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Economic Bulletin

WELFARE DEPENDENCY FALLS BUT MUCH FURTHER TO GO

- New ONS data shows that 51.5% of households receive more in benefits than they pay in tax.
- Net dependency of the middle fifth of households has fallen by 27% since 2010/11.
- The poorest are still suffering from high taxes.
- Deeper welfare reform is needed to reduce dependency and raise incomes.
- Inequality is now lower than at any time under New Labour.

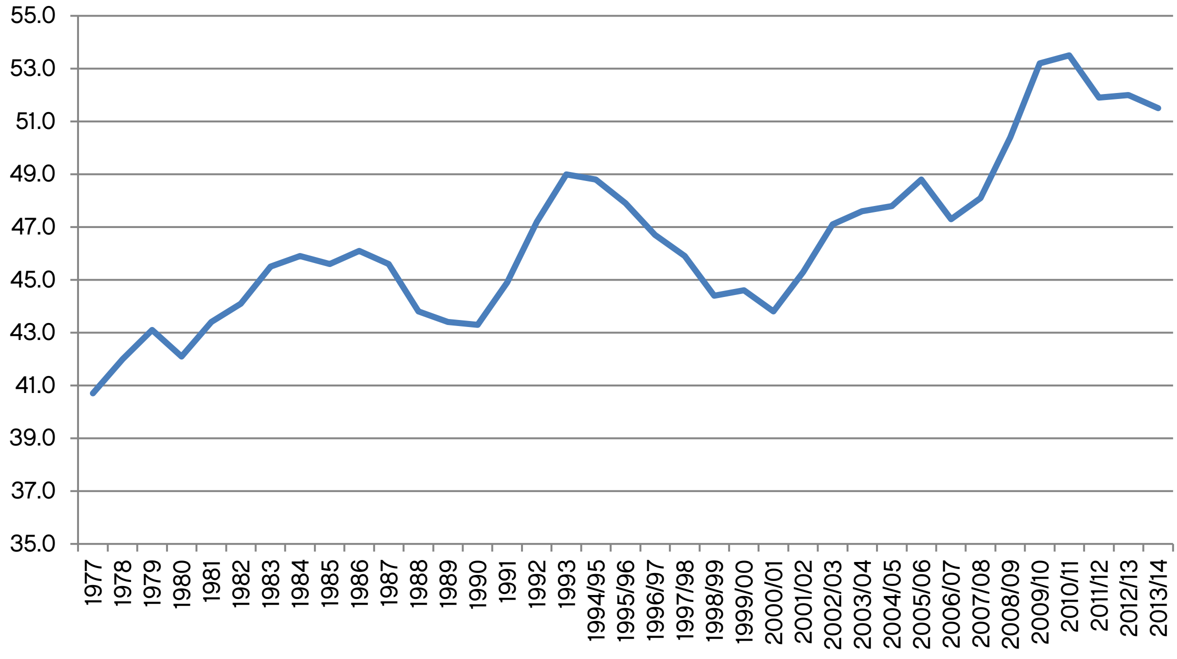
1. NET DEPENDENCY

Welfare dependency is an economically destructive phenomenon which tears at Britain's social fabric. It reduces the incentive to work and earn more whilst keeping people trapped in a cycle of low aspirations, low productivity and low pay. The welfare state must protect the vulnerable and encourage self-reliance but for too many households it has become a permanent trap. As President Franklin Roosevelt once 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."

Whilst the latest ONS data release on household incomes, taxes and benefits shows slight improvements over recent years, it also highlights the scale of the challenge which remains to reduce welfare dependency and raise incomes. In 2013/14, 51.5% of households received more from the state in cash benefits and benefits in-kind than they paid in taxes (both direct and indirect). This is a fall compared to the 52% of households in 2012/13 and is 2 percentage points lower the peak of 53.5% in 2010/11. Overall, this means that approximately 13.7 million households are receiving more from the state in benefits than they are paying in taxes.

