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Lessons for Welfare Reform from the United Kingdom

Introduction

Welfare reform is high on the political agenda in both New Zealand and the United Kingdom. In New Zealand an independent welfare working group has released its final report and the prime minister, John Key, signalled that the government would consider its findings. In the United Kingdom the secretary of state for work and pensions, Iain Duncan Smith, has outlined plans to radically reduce the cost and complexity of working-aged benefits and to increase the involvement of the private sector in the delivery of services. This article compares welfare reform in New Zealand and the UK. Such a comparison is of interest given the similar social policy traditions in the two countries and similarities and differences in the approaches taken to their welfare reforms. There are also important lessons – on what to do and on what not to do – that the countries can learn from each other.

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The context for welfare reform

Welfare reform needs to be considered in its broader social and economic context. This is important for, at the very least, shaping the quantum of resources that can be committed to welfare spending. Measures such as GDP per capita[1] and rankings of global competitiveness[2] highlight how both New Zealand and the UK face challenges in ensuring that per capita incomes and relative living standards grow at rates comparable to those of other similar countries (such as Australia and Germany). This relative performance has a bearing on the resources available for redistribution (the dynamic size of the tax base and labour market). A fall in relative living standards may also create pressure to inflate incomes through borrowing or poorly targeted spending (Nolan, 2011).[3]

Public spending is lower (as a share of GDP) in New Zealand than in the UK. This partly reflects the UK's larger exposure to the global financial crisis (due to both the size of the financial sector and failures in the UK's approach to financial regulation), but it also reflects a large increase in spending before this. Between 2001 and 2007 (prior to the financial crisis) public spending in the UK rose from 36% to 41% of GDP (and

reached 48% of GDP in 2010) (Osborne, 2010). The health budget doubled in real terms between 1999 and 2010 and the welfare budget doubled between 1990 and 2010. The failure to combine this increase in spending with adequate supply-side reform (especially in areas like health) meant that much of the increase was absorbed in increased costs of delivering services rather than improved outcomes (Haldenby et al., 2009).

In New Zealand the increase in spending over this period was more moderate, from 31% to 34% of GDP between the turn of the century and 2010 (Whitehead, 2010), potentially reflecting the greater control over expenditure following the introduction of the Public Finance Act 1989 and Fiscal Responsibility Act 1994. There was, however, concern over public service productivity and the increase in tax burdens due to fiscal drag. There was also concern that the inflationary impact of increases in spending in New Zealand contributed to the country entering recession prior to the global financial crisis (NZIER, 2007). New Zealand's public finances were nonetheless on a stronger footing going into the crisis than those of the UK.

Both countries need to improve the quality of public spending. Achieving better outcomes is not simply a question of spending more but requires spending in better ways. Welfare must be central to this value-for-money agenda. In both countries welfare is the largest area of spending. In the UK the 2010 welfare budget (including departmental spending) was £218 billion (16% of GDP and 32% of government spending (Bassett et al., 2010)), which was twice what was spent on the health system. In New Zealand the figures were smaller but still significant, with welfare spending ($21.2 billion, or 10% of GDP and 30% of core Crown expenses (English, 2010)) being equivalent to one and a half times the spending on health.

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Welfare spending

Both countries have seen large increases in welfare spending over recent years. Some welfare spending varies with economic conditions, with increasing unemployment, for example, leading to greater expenditure on assistance to support people back into work (the automatic stabilisers). Yet in both countries over recent years spending on welfare has been increasing even when the economy was growing. There have been two drivers of this increase.

The first driver was increased spending on programmes designed to make work pay, such as the Working for Families tax credits in New Zealand and the working tax credit in the UK. It was hoped that by encouraging work these programmes would reduce child poverty and the overall costs of welfare. These programmes improved the incentives to work facing sole earners, but also meant that incentives for second earners in households to work were reduced. They also helped reduce child poverty,[4] but this approach of 'spending to save' did not succeed in reducing the cost of welfare.

The second driver was the increased spending on 'middle-class welfare' (spending on middle- to higher-income families). In New Zealand this included the extension to the Working for Families programme after 2005 and the introduction of an independent earner tax credit after 2008.[5] The extension of middle-class welfare in the UK since 1997 has been more extensive, with Labour introducing 13 new benefits after they came into power.[6] Many of these benefits lacked any real rationale (beyond simply attracting votes). This included the establishment of a universal winter fuel allowance for pensioners, which in 2010 cost £2.7 billion and of which 88% went to people not in fuel poverty (Environment, Food and Rural Affairs Select Committee, 2009).

