The fiscal crisis and welfare benefits in the UK: big cuts and radical reforms

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(drawing on work by James Browne, Rowena Crawford, Carl Emmerson, Wenchao Jin, Robert Joyce and Gemma Tetlow at the Institute for Fiscal Studies. For original publications, go to www.ifs.org.uk)

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Motivation and overview

- The financial crisis and recession gave rise to unsustainable levels of public borrowing
- The government is closing the deficit with a programme relying far more on spending cuts than tax increases
  - Tightest period for spending on public services since late 1970s (when UK borrowed from IMF)
  - Welfare benefits and tax credits to be cut by c£18bn (1% GDP) by 2014-15
- As well as cuts, Government proposing major overhaul of welfare through a new Universal Credit, integrating all means-tested welfare benefits and tax credits
- Use (static) microsimulation to assess
  - who will win and lose
  - impact on poverty
  - how work incentives will change

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Outline of talk

- Impact of the crisis and the fiscal consolidation package on key fiscal aggregates and spending on public services
- Overview of welfare benefits in UK
- Recent changes to welfare benefits, tax credits and personal taxes
- Long-term reform: “Universal Credit”

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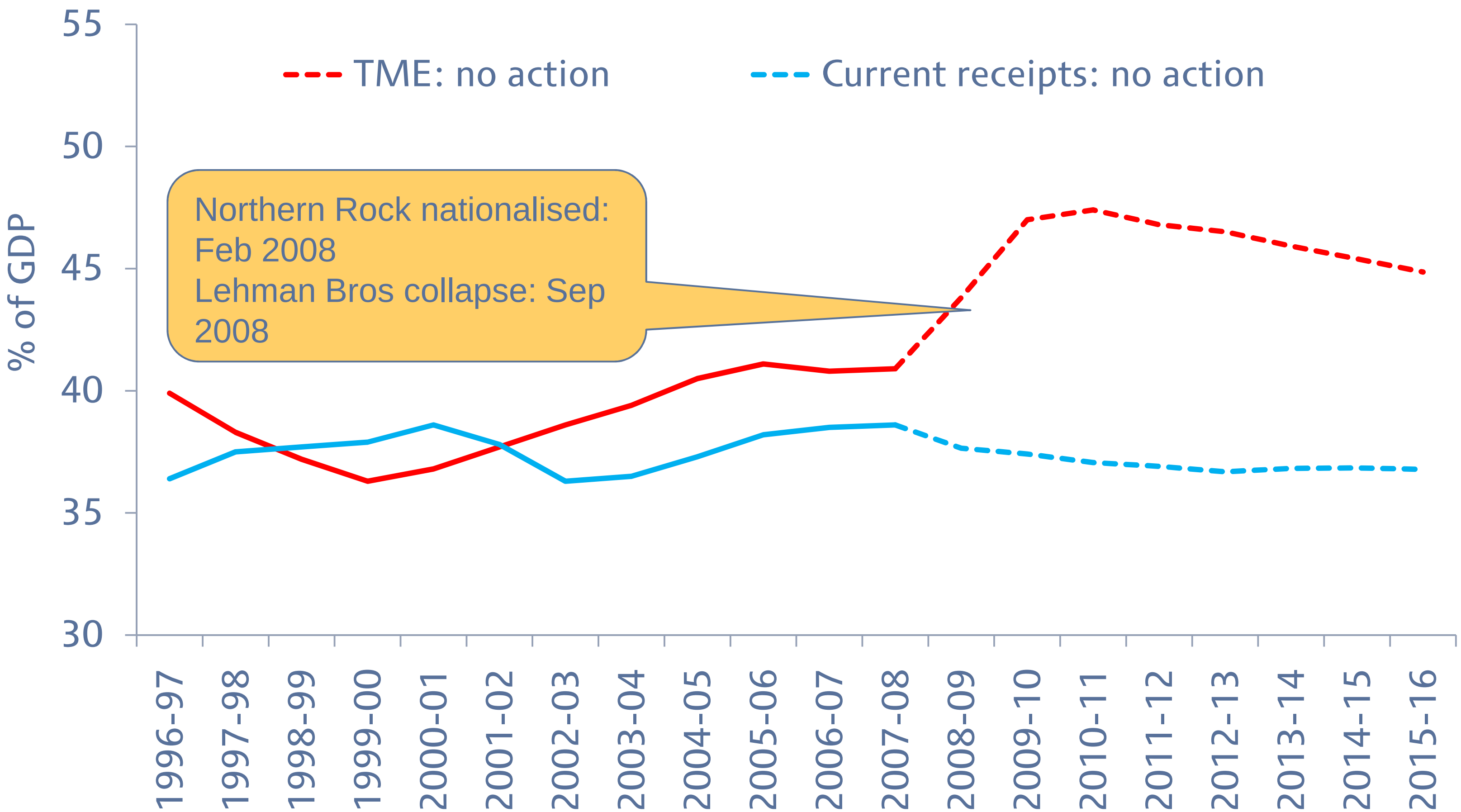
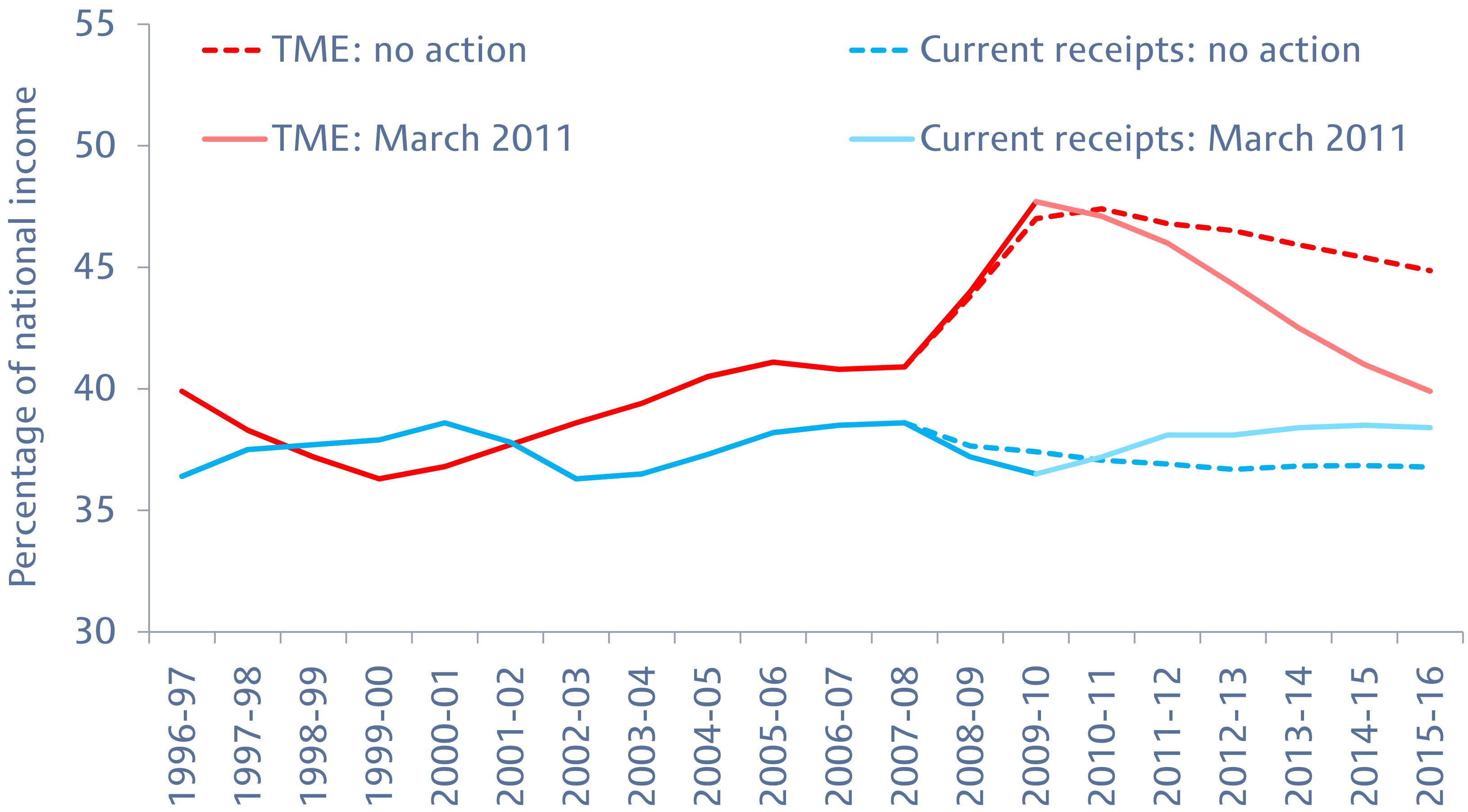
The fiscal crisis in the UK



