Making the Cap fit

The implications of an AME spending limit

Ian Mulheirn, April 2013

Summary

At the Budget, the Chancellor of the Exchequer announced his intention to set a limit on a significant proportion of Annually Managed Expenditure (AME) – demand-led spending that comprises half of all government expenditure. This is a potentially very significant move with big implications for further cuts to social security benefits.

The purpose of this briefing is to explore what this commitment might entail by answering three questions:

- What has been happening to AME spending in recent years?
- What will drive AME spending over the next five years?
- What would a limit on the social security parts of AME mean for the policy we're likely to see?

Our analysis shows that AME has risen substantially in recent years and is set to go on rising rapidly in the next five years. Working age welfare has been the biggest element of the recent rise in AME, but it is set to fall in the years ahead, both in real terms and as a proportion of national income. Pensioner benefits and debt interest were big contributors to past rises in AME and are set to add even more in the years ahead.

Given the politically untouchable nature of pensioner benefits at the moment, the obvious implication of an AME cap is that working age benefits will be cut further to accommodate rising pensioner spending.

But the Chancellor also said he wanted to impose the AME limit in a way which allows the 'automatic stabilisers' to operate. In other words, he wants to allow benefits that rise during recessions to continue being responsive to the state of the economy. Our analysis shows that the working age benefits most responsible for recent increases in AME are exactly the ones that have increased as a direct result of the recession and subsequent economic stagnation.

It therefore appears that the Chancellor is impaled on the horns of a trilemma. He can have any two of three goals: an AME cap; allowing the automatic stabilisers to operate; or protecting pensioner benefits. He cannot reconcile all three.

An AME cap therefore looks impossible to achieve in the terms described by the Chancellor. It seems likely that working age benefits are again in the firing line even if further cuts do impair the automatic stabilisers.

The only real virtue of an AME cap seems to be a rhetorical one: to lump together a number of different elements of spending which have no necessary association, facilitating cuts to some benefits when others rise, under the political cover of a statement that "overall AME spending - the AME cap – continues to rise in real terms". A cap would therefore serve to obfuscate rather than clarify public policy choices about the shape of the welfare state and the things the electorate wants its money spent on.

Introduction

In a little-noticed part of his budget statement last month, the Chancellor set out the need fundamentally to reform the public spending framework. As the Chancellor explained:

> *"The public spending framework introduced by the previous government divided government spending into two halves: fixed departmental budgets and what is called Annually Managed Expenditure. Except in practice it was annually unmanaged expenditure."*

Total Managed Expenditure in the year just ended is estimated by the Office of Budget Responsibility to have been £701.3bn.[1] Of that, £375.9bn was departmental spending on public services, and £325.4bn was Annually Managed Expenditure (AME). Social security benefits and tax credits make up two-thirds of the AME component, and about £1 in every £3 of total current government expenditure this year, a very substantial element of overall public spending.

What characterises the elements of public spending that make up AME is that the level of spending on each item isn't directly controlled by government, in that it is partly demand led. For example, Government can set the level of weekly unemployment benefit for the year but it can't control how many people will need to claim it. This is what makes AME somewhat unpredictable from year to year.

Departmental expenditure limits (DEL), which comprise the other part of public spending, are, in contrast, directly controlled. So spending on health, for example, is fixed from year to year, and the Department for Health and others allocate the budget as they see fit.

Nevertheless, the government does attempt to forecast the likely level of AME, and - as in the case of the deep welfare cuts of recent years – often seeks to control it by changing the generosity of benefits. So it's not quite accurate to suggest that AME spending goes unmanaged. But if AME spending rises rapidly it can indeed squeeze what is left over to be spent on public services. For this reason, the Chancellor argued that more spending on public services and infrastructure would not be possible unless we "go on tackling the growth of spending of welfare budgets". Hence he intends to exert more control over AME spending.

> *"We will now introduce a new limit on a significant proportion of Annually Managed Expenditure. It … will bring real control to areas of public spending that had been out of control."*

The plan to cap AME echoes a similar announcement made at Budget 2011[2], which apparently came to nothing, and begs the question of which AME spending elements would be inside the cap? And what would the implications be?

The purpose of the briefing is to explore what this commitment might entail by answering three questions:

- What has been happening to AME spending in recent years?
- What will drive AME spending over the next five years?
- What would a limit on the social security parts of AME mean for the policy we're likely to see?

[1] Excluding the transfer of assets from the Royal Mail Pension plan to the public sector.

