

Radical welfare reform

To motivate its proposed reforms to the UK's system of benefits, the coalition government asserts that welfare is broken and spending out of control. Paul Gregg assesses these claims in the light of the recent performance of the welfare system, and examines the key issues involved in moving to a 'universal credit'.

Work and Pensions Secretary Iain Duncan Smith is proposing a 'universal credit' to replace the current range of welfare benefits and tax credits. The central idea is to have a single deduction rate as incomes rise, designed to ensure that people are always better off working and that those on low incomes do not face punitive effective tax rates when they seek to earn more.

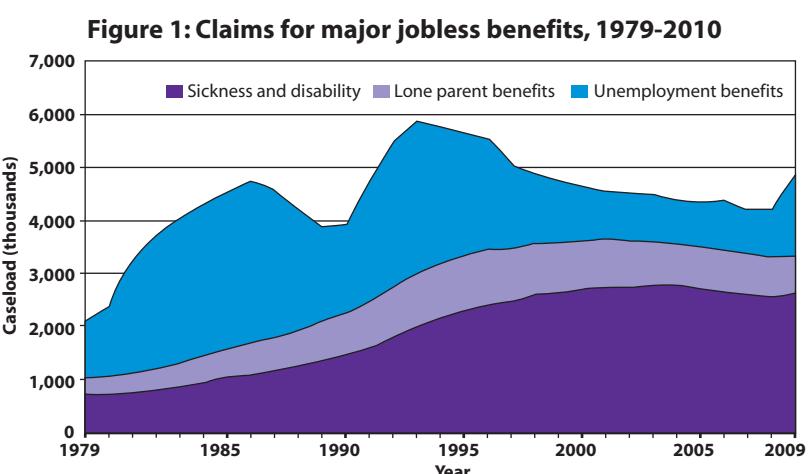
Some key facts are used to support his assertions that welfare spending is out of control and the system broken: that there are five million claims for jobless benefits; that the proportion of children growing up in workless families (16%) is the highest in Europe; that spending has risen by 40% in real terms over the last decade; and that 1.7 million families face tax and benefit withdrawal rates of over 70%.

All these facts are true – but do they support the government's view? We have just experienced the worst recession since the Second World War and the welfare system is doing its job of supporting the workless in a downturn. So it is essential to look at how welfare dependence and spending have evolved over time.

Table 1: Excess workless household rates (all figures exclude full-time students)

	Workless household rate (%)	Excess workless households (%)	Employment rate (%)
1977	8.2	- 0.2	76.5
1986	16.3	+ 4.9	71.0
1990	13.9	+ 5.0	75.6
1995	19.3	+ 6.7	73.9
1997	18.2	+ 6.5	75.9
2006	16.0	+ 5.2	77.9
2009	17.3	+ 5.0	76.7

Source: Labour Force Survey, author's calculations



Is welfare broken?

Figure 1 shows the numbers of claims for the major workless benefits since 1979. Current claims number five million, up from four million before the recession. But at the end of the last recession, which was milder, claims stood at six million. So the number of welfare claims has actually declined given the state of the economic cycle.

But ideally we would like to separate the cycle from the effectiveness of the welfare system in shaping the numbers reliant on benefits. One approach is to measure how many more households are without work (and normally reliant on benefits) than there would be if work were randomly allocated across the working age population given overall employment levels.

Table 1 shows the rate of household worklessness, the employment rate and the 'excess' of households without work compared with a random allocation. The idea is that if the welfare system provides weak work incentives, then this would show up in growing numbers of workless households.

The random allocation assumption acts as a benchmark of what would be predicted by chance; and the excess workless household rate is a benchmark of trends given family structure and employment levels.

In the 1970s, the actual picture equated closely to the random allocation, so there was no excess of workless households. From then until around 1995, an excess of welfare dependence began to emerge, so that 6.7% (1.2 million) more households were without work – signs of a welfare system that was plausibly 'broken'. Since then the number has fallen to 5% in 2009, which means that since 1995, 350,000 extra households are working.

One sign that this is driven by welfare reform is that the improvement is far greater for lone parents (a key focus of reforms over the last decade) than for other people. Employment among lone parents (given their education levels, etc.) has risen by 11% above that of other groups. So by this measure, welfare reforms since 1996 have unpicked about 30% of the build-up of excessive welfare dependence after 1979.

Table 2: The effect of government reforms on high marginal deduction rates

Marginal deduction rate	Pre-1998 Budget	Financial year 2010-11	Financial year 2001/12
Over 100%	5,000	0	0
Over 90%	130,000	70,000	130,000
Over 80%	300,000	270,000	330,000
Over 70%	740,000	330,000	1,710,000
Over 60%	760,000	1,895,000	1,935,000

Source: Budget documentation for 2009 and 2010

It is for families with children that excess worklessness has fallen most. The UK still has the highest proportion of children living in families without work in Europe. But in 1997 the figure was 19% in what was a much healthier labour market, and in the early 1990s, it was over 20%. It is a sign of how bad things were in the mid-1990s that steady improvements since 1995 still leave the UK behind.