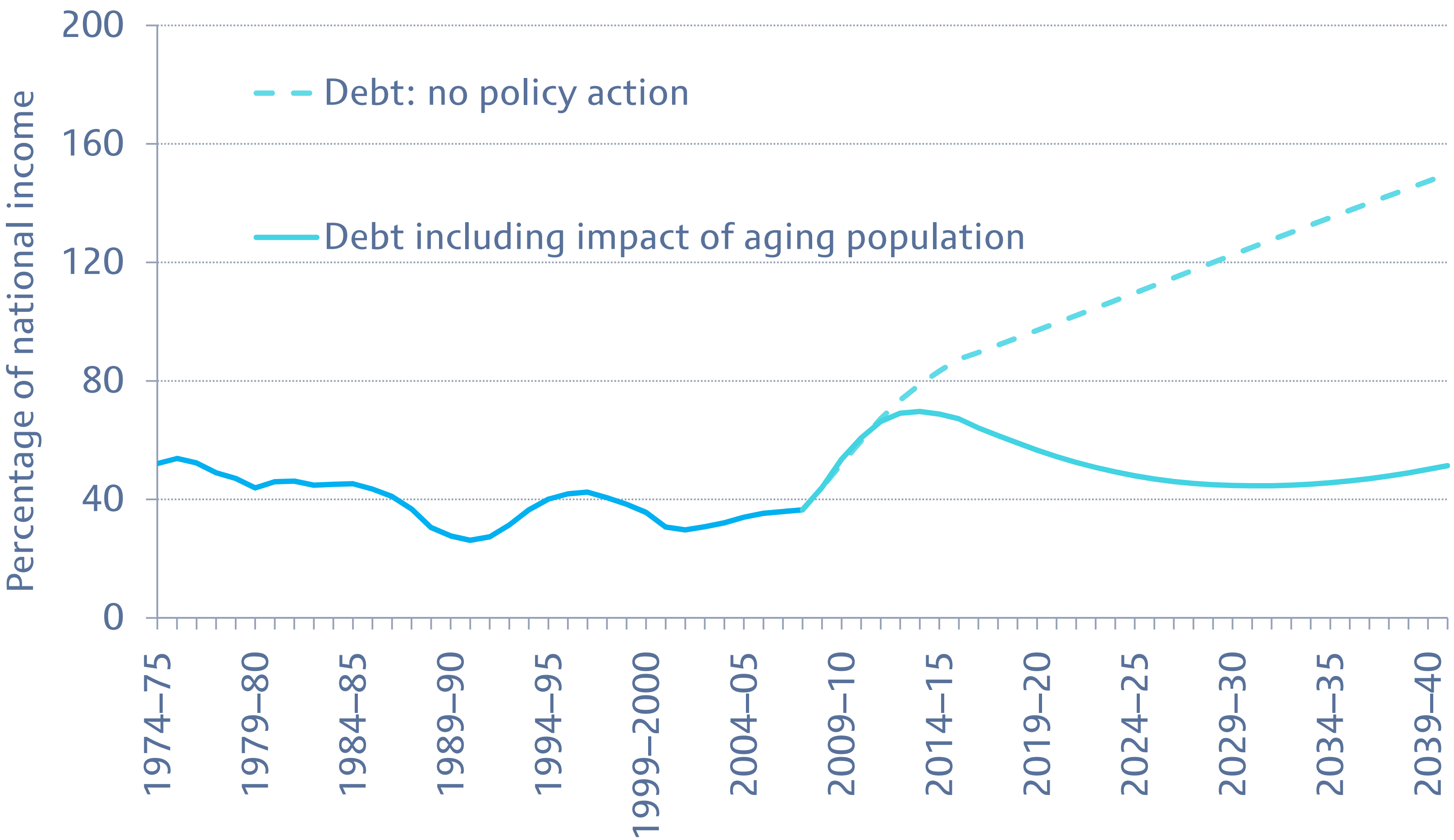
Note: TME = Total Managed Expenditure
Sources: Office for Budget Responsibility; IFS calculations.

The fiscal crisis in the UK



Note: TME = Total Managed Expenditure
Sources: OBR; IFS calculations.

Debt not back to pre-crisis levels for a generation



Notes and sources: see Figures 2.6 & 2.7 of the *February 2011 IFS Green Budget*.

The UK fiscal tightening in 2014–15

£ billion (nominal)	As of March 2011 Budget
Tax	30.0 (1.7% GDP)
Spending	80.0 (4.4% GDP)
Investment spending	17.1 (c1% GDP)
Current spending	63.0 (c3.5% GDP)
Of which:	
Debt interest	10 (c0.5% GDP)
Benefits	16.8 (c1% GDP)
Public services	36.0 (c2% GDP)
Total tightening	110.0
% Spending	73
% Tax	27

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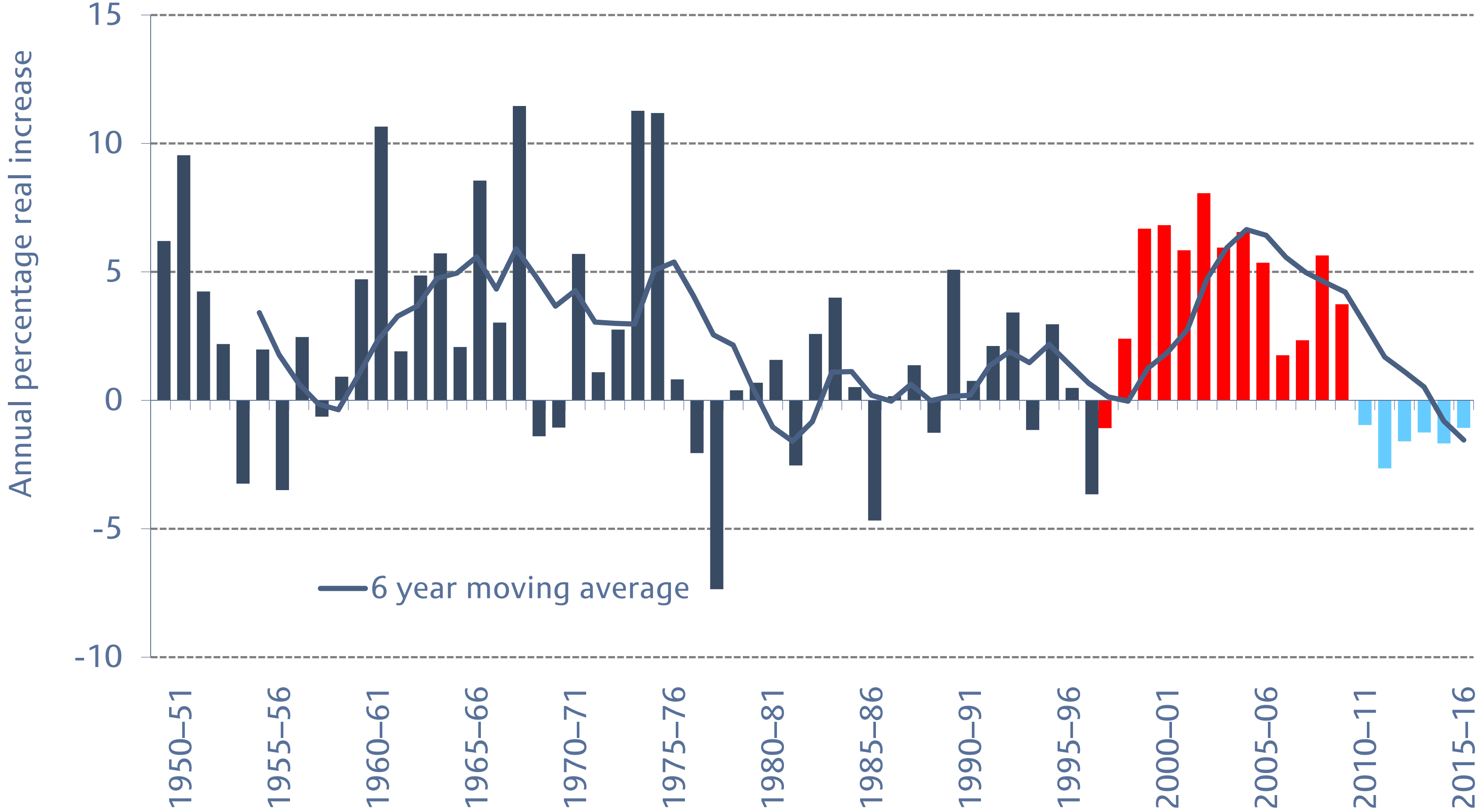
Public service spending set for a squeeze



Note: Figure shows total public spending less spending on welfare benefits and debt interest.

