallen to 46 per cent, while the proportion channeled through universal benefits had also declined to 19 per cent – but, by contrast, over the same period the share of spending on means-tested benefits more than doubled, reaching 35 per cent of total social security expenditure.

These trends in the distribution of spending continued over the subsequent fifteen years to 2011/12, with contributory benefits now accounting for 42 per cent of the overall social security budget, compared to 18 per cent on universal payments and 39 per cent on means-tested entitlements. Looked at another way, spending on contributory benefits doubled in real terms between 1979/80 and 2011/12, while spending on means-tested benefits rose almost eight-fold over the same period.

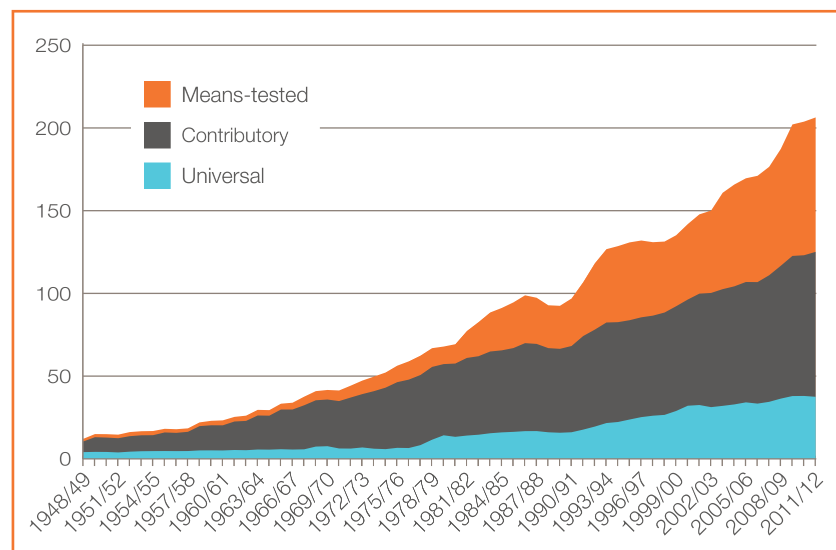


Figure 2.7 Trends in welfare expenditure by entitlement principle in real terms (all households), 1948/49–2011/12 (£bn, in 2013/14 prices)

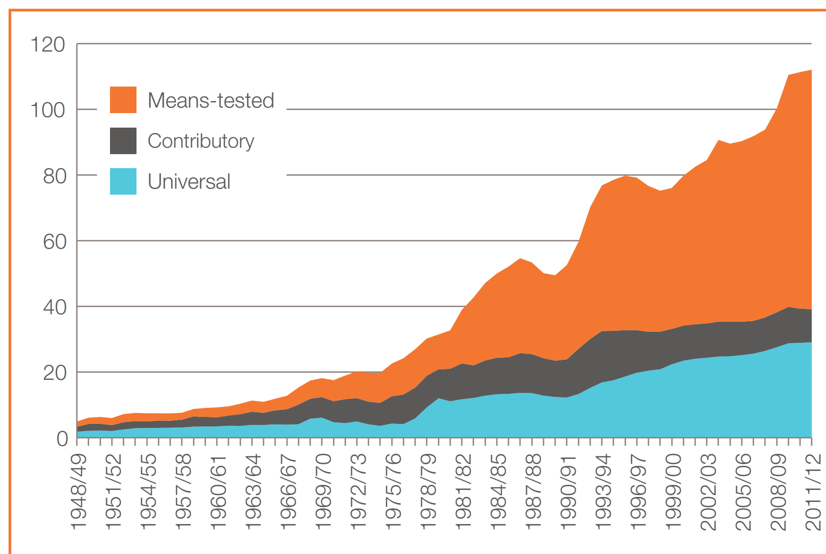
Source: DWP 2013a: 'Benefit Summary' and 'GB Benefits and Tax Credits' tables.
Note: includes tax credits.[23]

23 Child benefit is treated here as a universal payment, despite the recent decision to remove entitlement from higher-rate taxpayers.

Almost £9 in every £10 spent on contributory benefits (88 per cent) goes on the state pension, which is illustrative of the fact that the decline in the role of contribution-based benefits is concentrated among working-age adults and children. This data is shown in figure 2.8, in which the clearly dominant trend is the substantial increase in spending on means-tested benefits, both in real terms and as a share of non-pensioner welfare spending.

In 1979/80, the greatest share of working-age social security spending (38 per cent) went on universal benefits, largely due to substantial increases in payments to families with children after the creation of child benefit. That year, 28 per cent of non-pensioner welfare expenditure went on contributory benefits (principally unemployment benefit, sickness benefit and invalidity benefit), and 34 per cent was channeled through means-tested entitlements (largely income support, but also housing benefit).

Figure 2.8
Trends in welfare spending, by entitlement principle, in real terms (non-pensioner households) 1948/49–2011/12 (£bn, in 2013/14 prices)



Source: DWP 2013a: 'Benefit Summary' and 'GB Benefits and Tax Credits' tables.
Note: includes tax credits.[24]

Nearly two decades later, in 1996/7, the share of non-pensioner spending going on means-tested benefits had shot up to 59 per cent, while spending on contributory and universal entitlements had declined to just 16 per cent and 25 per cent respectively. This headline trend continued over the following 15 years to the point that, by 2011/12, nearly two-thirds (65 per cent) of spending on working-age and children's benefits now goes on means-tested payments. Almost three-quarters (73 per cent) of this figure is accounted for by tax credits and housing benefit.

Since the late 1990s the decline in the proportion of non-pensioner welfare spending going to contributory benefits has continued, dropping to less than £1 in £10 by 2011/12 (most of which is now accounted for by contributory incapacity benefit and employment and support allowance, with a significant amount going to statutory maternity pay).

24 As per figure 2.7, child benefit is treated as a universal payment despite the changes introduced by the Coalition government. Figure 2.8 excludes expenditure on benefits claimed entirely by pensioners. However, it does include some expenditure which goes to pensioner households though mixed-demographic payments such as housing benefit.

Spending on universal benefits was broadly flat over this period, ticking up to a share of just over a quarter (26 per cent), and is now comprised largely of child benefit and DLA.

Labour's announcement that it would not prioritise the reversal of the Coalition government's decision to remove child benefit from higher-rate taxpayers, and to consider removing entitlement to the winter fuel allowance from the wealthiest pensioners, sparked a debate about universalism. Some on the left argued that these moves marked a fundamental breach of principle, while those on the right called for further steps to scale back the 'universal welfare state'.

What figures 2.7 and 2.8 make clear is that there has always been a mix of entitlement principles in the postwar social security system (albeit with big shifts in their prominence over time). Less than a fifth of welfare spending is paid through universal benefits, so the target that some on the right are taking aim at is rather smaller than they tend to suggest. On the other hand, the left should avoid defending particular benefits, and rather consider the shape of the system as a whole. It's worth remembering that winter fuel allowance, for instance, did not exist prior to 1998, and that free TV licences for older people were only introduced in 2000 – these were not foundation stones of the postwar welfare state.

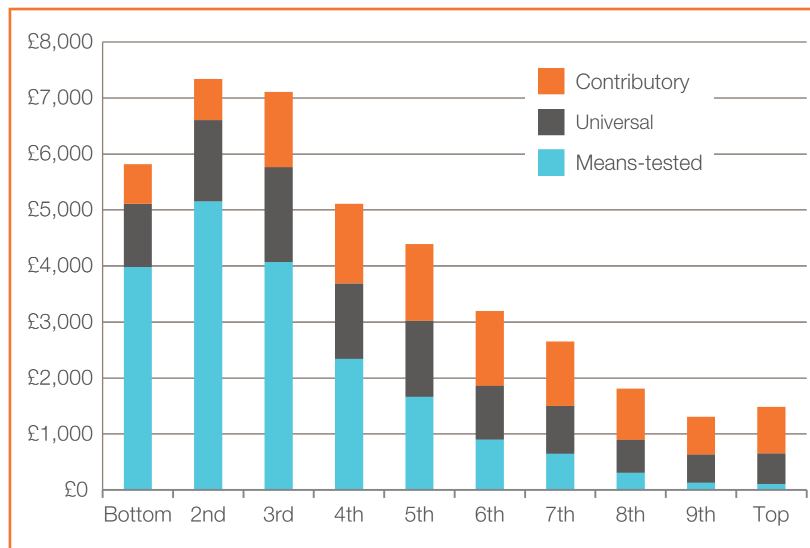
2.6 Welfare spending is progressive overall, but has a broad distributional reach

It is important to consider both the distributional impact of social security and tax credit expenditure, and the extent to which it acts to reduce inequality and poverty (after income from wages and investments, and separate from taxation). Based on the latest available data, figure 2.9 illustrates the average income received from benefits by each decile of UK households, ranging from the poorest to the richest. This demonstrates that welfare spending is strongly progressive, but also that it is distributed across the income spectrum. Means-tested payments are much more progressive than contributory benefits (such as incapacity benefit/employment and support allowance) and universal entitlements (like disability living allowance and child benefit).

Figure 2.9 also suggests that households in the second, third, fourth and fifth deciles receive more from the social security and tax credit system than those in the first (poorest) decile. This is partly explained by difficulties in collecting accurate data on households with very low, or highly fluctuating, incomes. Nevertheless, it also reflects the fact that the receipt of certain benefits which offer relatively large amounts of support, such as tax credits and housing benefit, is clustered in the lower half – but not the bottom – of the income distribution. This could be the result of low take-up rates by the poorest households, or of some benefits being restricted to those in employment (or, to a lesser extent, being based on an employment record).

A further way of analysing social security expenditure is to consider the number of households that receive different amounts from benefits, tax credits and pensions. Figure 2.10 below shows such a breakdown, on a weekly basis, for all households. This analysis uses data taken from the Family Resources Survey 2010/11 (DWP 2012), which is based on self-reported income, and therefore may differ from administrative data on benefit expenditure.

