WELFARE REFORM COMMITTEE

THE FUTURE DELIVERY OF SOCIAL SECURITY IN SCOTLAND

WRITTEN SUBMISSION FROM PROFFESSOR DAVID BELL

1. Introduction

Scotland is to be granted a range of welfare powers as a result of the Smith Commission proposals and subsequent legislation. There has been extensive discussion of how these new powers might be used and how the Scottish welfare system could be made “fairer” as a result. What has not been discussed is the size of the budget that will support these new powers and the mechanism for adjusting this budget in the future. This indexation mechanism will play a key role in determining the scope for change in Scotland’s welfare system. However, its form has not been determined and indeed has hardly been discussed. This paper discusses some of the issues associated with the design of the mechanism.

2. Welfare powers for Scotland

Welfare benefits and the state pension in Scotland are paid for by the Department for Work and Pensions (DWP). They do not form part of the Scottish Government’s budget. In many countries, welfare benefits are entirely controlled by central government. This is about to change as far as the UK is concerned. Following the report of the Smith Commission in November 2014, it was agreed that a number of welfare benefits would be transferred from DWP to the Scottish Government. Table 1 lists the specific benefits that have been selected for transfer, the associated expenditure in Scotland on these benefits in 2013-14, and, where available, the (estimated) size of the associated caseload.

Table 1: Expenditure and Caseload on Benefits to Be Devolved to Scotland

Devolved benefit	£m	Share	Caseload (000s)
Disability Living Allowance	£1,473m	58.2%	330.3
Attendance Allowance	£481m	19.0%	129.0

Winter Fuel Payment	£186m	7.4%	1086.1	
Carer’s Allowance	£182m	7.2%	62.9	
Industrial Injuries Disablement Allowance	£91m	3.6%	37.6	*
Severe Disablement Allowance	£91m	3.6%	23.3	*
Discretionary Housing Payments.	£18m	0.7%		
Sure Start Maternity Grants	£4m	0.2%		
Funeral Payments	£4m	0.2%		
Total	**£2,530m**		1669.1	

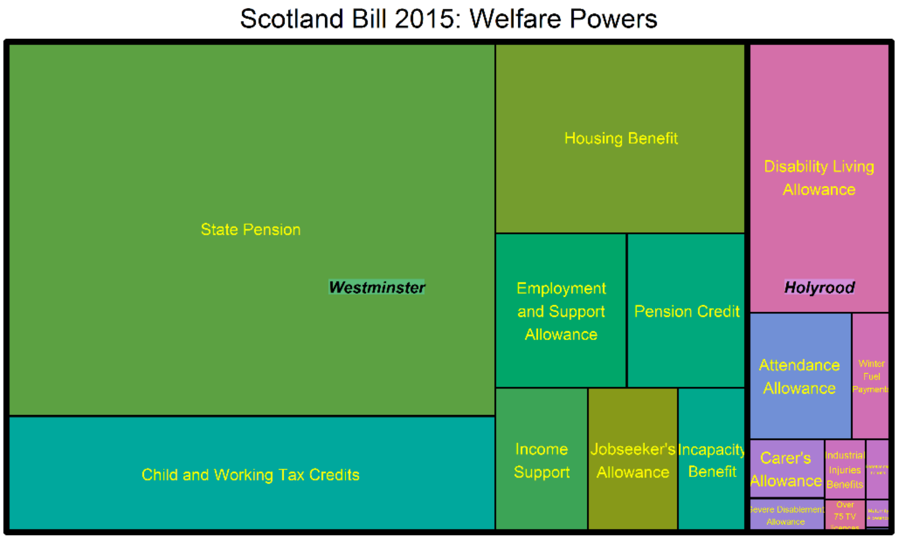
* estimate based on most recent DWP statistics for UK as a whole

It is clear that a large number of individuals will be partly dependent for their income on Scottish Government welfare payments. The number will be somewhat less than 1.7 million because many individuals receive more than one benefit. Nevertheless the assessment, processing and distribution of these payments will pose a significant challenge to the Scottish Government. Should Scotland choose to set up its own agency to carry out these administrative functions, the associated costs will be substantial given the size of the caseload.