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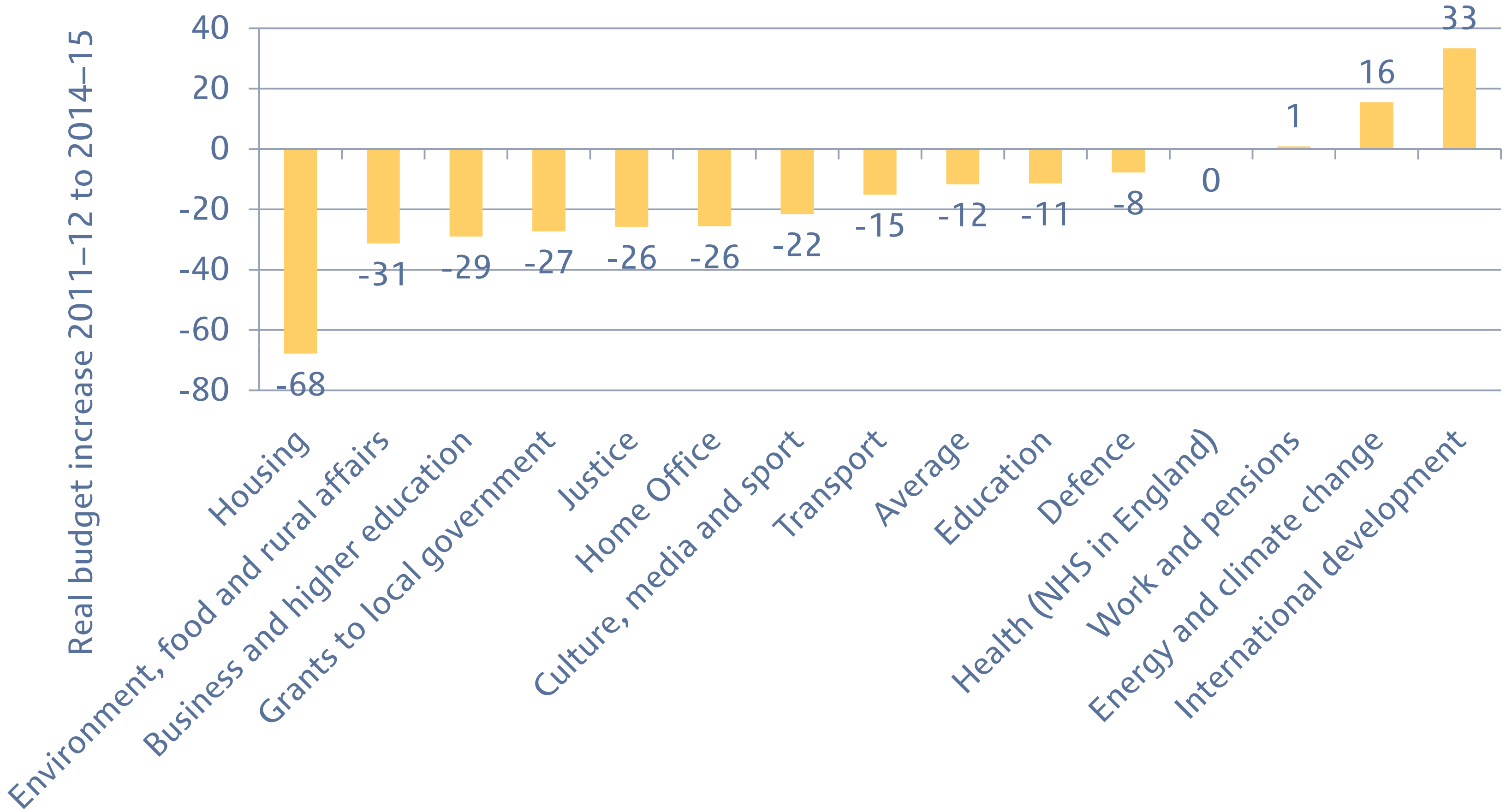
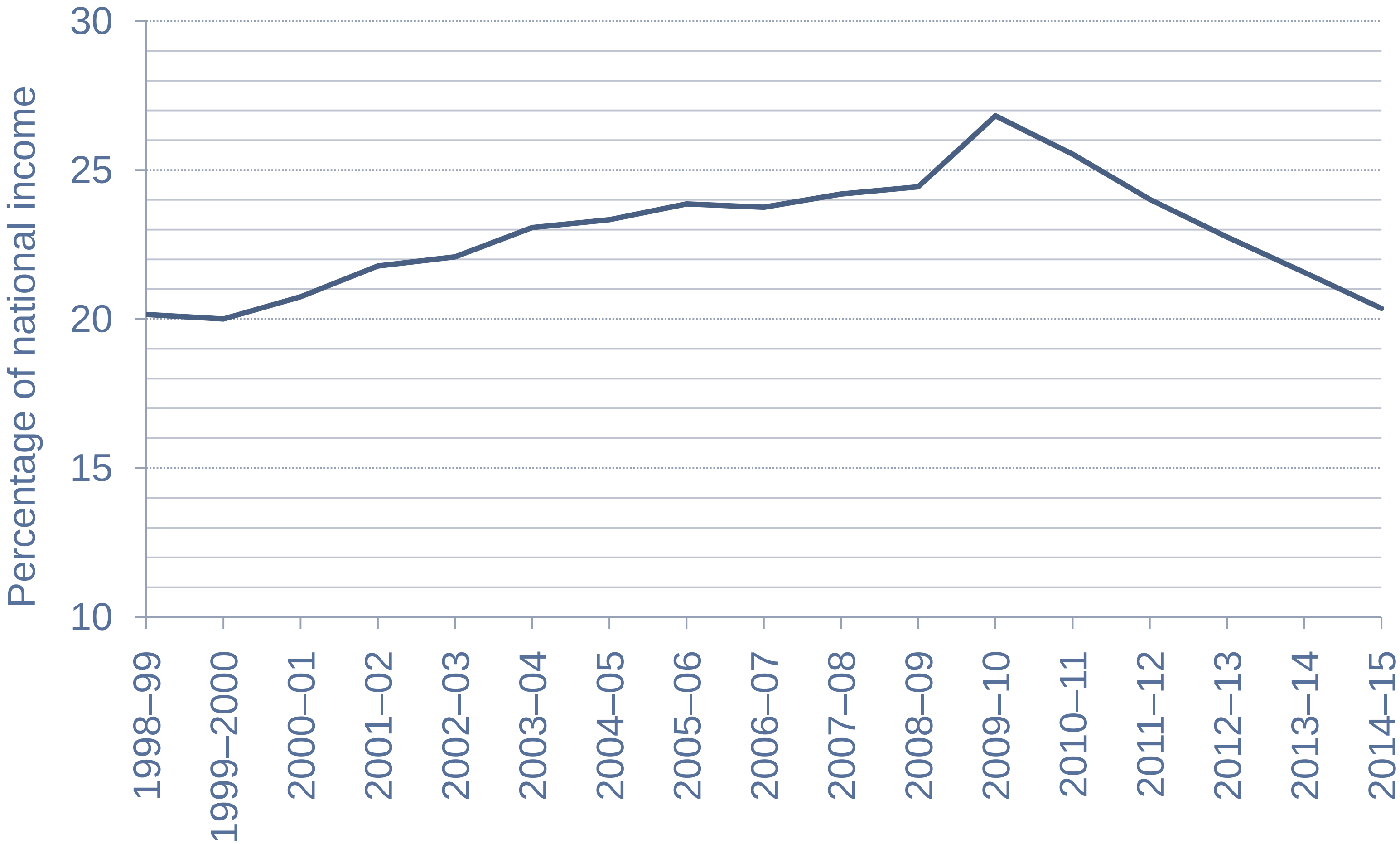
Departmental ‘winners’ and ‘losers’



DEL = Departmental Expenditure Limits

© Institute for Fiscal Studies Notes and sources: see Figure 6.4 of *The IFS Green Budget:* .

Public service spending as fraction of national income



Note: Figure shows Departmental Expenditure Limits (DELs) as a share of national income under current policies.

Overview of welfare benefits and tax credits for working-age adults

- Spend c12% GDP on welfare benefits and tax credits, about half of which goes to pensioners
- Insurance benefits unimportant and means-testing important
  - most benefits depend on income and/or specific characteristics (old age, children, disability or sickness)
  - "Income" is that of adult plus any spouse
- In general, families not working and with no other sources of income can receive welfare benefits
  - Conditions and generosity vary depending if sick or disabled, a sole parent (lone parent) or "unemployed"
- Refundable tax credits available for those in work on a low income
- Very generous (and sharply means-tested) help with costs of rental housing
- Welfare and tax credit system is particularly generous to families with children <19, and for those aged above state pension age

Main cuts to welfare benefits and tax credits, 2010-11 to 2014-15

- Child-related benefits
  - Non-means-tested child benefit removed from richest
  - Tax credits more closely focused on the poorest
- Disability and sickness benefits
  - Tougher medical tests, more means-testing
- Rental subsidies (housing benefits)
  - Less generous, especially for large families and/or central London
- Change in inflation measure used to index benefits each year
  - CPI usually lower than RPI as excludes most housing costs, and through "formula effect"

- Meanwhile: basic state pension to be linked to earnings and pensioners spared impact of most cuts

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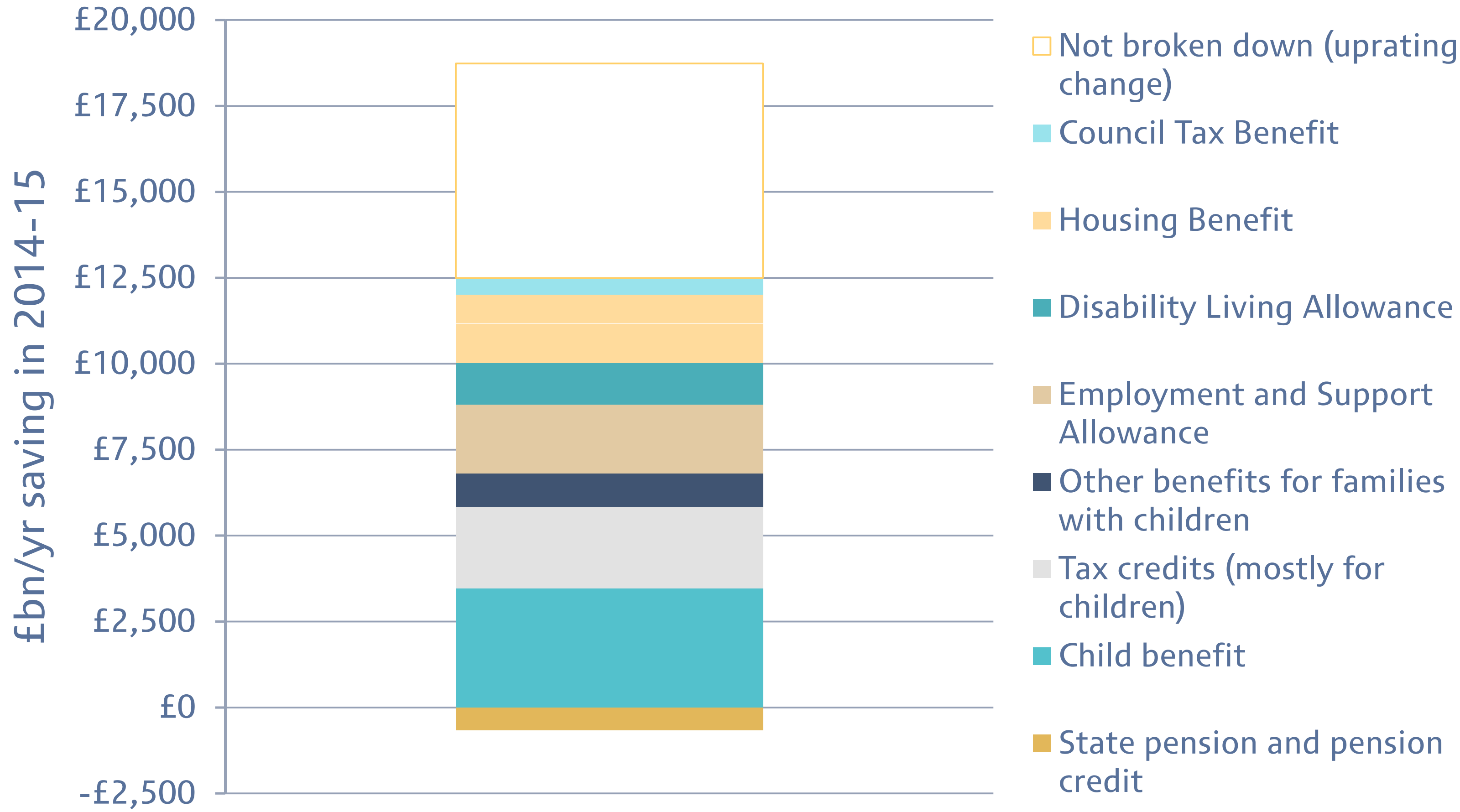
Composition of cuts to welfare benefits and tax credits