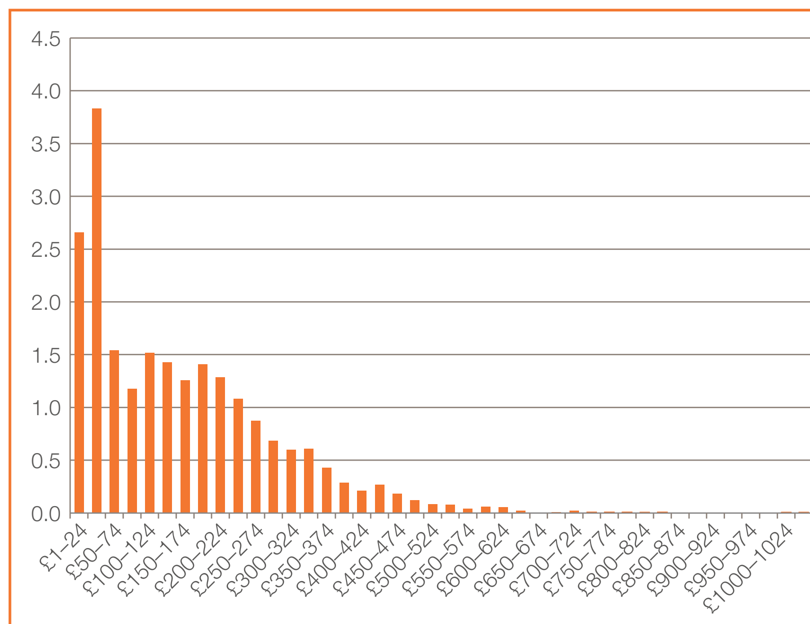
Figure 2.9
Average annual cash benefits (£) received by non-retired households, by decile, 2010/11



Source: ONS 2013: table 16

One of the most striking findings from this analysis is that almost three-quarters (74 per cent) of households receive some income from the welfare system (the 26 per cent of households that have no income from this source are not shown in the chart). Half of all households (50.2 per cent) receive between £1 and £199 a week from social security of one type or another; a fifth (19.9 per cent) receive between £200 and £399 a week. Just 1.3 per cent of households receive a weekly income from benefits, tax credits and/or pensions of more than £500 – the level at which the government has set its 'benefit cap' for couple families and single parents with children (which applies only to working-age households) (all figures from DWP 2012).

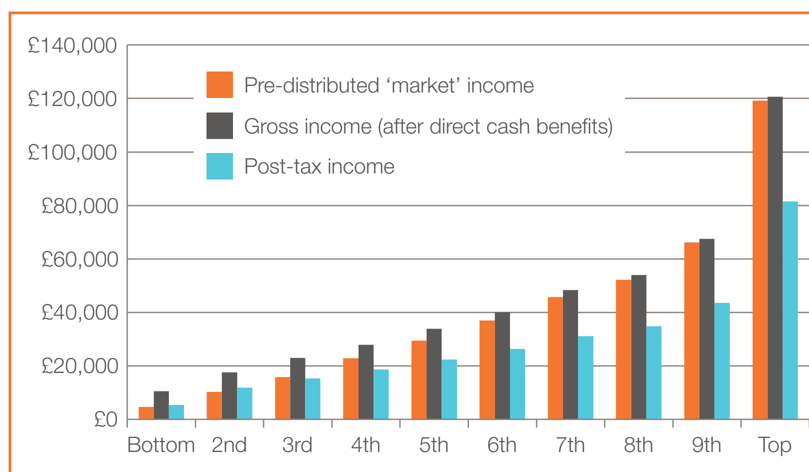
Figure 2.10
Distribution of social security and tax credit income by number of households (millions)



Source: DWP 2012

To complete the distributional picture, figure 2.11 illustrates the impact of both the social security and tax systems on narrowing income inequality. It highlights the fact that households across the income spectrum see their 'predistributed' market income increased by benefit payments. While the biggest proportional difference is felt by the average household in the lower deciles, even those with higher original incomes see a gain.

Figure 2.11
Predistributed, post-benefits and post-tax income (£), by decile groups of (non-retired) households, 2010/11



Source: ONS 2013: table 16

By contrast, the tax system does far more to narrow the gaps between deciles, significantly pulling down incomes at the top of the wealth distribution. That said, the average household in the top 10 per cent of the distribution evidently still has a substantially higher final income than the rest of the population, while the average household at the bottom of the distribution sees all the gains from social security wiped out through taxation (particularly by indirect taxes like VAT).

2.7 Welfare spending is not comparatively high, but concentrated in certain areas

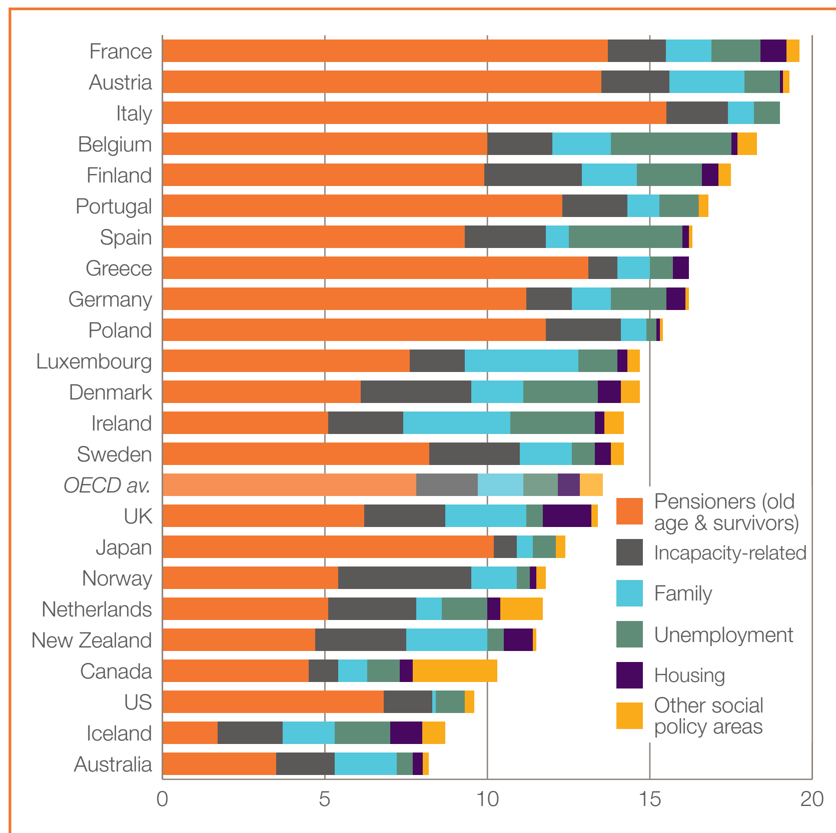
Given the claims that social security and tax credit expenditure is 'out of control', it is important to consider UK welfare spending in an international context. To that end, figure 2.12 presents a comparison of public spending as share of GDP across developed nations.

It shows that UK welfare spending is slightly lower than the OECD average, and below a number of major continental European countries including France, Austria, Italy, Belgium, Finland, Portugal, Spain, Germany, Denmark, Sweden and Ireland. However, UK spending is higher than in Norway, the Netherlands and the collection of liberal welfare regimes with which the UK is often grouped in the literature – the United States, Canada, Australia and New Zealand).

This comparison shows that expenditure on pensioners dominates the welfare systems of developed countries. In fact, many OECD countries devote a far greater share of (public) social security spending to older people than the UK does. Italy, where 82 per cent of spending goes on pensioners, is the most extreme example, and contrasts with the figure of 46 per cent in the UK. When spending on pensioners (and survivors) is stripped out of the data, the UK rises towards the top of the OECD league table in relation to spending on working-age households and those with children. With the UK figure running at 7.2 per

cent of GDP, only Ireland (9.1 per cent), Denmark (8.6 per cent), Belgium (8.3 per cent) and Finland (7.6 per cent) spend a greater share of national income on family, incapacity, housing, unemployment and other social benefits (OECD 2012).[25]

Figure 2.12
Breakdown of social security spending by major benefit category (as % of GDP), 2009



Source: OECD 2012
Note: does not include expenditure on health or active labour-market programmes.

Beyond these headline insights, a few further important points on comparative social security spending stand out:

- First, according to these figures the UK spends more on subsidising housing costs as a percentage of GDP than any other country in the OECD. At 1.5 per cent of GDP, this figure is more than double the OECD average of 0.7 per cent, and substantially greater than in countries like the Netherlands, Canada, Ireland, Australia, Spain, Norway, Belgium and Austria (all of which spend less than 0.5 per cent of their GDP on cash benefits for housing).
- Second, this data also suggests that the UK spends a greater share of national income on cash benefits for families (2.5 per cent of GDP) than every OECD country except Luxembourg (3.5 per cent) and Ireland (3.3 per cent). Wider data on family-related spending suggests that the UK channels a much higher proportion of expenditure through cash benefits relative to 'benefits in kind' (such as services

25 It should be noted that these figures relate to 2009 (the most recent comparable data), and that results will therefore be skewed by the impact of the global recession. Similarly, this data refers to public spending, and it should be remembered that welfare systems in many continental European countries have strong employer-funded dimensions.

like childcare and early-years education (OECD 2012)[26]). According to the OECD, two-thirds (66 per cent) of UK public spending on families goes on cash benefits – a higher share than in Germany (57 per cent), Finland (52 per cent), Italy (50 per cent), France (44 per cent), Norway (44 per cent), Sweden (43 per cent), Denmark (41 per cent) and Iceland (40 per cent) (ibid)

- Third, the UK is a comparatively low spender on unemployment benefit, expenditure on which (at 0.5 per cent of GDP) was less than half the OECD average (1.1 per cent of GDP) in 2009, at a time when unemployment was rising rapidly. Spending on unemployment benefit as a share of national income is lower in the UK than in every other major European country except Norway.[27] This cannot be explained by unusually high unemployment, and owes far more to the relative meanness of jobseeker's allowance (Mulheirn and Masters 2013). In 1972, unemployment benefit was worth 21 per cent of contemporary average earnings, but by 2012 this had fallen to just 12 per cent.[28]

The combined impact of these trends can be discerned in broader OECD data on comparative 'replacement rates': the proportion of previously earned income received by a household from the benefits system during an initial phase of unemployment. The table below compares UK and OECD net replacement rates, after taxes and benefits, for different family types who had, before becoming unemployed, been on the UK and OECD average wages respectively. In these figures, child-related payments are assumed to be included in the basic benefit amount for applicable families, while 'extra social assistance' refers to all other 'top-ups' (including housing support, which is likely to dominate this category).

Table 2.1
Net replacement rates (%) for average-earning families, UK versus OECD average, 2011

	UK	OECD average
Single person: no children with no extra social assistance	13%	56%
Single person: no children with extra social assistance	38%	57%
One-earner couple: no children with no extra social assistance	21%	58%
One-earner couple: no children with extra social assistance	46%	59%
Lone parent: two children with no extra social assistance	40%	67%
Lone parent: two children with extra social assistance	65%	71%
One-earner couple: two children with no extra social assistance	47%	64%
One-earner couple: two children and extra social assistance	72%	72%

Source: OECD tax benefit models, www.oecd.org/els/social/workincentives

A number of points stand out from this data. First is that net replacement rates are in most cases considerably lower in the UK than the OECD average, and also far more variable between different family types. Second, net replacement rates in the UK are substantially higher (sometimes as much as twice as high) for families with children than for those without children, even where those families are similar in every other respect. This highlights both the very low level of unemployment benefit in the UK, and the significance of child-related payments. Third, social assistance 'tops-ups' – principally for housing – also make a large impact on replacement rates in the UK. Among those with no children, it doubles the net replacement rate for single people, and triples it for couples.