The main client group will be older people. Winter Fuel Payment (WFP), which has the largest caseload, is paid to over 1 million people in Scotland, all of whom are aged 60 and over. Population data from the National Records of Scotland suggests that the average age of those aged 60 and over is 71 in 2013. Data from the Family Resources Survey suggests that the average age of those receiving Attendance Allowance (AA) and Disability Living Allowance (DLA) in Scotland was 60.5 in 2013. Together, AA, DLA and WFP account for 85% of the spending on the welfare benefits being devolved to Scotland. It is evident that the spending is substantially weighted towards older people rather than those of working age.

The total budget for the welfare benefits transferred to Scotland stood at £2.5 billion in 2013-14. Total benefit expenditure in Scotland by DWP in that year was £14.4 billion. Thus, the Scotland Bill 2015 will devolve control of 17.6% of this budget to the Scottish Government. The division of welfare powers between Holyrood and Westminster is shown in Figure 1, with those retained by Westminster to the left of the bold vertical line while those being transferred to Holyrood to its right. The sizes of the rectangles in Figure 1 are proportional to spending on the individual benefits and thus those allocated to Scotland account for 17.6% of the area of the rectangle.

Figure 1: Division of Powers over Welfare between DWP and the Scottish Government



Under the “no detriment” principle, the budget of the Scottish Government will be increased by £2.5 billion when the powers are transferred or to the equivalent sum for the year when the transfer occurs. Thus, the Scottish Government will have sufficient additional funds to exactly meet the costs of the benefits over which it has gained control, assuming eligibility criteria and rates of payment are maintained at existing levels. This process will also leave the overall UK budget unaffected, since it effectively involves a transfer from DWP to the Scottish Government. Thus, neither the Scottish Government, nor the UK Government suffers detriment.

But how much will the Scottish Government receive in subsequent years? After these benefits are transferred, the Scottish Government will no longer be obliged to maintain their present structure. It can alter their design as it sees fit. Indeed, a strong expectation has been built up that these monies can be used to develop a “fairer” or perhaps more generous welfare system in Scotland. But the monies that will actually be transferred after the first year will depend on how the initial transfer of £2.5 billion is “indexed” in subsequent years. This is taken up in the next section.

3. The Indexation Mechanism

The UK Government's approach to the indexation issue will be constrained by a desire to maintain control over the U.K.'s fiscal stance. The signatories to the Smith Commission accepted that "the UK Government should continue to manage risks and economic shocks that affect the whole of the UK." (Para 95.8). Following from this, the interpretation of the "no detriment" principle in the "Enduring Settlement" document implies the transfer of welfare powers to Scotland will *not* lead to a change in aggregate UK public spending.

> *"So while the Scottish Government and UK Government budgets will in fact change as a result of the decision to devolve further areas of spending, overall spending in Scotland and the rest of the UK should be unaffected (on an ongoing basis) by this decision to devolve further spending powers."*
>
> (UK Government, (2015) `Scotland and the United Kingdom: An Enduring Settlement ', P30)

This is somewhat confusing. Suppose that Scotland undertakes a tax-financed increase in welfare spending. This would increase overall public spending in the UK, but would have no effect on the UK's public sector deficit. The implication that the increase in spending would be "detrimental" to rUK would seem to imply that there is a cost associated with increased aggregate public spending for which Scotland would have to compensate the UK Government. This would be an extremely difficult calculation to make. Whether this issue is critical to the effective exercise of UK fiscal policy, given Scotland's size, must also be open to debate.