[2] "The Government is therefore considering options for strengthening control over AME by increasing the amount of spending that is managed within fixed budgets. This will improve incentives to manage AME, in particular social security spending which is the most significant component. Further detail will be set out by the summer." Budget 2011, p21

Why has AME risen?[3]

First, we examine the argument that AME spending has been 'out of control', as the Chancellor implied in his budget statement. Then we'll look at his claim that we will see continuing 'growth of spending of welfare budgets' in the years ahead.

It is true that AME spending has jumped in recent years. From 2007 to 2012 AME grew by a huge £46bn (in 2011-12 prices) – approximately equivalent to the revenue from increasing VAT by nine percentage points. Two-thirds was accounted for by growing benefits and tax credits expenditure. The rest was mainly down to higher debt interest payments as the Public Sector Net Debt ballooned after the financial crisis. Chart 1, below, shows the contributions to rising AME over the period in 2011-12 prices.

Chart 1: Sources of rising AME 2007 to 2012[4]

Source: PESA, 2012

So what has been going on to drive welfare spending up by £30bn in just four years? Breaking down the recent growth in welfare spending, we can see that just under half of it went to pay pensioner benefits to the growing number of retirees. The other (slightly more than) half went on working age benefits. Nevertheless, a £17bn rise in annual spending on working age benefits is a very large jump. Substantial government cuts to working age welfare have often been justified with reference to this recent development.

But this is all history. To know how an AME cap would work to restrain spending, we need to look at what is set to drive AME in the next five years.

[3] AME growth figures reported in this section exclude locally-financed expenditure

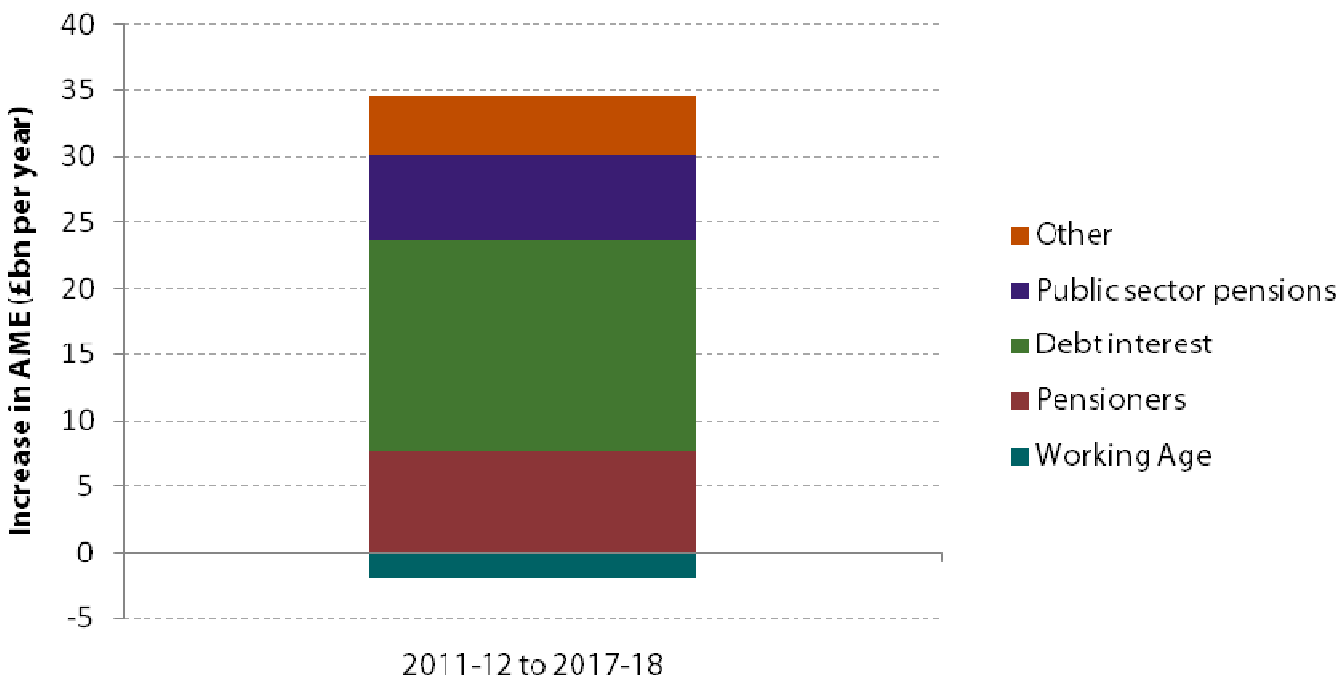
[4] All figures in 2011-12 prices

Why is AME set to rise in the future?