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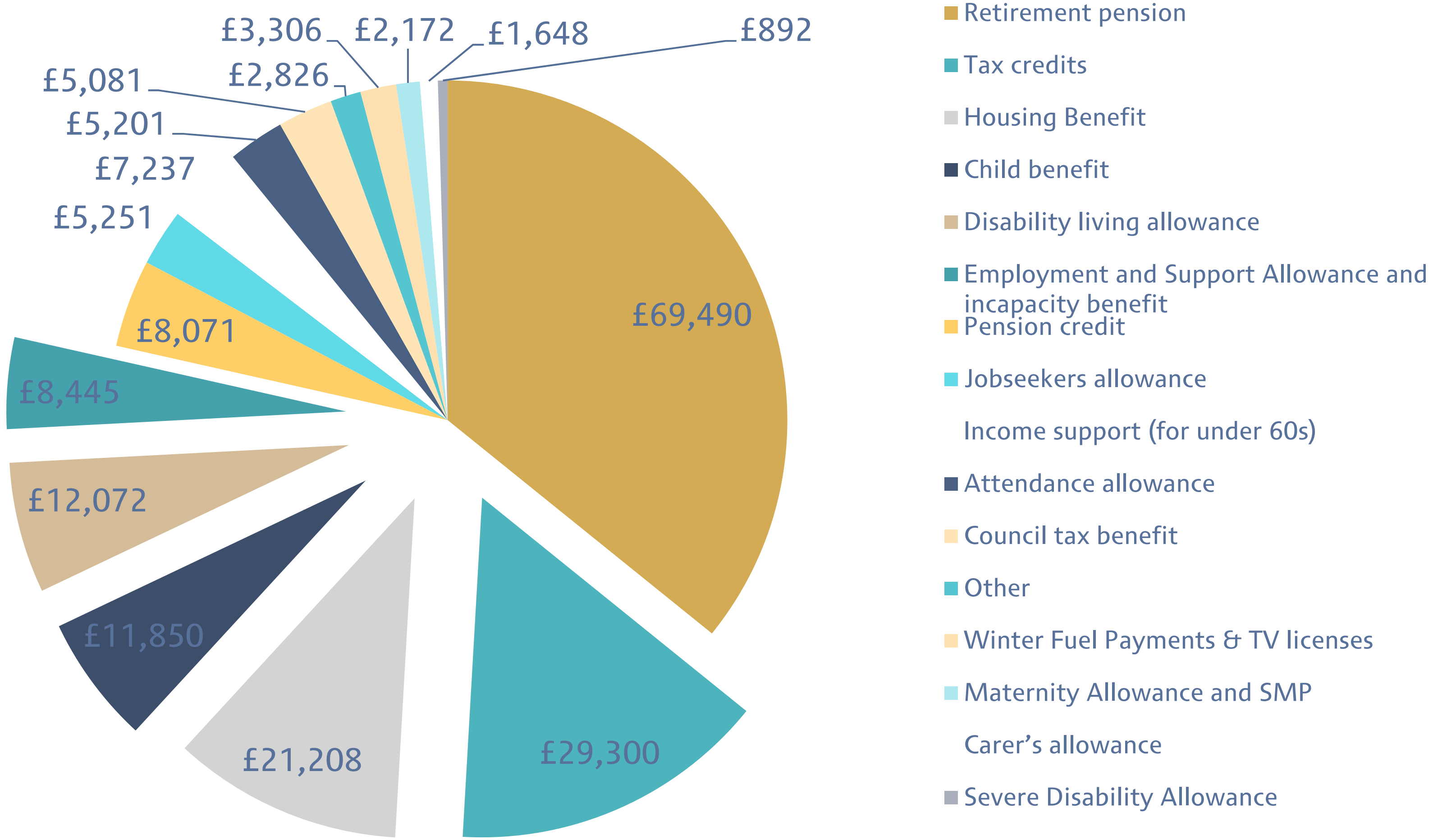
Welfare spending: the main losers



Figures show estimated spend in £m in 2010-11.

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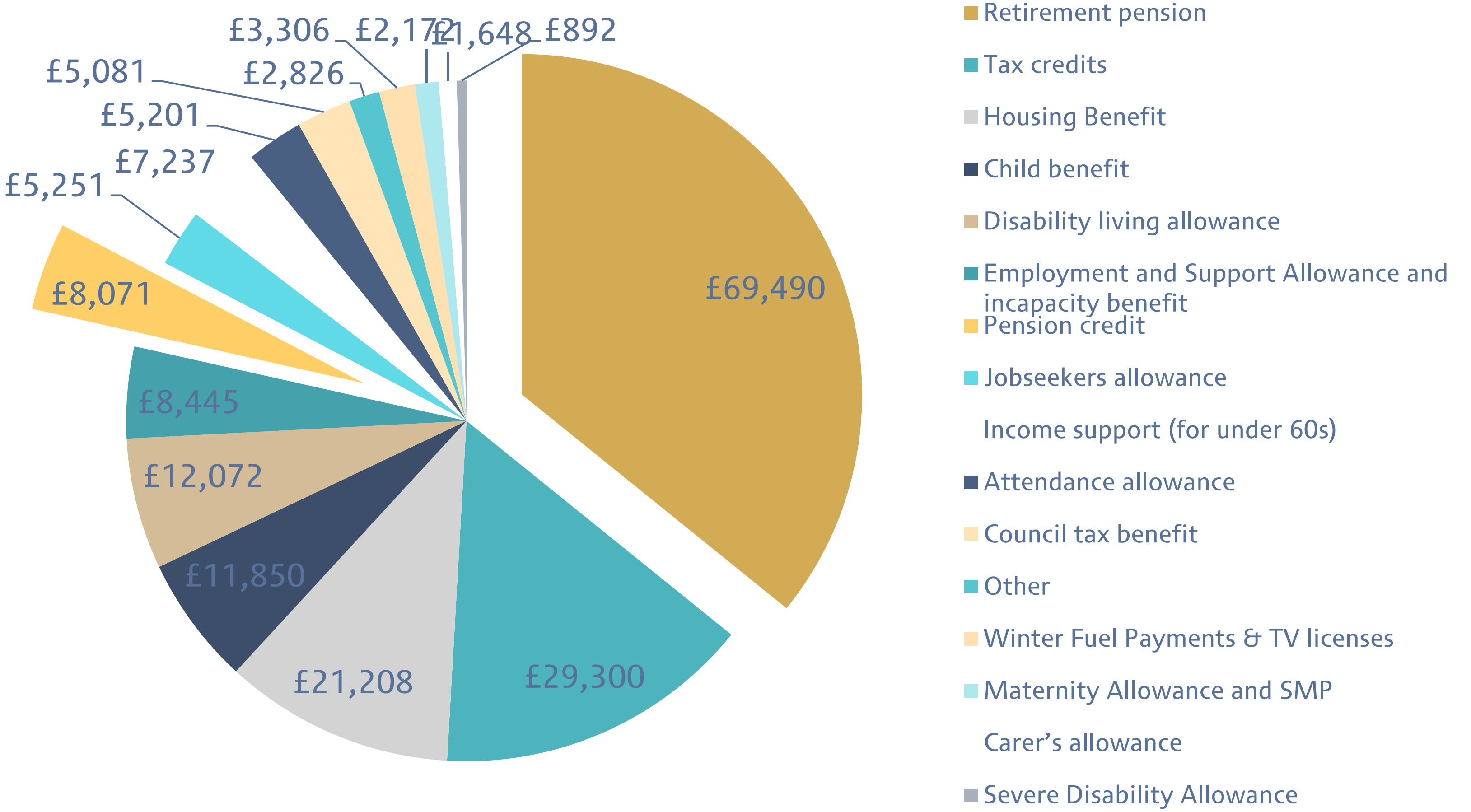
Welfare spending: pensioners mostly unaffected



Figures show estimated spend in £m in 2010-11.