However, to return to the indexation mechanism, it appears that this has not yet been established or agreed. HM Government has argued that:

> *"For welfare, such as disability benefits, as this spending is outside Departmental Expenditure Limits it is therefore outside the scope of the Barnett Formula. While there will again be an increase in the block grant in year 1, reflecting the spending (both on front line programmes and the associated administration costs) that the UK Government will no longer*

undertake, the UK and Scottish Governments will need to work together to determine how this funding changes in subsequent years to dynamically and mechanically reflect changes in the welfare spending that would have been undertaken by the UK Government over time. While the Smith Commission Agreement indicated that the adjustment would need to be "indexed appropriately", as with tax devolution it stopped short of suggesting what the index should be."

(UK Government, (2015) `Scotland and the United Kingdom: An Enduring Settlement ', P30)

There is a symmetry between the arguments around the increase in Scotland's budget arising from new welfare powers and those that have been used to design the *reduction* in Scotland's block grant that follows from the new tax raising powers which it has gained as a result of the Scotland Act 2012 and which will be extended by the Scotland Bill 2015. These new tax powers are focussed on income tax, both in terms of the revenues it will generate and of the powers to redesign the tax that will be available to the Scottish Parliament. The reduction in the block grant is known as the Block Grant Adjustment (BGA). It is indexed on the rUK income tax base. Thus, after the initial year, the size of the BGA will grow in line with the increase is the rUK income tax base. The faster it grows, the more rapidly will Scotland's block grant be reduced. This provides a clear incentive for the Scottish Government if it wishes to maintain or expand its budget. It must increase its tax revenues faster than those in rUK, otherwise its budget will contract relative to rUK. The cost of the new tax powers is that Scotland takes the risk that its economy and therefore its tax base grows more slowly than that in the rest of the UK.

The design of the indexation mechanism is a decision about the allocation of risk. Some lie on the supply-side and therefore cover risks to the availability of resources to support welfare payments, while others lie on the demand side, and therefore reflect fluctuations in the need for welfare support from eligible individuals and households. Risks may be affected by government action at either the Scottish or UK levels. It is worth discussing the main risks that are likely to be associated with the set of welfare powers being transferred to Scotland. These are:

1. Inflation – supply

   Inflation erodes the real value of welfare payments. Since UK inflation is not significantly influenced by the actions of the Scottish Parliament, a case can be made that the indexation formula for Scottish welfare benefits should reflect variations in UK inflation rates. The UK government has intervened in the indexation of benefits in recent years, holding the increase in selected benefits below the rate of inflation. It is difficult to make the case that this is a macroeconomic instrument, given that some benefits have been indexed while others have not. It will be possible to index the transfer to Scotland to changes in the value of the individual benefits that are being transferred, but if this leads to a decline in the real value of benefits, there are likely to be further opportunities for inter-governmental arguments around the interpretation of "no detriment" and the role of inflation adjustment within the fiscal strategy.

2. Macroeconomic - supply

   There is a risk that the value of resources available to support Scottish welfare benefits may be affected by UK macro-economic fluctuations. UK governments typically allow welfare payments to move against the economic cycle, but recent increases in the share of welfare benefits in GDP have led to the introduction of a nominal "welfare cap" which limits the aggregate amount that government can spend on certain benefits. It is applied to forecast expenditure and significant changes in its level requires the consent of Parliament. Over time, though it short run effect will be limited, this device is likely to have a considerable influence on the size and composition of welfare spending in the UK.

   A number of the benefits being transferred to Scotland fall within the welfare cap. However, the DWP will not be required to account for this spending in relation to welfare cap. This is made clear in the "Enduring Settlement" document. What is not clear is whether this responsibility will be transferred to the Scottish First Minister.