26 This data also includes expenditure on children's social services. See Cooke and Henehan 2012 for a more detailed discussion of the split between expenditure on benefits versus services for children in the OECD data.

27 The OECD countries that spend less than the UK on unemployment benefits are Poland, Israel, South Korea, Chile and Turkey, none of which have comparably developed welfare systems.

28 https://www.gov.uk/government/organisations/department-for-work-pensions/series/abstract-of-statistics-for-benefits-national-insurance-contributions-and-indices-of-prices-and-earnings

Overall, the generosity of the UK social security system to those who become unemployed (and who previously earned average wages) varies much more dramatically across different family types in different circumstances compared to the OECD averages. This may be a factor which drives grievances towards the welfare system in the UK.

2.8 Are increases in welfare spending driven by cyclical or structural factors?

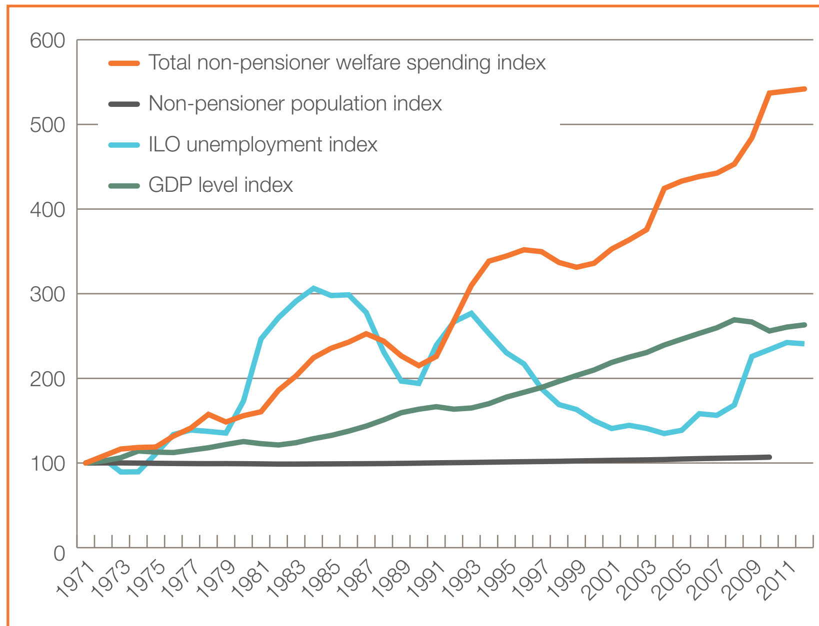
Social security and tax credit spending is driven by both cyclical factors concerning the performance of the economy, and structural factors that are related to wider economic, social and demographic forces. The former include changes in GDP, employment, wages and inflation, and the latter relate to phenomena such as changes in population change, household formation, the prevalence of disability and the level of rents. Both types of factor, in turn, feed through into caseload levels and claim durations, which affect spending levels. Expenditure trends are also driven by political choices about the focus and generosity of welfare provision, alongside the wider forces of poverty and inequality at work throughout society.

It is difficult to separate out the impacts of cyclical and structural drivers of welfare spending, and in practice they are not wholly distinct. For example, the benefits bill is affected by the unemployment rate, which in turn is a function of both demand in the economy and supply-side factors. Decomposing the various drivers of social security and tax-credit expenditure – and its sensitivity to a range of factors – would require sophisticated multi-level modeling. However, looking at spending trends in relation to the dynamics of the economic cycle offers some insights into the extent to which this has driven expenditure.

For instance, figure 2.13 suggests that non-pensioner welfare spending rose on a trajectory similar to that of unemployment during the 1970s, and then lagged well behind it throughout most of the 1980s, when the jobless rate topped three million. Expenditure and unemployment levels then moved in concert until mid-way through the 1990s – initially down, then up again. At that point the relationship appears to break, with unemployment dropping substantially over the next two decades while expenditure rose dramatically. This pattern is consistent with analysis earlier in this report which pointed to the declining role of income replacement benefits and the relative rise of payments that are focused on working households and which aim to meet ‘extra costs’ (and are often less related to labour-market status).

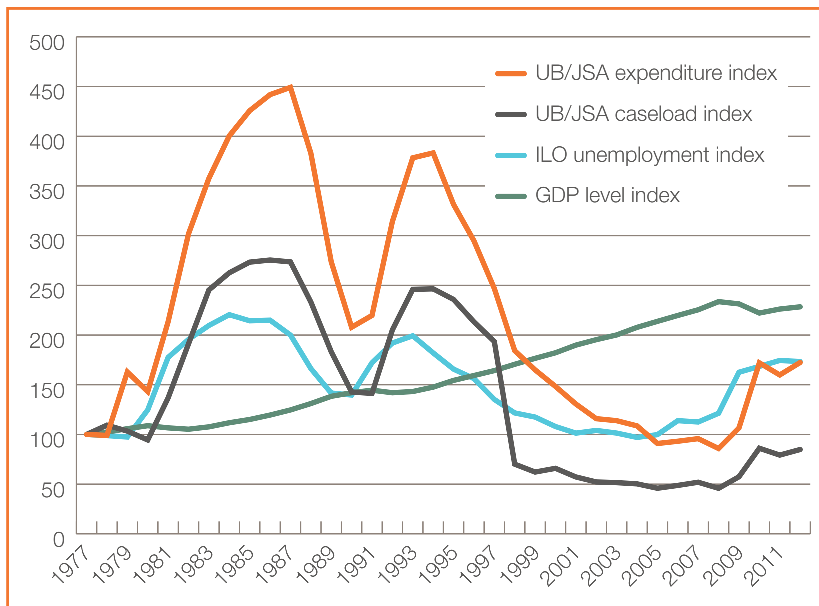
This conclusion is supported by figure 2.14, which demonstrates far closer relationships between trends in expenditure on unemployment benefit (‘jobseeker’s allowance’ from 1996) and both the number of claimants and the level of joblessness. During the 1980s and early 1990s, patterns of spending, caseload and unemployment shifted broadly in sync. After this point, the expenditure and caseload both dropped much further and faster than unemployment, as benefit eligibility and generosity were tightened. It is also noticeable that across the period as a whole, expenditure on unemployment benefit was less (in real terms) before the 2008–2009 recession than it was in the late 1970s, and has fallen considerably relative to the rise in GDP over that period.

Figure 2.13
Growth in non-pensioner welfare expenditure relative to economic and demographic trends (by indexes of non-pensioner welfare spending and population, unemployment and GDP, with 1971 = 100 in each case), 1971–2012



Sources: Author calculations based on DWP 2013a, budget 2013 documentation, HM Treasury GDP figures, the ONS's *Annual Abstract of Statistics* 2012 and Labour Force Survey data.

Figure 2.14
Growth in unemployment benefit expenditure relative to economic and caseload trends (by indexes of unemployment benefit/ jobseeker's allowance spend and caseload, ILO unemployment and GDP level index, with 1977 = 100 in each case), 1977–2012



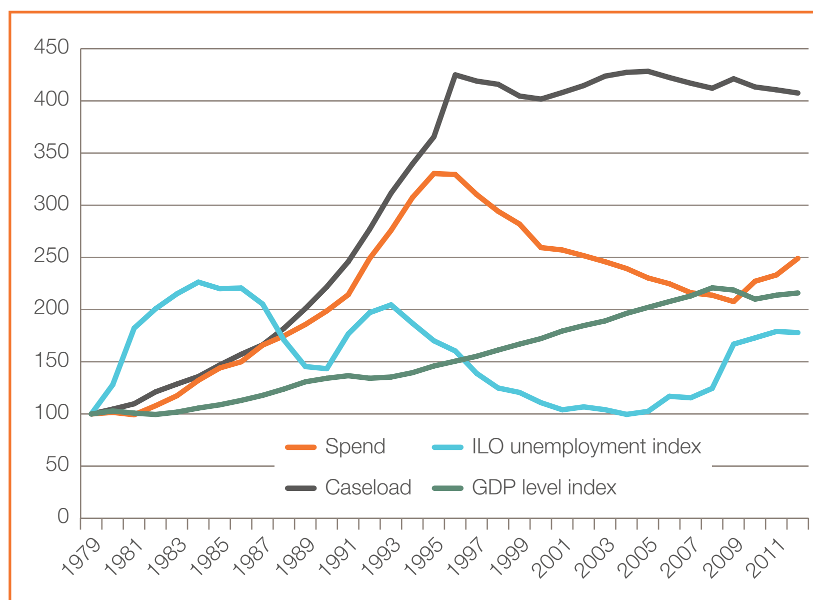
Sources: Author calculations based on DWP 2013a, budget 2013 documentation, HM Treasury GDP figures, the ONS's *Annual Abstract of Statistics* 2012 and Labour Force Survey data.

A contrasting set of relationships are visible in figure 2.15, which illustrates trends in expenditure on disability benefits that serve an income replacement function (as opposed to those such as DLA which meet 'extra costs'). This highlights a loose association between rising unemployment in the early 1980s and increases in both caseload and expenditure on disability benefits. The jobless total initially grew more

rapidly but, as short-term unemployment fed through into long-term inactivity, the numbers on invalidity benefit and the level of spending continued to grow substantially though until the mid-1990s, despite a significant recovery in the labour market.

Strikingly, from this point the upward trend in the number of claimants flattened off, though it did not fall. Another reason to suspect that the relationship between the caseload and the labour market may not be strong is that the spike in unemployment which began in 2008 did not lead to a rise in the number of people receiving disability benefits. Expenditure on disability benefits not only stopped rising from the middle of the 1990s but fell considerably, while caseload numbers remained relatively static. The shift to incapacity benefit, and then to employment and support allowance, both of which were less generous to many claimants, is likely to have been an important factor in this.