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Key tax changes, 2010-11 to 2014-15

- Key personal tax rises:
  - 1ppt increase in all rates of National Insurance Contributions
  - Cut in point at which pay higher-rate income tax
  - Big cut in tax relief on pension contributions made by very rich

  - Offset by increase in income tax allowance and National Insurance Contributions thresholds

- Key indirect tax rise: VAT up from 17.5% to 20%

- Key corporation tax change: main rate cut, but paid for by broadening of base

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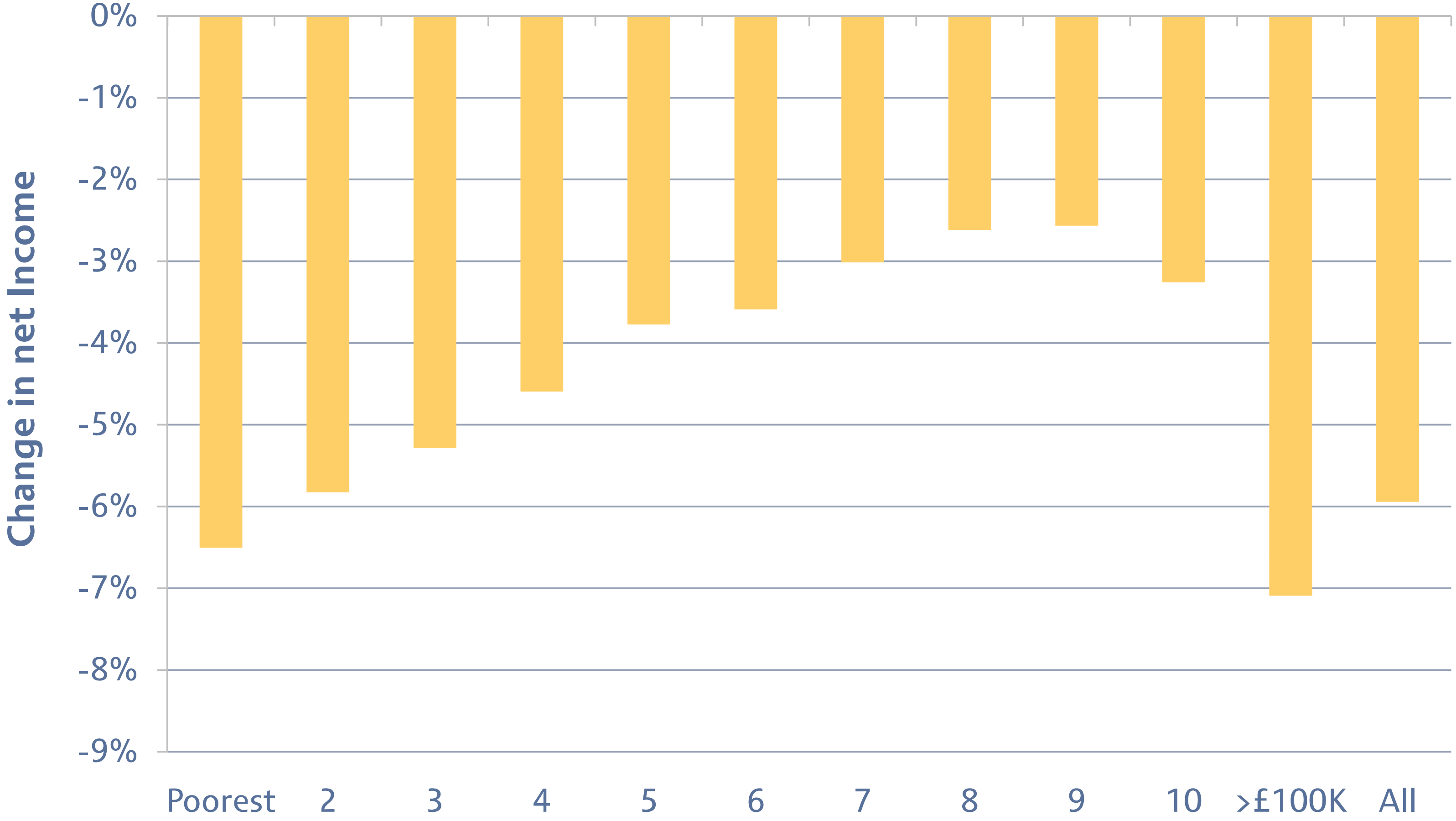
Impact of personal tax, tax credit and welfare benefit changes on household incomes by 2014 – 15



Note: assumes employers increase or reduce wages in response to changes in employer NICs, councils means-test CTB more aggressively

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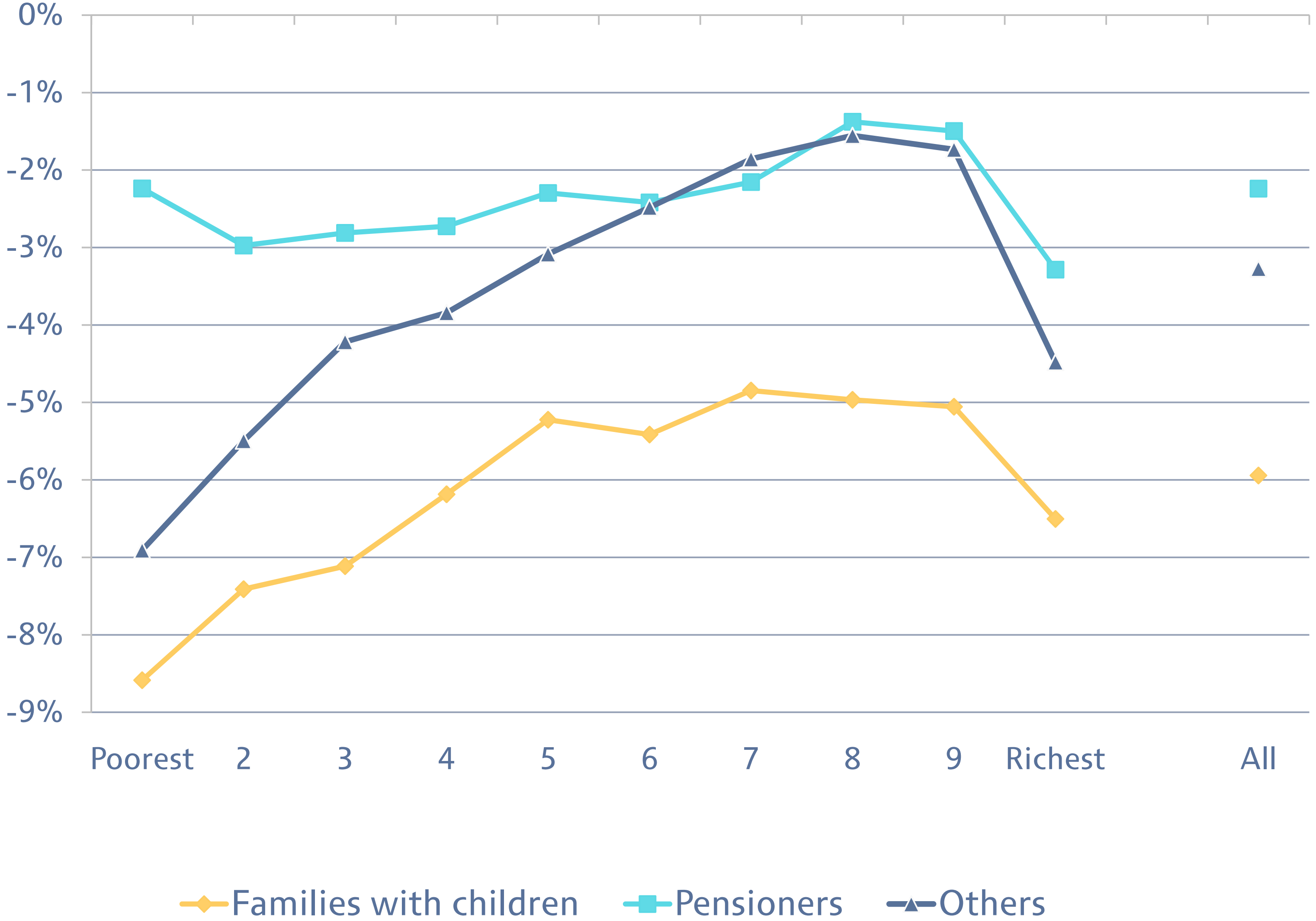
Impact of personal and indirect tax, tax credit and welfare benefit changes on household incomes by 2014 – 15 by family type



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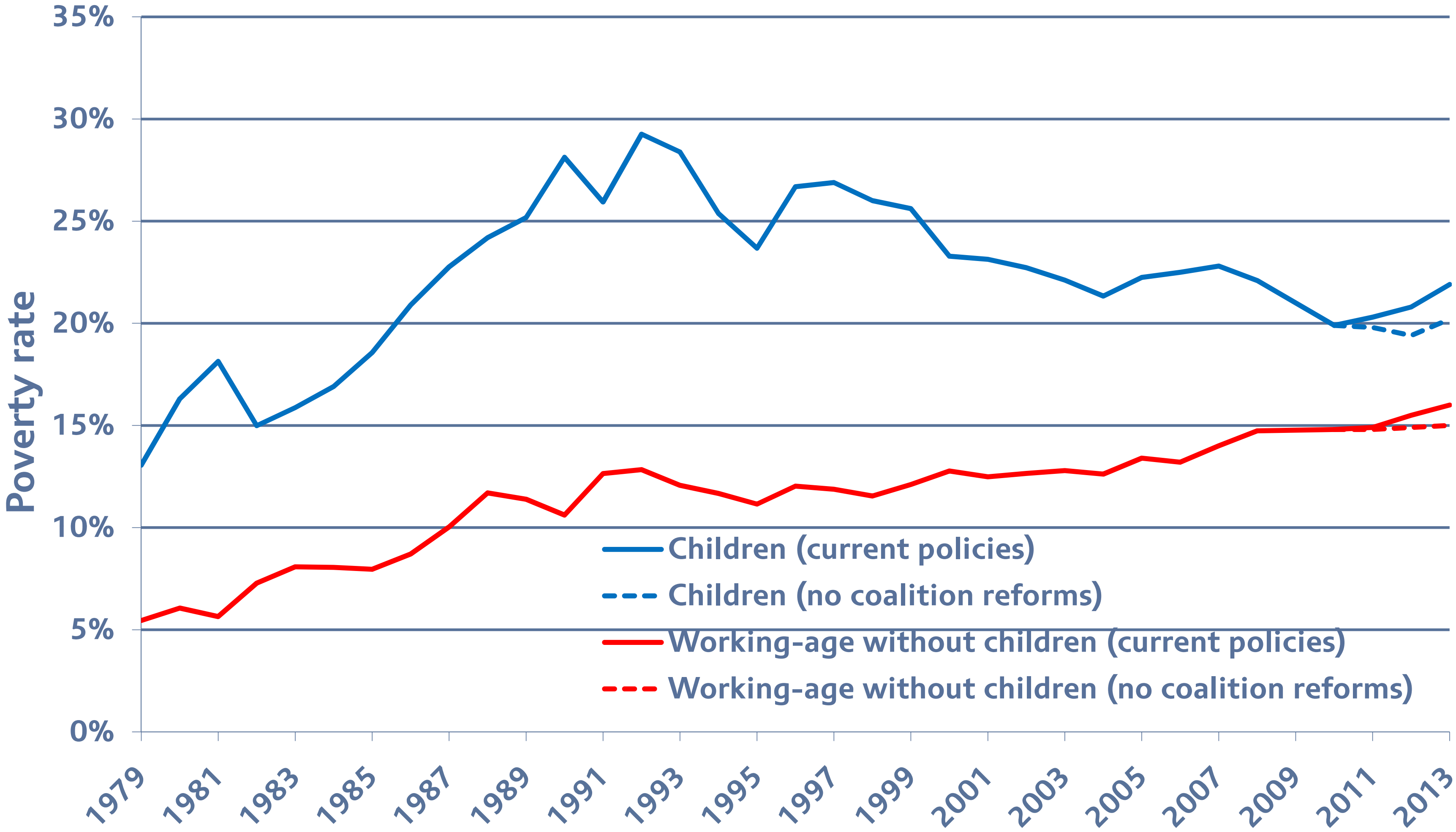
Prospects for relative poverty (<60% median household income)