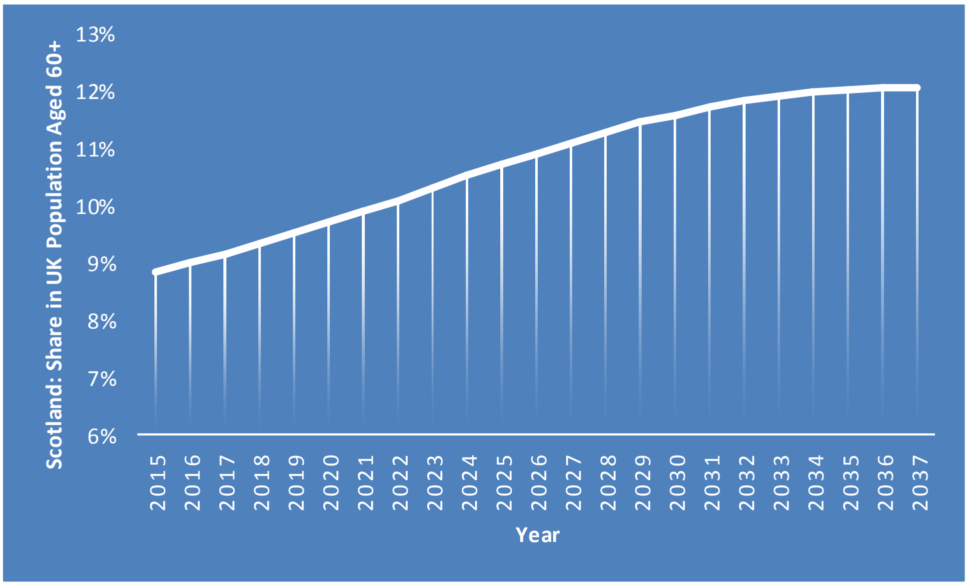
"In relation to the welfare cap, the UK government intends to remove welfare programmes devolved to the Scottish Parliament from the UK welfare cap, so that the Secretary of State for Work and Pensions would not be accountable to the UK Parliament for controlling Scottish Government expenditure on these devolved programmes" (UK Government, (2015) `Scotland and the United Kingdom: An Enduring Settlement ', P30)

If the welfare cap can legitimately be regarded as a component of macroeconomic policy, then a case could be made for bringing Scottish welfare spending within the overall cap and therefore the Scottish Government would have some responsibility in ensuring that the Scottish welfare spend did not jeopardise the overall welfare cap. However, this issue would undoubtedly be hotly contested.

3. Population at risk – demand

On the demand side, it is possible that the population at risk of requiring welfare support grows more quickly in Scotland than in rUK. Given that the benefits being transferred to Scotland focus mainly on older people, one measure of the relative change in populations at risk in Scotland and rUK can be derived from projections of numbers of older people in Scotland and rUK. Consider Scotland's projected share of the UK population aged 60+ which is shown in Figure 2. During the projection period (up to 2037), Scotland's share grows substantially - from 8.8% in 2015 to 10.7% by 2025.

Figure 2: Projection of Scotland's Share of UK Population Aged 60+



Source: Office of National Statistics Principal Population Projections 2012 Based.

If the probability of claiming benefits remains constant, then the costs of claims is likely to rise faster in Scotland than in rUK due to the more rapid growth in the elderly population. However, if the indexation mechanism takes account of Scotland's growing share of the elderly population, then the risk that claims in Scotland could only be funded by diverting funds from other priorities would be avoided. However, the corollary is that the increased claims would be funded by the UK taxpayer, with again, a somewhat diminished contribution from Scottish taxpayers. Note that the Barnett formula does control for *overall* population risk: it is adjusted each year to take account of variations in Scotland's share of the UK population. However, it does not adjust for changes in the age structure of the population.

4. Prevalence – demand

Changes in the share of claimants from within the "at risk" population who actually make claims clearly affects the demands on the welfare system. By accounting for relative changes in prevalence between Scotland and rUK, the indexation formula could remove the risk associated with changes in the prevalence of disability as between Scotland and rUK. This would imply not only an adjustment for changes in the relative size of the populations at risk, but also for changes in the probability of claims within these populations.