Figure 2.15
Growth in expenditure on out-of-work disability benefits relative to economic and caseload trends (by indexes of ESA/invalidity benefit/incapacity benefit spend and caseload, unemployment and GDP, with 1979 = 100 in each case), 1979–2012

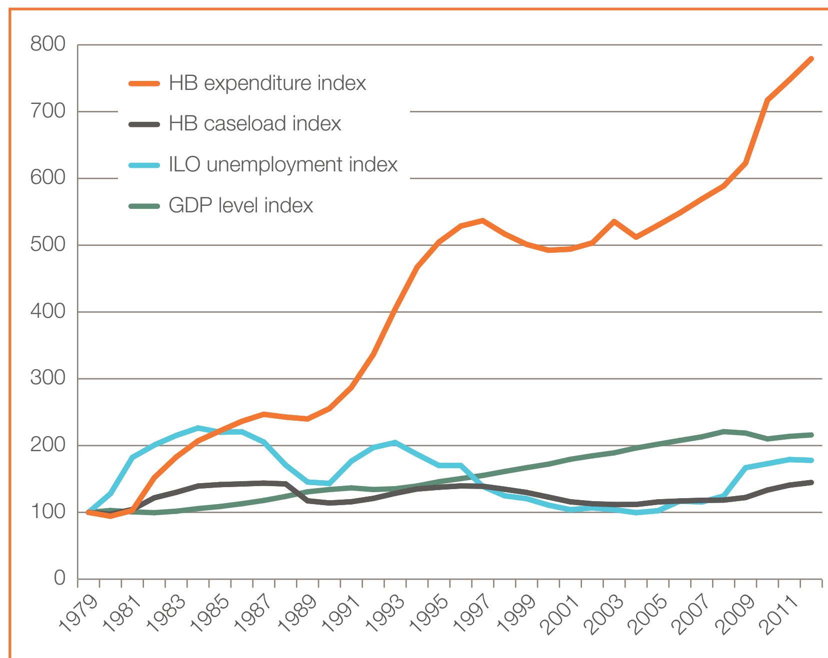


Sources: Author calculations based on DWP 2013a, budget 2013 documentation, HM Treasury GDP figures, the ONS's *Annual Abstract of Statistics* 2012 and Labour Force Survey data

Figure 2.16, which is focused on housing benefit, shows that from the late 1970s expenditure rose far faster than the caseload level, and with little apparent relationship to the economic cycle. In the first half of the 1980s spending grew broadly in line with higher unemployment, but while the jobless rate then dropped, housing benefit expenditure continued on its rapid upward path. It is striking that, across the three decades covered by the chart, the housing benefit caseload remained broadly flat. As discussed in previous IPPR research, growth in expenditure on rent subsidies is rooted in shifts in tenure, rising rent levels and the changing demographic profile of claimants (Hull and Cooke 2012).

The charts and analysis above constitute only a partial view of the factors which have driven, and continue to drive, higher welfare spending in different parts of the system. They do not demonstrate causal links, and omit a large number of additional factors that are likely to explain a great deal more about expenditure patterns. However, they do suggest that cyclical factors – and trends in the unemployment rate in particular – do not play a dominant role in driving spending patterns over a significant timeframe.

Figure 2.16
Growth in housing benefit expenditure relative to economic and caseload trends (by indexes of housing benefit expenditure and caseload, unemployment and GDP, with 1979 = 100 in each case), 1979–2012



Sources: Author calculations based on DWP 2013a, budget 2013 documentation, HM Treasury GDP figures, the ONS's *Annual Abstract of Statistics* 2012 and Labour Force Survey data

To drill down into this conclusion a little further, what the charts above indicate is that while JSA expenditure is strongly cyclical, ESA (and incapacity benefit before it) is not. It is harder to draw any such conclusions about housing benefit, which has a distinctly cyclical element but has also followed an unrelenting structural rise. Clearly much further analysis is needed to fully decompose the drivers of welfare spending, both overall and among its component parts.

A further, broader conclusion can be drawn: it appears that while rises in social security spending often follow a labour market downturn, it is harder to spot equivalent falls when the economy recovers. In significant part this is due to a shift in the dominant functions of expenditure over recent decades. Spending on the most cyclically-sensitive out-of-work benefits has fallen as a share of GDP, while those for working households, and those that meet 'extra costs', have risen substantially both in real terms and, even more dramatically, as a share of the welfare budget.

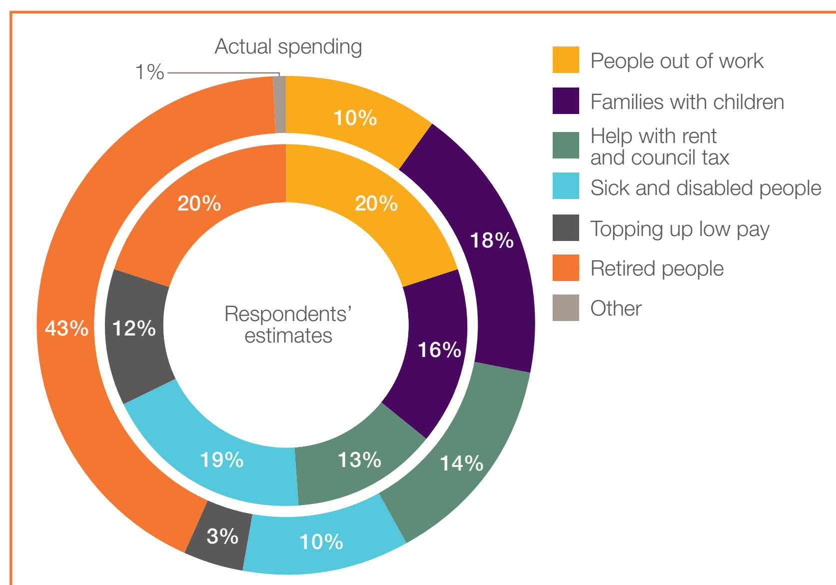
2.9 Public attitudes on the drivers of welfare spending

To conclude this section of analysis, presented below are results some original polling, commissioned by IPPR and conducted by YouGov in June 2013, to explore what the public thinks about trends in welfare spending. While there is a vast amount of data that highlights public hostility to welfare in general, there is rather less that gets beneath that headline to explore views on different aspects of the system. Our poll aimed to start filling that gap, asking people about how they think welfare expenditure is distributed across various functions, why they think spending has risen in recent years, and who they think is most, and least, deserving of support. The full results are available on IPPR's website,[29] but the main findings were that:

29 http://www.ippr.org/publication/55/11290/on-the-front-foot-designing-a-welfare-cap-that-reforms-social-security

- **Respondents massively underestimated the amount spent on pensioners, and substantially overestimated the amount spent on out-of-work benefits.** As figure 2.17 below shows, the average respondent to our poll thought that 20 per cent of the welfare budget goes to retired people, and that an equal share is spent on out-of-work benefits. In fact, a little under half of expenditure (43 per cent) is accounted for by pensioner benefits, while just over a tenth (10 per cent) goes on the main income replacement benefits for people who are out of work.[30] This suggests that the debate on welfare is taking place against a backdrop of poor public understanding about how spending is currently distributed.

Figure 2.17
Distribution of social security spending on different functions (as % of total): average of poll respondents' estimates versus actual shares of spending in 2011/12



Sources: YouGov poll for IPPR, and DWP 2013a: table 1a. Full poll results are available at http://www.ippr.org/publication/55/11290/on-the-front-foot-designing-a-welfare-cap-that-reforms-social-security

An important caveat must be made here: as previously discussed, this categorisation of spending is imprecise given the overlapping nature of certain benefits. Housing benefit tops up low pay as well as subsidising the cost of rent. Support for families with children is available to those both in and out of work. Payments to retired people are not restricted to 'pensioner benefits' – benefits such as DLA are also paid to the over-65s. Therefore it cannot be assumed that respondents to the poll shared a common understanding of the categories, which were artificially created for this paper. Also, the respondent shares in the table above only reflect average responses from our poll.

- **Respondents were split over whether individual behaviour or structural factors are to blame for recent rises in the benefits bill.** When asked to pick two options from a list of potential causes of higher welfare spending, 39 per cent said that they thought that greater numbers of immigrants coming to Britain was to blame, while 30 per cent said rising numbers of people choosing not to work was a key factor. By contrast, 37 per cent pinpointed rising unemployment and falling wages caused by the recession, and 34 per cent identified a greater number of people in retirement and living longer as a main explanation for growth in social security expenditure. These results point to a fundamental divide among the public about why welfare spending

30 Source: DWP Benefit Expenditure Tables 1948/49–2017/18, table 1a

has been rising, which in some ways mirrors the split in public attitudes towards the causes of both the budget deficit and Britain's current economic difficulties.

- **Pensioners, disabled people and (to a much lesser extent) the recently unemployed were judged to be the most deserving of support from the welfare system.** Given three choices from a range of options, over three-quarters (76 per cent) of respondents to our poll said that pensioners who have worked most or all of their lives are among the most deserving; over two-thirds (67 per cent) put people with a serious, long-term disability in that camp. The group viewed as next most-deserving was those who have been in work but have just lost their jobs (39 per cent). These results suggest a potential prize for the disability lobby in an assessment system for benefits that is effective and carries wider public credibility.
- **Wealthy pensioners, large workless families, and those deemed to be 'not trying hard enough to find work' garnered the least public sympathy.** Offered another three choices from the same range of options, nearly three-quarters (74 per cent) of respondents picked those who could work but aren't making enough effort to do so as among the least deserving of support from the welfare system. Almost two-thirds (63 per cent) put wealthy pensioners with other sources of income in this category, while a little under half (46 per cent) selected families with more than three children and no adult in work. This suggests public support for Ed Balls' proposal of no longer giving the winter fuel allowance to the richest pensioners, but also that the welfare system has a vulnerable flank in relation to large workless families.
- **A substantial share of respondents thought that the welfare system provides too little financial protection when people fall on hard times.** Almost half (49 per cent) agreed with this statement, with less than a fifth (17 per cent) disagreeing. This is consistent with the comparative analysis above which illustrated the UK's relatively low net replacement rates for the majority of family types upon becoming unemployed. However, respondents were more evenly split when asked whether the system provides too little money to families with children in poverty: over a third (37 per cent) agreed with this statement, but nearly a quarter (24 per cent) disagreed.
- **There was a strong consensus that the welfare system does too little for people who have contributed to it, and is too soft on people who could work but don't.** Nearly eight in 10 respondents (78 per cent) agreed with the former proposition, while over three-quarters (76 per cent) backed the latter. Significantly, large majorities of Labour voters were part of this consensus (with 75 per cent and 65 per cent respectively supporting these positions). Backing for a welfare system that is conditional and contributory reflects broadly-held, mainstream public opinion – one that politicians should be wary of standing against. Only 16 per cent of respondents to our poll agreed that there are no fundamental problems with the welfare system as it stands, which indicates the dangers of defending the current settlement and vacating the territory of reform.

3. DESIGNING THE WELFARE CAP TO DRIVE CENTRE-LEFT REFORM

Many on the centre-left have responded to the chancellor's announcement of a welfare cap with hostility. Given the current government's record of taking over £21 billion out of social security spending, affecting thousands of families on low incomes, this reaction is not surprising. Such hostility will be well-founded if the cap is used simply as a mechanism for justifying and driving a further series of uncoordinated raids on benefit and tax-credit spending. However, this paper's argument is that not only can such a risk be minimised through careful design, but the concept of a welfare cap could be harnessed in service of strategic centre-left goals.