Notes: Years refer to financial years. Incomes measured before housing costs have been deducted. Values after 2008/9 are forecasts.

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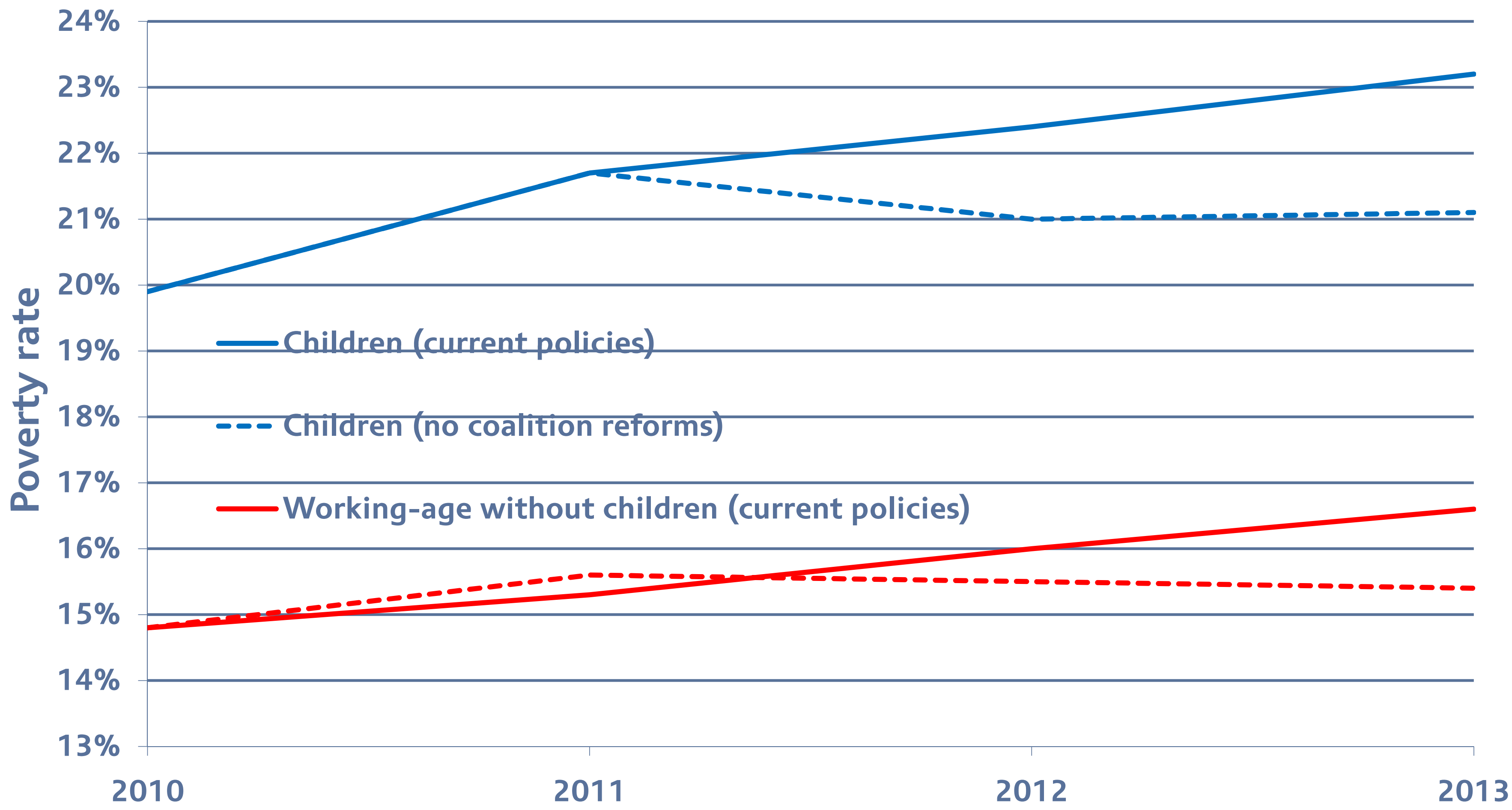
Prospects for poverty with fixed poverty line (set at 60% median household income in 2010-11)



Notes: Years refer to financial years. Incomes measured before housing costs have been deducted.

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Impact of tax and welfare cuts on household incomes and poverty: summary

- Unsurprisingly, tax rises and welfare cuts hit those on lower incomes by more than those on higher incomes
- This is on top of a general decline in households' real living standards as unemployment rises and real earnings fall
- Relative poverty, and poverty against a fixed real poverty line, is forecast to rise from 2010-11
  - Government inherited high-profile targets to reduce relative child poverty to 5% by 2020. Looks implausible: level in 2013-14 is forecast to be 22% (and rising)

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Radical welfare reform: benefit integration

- **Universal Credit** will be a means-tested benefit, based on family income, which will replace all means-tested welfare benefits and tax credits for working-age adults

- Aims
  - Simplify the system for recipients and government
  - Alter the way that support is reduced as income rises to strengthen the incentive to be in work

- Impossible to integrate and simplify without changing entitlements to benefits for some households, so there will be winners and losers, although those who would lose when transferred from old system to new will be compensated

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Problems with the current system of welfare benefits

Assumes: couple with 2 children, 1 earner @ £6.50/hr, £80/wk LHA or eligible rent

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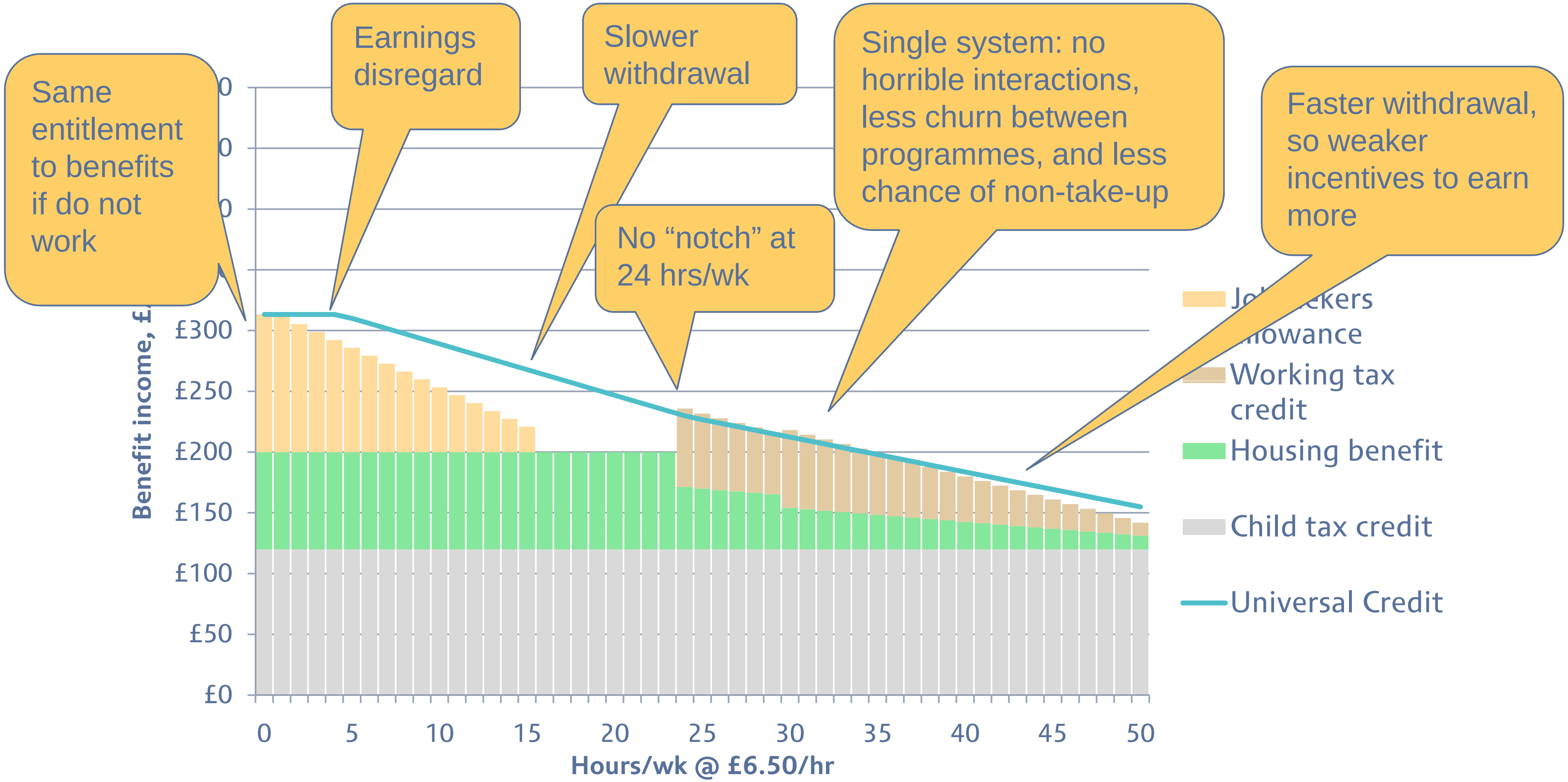
Proposed reform



Assumes: couple with 2 children, 1 earner @ £6.50/hr, £80/wk LHA or eligible rent. Ignores child benefit.