So in terms of worklessness leading to reliance on welfare, the picture is not of a broken system. Rather it is of a system that has been steadily improving since 1995 but masked by the current recession.

Is spending out of control?

Figure 2 shows the real increase in annual welfare spending since the 1950s. As the government says, there has been a 40% real increase over the last decade, but the rise was much greater in the 1950s, 60s and 70s. Indeed, apart from the current recession, the growth of welfare spending has slowed rapidly since the mid-1980s, and is less out of control now than at any time since the Second World War.

The deeper point is that it is not the real increase that matters but the rise relative to GDP growth. GDP grew by 25% in the ten years to 2007, so the long-term pattern of welfare spending relative to GDP was falling and had been throughout the new millennium. It is only the recession since 2008 that has pushed long-term growth in spending above that for GDP.

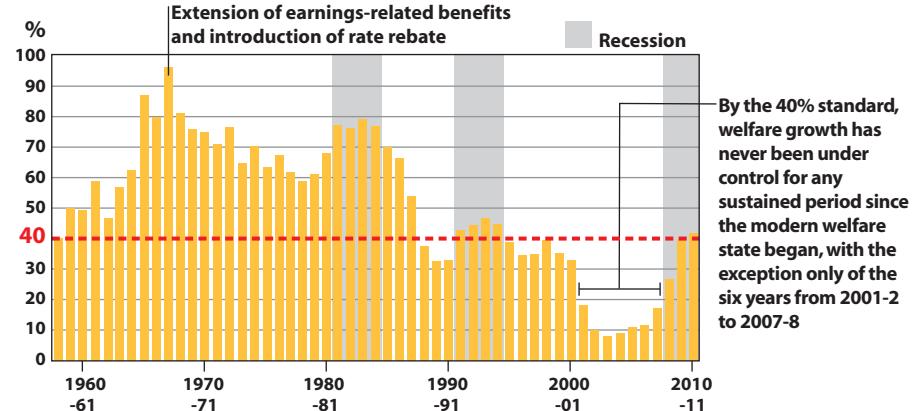
This is not a welfare system where spending is out of control but one that is doing its job in a recession when real spending rises while GDP falls because of increased need for support. This is part of the economy's system of 'automatic stabilisers' to prevent recession turning into a depression, and it will be reversed as growth returns. Indeed, the real rise in spending through this recession is well below that in previous recessions.

Issues with a universal credit

The real picture that emerges for the welfare system is one of long-term declines in numbers of claims and total spending as a share of GDP. So government claims of a broken welfare system and spending out of control simply do not stack up. They are more

Figure 2: Cost of welfare

Rolling 10-year percentage increase in social security spending in real terms, 2010-11 prices*



*Thus the 1958-9 figure of about 40% indicates 40% growth over 10 years up to 1958-9.

Source: Institute for Fiscal Studies

the hyperbole that politicians use to motivate change rather than a depiction of reality.

The government argues that the system is too complicated and that work incentives are too low because of excessive rates of benefit withdrawal when people earn more. The preferred solution – the universal credit – would take all income-related benefits and tax credits for working age people into a single system with a single withdrawal rate of 65p in the pound as earnings rise.

This withdrawal would have to be based on joint family income. But the universal credit still needs to address the residual entitlements to individual contributory benefits (based on NI contributions made rather than an assessment of family needs), mainly short-term Jobseeker's Allowance (JSA) and incapacity-related benefits.

Keeping these individual elements separate from the family-based universal credit would add considerable complexity, undermining the very logic of the reforms. The government has moved to make contributory access to incapacity-related benefits limited to a year. This saves money but also leads to many people losing entitlement to any financial support.

The remaining individual contributory elements still add substantially to the complexity of the proposed system with two additional benefits outside the credit. Hence the expectation must be that the remaining contributory elements in benefit entitlement will eventually go. There are four additional fundamental design features that will be a problem with moving to a universal credit.

Many benefits are supplements for specific additional costs: Housing Benefit (HB), Council Tax Benefit (CTB), the higher value of benefits for disability than for jobseekers, Disability Living Allowance (DLA) and Attendance Allowance (AA) all reflect payments for additional costs that only apply to some claimants. A single universal credit would not be high enough to meet these additional costs unless it was very generous and thus prohibitively costly.

But keeping them as extra payments requiring additional claims means that the new system would simply replicate the current system but with extra supplements rather than different benefits. It was the addition of supplementary elements in the tax credit system that led to it becoming so complex. This is such a profound problem that it has to be at least partly fudged, and the government has already suggested that CTB, DLA and AA are to stay out of the credit. But for the reform to be meaningful, HB and the higher value benefits for disability would have to be inside.

Keeping these supplements unreformed makes the system complex. But ironing them out entirely so there is a flat rate benefit for all would be prohibitively expensive even with substantial losers. So it is not surprising that the government has ended access to higher value disability benefits when a claim reaches a duration of one year for all those except the most extremely ill or disabled. Even with a one-year limit, this looks clunky and may presage its abolition.