It is sometimes argued that spending on middle-class welfare is an important part of generating support for spending on the poor. Reform research has questioned whether this is the case (Cawston, Haldenby and Nolan, 2009, 2010). An increase in middle-class welfare tends to crowd out spending on the poor, with political incentives meaning that the wrong type of support tends to increase in value. Increased spending on middle-class welfare also undermines the legitimacy of a welfare system. Reform research on the British Social Attitudes Survey has shown, for example, that as spending on middle-class welfare increased in the UK from 1997 the public support for working-aged benefits for people out of work fell (Nolan, 2011).

A need for a clearer focus on priorities is important in both countries given the risks of increasing long-term unemployment arising from recent economic shocks, such as the global financial crisis and the 2011 Canterbury earthquake. Spending must be prioritised not only within the welfare budget, but also between this and other budgets. When government finances and tax revenue are limited, there is a trade-off between spending on welfare and departmental and infrastructure spending. Research by Gemmell, Kneller and Sanz (2008) has found that the return (in terms of growth) from spending on social protection (such as welfare and health) tends to be lower than spending on economic development (such as infrastructure) and education. This finding is consistent across studies and holds for both developed and developing countries.

A need for a clearer focus on priorities is also important given the changing demographic profile of the populations in the two countries. Increasing dependency ratios mean that in the absence of reform the costs of current welfare policy will escalate rapidly. A start has been made with managing the costs of pensions

in New Zealand, with contributions (currently suspended) being made to prefunding the costs of New Zealand Superannuation and the introduction of (heavily subsidised) personal retirement accounts. However, the ring fencing of New Zealand Superannuation, the cost of the KiwiSaver subsidies, the level of the state pension age and managing the long-term costs of health and long-term care require further debate.

In contrast, in the UK, while the debate on long-term care has been prolonged (although there is still political reluctance to commit to a funding framework) the debate on managing the cost of pension commitments is less developed than in New Zealand. Indeed, although some changes in the treatment of public sector pensions have been made, it is proposed to encourage contributions to individual retirement accounts (National Employment Savings Trust (NEST)) through auto-enrolment, and a proposed increase in the retirement age has been brought forward, the government remains largely in denial about the need to reduce the longer term cost of state pensions (and has actually significantly increased these costs through changing the basis for indexation).

'21st Century Welfare'

In the UK the Coalition government has made welfare reform (under the banner of '21st Century Welfare') a central feature of its policy agenda. Key reforms are shown in the box, and the three most important features are discussed below.

The flagship feature of these reforms is the proposed introduction of a universal credit. This proposal, similar to the single core benefit proposals of the fifth Labour government in New Zealand (Sainsbury and Stephens, 2009), would represent a significant simplification of the income transfer system. However, while simplification is the right goal, the universal credit is the wrong fix (Work and Pensions Committee, 2011, qn 17):

- The reforms place a lot of emphasis on the ability of smart automation to update changes in circumstances in real time. Experience shows how difficult it can be to accurately monitor fluctuations in income and adjust levels of assistance. Further, not all important criteria for determining assistance can easily be automated without incurring significant administration and compliance costs.[7]
- There has been a lack of thought given to implementation of the reforms. There are important outstanding issues relating to the treatment of disability benefits, housing benefits and child support programmes.
- The approach of increasing the amount that can be earned before benefit abatement begins does not reward the right decisions. There will be a large increase in disincentives to work facing second earners in households, which was not recognised in the white paper proposing these reforms.

The Coalition's welfare agenda also includes the introduction of the work programme. This programme built on successful reforms introduced by the previous Labour government. It aims to engage private and third sector organisations in the delivery of welfare-to-work services. This is based on a new approach to contracting which aims to ensure that providers are paid out of the savings from reduced benefit payments. Getting these contracts to work will be difficult and there is a challenge in ensuring that there are enough contractors who can bring sufficient balance sheet strength to the table.

