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WELFARE DEPENDENCY AND THE SIZE OF THE STATE

- Under Labour's plans 750,000 more households could be in welfare dependency by 2020.

- Strong positive correlation between the size of the state and welfare dependency.

- This correlation is strong both for working and for retired households.

- There are still 241,000 children living in households where nobody has ever worked.

1. WELFARE DEPENDENCY

At the Autumn Statement in December last year, the Chancellor outlined his plans to reach an absolute budget surplus by 2018/19. In its latest Economic and Fiscal Outlook, the OBR forecasts that under that plan for deficit reduction, public spending will reach 35.2% of GDP. The Labour party has strongly condemned these plans to cut the deficit and has argued in favour of higher taxes and more public spending. The result would be that under the Labour party's plans, the state would be a larger share of the economy by 2020 than envisaged by the Government.

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The size of the state matters because it reflects the level of economic freedom in a country and influences long term economic growth rates. It also matters because the size of the state in the UK has a strong, positive correlation with welfare dependency.

Welfare dependency is an economically and socially destructive phenomenon. Not only does it lead to blunted work incentives but has the pernicious effect of engendering a culture of low aspirations in some communities. The welfare state should be about protecting the vulnerable in their times of need and where possible helping them to get back to a situation of self-reliance. Unfortunately, rather than a transitory phase, welfare dependency has become a permanent trap for many households. As President Franklin Roosevelt declared, dependency "induces a spiritual and moral disintegration fundamentally destructive to the national fibre. To dole out relief in this way is to administer a narcotic, a subtle destroyer of the human spirit."

All the political parties are, at least rhetorically, in favour reducing welfare dependency. Upon becoming Prime Minister in 1997, Tony Blair proclaimed that "the new welfare state must encourage work, not dependency" and Gordon Brown promised to "slash welfare dependency." Unfortunately these efforts failed. Dependency, which can be defined as the percentage of households receiving more in benefits than they paid in taxes, rose from 45.9% in 1997 to 53.5% in 2010 when the Labour party left office.

This proportion fell to 52% in 2012/13, the latest year for which data is available. Of particular note is that the net dependency of the middle 20% of households fell by 17% compared to two years before. However, with more than half of households receiving more in benefits than they pay in taxes, it is still too high.

2. DEPENDENCY IN 2020

Using data from the ONS and from the OBR, it is clear that there has been a strong, positive correlation between the size of the state and welfare dependency over the last quarter of a century. To measure the size of the state, we use the OBR's figures for Total Managed Expenditure as a percentage of GDP. To measure welfare dependency, as discussed, we use the ONS data on the percentage of households receiving more in benefits than paid in taxes. The definition of benefits includes both cash benefits and benefits-in kind.