It is difficult to form an accurate picture of the probability of claims being made. But some indication can be gathered from recent trends in levels of disability across the UK as a whole and in Scotland that have been made by the Office for Disability Issues. These are contained in Table 2 below which shows estimates of the number of people (millions) who have a longstanding illness, disability or infirmity, and who have a significant difficulty with day-to-day activities. There has been an increase of around 11% in the numbers of disabled in Great Britain between 2002-03 and 2011-12. Note that the increase has been more marked among those of working age than among those of state pension age. Estimates of changes in Scotland have to be treated with caution given that the estimates are based on a relatively small sample of around 3000 households. These data also conflate changes in the size of the relative populations at risk with changes in the propensity to claim. However, between 2002 and 2011, Scotland's share of the population aged 60+ in the UK varied only between 8.72% and 8.65% - a relatively small change in the population "at risk".

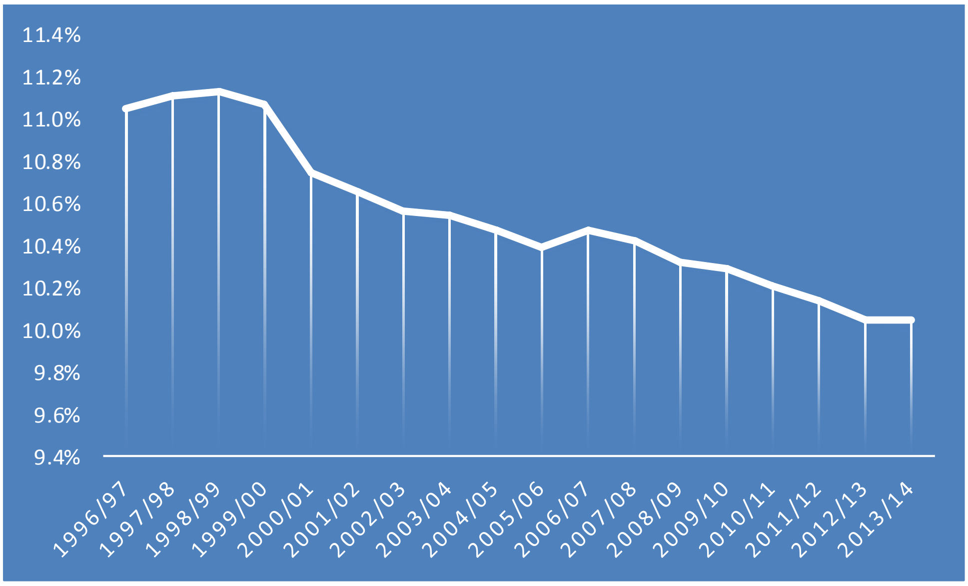
Table 2: Disability Prevalence in Great Britain and Scotland

	Adults of working age	Adults of state pension age	All adults	Children	All ages	Scotland
2002-03	5	4.7	9.7	0.7	10.4	0.9
2003-04	4.9	4.6	9.5	0.7	10.2	1
2004-05	4.8	4.6	9.4	0.7	10.1	0.9
2005-06	5.2	4.9	10.1	0.7	10.8	1
2006-07	4.9	4.9	9.8	0.7	10.5	1
2007-08	4.8	5	9.8	0.8	10.6	1
2008-09	5	5.1	10.1	0.7	10.8	1
2009-10	5.1	5.1	10.2	0.8	11	1
2010-11	5.3	5.2	10.5	0.8	11.3	1
2011-12	5.7	5.1	10.8	0.8	11.6	1

Source: Office for Disability Issues using the Family Resources Survey

Table 2 broadly suggests that disability has been rising less fast in Scotland than in the rest of Great Britain. As mentioned above, these data should be interpreted with caution, given the standard errors that follow from a relatively small sample. However further evidence to suggest that disability has indeed been growing more slowly in Scotland than in the rest of the UK is shown in Figure 3, which plots the share of expenditure on those benefits which are being devolved to Scotland that was spent in Scotland between 1996-97 and 2013-14. It is clear that over this period of time Scotland's share of overall UK spending on DLA, AA, Carers allowance etc. has been falling. This may indeed reflect relative improvements in Scotland's disability rates but might also indicate that "take-up" rates may have increased more rapidly in rUK than in Scotland[1].