The Coalition also proposes to shift people on incapacity benefits onto the employment and support allowance, which is more focused on assessing capacity to work. Existing incapacity benefit recipients will be required to undertake a new work test. For some beneficiaries the benefit will also be time limited. This process began under the previous Labour government and was motivated by a concern that too large a proportion of the population is on these benefits, with benefit numbers being equivalent to around 9% of the number of people over 15 in work. There was also concern that rather than changes in need, such as a higher incidence of disability among an increasingly elderly population, this increase reflected a tendency for benefit-switching (people

Key UK welfare proposals

- Universal credit: replace all means-tested benefits and tax credits for those of a working age with a single benefit from 2013.
- The work programme: combine existing welfare-to-work programmes into one scheme which funds providers out of benefit savings.
- Employment and support allowance (ESA): shift incapacity benefit recipients onto the ESA, time-limit some payments and introduce a stronger work capability assessment (medical test).
- Child benefit: freeze benefit for three years and withdraw assistance from families containing a higher-rate taxpayer.
- Child and working tax credits: increase rate at which tax credits are withdrawn (from 39% to 41%) and taper the family element of the child tax credit immediately after the child element is exhausted; above-inflation increases in the per-child element of the child tax credit in 2011 and 2012.
- Housing benefit: set local housing allowance at the 30 percentile of rents in a local area (rather than the median) and introduce a nationwide cap on the level of payment.
- Benefit indexation: link benefits and tax credits with the consumer prices index (CPI) rather than the retail prices index (RPI) or Rossi index.

moving from other benefits) to avoid the greater conditionality of other benefits.

Possible lessons from the UK

Debates on the proposed welfare reforms in the UK highlight a number of potential lessons for welfare reform in New Zealand. An important lesson is that it is inevitable that any policy change will involve trade-offs. These trade-offs are often referred to as an iron triangle (when it is impossible to simultaneously improve fiscal cost, incentives to work and poverty reduction), but even within objectives (such as making work pay) trade-offs are required. In the case of the universal credit, for example, increasing the amount that a person can earn before facing benefit abatement would mean that some people will face improved incentives to work a small number of hours a week, but other people would be encouraged to reduce their hours of work or to stop working all together. There is no silver bullet and it is impossible to make work pay for everyone at every time.

This need for trade-offs has two implications. First, welfare policy needs to recognise that families must take some responsibility themselves. In the real world there is no perfect welfare system where at every point work always pays, all in-work costs are covered and change never creates 'losers'. There are at times, for example, costs associated with working that no realistic welfare system could ever compensate for. But this should not be used as an excuse when families fail to make decisions that are in their – and society's – long-term interests. The flipside of having a welfare system which provides an important social safety net is that most people can reasonably be expected to take up work if it is available and adequate.

The Coalition has placed emphasis on conditionality and responsibility. Conditionality has already been successfully used in the UK. The Flexible New Deal, for example, required people who had been on the job seekers allowance for 22 months to engage in intensive activity periods. This conditionality, matched by more intensive support, reduced the level and duration of benefit receipt. Increases in conditionality have also led to reductions in caseloads in the US, Denmark, the Netherlands, Australia and New Zealand (DWP, 2008). Indeed, conditionality has been so successful that countries are extending variations of these policies to recipients of what were previously considered inactive benefits, such as lone parents, disabled people and people with health conditions.

A major reason for failure has been an unwillingness to reduce the generosity of entitlements, particularly those to people not in need.

The second implication is to not lose sight of the importance of the labour market context. There is a need to not just look at the impact of reform at the individual or family level but to consider how reforms interact with the labour market. In the UK the white paper on the universal credit contained no indication that broader labour market issues have been given consideration (Work and Pensions Committee, 2011, qn 18). But, as Chris Goulden (2010) from the Joseph Rowntree Foundation has noted, 'the crucial point is that the aim of policy should be to promote a good job match for all customers. ... This takes us back to the flipside of "making work pay" and the importance of the labour market – the kinds of jobs that are incentivised will be vital. It will be no good for long-term poverty if the benefits bill is reduced by making it easier for people to get stuck in cycles of low-paid, unskilled, insecure and dead-end jobs.'

The UK experience also highlights that the only way to effectively lower the cost of welfare is through reducing entitlements, especially poorly targeted ones. While there is a broad consensus across the political spectrum on the benefits of having people enter work (both for the people themselves and for society), the fiscal savings from such 'spending to save' approaches tend to be overstated. To make savings, entitlements have to be reduced. Yet a risk in making these cuts is that they are made in the wrong places or in the wrong way.

A criticism that Reform has made of the Coalition's welfare policy is that too much emphasis has been given to 'salami slicing' the main out-of-work benefits, while large middle-class benefits have remained untouched, particularly the poor value-for-money expenditures on the elderly (Cawston, Haldenby and Nolan, 2010). The reason for this is political, with the Coalition being unwilling to risk a backlash among the large number of pensioners who vote. Consequently, the principle that spending should be cut from those areas that produce least value has been lost and the Coalition has exposed itself to the challenge that it is unfairly targeting segments of the working-aged population.