Despite falling, net dependency on the state since 2010/11 is still well above historic levels. In 1979, the proportion of households in net dependency was 43.1% and this had only increased to 43.8% by 2000/01. However, by 2010/11 this had grown to reach 53.5% of households. This increase in dependency cannot simply be blamed on the financial crisis as half of the rise came before the recession. The latest figure of 51.5% over 2013/14 is also 6.5 percentage points higher than the long term average of 45% between 1977 and 2000.

Figure 1: Percentage of Households receiving more in benefits than paid in taxes



This small fall in net dependency on the state is of course welcome but it is still greatly concerning that over half of all households receive more in benefits than they pay in taxes. There is still much more to do before we get back to the long term average of 45%. Despite claiming that "the new welfare state must encourage work, not dependency" New Labour clearly failed to "slash welfare dependency." The task of reversing the extraordinary growth in dependency under New Labour will take a number of years.

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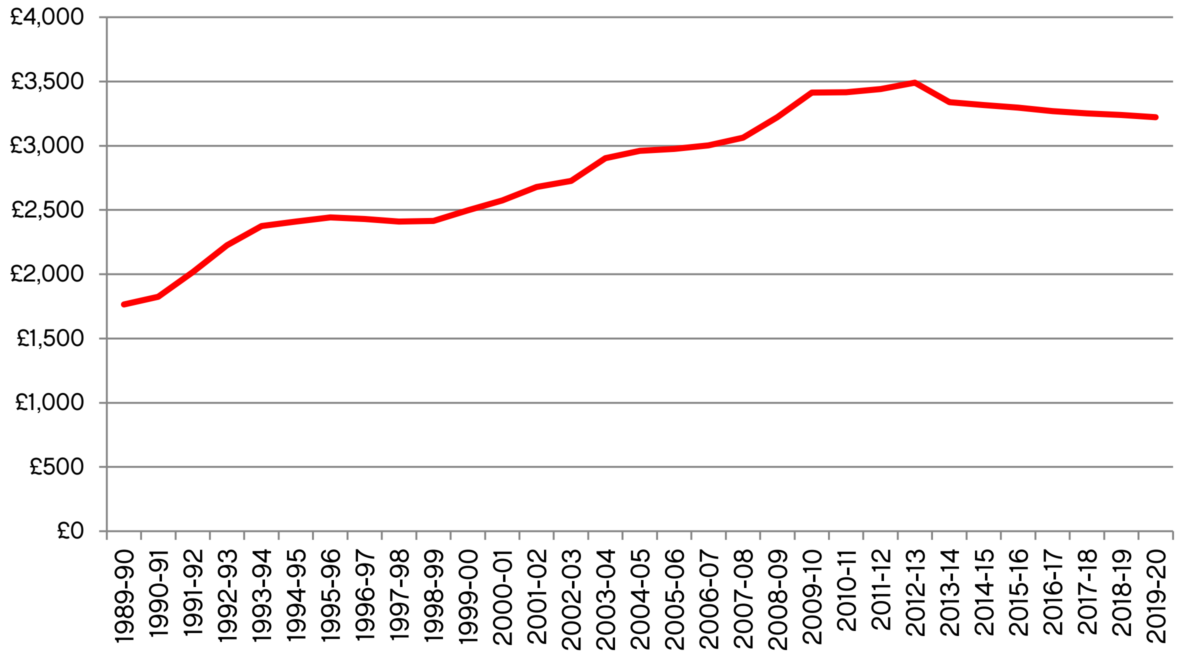
In 2010/11, the poorest 20% received £10,200 more than they paid and in 2013/14 this had fallen to £9.982. The middle quintile saw an average reduction in their net dependency of 27% over the same time period receiving £3,517 in 2013/14 compared to £4,820 in 2010/11. This fall in net dependency comes from falls in cash benefits, the value of benefits in-kind and higher amounts paid in tax.