Net Dependency — **Size of the State**
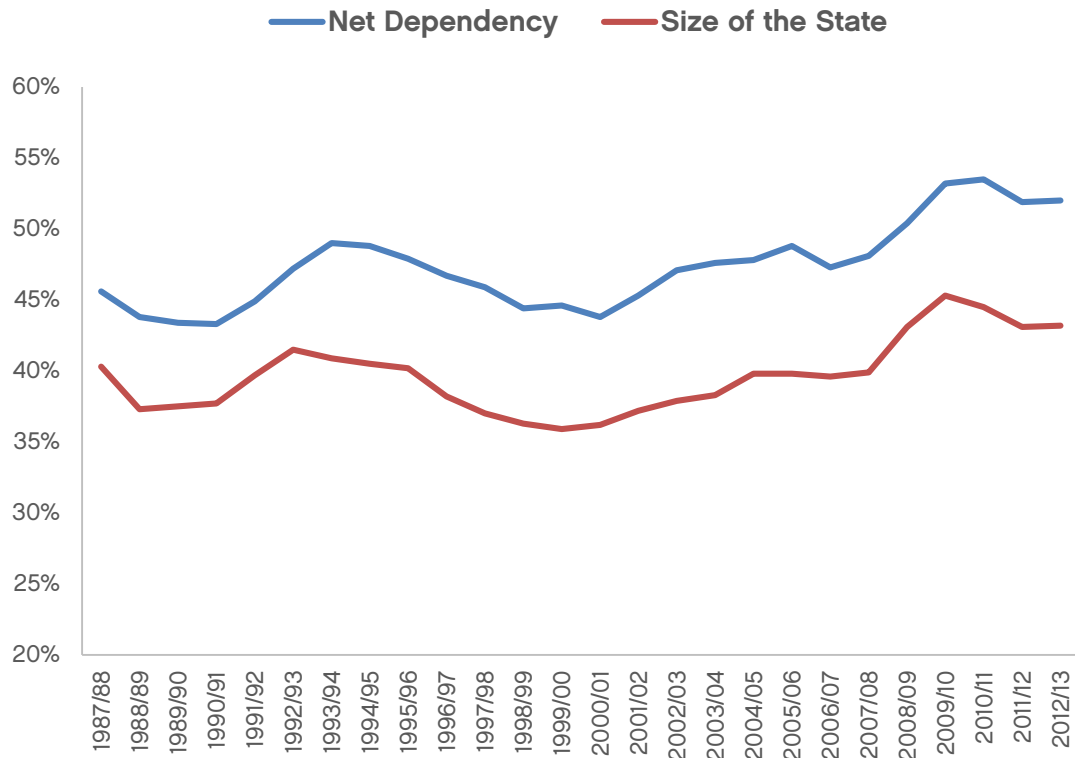
The correlation coefficient between net dependency and the size of the state is a very strong 0.91. To estimate the number of households in welfare dependency by 2020 under the different scenarios of the size of the state, we can use regression analysis and an estimate of the number of households in 2020.

The ONS estimates that in 2014, there were 26.7 million households in the UK. In its analysis of house prices, the OBR makes an assumption of an average annual increase of 1% of the number of households. However, over the last ten years, the number of households has grown at an average annual rate of 0.66%. Using that more conservative assumption would give an estimate of 27.8 million UK households by 2020.

The OBR estimates that over 2014/15, public spending will be 40.5% of GDP compared to 45.3% of GDP in 2009/10. We know that the Conservatives plan to have public spending at 35.2% of GDP by 2019/20. It is not yet clear what figure the Labour party is aiming for although given the need to cut the deficit and the party's criticism of Conservative plans, public spending will be between where it is currently and the 35.2% under Conservative plans. We therefore assume that Labour plans a state of 37.8% of GDP by 2020.

If the correlation between the size of the state and welfare dependency holds, then as public spending falls as share of GDP, welfare dependency should also fall; as happened between 2010/11 and 2012/13. This obviously depends on the type of taxes and welfare reforms implemented. Although generally, reduced benefit payments and public sector expenditure

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relative to tax revenue should lead to a smaller state which in turn should lead to a reduction in the proportion of households receiving more in benefits than they pay in taxes.

Net dependency in 2012/13 was 52% and the state was 43.2% of GDP. Assuming that the relation holds, then regression analysis suggests that for every 1 percentage point change in state spending as a percentage of GDP, dependency should change by 1.034 percentage points. Given our forecasts for the number of households and public spending, the number of households receiving more in benefits than they will pay in taxes under the Conservatives by 2020 is estimated at 11.89 million compared to 12.63 million under Labour's plans.

This means that **750,000 more households could be in welfare dependency by 2020 under Labour's spending plans** compared to under the Conservative spending plans.

If Labour plans to have public spending at 38.8% of GDP by 2019/20, then the increase in households in welfare dependency would be 1,050,000 relative to the Conservative plans. If Labour plans a state at 36.8% of GDP, then the increase in households in welfare dependency would be 450,000.

3. NON-RETIRED HOUSEHOLDS

Given that retired households are more likely to be classified as in welfare dependency due to the receipt of state pensions, it is also worth examining non-retired households separately. In 2012/13, 37.9% of non-retired households claimed more in benefits than they paid in taxes. As the graph shows below, even when looking only at non-retired households, the correlation between net dependency and the size of the state is still very strong. Indeed the correlation coefficient at 0.88 is almost as high as for all households.