3.1 The centre-left case for a welfare cap

First, **the level of welfare spending is an unavoidable question facing policymakers in the coming years, which requires its growth to be controlled**. Tax credits, benefits and pensions now account for 30 per cent of all public expenditure (of which 16 per cent was spent on pensioners, and 14 per cent on those of working age and children).[31] While this spending remained broadly flat overall as a share of total expenditure in the years prior to the financial crisis, subsequently there were sharp real-terms rises in certain key areas (particular those related to pensions, children, housing and disability). In the longer term, social security and tax credits account for a substantially larger share of national income now than in the postwar decades.

Currently, welfare is among the very few areas of expenditure to have risen in real terms as deficit reduction which constitutes a significant re-shaping of public spending has kicked in. It is hard to argue that these areas should be immune from the process of securing the long-term sustainability of the public finances, whatever the pace of deficit reduction. The centre-left should be wary of advocating higher social security spending as a mark of greater social justice – and of appearing to deny the existence of trade-offs between different areas of public expenditure.

Second, **even if it were argued that current levels of spending are appropriate, there would still be a strong case for questioning where expenditure is directed and for what purpose**. Put simply, there is a big difference between welfare spending which results from deliberate choices to pursue particular political goals – like reducing child poverty – and welfare spending that reflects the costs of economic or social failure, such as low pay or high rents.

In the academic literature a distinction is made between 'social investment'[32] – spending which is pro-jobs and pro-growth – and what might be called 'compensatory welfare' – spending which seeks to ameliorate the negative impacts of capitalism on certain groups of citizens. Not every aspect of social security and tax credit expenditure can be precisely divided in this way, but a broad policy objective should be to reduce the demand for welfare spending that arises from the 'costs of failure', in order to make more resources available for social investment. In this way, the centre-left can avoid defending the current constellation of spending as the best possible embodiment of its values.

Third, **given this concern, there are good reasons to worry about the relative drift away from services and towards benefits (and from DEL to AME) that has taken place in recent years.**[33] Relative to spending on transfer payments, expenditure on

31 Based on estimates for 2012/13. https://www.gov.uk/government/publications/benefit-expenditure-and-caseload-tables-2013

32 See for example Hemerijck A (2013) *Changing Welfare States*, Oxford: Oxford University Press

33 There has also been a significant – and damaging – shift away from capital spending. However, this represents a small share of overall public expenditure relative to current spending on services and benefits.

public services tends to be more productive, supporting and generating employment rather than simply sustaining consumption. Compare, for example, spending on childcare – which creates jobs and enables parents to work – to spending on child tax credit which, by boosting out-of-work incomes, erodes the incentive to work.

Arguably, expenditure on services is also more resilient: popular support for schools and hospitals is substantially greater and deeper than it is for benefits. It is thought to often be more efficient in terms of achieving greater value for money through pooling resources in collective services, with the NHS being the quintessential example of this; by contrast, subsidising demand can push up prices (such as in childcare and housing). Furthermore it is also, perhaps, more solidaristic – services like children's centres underpin real relationships among people, whereas bureaucratic transactions, such as money transferred from the government to households, which are focused on individuals.

The drift towards AME also makes the management of the public finances – and the pursuit of political priorities through public spending – more difficult, as this expenditure is less under the government's control. Cash benefits should – and will – continue to play a major role in social security policy, especially where they are the best means of advancing a particular political objective. However, there is a strong centre-left case for re-balancing spending towards services in the years ahead, particularly given the overall constraints on public expenditure.

Fourth, **in light of this analysis, the absence of an institutional mechanism for understanding and acting on the connections between AME and DEL presents a huge problem**. Consistent with the 'social investment' argument, there are aspects of social security and tax-credit spending that could be reduced if other areas of public policy were made more effective. It may be hard to track precisely, but there are relationships between the level and effectiveness of departmental spending (for instance on childcare, housing or skills) which affect the demand for welfare spending. In recent years, governments have tried to draw on this insight through introducing payment-by-results models and making greater use of the private sector to pursue so-called 'DEL-AME' switches' – such as the Work Programme, whereby support to get people back into work is funded by the benefit savings generated by the success of such interventions.

However, there is currently no systematic way to measure the strength and nature of the links between aspects of welfare spending and other expenditure or policy decisions, or the sensitivity of welfare demand to exogenous factors. This is a major impediment to the advancement of reforms and spending choices that could drive genuine savings and make better use of public resources. Consequently, perverse and inefficient spending continues – such as in housing, where decisions about capital spending, social rent setting and housing benefit are uncoordinated, despite being intimately interrelated. There is a big potential prize for the centre-left in establishing a means of understanding the links between DEL and AME in ways that can drive better spending decisions.

Fifth, **standing back from the technicalities, public confidence in the social security system is fragile, which makes an assertive rather than defensive stance politically essential**. As our polling makes clear, anyone committed to a strong and effective welfare system has reason to be extremely concerned about the level of public hostility to it. Greater levels of public understanding about where money is spent – and on whom – would surely help. However, even if that were to be achieved, it is far from clear that spreading 'the facts' would be enough to restore public trust in, and affection for, welfare. There is a widely shared

sense that, in part because of trends in spending, the welfare system has taken a wrong turn, and this must be confronted.

In response, the centre-left should contest rather than concede the terrain of reform. It should agree that there is a need to control welfare spending given the pressures on the public finances and the importance of other areas of expenditure. But it should also offer a distinctive analysis of the challenges which face the system – making common cause with broadly shared public sentiment wherever possible – and articulate a concrete strategy for change. In this context, the concept of a 'welfare cap' offers a great deal of opportunity for reform.

3.2 Three components of a plan for reforming welfare spending

In the abstract, a welfare cap is politically neutral. It is more accurately described as a 'budget' rather than simply a 'limit'. The key question, of course, is the size of that budget, but equally important is what it is used for and (perhaps even more so) what effect that cap has on spending decisions and policymaking more broadly. Without claiming to offer a detailed or fully costed plan for reforming welfare spending, what follows are three core strategic objectives that a welfare cap could encourage and support.

1. *Bring down cyclical welfare spending as quickly as possible, while enabling the automatic stabilisers to support demand during economic downturns.*

As discussed previously, it is difficult to distinguish between cyclical and structural factors and their relative significance as drivers of welfare spending, and in practice they are not wholly distinct. However, the size of the benefit bill is clearly related to macroeconomic trends, and to reduce it the priority must be to reduce the short-term cyclical spending pressures that have their roots in the recent recession.

Reducing unemployment and increasing employment

The starting point of such a strategy must be a sustained reduction of unemployment, which would mean fewer people would be reliant on out-of-work benefits, and the cost of other cash transfers would decline as household income rises. Increases in the employment rate – and in the number of hours worked – would have a similar affect, especially on welfare spending that is subject to a household means test (like tax credits and housing benefit).

New IPPR analysis for this report enables the scale of fiscal gains from higher employment to be quantified. Our modelling finds that increasing the employment rate by 1.5 percentage points – from its current level of 71.5 per cent to 73 per cent – would reduce spending on tax credits and benefits by £2.4 billion. Furthermore, a growth in the employment rate of this order would generate £3.1 billion in extra income tax and NICs, meaning an overall net gain to the exchequer of £5.5 billion. In the years ahead, a higher employment rate would constitute a vital foundation from which to secure long-term fiscal sustainability and finance both the social security system and public services more widely.

At the macro-level, key levers for pursuing this goal could include building on Mark Carney's recent 'forward guidance' by giving the Bank of England an explicitly dual mandate in relation to employment as well as inflation. It could also involve reorientating fiscal policy towards rising employment. In the short term this might mean making fiscal contraction dependent on falling unemployment. More broadly, it would mean prioritising

public spending which drives job creation – such as capital rather than current expenditure – and steering wider economic, labour market, taxation decisions towards outcomes that are pro-employment (Dolphin and Lawton 2013).

Raising wages and tackling low pay

In addition to increasing employment, rising wages would also bring down cyclical welfare spending.[34] In recent years there has been a substantial expansion in expenditure on working households. This is partly the result of deliberate decisions to improve work incentives – through the introduction of tax credits, for example – but also because there is a large number of households which have at least one adult in employment but which are still on a low income. This might be due to either low wages, or insufficient hours being worked.[35]

IPPR's tax benefit model makes it possible to quantify the impact of different trends in earnings growth on welfare spending.[36] Our analysis finds that if average earnings were to fall by 1.5 per cent in real terms in 2013/14 – as they did in 2012/13, and as the OBR predicts for this year – it would cost the Treasury almost half a billion pounds (£497 million) more in tax credits and benefits than if earnings growth were to remain flat in real terms. Four-fifths of that extra cost would come from higher tax-credit spending (£399 million), with the remainder going on other means-tested benefits.

If earnings growth were to return to something approaching a 'normal' level this year, such as a real terms rise of 2 per cent,[37] then tax-credit and benefit spending would be £1.1 billion lower than it will be if the expected 1.5 per cent real-terms fall occurs; tax-credit spending would be over £900m lower. This analysis finds that patterns of wage growth have an even larger effect on income tax and national insurance receipts. For example, annual revenue in 2013/14 would be £5.4 billion higher if real earnings growth were to remain flat than if earnings were to again fall in real terms by 1.5 per cent as it did in 2012/13. If wages rose by 2 per cent this year then the difference would be a staggering £12.5 billion – almost equivalent to the annual amount raised by the chancellor from increasing VAT from 17.5 per cent to 20 per cent.

The causes of the current period of pay stagnation – and the conditions necessary for earnings to start rising again – have been the subject of considerable analysis and debate (Resolution Foundation 2012). A return to productivity growth is a necessary prerequisite but insufficient in itself, while deeper trends – like the financialisation of the economy, occupational polarisation and the decline of trade unions, which are thought to have weakened the wage returns for the average worker (Lansley and Reed 2013) – are not easily reversed. In addition to a decline in the labour share over recent decades, those at the top of the earnings distribution have captured an ever-larger proportion of wages.

The best prospect for securing rising wages for low- and middle-earners is falling unemployment and a tighter labour market (Gregg and Machin 2012). Other proposals

34 Inflation is the other macroeconomic trend that affects patterns of social security and tax-credit spending, through its connection to uprating decisions. However, the recent decision to uprate many working-age benefits by less than CPI is currently weakening this relationship.