In areas where the Coalition has been willing to address the costs of middle-class welfare, such as by means-testing the child benefit, the right thing has been done in the wrong way. Means-testing can create economic cost (such as disincentives to work) and compliance and administrative burdens, and both New Zealand and the UK already have overly complex welfare systems. Yet the political reluctance to abolish this programme means that a half-measure approach has been taken and as a result the Coalition's policy (withdrawing the child benefit from families with higher-rate taxpayers) will make complexity worse (Cawston, Haldenby and Nolan, 2010).[8] Reducing costs requires removing programmes entirely, not merely fine-tuning them.

The reforms in the UK also highlight the importance of changing the way assistance is delivered and not just the structure of its design. Through

encouraging the greater involvement of private sector and charitable providers it is hoped that the provision of welfare-to-work services will to a greater degree reflect local variations in welfare and labour market conditions. Taking a more creative approach to contracting providers could potentially allow independent providers to absorb more of the risk associated with getting people back into work, although the difficulties in developing contractual arrangements should not be underestimated. If done correctly, encouraging profit-making firms to enter the welfare-to-work market can improve productivity and achieve better outcomes at lower costs.

Conclusion

New Zealand and the UK have approached welfare reform in relatively similar ways. In both countries there has been a greater emphasis on conditionality, and efforts to make work pay have been pursued through the tax credit system. These approaches have been consistent with those of many other OECD countries, where conditionality of benefits has been extended to new groups and there has been greater use of private sector providers and insurance mechanisms, especially for disability benefits. Yet in both countries approaches of 'spending to save' have failed to reduce the overall cost of welfare. A major reason for failure has been an unwillingness to reduce the generosity of entitlements, particularly those to people not in need. Spending on the elderly has proven especially difficult to reduce. The need to put welfare on a fiscally sustainable footing means that popular spending cannot remain outside the value-for-money agenda. Consideration must be given to reforming New Zealand's state pension age, KiwiSaver subsidies, Working for Families tax credits (especially the parental tax credit) and independent earner tax credit.

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1 The UK is the sixth largest and New Zealand the 26th largest economy in the OECD. On a GDP-per-capita basis the UK is 16th and New Zealand 22nd. Although it is important to recognise that the OECD is a collection of relatively high-income countries, within this group the UK is a middle-ranked country and New Zealand a low-ranked one.

2 The World Economic Forum's global competitiveness report 2010–11 ranked the UK as the 12th most competitive economy in the world, down from second in 2006–07. The main factors holding back competitiveness were the macroeconomic environment and budget deficits. New Zealand was ranked 23rd in 2010–11, compared with 21st in 2006, largely due to the need to upgrade infrastructure, especially roads and the electricity supply.

3 This can be seen most clearly in the UK, which has high levels of both household and public debt and is, among developed countries, second only to Japan in levels of national debt (McKinsey Global Institute, 2010). New Zealand has lower levels of public borrowing but household debt is high (McDonald et al., 2011). High levels of debt make the economy vulnerable to shocks such as a global financial crisis or a natural disaster. High public debt also crowds out other areas of spending, with, for example, more now being spent on servicing debt than on schools in the UK (Bassett et al., 2010).

4 The policy objective of reducing child poverty was given greater emphasis in the UK, with the goal to eradicate child poverty being enshrined in legislation.

5 Other areas of poorly targeted spending in New Zealand include KiwiSaver subsidies and the interest free student loans policy. Gibson and Le (2008) highlighted that the KiwiSaver subsidies represent poor value for money. Only a small proportion of each dollar of KiwiSaver balances represents new saving. The large majority of these balances is 'either reshuffling amongst existing saving and debt by KiwiSaver members, or else taxpayer and employer transfers which reduce national saving elsewhere'.

6 Child trust fund, child tax credit, working tax credit, education maintenance allowance, local housing allowance, sure start maternity grant, child care vouchers, healthy start, health in pregnancy grant, winter fuel allowance, free TV licences, free bus passes, employment and support allowance and the job grant.

7 While, for instance, earned income and ages of children could be monitored automatically, criteria such as marital status, the length of time a child resides with a caregiver in a separated household and hours of work are more difficult to keep track of.

8 Rather than withdrawing the child benefit from higher-rate taxpayers, commentators such as Reform, the Institute for Fiscal Studies and Martin Narey (recent chief executive of Barnardo's) have proposed the simpler approach of abolishing the child benefit and compensating lower-income families through increasing the generosity of an already widely received means-tested programme (the child tax credit) (see Cawston, Haldenby and Nolan, 2010).

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