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4. CASH BENEFITS

Net dependency should really look at both cash benefits and benefits in-kind to give a true reflection of dependency on the state. However, some might argue that dependency should look purely at direct transfers rather than benefits-in kind which include health and education spending. In 2012/13, 37.5% of households received more in cash benefits alone than they paid in taxes. The correlation between net dependency on that measure and the size of the state is slightly weaker with a correlation coefficient of 0.73. However, as the graph below shows, the relationship over the last quarter of a century is clear.
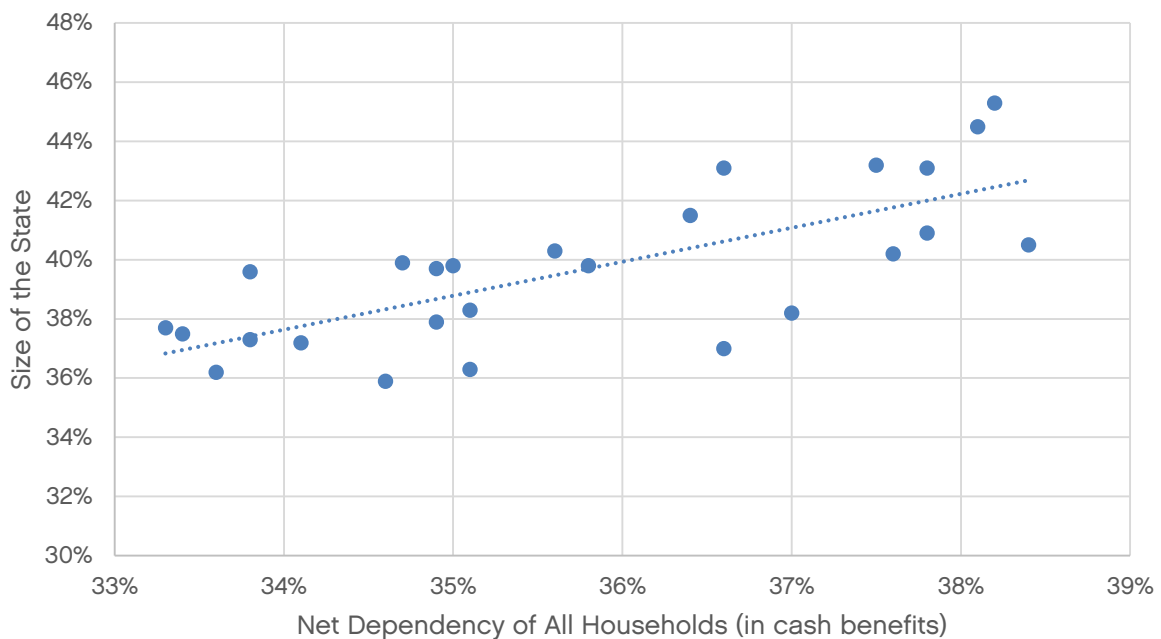
5. IMPACT ON CHILDREN

Non-retired households with children seem to be <u>particularly dependent</u> on the state. In 2012/13, 56% of such households received more in benefits than they paid in taxes compared to 25.6% of non-retired households without children. This must in large part be explained by heavier reliance on education spending and other child related cash benefits. Nevertheless, this does highlight the need for continued pro-growth reforms to boost employment and real wages.

There are 1.5 million children who are currently living in <u>workless households</u> and there are <u>still 241,000</u> children living in households in which nobody has ever worked. This is an improvement on previous years but still too high. A larger state will mean more children growing up in households dependent on welfare.

6. CONCLUSION

Welfare reform must come alongside deficit reduction. Stronger real wage growth is required to boost income tax revenues and reduce reliance on welfare payments such as tax credits

and housing benefits. This real wage growth ultimately depends on stronger productivity growth. Effective welfare reform which boosts employment, skills and training can help to generate higher real wages and productivity growth.

Elevated and persistent welfare dependency leads to reduced work incentives, distorts behaviour and tears at the social fabric of a nation. The size of the state is strongly related to welfare dependency in the UK. It is clear that Labour's plans for a larger state will inevitably lead to hundreds of thousands more households in welfare dependency.

Adam Memon and Tim Knox
Centre for Policy Studies

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