35 For more analysis of this trend see Gaffney D (2013) 'Social security and working households', in *The Double Lockout: How low income families will be locked out of fair living standards*, London: Child Poverty Action Group. http://www.cpag.org.uk/sites/default/files/CPAG-report-The-Double-Lockout-0113.pdf

36 This modeling is based on tax thresholds and benefit rates for 2013/14; all monetary figures are given in 2013/14 prices. It is assumed that earnings growth is shared equally across the income distribution.

37 As a guide, average real wages grew by 2.3 per cent between 2001 and 2006.

include reigning in excessive pay at the top of the labour market, improving intermediate-level technical skills (and increasing demand for them among employers), a more assertive industrial policy, the development of stronger institutional arrangements to support 'high road' economic development, and increasing the bargaining power of ordinary workers (Resolution Foundation 2012, Lansley and Reed 2013). In the end, low pay is partly a result of cyclically-driven weak demand, but it also reflects the deeper structural problems of a declining labour share and a rise in wage inequality.

Increasing the national minimum wage would reduce welfare spending, while if the living wage were paid to all workers whose earnings are currently below it, annual spending on tax-credits and benefits would drop by £1.1 billion (Lawton and Pennycook 2013). This would, of course, impose costs on employers, unless they were able to offset higher labour costs with greater productivity.

Strategies for spreading the living wage include adopting it across the public sector and its supply chain (via procurement rules), requiring transparency about low pay in the private sector, and developing 'living wage zones' in which tax and benefit savings made by paying local government workers the living wage are drawn forward and devolved to support private sector firms in making the transition away from low-pay business models (Lawton and Pennycook 2013)

Strengthening the automatic stabilisers

It is vital that the welfare cap does not impede the operation of the automatic stabilisers and the role that these play in maintaining demand during a downturn; if anything, their firepower should be strengthened. Given that the marginal propensity to consume is greater among those with less disposable income, higher levels of short-term wage replacement for newly redundant workers would boost demand, while also supporting efficient job-matching (Mulheirn and Masters 2013).

Counter-cyclical policy would be further strengthened by the implementation of a mechanism whereby both a cut to employers' national insurance contributions, and extra funding to JobCentre Plus to maintain adviser-claimant contact levels, is automatically activated if unemployment hits a certain level. Similarly, the payment schedule of the Work Programme could be made more sensitive to the economic cycle, so that it becomes a proper measure of provider performance: maintaining cash flows during downturns, and preventing windfall gains when there is a labour swing (an idea suggested by Tony Wilson of the Centre for Economic and Social Inclusion).

2. *Advance reforms that reduce the costs of market failures, and switch resources to social investments among the working-age population.*

It is essential that social security and tax-credit expenditure rises in a recession. The problem is that it has not fallen overall – either at all or by enough – during periods when the economy is growing. This is because the drivers of welfare spending are not entirely cyclical, but also reflect structural drivers such as rising rents, inadequate childcare, low skills, and disguised worklessness among those on inactive benefits.

The causes of these structural factors often lie in wider economic and social challenges, which it is beyond the reach of the benefits system to address. However, in many cases there are other areas of public policy – and public spending – which aim to address them in various ways. Therefore an important objective for government should be to

better understand these connections, in particular the relationship between aspects of AME and DEL.

Such an analysis could identify opportunities for switching spending and pursuing institutional reforms that could deliver better outcomes and greater value for money by reducing the *demand* for social security and tax credit expenditure (outside of variations in the economic cycle).

This is not to say that non-cyclical welfare spending should be eradicated. In many areas, such as pensions, it is driven by irreducible demographic factors, or by the advancement of important and chosen goals like meeting the extra costs of being disabled. Instead, the objective of welfare spending reform should be to reduce as far as possible the costs that arise due to 'market failures', and to ensure that public money is spent in the most effective way.

Prioritising services over benefits

In some instances, putting cash in the pockets of individuals or households is essential or desirable. Retired people need an income when they stop working; disabled people's independence is enhanced if they, rather than a bureaucracy, have control over money to which they are entitled.

However, on the grounds of efficiency, resilience and solidarity – not to mention supporting production over consumption – there are reasons for preferring spending on services over benefits in some instances, particularly where the latter is given principally to purchase the former. In areas like housing, childcare and social care, demand subsidies are often not an effective or efficient means of developing high-quality, reliable provision and, unless there is sufficient supply in a given market, they risk simply increasing prices.

The major advantage of personal subsidies for services such as these is that they put choice and power in the hands of consumers over providers (including the ability to reject poor provision). However, whether they maximise user interests overall depends on the quality and price of the services that are available for them to purchase. In the cases of rented housing and formal childcare in particular, it is hard to argue that there is a stable market of high-quality, reasonably priced provision. In such circumstances, there is a danger that both taxpayer and consumer get a sub-optimal or inefficient outcome. Furthermore, there are other ways of bolstering the position of consumers in public services other than direct purchasing power in voucher-style schemes – such as through a judicious mix of funding, regulation, entitlements, accountability and transparency.

This instinct – of prioritising services and social investment over transfers and compensatory welfare – could have substantial implications for the direction and organisation of spending.

In housing, it could mean creating the institutional conditions for a long-term shift towards capital expenditure on building homes, and away from subsidising rents through the benefit system (Hull and Cooke 2012). This could be done through mobilising the energy and leadership of our major cities by putting them in control of all public spending on housing in their area. Merging AME and DEL budgets, this would enable them to strike a balance between subsidising rents and investing in new homes that is right for their area (while retaining national rules about eligibility for assistance with rent). This process of switching from 'benefits to bricks' could be kick-started by changing the rules which

govern local authority finance to enable them to borrow (safely) against their housing assets and rental income (Griffith and Jefferys 2013).

In childcare, it could mean shifting the balance of public spending away from cash benefits to families with children and towards investing in the quality and availability of childcare services, thereby enabling more parents to work and helping to overcome early childhood disadvantage. This would bring the UK into line with other OECD countries, including states like Denmark, that have higher rates of maternal employment and lower rates of child poverty than this country. Fixing child benefit in cash terms over a 10-year period, for example, would release £2.5 billion that could be spent on improving childcare services[38] (which, in time, could pay for itself if it generated a boost in employment). There is a strong case for advancing universalism in services and conceding it in transfer payments.

In social care, such an approach could mean including attendance allowance (and DLA for the over-65s) in a future reform of funding and provision for those who have care and support needs in later life. At present, this system is a confused mix of the NHS, local authorities and the social security system. There is a debate currently about a better model – including the government's so-called 'Dilnot cap' and the Labour party's goal of 'whole-person care' – which would integrate health and social care systems. Provided that the important principles of choice and control for older people are adhered to, it would seem sensible for 'extra-cost' benefits to be part of this discussion.

Reducing structural unemployment

Long-term unemployment and inactivity (and low labour productivity) is another area in which spending switches and institutional reform could reduce the structural drivers of social security and tax-credit spending. The welfare system currently yokes together expenditure on income-replacement benefits for the cyclically jobless and for those who have been out of work for longer periods of time (and have deeper barriers to employment). This is in part a consequence of the erosion of the distinction between social insurance and social assistance that (along with the contributory principle) abides in many European social security systems.

The distinction between cyclical and structural unemployment is not absolute, given that the level of the NAIRU[39] can be shifted. However, while they cannot be precisely measured, there is a meaningful difference between economically inactive people who are 'work ready' – who need their income to be sustained during (hopefully) temporary periods in-between jobs – and those who require more than an upturn in labour demand before they can gain employment.

Policy over the last 25 years has aimed to boost labour supply among this latter group through a mixture of carrots and sticks. There is good evidence that active labour market programmes (ALMPs) combined with conditionality on the receipt of benefits increases the likelihood of employment (de Koning 2007). This insight has led to the development of financing models that attempt to pay for ALMPs through subsequent savings to the benefit bill, such as the Work Programme's so-called 'DEL-AME' switch.

38 Author calculation. Analysis suggests that where extra childcare provision leads to additional parental employment, the resultant gains to the exchequer gain more than outweigh the upfront cost of that extra provision (Ben-Galim 2011).

39 The 'non-accelerating inflation rate of unemployment' refers to the level of unemployment that economists believe is consistent with an economy operating at full capacity but not overheating.

The jury remains out on the effectiveness (and cost-effectiveness) of the Work Programme: there are uncertainties about whether the 'price' paid for getting the long-term unemployed into work is enough, and about how dependent such efforts are on the economic cycle. Ultimately, such programmes are dependent on an employer with a job opening being prepared to hire someone who may look relatively less attractive or more risky than other jobseekers. There are also doubts about whether 'payment by results' contracting models drive innovation, and concerns about perverse incentives.

There are two potential policy insights to be gleaned from this analysis. First, traditional 'supply-side' ALMP strategies could be complemented by more aggressive approaches to generating work for the longer-term unemployed, including boosting the incentives for employers to hire them. This could take the form of more intensive job brokerage, wider use of intermediate labour market programmes such as 'job guarantees', or more work experience and job trial opportunities that help people to 'get a foot in the door' (Fishwick et al 2011).

Boosting 'incentives to hire' could involve wider use of wage subsidies, or lowering labour taxes in respect of those facing labour market disadvantage (such as having not worked for a long period), thereby making them more attractive to prospective employers. Alternatively, hiring could be 'de-risked' for employers – for example, the state could take on liability for sickness absence among workers with a pre-existing health condition. Employment opportunities for the long-term unemployed could also be generated through public procurement rules, or even quotas of the kind used in countries such as the Netherlands and Germany.

Second, the principle of meeting the costs of reducing unemployment – particularly for those who are otherwise unlikely to find work – by offsetting reductions in benefit spending could be extended. One option would be to develop more sophisticated 'payment by results' models, perhaps by utilising social finance as well as private finance;[40] another would be to do more to identify and closely monitor the impact of DEL on the drivers of AME across Whitehall, in order to better inform long-term spending decisions in areas like childcare, housing and health.

Alternatively, experiments in community budgets and the city-deals process could be expanded into more ambitious approaches to multi-year 'place-based budgets', under which cities and combined authorities would be able to pool funding and make the trade-offs between AME and DEL which would be most effective and offer the best value for money in their particular parts of the country.

Public reactions to potential spending switches and institutional reforms

A number of the ideas discussed above are being considered by IPPR as part of our Condition of Britain programme.[41] Our twin starting points for this programme are, first, the need to control rises in social security and tax-credit spending, and second, the potential for spending switches and institutional reforms to deliver real savings – not just short-term cuts – through shifting the focus of expenditure onto social investment and reducing the demand for welfare.