Figure 3: Scottish Share of GB Expenditure on "Scottish" Benefits



[1] For a discussion of the determinants of "take-up" rates see Hancock, R., Pudney, S., Barker, G., Hernandez, M., & Sutherland, H. (2004). The Take-Up of Multiple Means-Tested Benefits by British Pensioners: Evidence from the Family Resources Survey. Fiscal studies, 25(3), 279-303

Source: Department for Work and Pensions

Taken together, the evidence on demand-side risks suggests that although the "population at risk" in Scotland is likely to rise faster than that in the UK as a whole over the next few decades, recent experience suggests that Scotland's share of UK spending on those benefits that are being transferred to Scotland has been falling. This is clearly a mixed picture and would imply that only a relatively complex indexation mechanism could reflect both population at risk and prevalence.

To illustrate, the preceding analysis shows that it would be in the Scottish Government's interest to index the budget adjustment for welfare reform to the relative growth of Scotland's elderly population. It would be in the UK Government's interest to index the budget adjustment to recent trends in expenditure on disability. Indexing to the population age structure would "insure" Scotland against the risk of an elderly population, but would reduce its incentive to promote policies to promote a younger population age structure. Indexing to trends in disability spending would ensure the UK Government against further relative reduction in Scotland's share of expenditure on devolved benefits.

This discussion suggests that there are several possibilities for "fine tuning" the indexation formula for Scottish welfare benefits. Such changes would determine the allocation of the risk associated with this spending as between Scotland and rUK. However, complexity may lead to protracted disputes around the evidence that supports or undermines particular adjustments and may also undermine public confidence in the adjustment due to lack of transparency. One way to circumvent such objections is to adopt a relatively crude formula that might be reviewed at pre-specified intervals.

Thus, for example, one might simply set the adjustment to Scotland's budget to equal its share of UK benefit spending in a base year, holding that constant for the following five years. Suppose that 2013-14 was the base year. What would this rule imply for the adjustment to Scotland's budget for the next five years? The Office of Budget Responsibility has recently produced forecasts of benefit expenditure by individual benefit for the period to 2019-20. These cover almost all the benefits that are to be devolved to Scotland. Suppose that the UK and Scottish Governments agree to determine the adjustment to Scotland's budget by holding Scotland's share of each of these benefits constant at their 2013-14 value until 2019-20. What would be the implied adjustment to Scotland's budget over this period? The estimates, based on the OBR forecasts, are shown in Table 3.

Table 3: Estimates of Scotland's Welfare Budget Adjustment 2013-14 To 2019-20

	2013/14	***2014/15***	***2015/16***	***2016/17***	***2017/18***	***2018/19***	***2019/20***
Benefit	***Outturn***	***Forecast***	***Forecast***	***Forecast***	***Forecast***	***Forecast***	***Forecast***
Attendance Allowance	£481m	£487m	£494m	£504m	£512m	£524m	£538m
Carer's Allowance	£59m	£57m	£54m	£53m	£53m	£49m	£47m
Disability Living Allowance	£1,475m	£1,475m	£1,391m	£1,083m	£689m	£561m	£545m
Discretionary Housing Payments	£29m	£27m	£20m	£14m	£15m	£15m	£15m
Industrial injuries benefits	£94m	£94m	£94m	£92m	£91m	£91m	£91m
Personal Independence Payment	£17m	£170m	£252m	£513m	£857m	£989m	£1,037m
Severe Disablement Allowance	£91m	£4m	£4m	£4m	£4m	£4m	£4m
Sure Start Maternity Grant	£3m	£0m	£0m	£0m	£0m	£0m	£0m
Winter Fuel Payments	£188m	£186m	£184m	£182m	£179m	£176m	£175m
Total	***£2,437m***	***£2,500m***	***£2,493m***	***£2,445m***	***£2,401m***	***£2,409m***	***£2,451m***

The implication of this rule is that the addition to Scotland's budget to meet its new welfare responsibilities will vary relatively little in the period to 2019-20. Between 2015-16 and 2019-20, the OBR forecasts suggest a fall of around £42 million in the aggregate adjustment. Thus, if Scotland does want to increase spending on welfare, it would have to source such increased spending either from tax rises or from other parts of the Scottish budget.