Recent sharp growth in AME, then, has been driven by rising debt interest payments, a growing pensioner benefits bill and a jump in working age welfare. In the next five years, AME growth will continue to be driven by the first two of these, but is there actually any 'growth in welfare spending' for the Chancellor to 'go on tackling'? A look at the OBR's forecast suggests not. In fact quite the opposite.

AME spending on comparable basis is projected to be an eye-watering £33bn per year higher by 2017-18 than it was in 2011-12 (in 2011-12 prices). But the components of the projected growth are rather different to those of recent years, as Chart 2 shows.[5] Far from growing unsustainably, spending on working age benefits and tax credits is projected to fall in real terms, leaving the annual bill £2bn per year lower by 2017-18. Nevertheless, pensioner benefits will continue to grow as society ages, adding around £8bn to the annual bill by 2017-18.

Chart 2 : Sources of rising AME 2011 to 2018[6]



Sources: OBR, DWP

But alongside pensions spending, the other major driver of run-away AME in the next five years is a big rise in debt interest. Growth in public sector pensions – again the result of an ageing society – also plays a significant role.

In summary, working age welfare has been the biggest element of the rise in AME in recent years, but spending here is set to fall in the years ahead. Pensioner benefits and debt interest were big contributors to past rises in AME and are set to add even more in the years ahead.

[5] In both cases the locally-financed current expenditure element of AME is omitted both because accounting treatment changes mean that it will jump in 2013-14 distorting the message about the underlying drivers of AME, and because, being locally-financed, it is unlikely to be the part of AME that the Chancellor is seeking to control.

[6] Excludes locally-financed expenditure, all figures in 2011-12 prices

So what would it mean to cap AME?

Given the many different components of AME, what would it mean for the Chancellor to cap AME? The answer depends on what parts of AME would subject to such a limit.

Debt interest – the largest contributor to the growth of AME – is unavoidably the first call on the government's resources. So any cap on the whole of AME that would restrict spending to less than its projected growth, would necessitate making off-setting cuts to pensions and welfare. Aside from whether that is fair, it would barely be credible to mechanistically knock, say, 10% of pensioner and working age benefit entitlements if debt interest costs suddenly rose. So any AME cap would likely exclude debt interest payments.

Similar considerations would lead to pensions promises made to public servants being honoured. Again it would be unreasonable for benefit recipients to pick up the tab for pensions promises made to retiring public servants.

A few other minor bits and pieces aside, that really only leaves welfare benefits and tax credits inside any new AME cap. But as we've seen, the dynamic here in the coming years is one of rising pensioner benefit spending being slightly blunted by falling working age spending. If he wants to tackle the 'growth of spending of welfare budgets' the Chancellor's headache is being caused by the growing cost of pensioner benefits. A limiting cap on welfare as a whole would therefore mean that an ageing population would either force cuts to pensioner entitlements or further cuts to working age transfers, despite the fact that spending on the latter is on the way down.

Given the politically untouchable nature of pensioner benefits at the moment, the obvious implication of an AME cap is that working age benefits will be cut further to accommodate rising pensioner spending.

Working age welfare and the automatic stabilisers

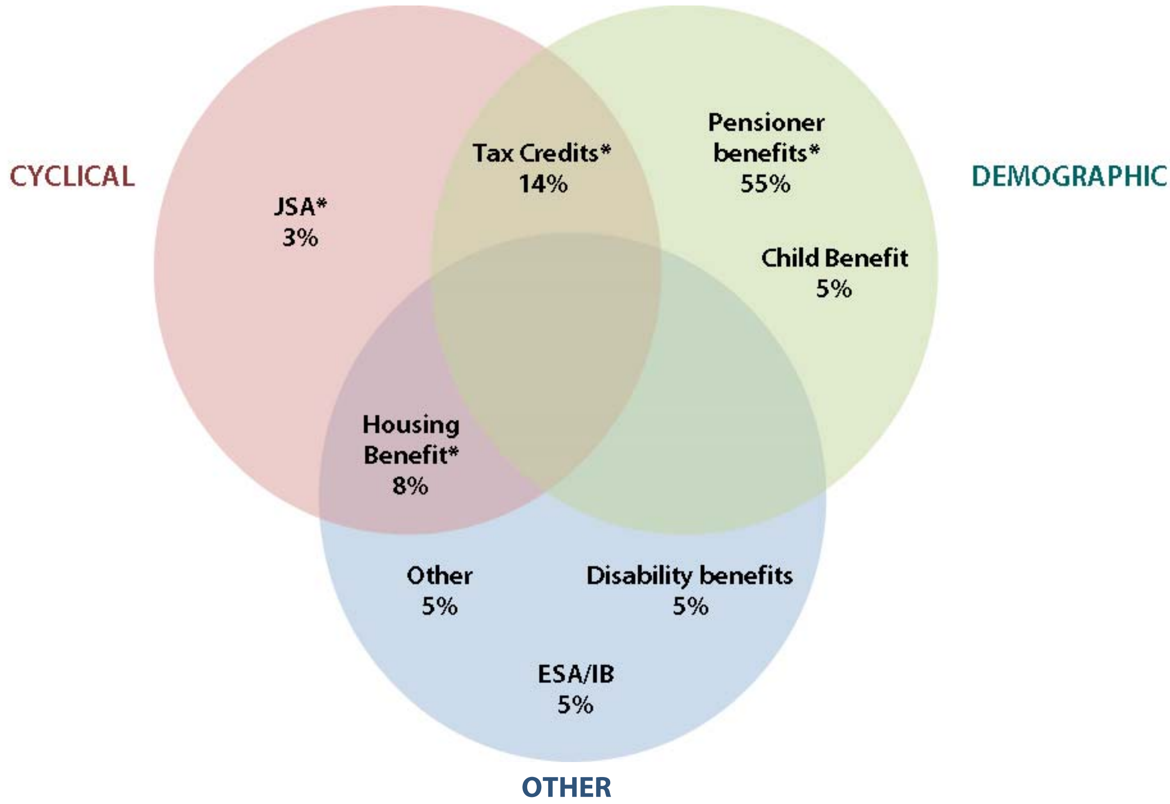
So the only politically viable AME cap, it appears, will involve imposing further deep cuts to working age welfare. But this is where things get tricky. The Chancellor also specified that:

> *"[The AME limit] will be set out in a way that allows the automatic stabilisers to operate"*

What does this mean? The demand-led drivers of welfare spending take different forms depending on the benefit in question. Demographic changes drive the cost of child benefit and the state pension, for example, while levels of disability determine spending on Disability Living Allowance. The economic cycle is the other big determinant of welfare for obvious reasons, and benefits affected by the state of the economy are therefore part of the so-called 'automatic stabilisers': they rise when the economy tanks and fall when it recovers. The Chancellor wants to ensure that any cap will not prevent that important demand management mechanism from operating.

The difficulty is that some benefits are determined by a combination of these factors. Tax credits spending turns on the numbers of children and families, and household incomes from employment. Aggregate Housing Benefit is driven by the rental market and the state of the labour market. The diagram overleaf locates the different elements of welfare spending according to the factors that determine aggregate spending.

Figure 1: Demand-side drivers of welfare spending[7]



A look back at the drivers of recent AME growth gives some insight into which benefits were behind the recent rise and therefore the proportion of the benefit spending rise that was cyclical rather than structural.

There was a significant rise in disability benefits spending, which rose by just over £2bn between 2007-08 and 2011-12 (in 2011-12 prices). But the vast majority of the working age welfare increase is accounted for by higher spending on three items: tax credits, Housing (HB) Benefit and Jobseeker's Allowance (JSA).

So what determines these elements of the welfare bill? To what extent can they be described as automatic stabilisers? JSA is responsible for about 2½bn of increased AME spending over the period. Absent any policy change, JSA claims obviously respond to the state of the labour market and hence the economy. This is a 'pure' automatic stabiliser. The Chancellor seems to have ruled out doing anything that would prevent this benefit from responding to a deterioration in the labour market. But JSA is a very small part of AME.

That leaves HB and tax credits. Spending on these benefits is partly driven by the level of rent and demographics (the number of families and children), respectively. But the state of the economy is also a factor. Since these benefits are the real sources of the jump in welfare spending between 2007-08 and 2011-12 – tax credits jumped by almost £8bn and working age HB by over £4bn – it is important to pin down the main cause of the rise.