40 Examples of social finance include the Cabinet Office's Social Outcomes Fund and the Big Lottery Fund's Commissioning Better Outcomes Fund, which both aim to build capacity and test out such innovations further. See http://www.biglotteryfund.org.uk/sioutcomesfunds

41 For more information see http://www.ippr.org/research-project/44/10307/the-condition-of-britain

To inform this thinking, we decided to use our YouGov poll to test the public's mood on some of these emerging policy directions, including the trade-offs that might be involved:

Table 3.1 Public reactions to proposed spending switches and institutional reforms

Policy direction	Support	Oppose
Put a limit on the amount of time for which someone can be unemployed by providing work of social value, paid at the minimum wage, for anyone who has been out of a job for more than 12 months; require them to take this job or lose access to benefits.	71%	13%
Reduce spending on housing benefit by, over time, shifting some of that money into building more houses in order to increase the number of affordable homes and reduce rises in rents.	64%	12%
Increase the minimum wage substantially, and reward firms for adopting the living wage. This would increase costs for some employers, but reduce the need for the government to top up people's wages with tax credits.	63%	13%
Shift government funding over time away from cash benefits to parents, like child benefit and child tax credit, and use the money saved to increase the amount and quality of affordable childcare that enables parents to work, such as nurseries, childminders and Sure Start centres.	45%	22%
Reduce spending over time on cash benefits to disabled people who are not working by increasing the incentives for employers to recruit disabled people, using public money to pay some of their wage costs.	39%	26%
Keep young people out of the adult welfare system, restricting their access to things like disability benefits and social housing, but provide financial support for and greater access to education, apprenticeships and opportunities for work-with-training.	60%	14%

Source: YouGov poll for the IPPR. The full results of this poll are available at http://www.ippr.org/publication/55/11290/on-the-front-foot-designing-a-welfare-cap-that-reforms-social-security

There is still much work to be done to develop these directions into fully designed and costed strategies for reform. However, the results above suggest that, alongside real public dissatisfaction with the welfare system, there exists the possibility of harnessing popular support for distinctively centre-left policy directions that take fiscal constraints seriously, increase social investment and advance institutional reform.

3. *Defend the value and integrity of the state pension, while addressing the fiscal challenges of rising longevity.*

The third component of a centre-left plan for reforming welfare spending concerns pensions. As our polling shows, this is by far the most popular aspect of social security expenditure, with the state pension retaining broad public support. Like the NHS, it is an enduring and resilient part of the postwar social democratic settlement, and plays a major role in ensuring dignity and security for people in their retirement.

There were fears that the ending of the earnings link in the early 1980s would lead to the state pension withering away, both financially and politically. However, this has not been the case – indeed, as private and occupational pension provision has faltered badly, the state pension has been strengthened and secured for the long-term in recent years.

The coalition government has drawn a clear distinction between the state pension, which has been increased through the 'triple-lock' uprating, and working-age welfare, which has been aggressively cut back. Other pensioner benefits like the winter fuel allowance have been protected, and pensioner claimants have been shielded from reductions to other payments such as council tax benefit.

Furthermore, the longstanding objective of creating a unified, flat-rate state pension has progressed, albeit in a way that will generate savings to the exchequer in the long term. When outlining his plans for a 'welfare cap', the chancellor made clear that while other pensioner benefits would be included under it, the state pension would be exempt. After some initial uncertainty, it seems highly likely that, if it won the next election, Labour would do the same.

Securing the affordability of the state pension

Defending the state pension does, however, require that its long-term affordability is secured in the context of rising longevity. The chancellor's solution – and his stated explanation for keeping it out of the 'welfare cap' – is incremental increases in the state pension age. This has happened twice during the current parliament, delivering substantial savings.

First, the increase of the state pension age from 65 to 66 years old was brought forward from April 2026 to October 2020, resulting in net average benefit savings of £3.6 billion a year between 2016/17 and 2025/26, and a further £800 million a year in increased income tax receipts and NICs from people working longer (in 2011/12 prices).[42] Subsequently, shifting the increase from age 66 to age 67 from April 2036 to March 2028 will deliver further net average benefit savings of £6.3 billion a year between 2026/2027 and 2035/2036, and a further £1.3 billion a year in greater income tax revenue and NICs (in 2012/13 prices).[43]

Given the pace at which the population is ageing, these steps might not be enough. The OBR projects that spending on pensions will rise from 5.8 per cent of GDP in 2017/18 to 8.4 per cent in 2060/61. This includes the impact of the single-tier pension, which will reduce expenditure on the state pension by 0.7 per cent of GDP by 2062/63.[44] So far, the date at which the state pension age will be increased to 68 (planned for 2046) remains unaltered, but bringing this date forward would deliver substantial savings. The sooner such a decision is taken, the longer people have to plan ahead.[45]

Another option would be to ditch the triple lock and return to earnings-linked uprating – the long-standing goal of pension campaigners during the 1980s and 1990s. The OBR estimates that increasing the state pension in line with earnings, thereby maintaining its value relative to the working-age population, would save 0.9% of GDP – or £14 billion in 2013/2014 prices – by 2060 compared to maintaining the triple lock.[46]

More radically, there may also be a case for making the link between NICs and the financing of the state pension more explicit – perhaps even hypothecating revenues from the rest of the public finances – in order to entrench its contributory nature, protect it from political raids, and internalise the long term affordability challenge. IPPR is conducting further work on this issue.

42 See tables 3 and 4, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/181462/pensions-bill-2011-ia-annexa.pdf

43 See tables 2 and 3, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/181187/state-pension-age-67-impact-assessment.pdf

44 http://budgetresponsibility.org.uk/wordpress/docs/2013-FSR_OBR_web.pdf

45 The government is consulting on plans to develop an automatic mechanism for adjusting the state pension age in line with rising longevity.

46 This assumes that earnings and inflation follow the same pattern as has been the case since 1993.

Sharing the burden across the generations

Not all of the social security spending that goes to older people is channeled through the state pension. In 2011/12, £8.4 billion was spent on pension credit (a figure which is set to fall due to state pension reform), £2.2 billion on the winter fuel allowance, and £600 million on free TV licences for the over-75s. Strategically, the defence of these more marginal benefits is not as important as that of the basic state pension, especially at a time when working-age households are facing such substantial hits to their income. For example, restricting the winter fuel allowance and free TV licences to households on pension credit would save £1.7 billion a year (Mulheirn 2012).

Another question is whether to protect pensioner claimants from reductions in non-age-specific benefits. For example, £2.3 billion of the £5.1 billion spent on council tax benefit in 2011/12 went to pensioners who were immune from the cuts that accompanied its localisation. Over a third (34 per cent) of expenditure on DLA goes to pensioners, as does more than a quarter (28 per cent) of housing benefit spending.[47] Both of those benefits are set to be included in the welfare cap.

Older people can also share the burden of ensuring fiscal sustainability by working longer. This is already happening: data from the Office for National Statistics shows that the employment rate of those aged 50–64 rose from 56 per cent to 66 per cent between 1992 and 2012. Over the same period, the employment rate of those over 65 has grown even faster, from 5.6 per cent to 9.0 per cent.

Evidence suggests that not only have such rises had a major fiscal impact, but also that increases in the state pension age have helped to achieve it. Modeling by the Institute for Fiscal Studies found that 'women's employment rates at age 60 increased by 7.3 percentage points when the state pension age was increased to 61 and their probability of unemployment increased by 1.3 percentage points' (Cribb et al 2013). The employment rates of their male partners were also found to have risen by 4.2 percentage points, and in combination the two increases delivered a substantial overall fiscal gain.

3.3 Designing a 'welfare cap' that helps drive reform

It is perfectly possible to view the proposed 'welfare cap' as either meaningless or dangerous. The former case rests on the argument that AME is not 'uncontrollable' given that spending reviews are already based on forecasts for benefit and tax-credit spending, and that the current government has demonstrated its capacity to implement policies to reduce it. On this view, the 'welfare cap' is largely a symbolic political device, underlined by the weak sanction attached to breaching it.

This standpoint is not without merit. However, it overestimates the current level of strategic decision-making in relation to AME, especially its sensitivities to other factors including DEL, and underestimates the downside for the government of over half of public spending being demand-driven. This makes it much harder to pursue clear priorities in an era of fiscal constraint.

The alternative perspective is less generous, seeing the cap as a mechanism and justification for further cuts to social security and-tax credit budgets. This, after all, is consistent with policy during this parliament. Such a fear is stoked further by the cap's focus on working-age welfare despite the fact that higher spending on pensioners and debt interest payments will be the main causes of higher AME in the coming years.

47 Breakdowns for individual benefits taken from DWP 2013a: 'Disability Benefits' and 'Housing Benefit' tables.

The welfare cap will not aid strategic policymaking, or effective management of the public finances – if it simply provides cover for further rounds of cuts that do not get to the root causes of higher spending. Whatever the merits or otherwise of the 'bedroom tax', for instance, social security expenditure has not been rising due to a sudden surge in the number of spare rooms.

It is also the case that a broad range of fiscal choices remains available to governments in order to make the public finances sustainable in the medium term. First and foremost, these relate to the pace of deficit reduction and the extent to which this is dependent on growth and employment. Second, there is scope for altering the mix of spending cuts and tax rises (which under current plans will be skewed overwhelmingly towards the former in the next parliament). Finally, of course, there are big choices about priorities in both taxation and spending.

However, to outright reject the notion of a welfare cap in principle is to dismiss the need for greater strategic decision-making in relation to social security and tax-credit expenditure (in the context of wider policy and spending) and the potential for a new institutional mechanism to overcome the root causes of the current problems.

3.4 Limiting the risks and maximising the opportunities

To avoid its risks and maximise its potential gains, the welfare cap must be designed in a way that helps to bring down the welfare bill in the next parliament by driving real and enduring savings, rather than short-term and short-lived cuts.

This means not inhibiting steps to bring down cyclical spending as quickly as possible, positively driving strategies for spending switches and institutional reform, and contributing to the measures necessary for managing the costs of an ageing society.

Crucially, decisions related to the cap must be rooted in a strong understanding of the drivers of AME and its sensitivity to other factors, including relevant aspects of DEL. It must also enable more strategic decision-making and long-term planning in public expenditure.

The government has acknowledged that further work is needed on the design and operation of the welfare cap. However, even from what has been proposed so far, changes are needed. To advance the objectives outlined above, the welfare cap needs to have the following features:

The cap should be inflation-proofed to focus on real-terms trends in spending and protect claimants against permanent erosions in living standards.
When announcing the welfare cap in his spending round speech in June 2013, the chancellor said, 'It will reflect forecast inflation, but it will be set in cash terms'.[48] This means that after the cap is set, any changes in inflation will not be adjusted for across the whole five-year period. As a consequence, the cap could be breached – and reductions in support payments triggered – as a result of fluctuations in inflation rather than any underlying shift in spending pressures. This is contrary to the government's stated goal that the cap should protect against 'structural deterioration' in welfare (HMT 2013a: 27). The cap should operate on a real-terms, rather than nominal, basis. Clearly the government would retain the right to decide on the uprating rules for individual benefits.