How well with this mechanism have performed in the past? Suppose that the budget transfer to Scotland for its new welfare responsibilities has been set at the average share of Scotland's spending on the devolved benefits from 2000 to 2005. Failure to adjust for Scotland's declining share of UK spending on these benefits would have resulted in an overpayment to Scotland of around £139 million by 2013-14. Scotland would have received around 5% more into its welfare budget than DWP actually spent in Scotland on the devolved welfare benefits in 2013-14. Such a discrepancy might be a cause for re-examining the adjustment mechanism. However, if Scotland does change its welfare system, it will become increasingly difficult to calculate what spending on the devolved welfare benefits would have been had they not been redesigned. Simple comparisons of spending patterns between the two systems as described above will become increasingly difficult.

4. **Conclusion**

This paper has tried to illustrate the issues associated with the budget for Scotland's new welfare powers. The arrangement for the indexation of Scotland's welfare budget will be critical in determining how far it will be able to effect significant reform of the welfare system. The precise design of the indexation formula will affect the distribution of risks between the Scottish and UK governments in respect of welfare payments which are, in effect, a form of insurance against adverse circumstances. Welfare payments as a whole, being a significant proportion of overall government spending, are an important component of UK macroeconomic policy and it is not yet clear how far the UK government might wish to influence overall welfare spending in Scotland in relation to its macro objectives such as the welfare cap.

Given that the welfare benefits that are being transferred largely affect older people, Scotland would appear to be at greater risk of increased demand due to its more rapidly ageing population. On the other hand, recent expenditure data suggests that the prevalence of claims has been growing more rapidly in rUK than in Scotland.

There is clearly scope for fine tuning of risk and therefore complexity in the adjustment mechanism. This may not be in the interests of transparency, especially where different risks offset each other and where therefore a relatively crude mechanism might suffice.

Using the most recent projections of welfare spending from the OBR and adopting a simple fixed share rule, suggests that the transfer to the Scottish budget to meet its welfare obligations between now and 2019-20 will be almost fixed. Increased welfare spending would therefore have to be met either by increased taxes or reallocation from other Scottish Government priorities.

The incentives implicit in the block grant adjustment (BGA) to take account of Scotland's new tax raising powers are relatively clear: Scotland will have to grow its tax base faster than that in rUK if it hopes to increase government spending without increasing tax rates. The incentives associated with the transfer of welfare powers are much more complex and involve issues such as population structure and public health.

The more that the Scottish welfare system is redesigned as a result of the new powers, the more difficult it will be to calculate how much would have been spent in Scotland on the newly devolved welfare powers. This will make it more difficult to design an indexation mechanism based on past trends in welfare spending and may instead suggest that the mechanism follow some external indicators relating to issues such as population at risk and prevalence. There should be opportunities for periodic review to account for significant changes in the direction and/or reliability of such indicators.

Finally, given these considerations, it may be worth speculating on the likelihood of extensive redesign of Scottish welfare benefits. Changes may be more modest than expected. While, for example, there is a case that rationalisation of the resources devoted to social care provision by local authorities and disability benefits directed to personal care. This might offer opportunities for savings in welfare spending, but here it would be dangerous to underestimate the endowment effect - the notion that individuals value losses more than gains. If the overall welfare budget in Scotland is relatively static, then the gains for some from improved provision may be more than offset by losses to others.