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Universal Credit: aggregate results

- 2.5 million working-age families will gain
- 1.4 million will lose out in the long run
- 2.5 million will receive as much payment as they do under the existing system
- Cost
  - Total gain of the winners is £3.6 billion per year
  - Total loss of the losers is £1.9 billion per year
  - Long-run cost of £1.7 billion per year
  - Short-run cost depends on how families are moved across and nature of transitional protection

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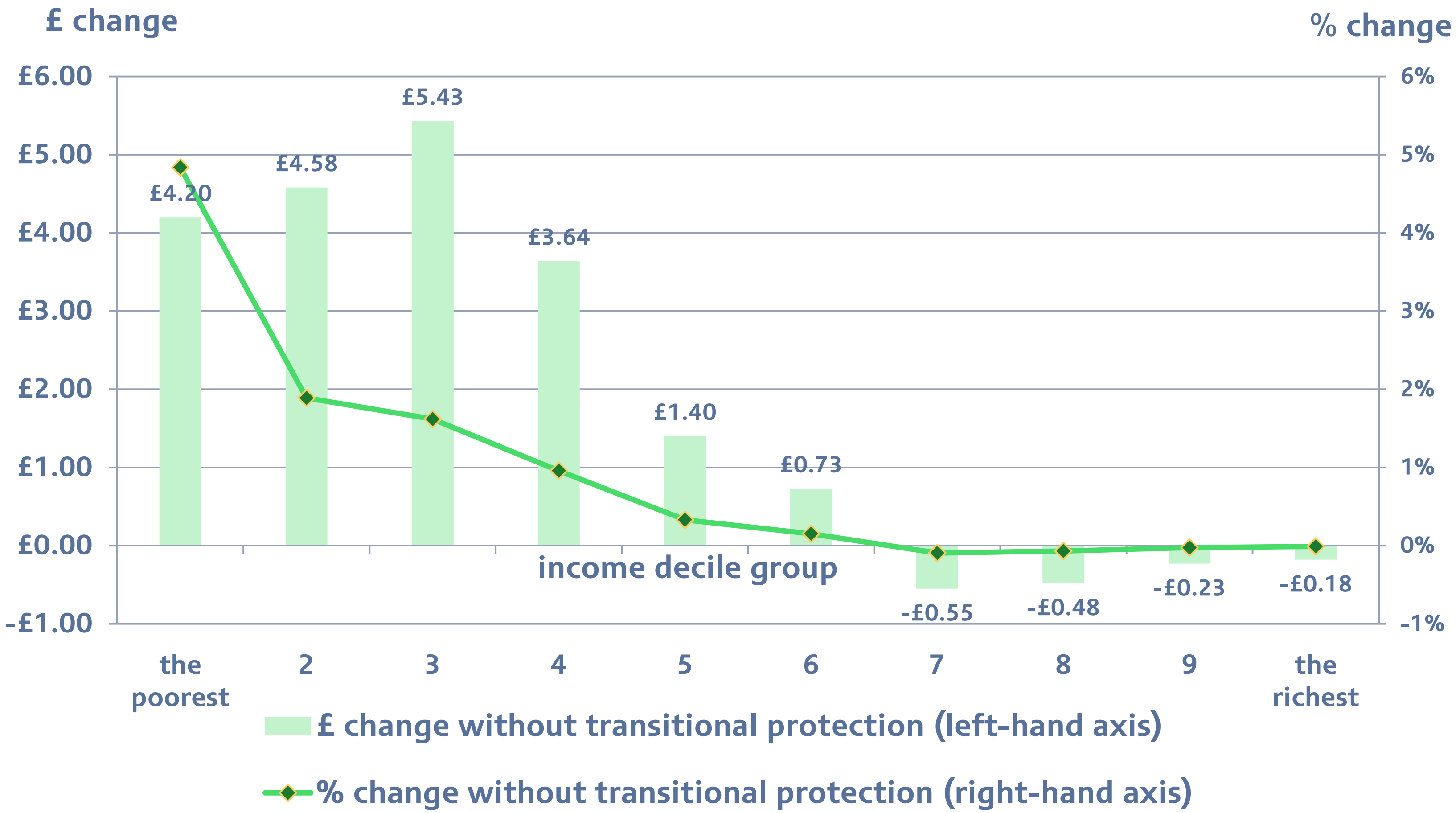
Universal Credit: change in income by income decile group



Notes: Income decile groups are based on equivalised family income using the McClements equivalence scale.
Source: Authors' calculations using the IFS tax and benefit microsimulation model, TAXBEN, run on uprated data from the 2008–09 Family Resources Survey.

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Aside: measuring financial work incentives

- Incentive to do paid work, as opposed to not working
  - Measured by Participation Tax Rate (PTR):

$$PTR = 1 - \frac{net\ income\ in\ work - net\ income\ out\ of\ work}{gross\ earnings}$$

  - This measures the extent to which taxes and benefits distort the decision about whether to work or not
  - Answers the question 'what proportion of my earnings are taken away in taxes and withdrawn benefits when I move into work?'
- Incentive to increase earnings slightly
  - Measured by Marginal Effective Tax Rate (METR)
  - Answers the question 'what proportion of each additional pound earned is taken away in taxes and withdrawn benefits?'

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Why does Universal Credit alter work incentives?

- Maximum benefit entitlement is unchanged: many non-working households will be entitled to the same
- Initially, Universal Credit withdrawn more slowly than existing welfare benefits
- At higher earnings, Universal Credit withdrawn more quickly than existing welfare benefits
- For second earners in couples, Universal Credit always withdrawn more quickly than existing welfare benefits
- Reflects choice of earnings disregards and withdrawal rates

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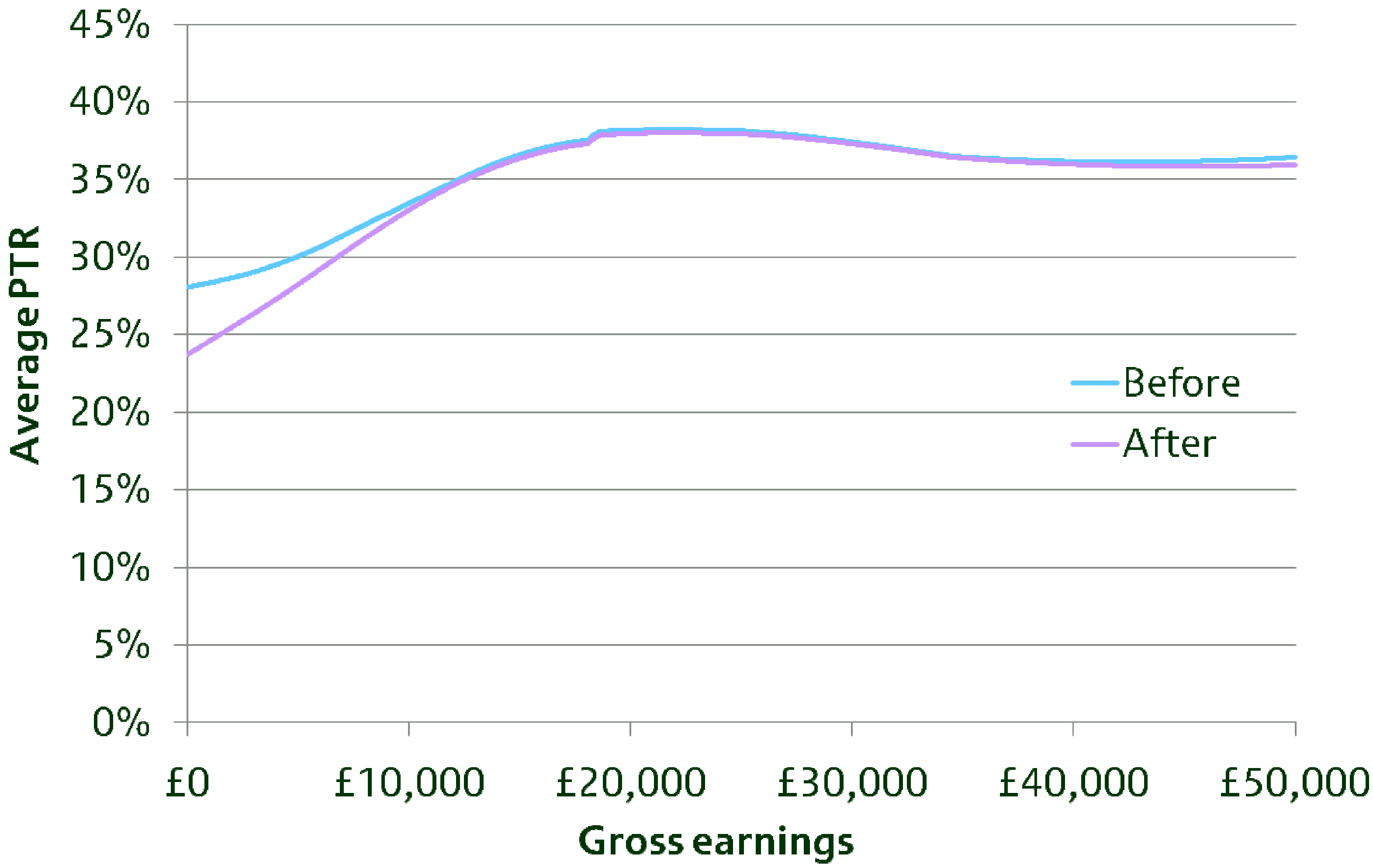
Universal Credit: impact on participation tax rates by earnings