48 https://www.gov.uk/government/speeches/spending-round-2013-speech

All contributory benefits should be kept out of the cap, alongside the state pension, as these are entitlements based on the payment of NICs.
The government's argument for keeping the state pension out of the welfare cap is that a separate mechanism is in place for ensuring its long-term affordability, via increases in the state pension age. However, another reason is that the state pension is a contributory benefit, entitlement to which is on the basis of having paid NICs while in work. Receipt, therefore, should not be affected by the decisions of the government of the day about how much it is prepared to spend on welfare. Theoretically, in a pay-as-you-go system like the National Insurance Fund, it should be based on what successive generations of contributors are prepared to pay for contemporary pensioners.

This principle – that there is a major difference between social insurance and social assistance benefits – should be extended to working-age entitlements. This would mean that contributory JSA and ESA, statutory maternity, paternity, adoption and sick pay, plus a few other, smaller contribution-based benefits would be kept outside the 'welfare cap'.[49] This would mark an important step in reviving the contributory principle and recognising its distinct status relative to means-tested and universal benefits. This arrangement would leave non-contributory pensioner benefits, such as pension credit and winter fuel allowance, plus the share of other benefits – like housing benefit and disability living allowance (and its successor, the personal independence payment) – which are paid to pensioners, within the cap.

All non-contributory benefits should fall under the cap, but with a 'buffer' based on assessments of the sensitivity of welfare spending to cyclical fluctuations.
The government intends to exclude the most counter-cyclical elements of welfare, such as JSA and passported benefits, from the cap. However, this is a crude metric for the automatic stabilisers: it is not only passported benefits (those to which eligibility is conditional on maximum entitlement to JSA) that are driven by the cycle, and not all JSA spending is cyclical (long duration claims, for instance, are not). Distinguishing between cyclical and structural spending on the basis of benefit categories is likely to prove crude and inaccurate.

Given that the government has also said that 'there will be a margin above the cap to ensure policy action is not triggered by small fluctuations in the forecast' (HMT 2013a), it would be better to preserve the automatic stabilisers through this provision. When the actual size of the cap is set, the scale of the 'buffer', within which spending could rise without the cap being breached, should be identified. This should be consistent with an OBR assessment of the sensitivity of relevant non-contributory welfare expenditure to the cycle. This should be based on historical data, contemporary modeling and the latest economic forecasts.

The OBR should conduct a detailed, annually updated analysis of what drives welfare spending, and its sensitivity to a range of factors, including DEL.
If the cap is to drive strategic decision-making it must be based on robust analysis of the factors driving welfare spending and its sensitivity to economic, social and demographic forces. Therefore, prior to the cap's introduction, the OBR should conduct and publish such a detailed analysis, covering social security and tax-credit spending that falls both inside and outside the cap.[50]

49 Technically, those benefits that are theoretically covered by the National Insurance Fund should be excluded from the cap. For more information see http://www.hmrc.gov.uk/about/ni-fund-ac-gb-1112.pdf

50 In its fiscal forecasts the OBR does make a distinction between DEL and AME. However, it only considers demographic changes and uprating policies in projecting future benefit spending, and does not model its sensitivity to other factors.

This should go beyond its existing modeling of long term-fiscal forecasts and provide a more fine-grained assessment of the extent to which rising costs are the result of cyclical or structural factors. It should also seek to quantify the relative importance of a wide range of other potential drivers, including longevity, the labour and housing markets, family formation and benefit uprating. This would greatly improve the evidence base for policymaking, and make it much more possible to discern whether expenditure has been rising for desired or undesired reasons.

The OBR modeling should also – crucially – include a dynamic estimate of the sensitivity of elements of future spending to a range of external factors, potential policy changes and possible spending alternatives. This is essential not only for setting the cap but also for highlighting where and to what extent relevant aspects of departmental spending or other policies and reforms might reduce the demand for welfare expenditure and make best use of public money in the service of a given goal.

After conducting its initial analysis to inform the setting of the first welfare cap, the OBR should publish annual updates. In addition to providing a much-needed guide for policymaking, such a process would also greatly enhance public awareness and media debates about welfare spending.

The cap should apply over a five-year time horizon, rather than biting annually, to allow space for genuine savings in the structural drivers of welfare spending.
In addition to robust analysis of the drivers and sensitivities of welfare spending, the other necessary condition for generating real savings, rather than short-term cuts, is a reasonable timeframe for reform. While the government plans for the cap to be set over a rolling five-year period, it will bite on an annual basis: the cap will initially be set in the 2014 budget to apply in the 2015/16 financial year and then in each subsequent year.

Focusing on an annual cap, which will begin to apply just 12 months ahead, would lock in short-termism. If by the 2014 autumn statement the OBR reports a deterioration in spending that risks breaching the 2015/16 cap, the current planned framework will push the government to find the most politically painless, administratively simple and cost-efficient way to quickly tuck spending back under the cap for the year beginning the following April. In other words, the proposed framework promotes the exact opposite of long-term, strategic decision-making.

Instead, the government should set a rolling five-year welfare cap consistent with wider fiscal rules and public expenditure plans. The OBR would be responsible for judging whether it is set to be lived within by the final year of the forecast horizon, based on current policy and forecasts. This approach would mirror the current government's fiscal mandate for eradicating the structural deficit.

This framework would force the government of the day to make active decisions in relation to welfare expenditure – it would mean that those decisions were held to account, but crucially it would also provide a sufficient timeframe in which to plan medium-term spending switches and institutional reforms capable of delivering genuine savings. Such a timeframe would fit well with the setting out, by a new government elected in 2015, of a five-year spending review covering the whole of the next parliament. In practice, this could mean that the process of setting the first cap would operate as a 'zero-based budget review' of social security and tax-credit expenditure.

The introduction of the cap should be combined with experiments in DEL–AME switches both between departments and through place-based budgeting.
To further drive strategic spending decisions that generate real savings, the welfare cap should be used as a prompt to launch a series of experiments and innovations in public spending. These should exploit the potential for shifting funding towards prevention and 'invest-to-save' opportunities, drawing on the OBR's analysis of welfare spending drivers and sensitivities, and taking advantage of a five-year timeframe.[51]

Building on the City Deals model, this should include multi-year place-based budgets for major cities and combined authorities which enable public spending to be pooled across existing departmental divides and between AME and DEL. Housing, skills and welfare-to-work are examples of departmental spending which could potentially be better organised within particular geographies to reduce the demand for welfare.

Innovations across Whitehall should also be undertaken, building on a little-noticed aspect of the recent spending review. The chancellor announced a series of measures aimed at increasing the flow of people coming off benefits and into work. This included weekly signings for JSA claimants, more in-depth quarterly meetings between advisers and claimants, a seven-day waiting period before receiving JSA, requiring lone parents to start preparing for work when their youngest child is three, and expecting claimants with poor English to take steps to improve their language skills (HMT 2013a: 25–26).

Altogether, these measures were 'scored' by the Treasury as delivering £350m in annual AME savings. However, the spending review also involved transferring an equivalent sum of money from the Treasury to the Department for Work and Pension's DEL in order to fund the cost of delivering these changes, leaving the package as a whole neutral in relation to overall public spending.[52]

Albeit on a small scale, this amounted to a DEL–AME switch within Whitehall, without the need for a complex financing arrangement involving the private sector. The Treasury was confident about funding the upfront cost of these interventions from future benefit savings, on the basis of OBR modeling which estimated that an equivalent AME reduction would be generated by their implementation.[53]

This was the first time the OBR was prepared to score welfare savings on the basis of behavioural changes rather than on direct reductions in benefit eligibility or generosity. It was prepared to do so on the basis of strong evidence about the impact of previous labour market interventions of a similar kind. However, this opens up the prospect of similar spending switches being made in other areas, where there is strong 'invest-to-save' evidence (such as childcare or housing, perhaps).[54]

Personal tax reliefs – such as for pensions and childcare – should be included under the cap, to promote a rounded view of public, private and employer spending on welfare.
Finally, a comprehensive policy on welfare spending requires an understanding of all the ways in which welfare needs are met. As social policy experts such as John Hills have argued, reductions in public spending on welfare goods often result in costs being shifted

51 Some similar arguments are made in Oakley 2013.

52 What is referred to as 'total managed expenditure' in the jargon.

53 In this instance, if the savings are not generated then the DWP will not be required to repay any costs to the Treasury.

54 Such innovations make the OBR's assessment of the factors driving welfare spending even more important.

to private individuals (where they can afford it). His recent analysis has shown that 'private welfare' spending doubled from £26 billion to £53 billion between 1995/6 and 2007/8 (Hills 2013). In addition, many employers contribute to certain welfare functions, such as pensions and maternity and sickness pay, either by compulsion or voluntarily.

Therefore, in its analysis underpinning the welfare cap, the OBR should report on trends in private and employer spending on equivalent functions. This would build on established work carried out on this topic, such as by researchers at the London School of Economics (Edmiston 2011). This would provide a valuable insight into where public spending is being supplemented or replicated by other parts of society, as well as where the largest gaps exist in provision across all sectors. It would also consider which individuals and households at different points in the income distribution have – and do not have – welfare needs met outside the state.

In particular, this analysis should include 'fiscal welfare' – spending that serves the same or similar functions to social security and tax credits, but which is directed via the tax system in the form of income tax reliefs or national insurance exemptions.[55] For example, in 2012/13, £21.6 billion is expected to be forgone in income tax revenue from contributions into private or occupational pension schemes.

Such spending – which mirrors social security – should be included in the 'welfare cap' to encourage integrated policymaking. Personal tax reliefs are opaque and tend to disproportionately benefit the better-off. For example, 60 per cent of the gain from pension tax relief accrues to higher-rate tax payers (Mulheirn 2012). Their inclusion under the cap would ensure that any burden it imposes is shared more evenly, especially at a time when the government is extending the use of such strategies to pursue welfare goals, such as through 'tax-free childcare'.[56]

The decision about the level at which the cap should be set will depend on circumstances – and will unavoidably be a highly political judgment. But its design is crucial too, particularly if it is to act as an institutional force for shifting the focus of spending towards social investments and reducing the demands placed on the welfare system. Getting the design right could help to offer a plausible strategy for maintaining fiscal responsibility while advancing distinctively centre-left objectives, and for promoting an assertive prospectus for welfare reform that taps into broadly shared public sentiment. Such an approach is essential for securing the future of an effective and resilient welfare state.

55 For a comprehensive list, which extends very far beyond what might be covered by the cap, see http://www.hmrc.gov.uk/statistics/expenditures/table1-5.pdf

56 https://www.gov.uk/government/consultations/tax-free-childcare

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