HB is even more difficult. In the private sector people are paid a housing allowance based

on family size and area where they live. Capping this has been at the centre of a major political row recently. In the social rented sector people are paid the benefit on the basis of their actual rent due. Social sector rents are subsidised and thus lower than those in the private sector, but the size of the gap varies considerably around the country and is much larger in the South East. Again it is not surprising that the government is indicating it will set rents at 80% of those in the private sector. This allows for a much simpler system of a housing allowance in the social sector set at 80% of that in the private.

This is the likely direction of travel for a universal credit. But as people in the social sector are paid their actual rent, they will often lose a large amount under this simple rule where they have a large property relative to their family size. For example, a couple with a three bedroom house whose children have left home will now only get an allowance for a one bedroom flat. Many older people would lose from such a change. So it is not surprising that the new system will be for new claims only.

Different elements of the current system are re-evaluated at different intervals:

Most benefits are based on current income, rent, etc. and are reassessed whenever there is a change of job, family structure or wages. But tax credits are based on last year's earnings and only reassessed within a year if there is a major change of circumstances. In addition, large income rises are tolerated so that there is no recalculation until the next year; but significant income falls trigger rapid reassessment.

Crudely, it seems sensible for out-of-work benefits to change when people start earning or lose jobs, but instant adjustment every time someone works an extra hour a week or gets a pay rise seems unwieldy. At present this is partially dealt with, though not without problems, by having separate in- and out-of-work systems. How a single credit would navigate this may again make it complex.

Out-of-work benefits come with conditionality: Jobseekers, including lone mothers whose youngest child is 10 or older, are required to show that they are actively applying for jobs and to take work that is offered. They can also lose benefits for leaving a job through choice.

Those with health problems are required to follow an action plan to get them back to

work but are not required to look for work on day one and can refuse jobs they do not feel are suitable. Those who are extremely sick or disabled and their carers, plus lone mothers with young children, are not required to undertake any activity. Those who only claim in-work benefits such as HB or tax credits are not subject to any conditionality.

At present, once a family is working 16 hours a week they are left on their own. Under a single credit, deciding the appropriate levels of conditionality and support to look for work need not be based on what benefit someone is on but a broader measure of employment barriers faced. But to extend conditionality to those who already work, especially 16 hours or more a week, could easily create widespread resentment.

The out-of-work welfare system and the in-work tax credit system create sharp incentives to work a minimum number of hours: Tax credits are only paid when people are working at least 16 hours and there are children in the family or a person is disabled, and 30 hours otherwise. The high rate of withdrawal for the major out-of-work benefits when someone starts to earn means that there is no incentive to work fewer than 16 hours a week for families with children, but at 16 hours the gains to work jump substantially.

Almost no family with children is less than £40 a week better off in work after one person is working 16 hours, or for those without children at 30 hours. The system generates gains to work by the use of tax credits but when withdrawn they can lead to high effective tax rates as both income taxes and lower benefits kick in at the same time.

Improving incentives to move into work without cutting benefits means two broad options. One is to pay higher in-work tax credits or withdraw them more slowly. The other is to raise allowances or have a low tax rate at low earnings, such as the 10p tax band.

Table 2 shows marginal combined tax and benefit withdrawal rates. In 1998, 750,000 people faced rates over 70% and a smaller number faced higher rates, some over 100%. Labour's tax credit system reduced numbers on these very high rates: the number with over 70% fell to 330,000 but very large numbers (1.9 million) face rates of 61-70%, most at the top end of that range.

In the recent budgets the withdrawal rate for

tax credits was raised, especially for those losing the family element, which was withdrawn at £50,000 and where the taper will go from 15% to 41%. This means that the number of people facing over 70% marginal tax rates will shoot up next year.

Lowering these high effective tax rates and also increasing the returns to working below 16 hours in a universal credit has major problems. Reducing the withdrawal rate from the normal 70% to 65%, as proposed by the government, only means that it will stretch further up the income distribution. This costs more money and means that even more people are subject to effective tax rates of 65%.

There are three potential solutions. First, the generosity of the universal credit could be much lower than the current system, so less needs to be taken away and, as out-of-work support is lower, work incentives are improved. Second, as the Liberal Democrats have argued, the allowance before income tax is paid could be raised – essentially the same idea as the 10p tax band.

The third route is an income range over which the tax credit is not withdrawn, which is targeted at where most taxpayers are – so part is withdrawn at low earnings where relatively fewer families are, and part from high earners where again there are fewer taxpayers. The last two options are expensive and unlikely to be used in an age of austerity, so more people are likely to be pulled onto 65% effective tax rates.

Radical welfare reform

The universal credit represents a radical administrative change. The simpler the new system is, the more it results in large numbers of losers even with substantial extra costs to the Treasury. The more complex it is, the less radical a reform it represents and the less attractive it becomes. Selling a system with substantial extra costs and many losers will prove difficult. And doing it in one big bang may repeat the administrative nightmare that occurred with the more modest integration of three different sources of support for children with the tax credit system. So perhaps it is not surprising that the government plans to start with only new claims.

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