Figure 2: Taxes paid minus benefits and benefits in-kind received

	Bottom	2nd	3rd	4th	Top
Balance	-9982	-9442	-3517	4478	20777
Change since 2010/11	218	515	1303	420	652

The recent Welfare Trends report from the Office for Budget Responsibility also highlighted the sharp rise in welfare spending per person over recent decades. Real terms welfare spending per person almost doubled from £1,766 per person in 1989/90 to £3,415 in 2009/10. The growth in inflation adjusted welfare spending per person was particularly strong between 2000/01 and 2009/10. This has fallen to £3,316 in 2014/15 and the OBR forecasts that the gradual fall under the Coalition and the current Government will continue over the coming years to reach £3,223 in 2019/20.

Figure 3: Real Welfare Spending per capita



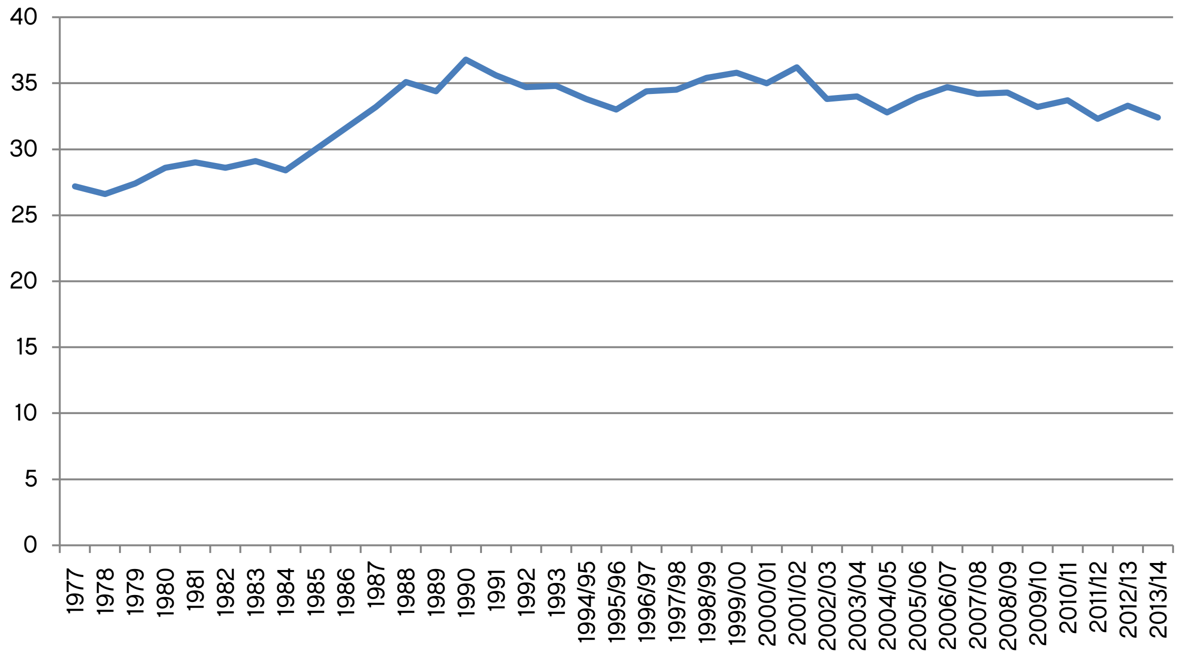
However, the OBR also highlights the extent to which welfare spending still depends on exogenous factors. For example, in the 2014 Budget, total welfare spending was forecast to reach £236.3 billion by 2018/19 however in the March 2015 Budget, this fell by £7 billion to a forecast of £229.3 billion. This is in part because of lower unemployment but mainly because of lower expected inflation. On the other side, modelling changes mean that incapacity benefits and disability benefits are expected to cost an extra £2.1 billion in 2018/19. Furthermore, total welfare spending is expected to fall to 10.6% of GDP by 2019/20 from 12.1% of GDP in 2014/15. Nevertheless, these gains are likely to be erased in the absence of further welfare reform over the following decade because of the sharp rise in the cost of the state pension as a percentage of GDP.