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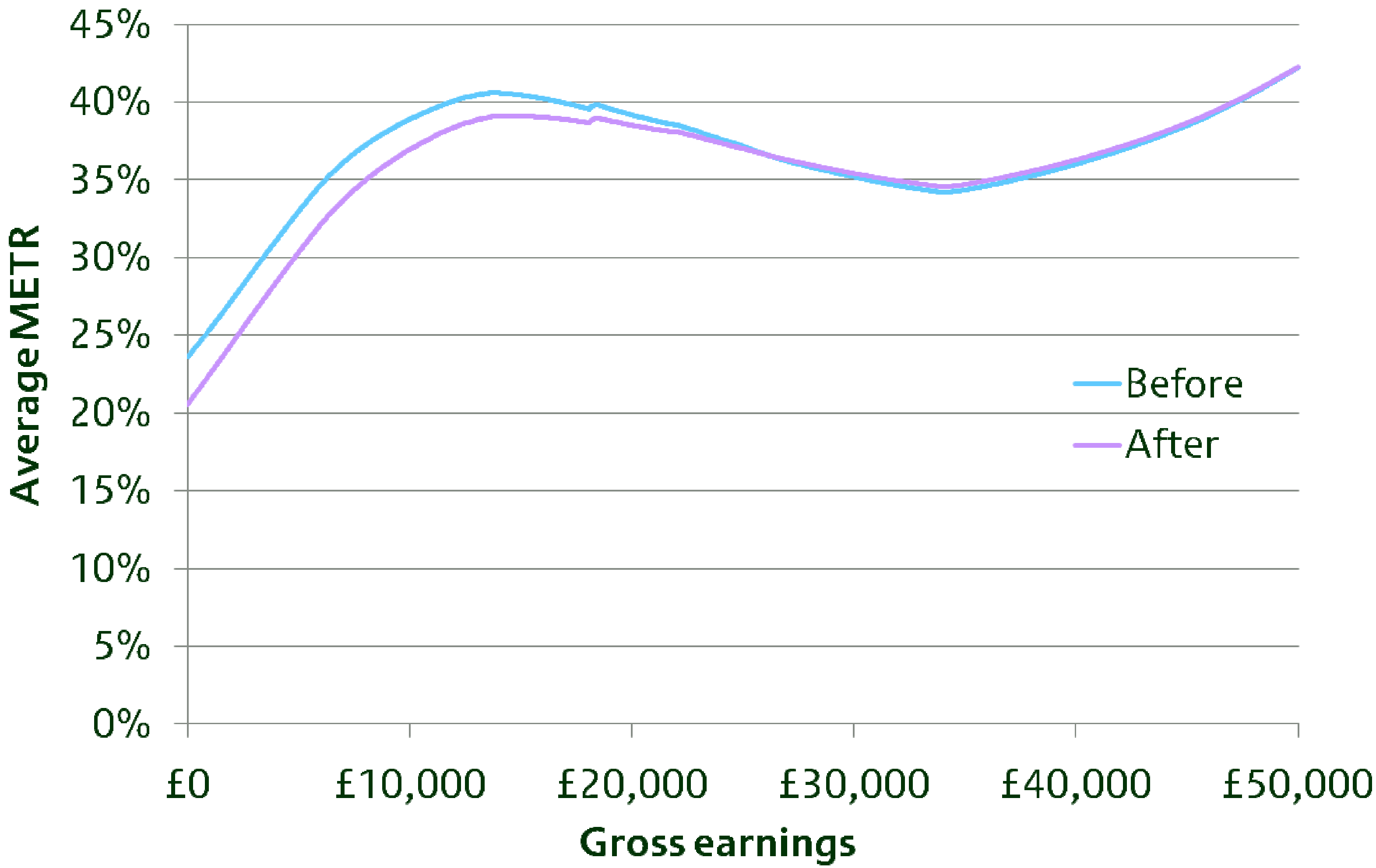
Universal Credit: impact on marginal effective tax rates by earnings



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Universal Credit: summary of impact on incomes and incentives

- Cost £1.7 bn a year without transitional arrangements
- 2.5 million winners, 1.4 million losers, and 2.5 million not affected. Bottom six-tenths will, on average, be better off, with a progressive pattern.
- Couples will fare better than single people, but substantial variation within each family type
  - No simple explanation; reflects values of disregards and tapers in UC
- Incentive to work for low earners stronger under Universal Credit for primary earners, but weaker for second earners
- Those facing highest METRs (low earners with children) will see them fall, but METRs will rise slightly for those on higher earnings and for second earners

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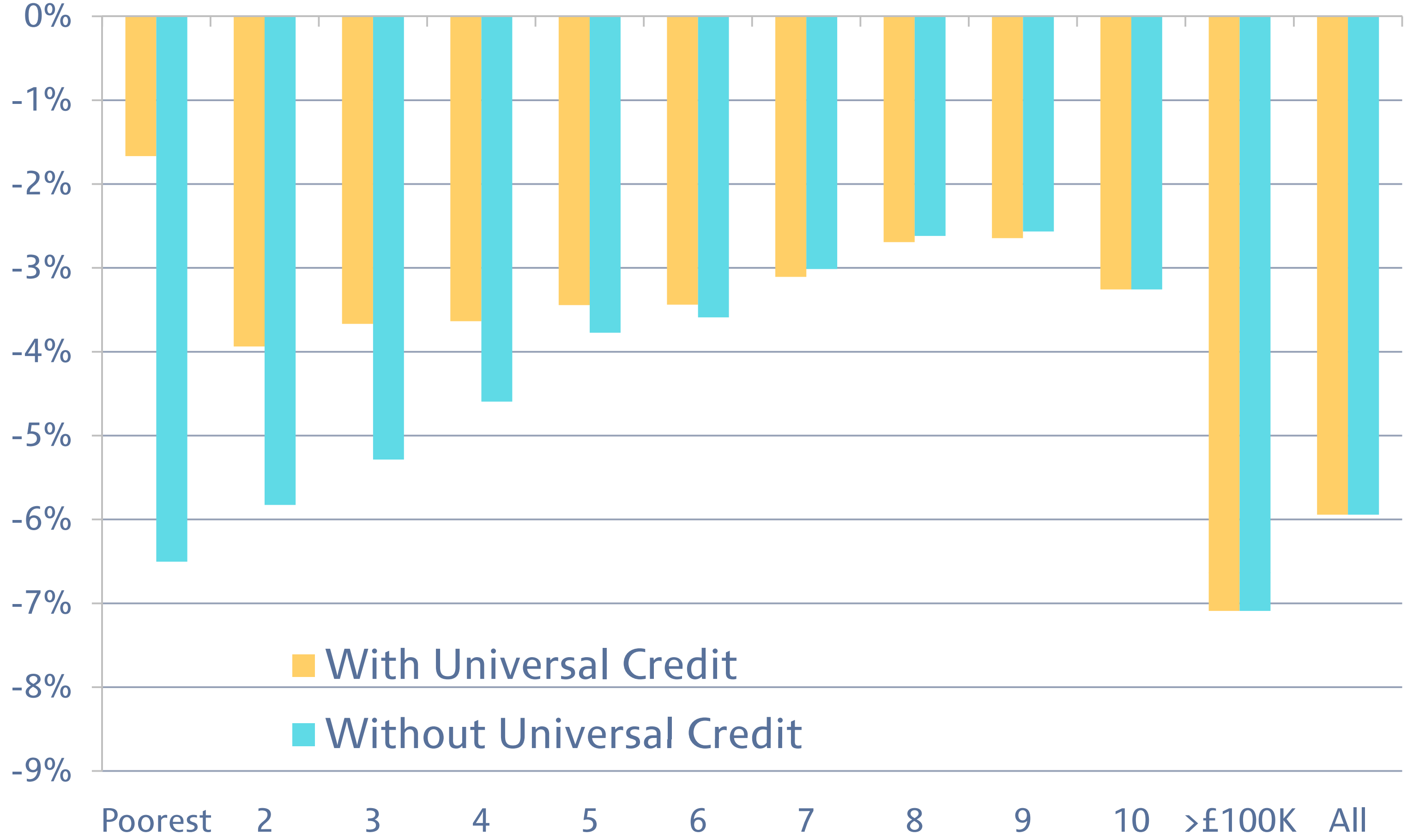
Impact of all personal tax, tax credit and welfare changes on household incomes



Assumes employers increase or reduce wages in response to changes in employer NICs: assumes councils means-test CTB more aggressively

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Summary

- GDP in UK has taken a bit hit from Great Recession. Real earnings will fall considerably, although employment less affected than feared
- Fiscal consolidation relies heavily on spending cuts
- The large package of welfare cuts will inevitably hit poorest hard, and so increase conventional measures of income-based poverty
- Long-term reform is to produce a simpler, integrated welfare system with stronger incentives to work

- As ever, IFS researchers have attempted to inform public debate about desirability of welfare cuts and long-term reform by providing impartial analysis, usually based on simple microsimulation techniques

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