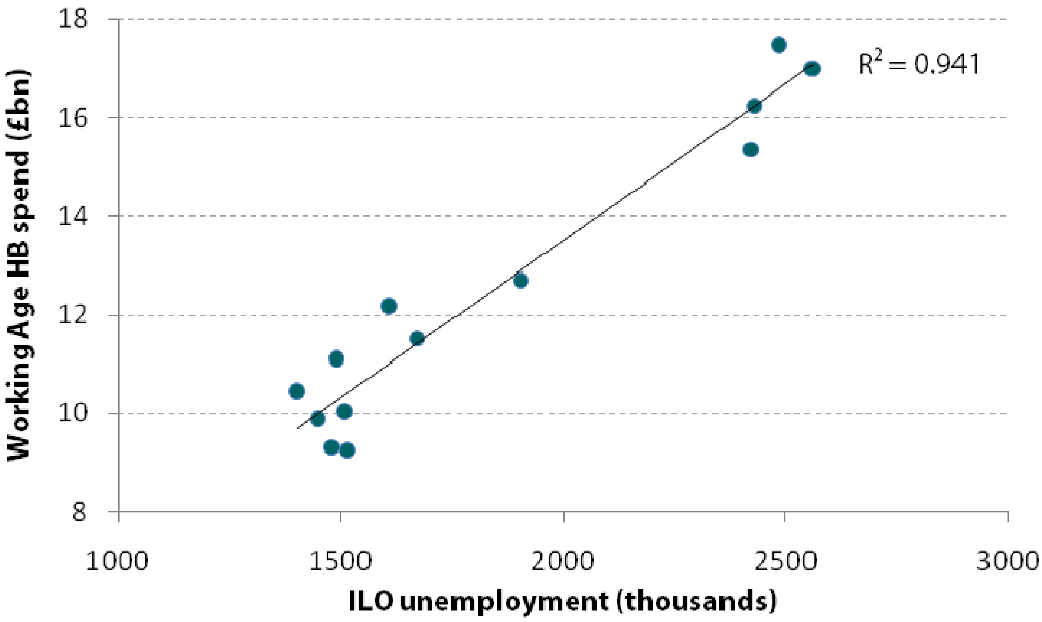
Tax credits and working age HB are similar in that they provide financial support to low-income working families and workless families. They are therefore likely to be affected in similar ways by macroeconomic conditions that result in

[7] Percentages indicate proportion of welfare accounted for by different benefits; * indicates biggest contributors to recent rises in AME

higher unemployment and greater numbers of people working short hours. So how important is the state of the labour market in explaining the recent rise in these benefits?

Chart 3, below, plots ILO unemployment against working age HB spending each year from the start of the century to the DWP's forecast for the year just ended, 2012-13. The trend line illustrates a very strong association between the two variables, suggesting that, although rising rents may be a contributing factor, the overwhelming cause of the jump in HB spending appears to be the state of the labour market. Tax credits tell a similar story: tracking unemployment, real terms spending here jumped between 2007 and 2009 and has since plateaued. The asterisks in Figure 1 identify those benefits that have seen substantial increases in recent years: all, apart from pensioner benefits, fall into the automatic stabiliser group.

Chart 3: What is driving up Housing Benefit expenditure? Unemployment and working age HB 2000-01 to 2012-13



The projected fall in working age welfare spending over the years to 2017-18 is therefore due to a combination of the government's welfare cuts and slowly falling unemployment. As unemployment falls further after 2017-18, and part-time workers move back to full-time jobs, expenditure on these benefits will likely continue to fall.[8]

Working age benefits distributed by the Department for Work and Pensions are set to fall from 3.5% of GDP in 2012-13 to 2.7% by 2017-18. This represents smaller proportion of national income than at any point since at least the introduction of tax credits in 2003. They will decline still further if unemployment falls back to its long-run level and economic growth continues after 2017.

Seeking to reduce these benefits further by imposing an overall benefit cap would therefore prevent the kind of jump in working age welfare that we saw from 2007 to 2012. But since that rise was overwhelmingly a reflection of the deterioration in the economy, such a move would also impair the operation of the automatic stabilisers.

[8] The OBR thinks that the economy should return to a long-run employment rate of 5.4%, but even by 2017-18 the unemployment rate is projected to be 6.9%.

In the end, it appears that the Chancellor is impaled on the horns of a trilemma. He can have any two of three goals: an AME cap; allowing the automatic stabilisers to operate; or protecting pensioner benefits. He cannot reconcile all three.

HM Treasury could choose to report a cyclically adjusted measure of welfare spending and set a limit on that instead. This would allow automatic stabiliser benefits to *change*, while cutting their *level*. In the medium term, however, this would be equivalent to preventing the automatic stabilisers from operating.

What would be the point of an AME cap?

An AME cap therefore looks impossible to achieve in the terms described by the Chancellor. It seems likely that working age benefits are again in the firing line even if further cuts do impair the automatic stabilisers.

Yet, in the first three years of the Coalition Government's term, it has made deep cuts to working age welfare that will have reduced its annual cost by around £22bn in 2014-15. These deficit reduction measures have been taken without any AME cap being in place, which raises the question of why one might consider and AME cap at all.

It appears that the only real virtue of an AME cap is rhetorical: to lump together a number of different elements of spending which have no necessary association, facilitating cuts to some benefits when others rise, under the political cover of a statement that "overall AME spending - the AME cap – continues to rise in real terms".

A cap would therefore serve to obfuscate rather than clarify public policy choices about the shape of the welfare state and the things the electorate wants its money spent on.