2. INEQUALITY

The main measure of income inequality used by the ONS is the Gini Coefficient. Despite repeated claims from some that the "austerity" policies of recent years would lead to sharply rising inequality, this does not seem to have happened. In fact, inequality as measured by the Gini Coefficient fell from 33.7% in 2010/11 to reach 32.4% in 2013/14. This is lower than every year under Labour and is the lowest since 1986.

Inequality of disposable incomes has also fallen. The ratio of the mean equivalised disposable income of the top fifth of households to the bottom fifth fell from 5.38 in 2010/11 to reach 5.27 in 2013/14. Moreover, the number of children in workless households has fallen quite dramatically from approximately 1.9 million in 2010 to reach nearly 1.5 million. The number of children growing up in a household in which nobody has ever worked fell from 300,000 to 230,000 over the same period.

Figure 4: Gini coefficient – All Households



3. TAXES AND BENEFITS

Median household disposable income grew by 3.4% to reach £24,500 in 2013/14 which is the largest annual increase since 2002/03. This means that real terms median household has doubled since 1977 which is an annual average growth rate of 2%. However, the ONS estimates that the majority of the growth in average incomes took place in the late 1980s and late 1990s. Average disposable incomes have remained broadly stable although it is clear that the richest have lost more than the poorest since the onset of the recession.

The average household paid £13,402 in taxes to receive £12,939 in cash benefits and benefits in-kind in 2013/14. This highlights the significant amount of "churn" in the welfare system. People are taxed, their money is put through the Government machine with all the consequent administrative and compliance costs and then the money is given back to them in benefits. It is far more efficient to tax less and spend less in order to reduce this unnecessary recycling.

Increasing the personal allowance, as advocated by the CPS, has clearly helped to reduce the tax burden on the poorest households. Income tax as a percentage of original income ie before taxes and benefits has fallen quite significantly in 2013/14 compared to 2011/12. For example, for the poorest fifth of households, income tax has fallen from 10.5% to 7.4% of original income. For the second bottom quintile, it has fallen from 11.7% to 8.8% and for the middle quintile it has fallen from 12.6% to 11.1%. The middle three fifths of earners are now enjoying the lowest level of income tax as a proportion of income in recent decades.

The ONS figures also show the highly redistributive nature of the tax and benefits system. Ignoring taxes and benefits, the richest 20% of households had income of £80,800 in 2013/14 which is approximately 15 times greater than the poorest 20% of households who had an average income of £5,500. However, when all the taxes and benefits are included the top fifth of households have on average a final income which is four times greater than the poorest fifth.

Nevertheless, despite the redistributive nature of the tax system and the significant income tax cuts, the poorest households are still paying very high taxes as a proportion of gross income. The richest fifth of households paid £29,200 in tax over 2013/14 which equates to an average tax rate of 34.8% of their gross incomes. The poorest fifth of households paid £4,900 in taxes over the year. Whilst this is much less in absolute terms, at 37.8%, it is proportionately even higher than paid by the richest households.

A strikingly high percentage of the gross income of the poorest households is derived from cash benefits. At 57.25% of gross income and an average of £7,394 this compares with 3.5% of the gross income of the richest quintile and an average of £2,947.

4. WELFARE REFORM

The proportion of gross income paid in taxes by the poorest households highlights the fact that cutting taxes can still significantly improve the living standards of poorer households even without considering the potential dynamic benefits. The alarmingly high proportion of gross income which comes from cash benefits for the poorest households also demonstrates the urgent need for more profound supply-side reforms which raise productivity and real earnings.

Net dependency at 51.5% is still too high. Simply attempting to alleviate difficult economic conditions with welfare payments can only ever be a short term fix. Indeed, the case for making a further £12 billion of savings in the welfare budget rests not only on the need to reduce the budget deficit but also on the need to reform welfare to boost employment and encourage growth in real wages. The Government must press ahead with deeper welfare reform.

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