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ILC-UK Policy Briefing

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The International Longevity Centre – UK (ILC-UK) is an independent, non-partisan think-tank dedicated to addressing issues of longevity, ageing and population change. It develops ideas, undertakes research and creates a forum for debate.

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Overview

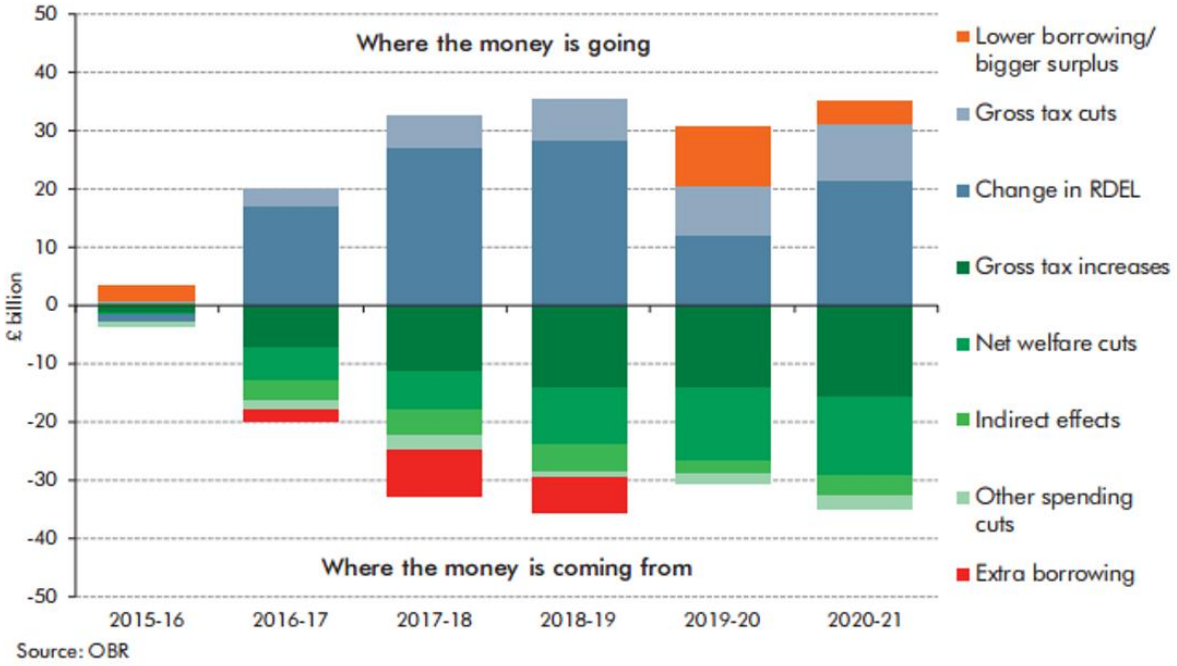
This budget offers some progress but there is still much to do. While many will be fixated on the immediate winners and losers, the long term challenges of low productivity growth, over reliance on private consumption and household debt to drive the recovery, systemic under saving by individuals and continued underfunding of social care remain big concerns. The measures contained within the Budget may help to address some of these issues at the margin, but more is needed to tackle these challenges.

What was announced?

A dramatic reduction and slow-down in the pace of spending cuts.

The Conservative's first Budget as the majority party since 1996 was not without incident or surprise. Ever the political pragmatist, and buoyed by better than expected economic growth figures and taxation revenues in the last year, Chancellor George Osborne dramatically reversed the scale of the planned spending cuts for this Parliament – by £83bn. What's more the remaining fiscal consolidation - a term referring to the efforts made by governments to reduce the yearly public spending deficit - will be centred on tax rises (worth an estimated £47.2 billion), and welfare cuts (of approximately £34.9bn). And rather than the welfare cuts being front loaded in the first two years of the parliament, they will be spread over the duration of the Government's term in office (see below chart).

Figure 1: The impact of Budget policy decisions over the forecast



Make no mistake – this is not the end to austerity. Indeed, with NHS, Education, Defence and Foreign Aid budgets ring-fenced over the next 5 years, this means other departments will have to do the heavy lifting. This is likely to result in more cuts to local government budgets which could lead to further spending pressures on the already underfunded social care sector. But the pace of cuts over the

course of this parliament will not be as fast as they were during 2011-12 and 2012-13 while the remaining fiscal consolidation will also be driven by tax rises. This is, arguably, a more balanced approach to reducing the UK deficit.

Welfare cuts and a new "living wage"

Much of the media frenzy following the Budget has focused on the welfare cuts and the extent to which the new living wage will offset this. Let's have a look at the proposed cuts:

- Working-age benefits will be frozen for four years (saving over £4bn in 2020-21).
- The income threshold beyond which tax credits are withdrawn will be reduced from £6,420 to £3,850; whilst the taper rate at which they are withdrawn will be increased from 41% to 48% (saving over 3.5bn in 2020-21).
- Tax credits will be limited to two children, with larger families receiving no increase beyond that for the second child (saving approximately £1.4bn in 2020-21).

With the Government ring-fencing pensioner benefits and having already made significant changes to out of work benefit in the previous parliament, the government's only option was to cut in work benefits in order to bring the welfare budget down in line with its Manifesto promises. Such a potentially controversial move was partially offset by the announcement of a new living wage for those aged over 25. This will be set at £7.20 per hour from 2016 rising to £9 per hour by 2020.

So will the living wage offset cuts to welfare?

Yes and no. There are likely to be working age winners and losers as a result of the policy. Analysis from Resolution Foundation has shown that the losers will be those who are low earners and who have children. Low earners with no children and those who are mid to high earners are likely to be better off (see table below). For those who are lone parents, working part time with one child the effects are highly significant – £1,000 worse off by 2020.

Table 1: Modelled outcome in 2020, Source: The Resolution Foundation

	Gross household earnings in the baseline	Net household income (after taxes and benefits) in baseline	Net change in household income	Gross household earnings required to offset losses	One-off household earnings rise *(pay & hours in combination)*
	before Budget	*before Budget*	*after Budget*		
Single (no kids), full-time, low earning *works 35 hours a week at NMW*	£15,050	£11,950	+£2,200		
Single (1 child), part-time, low earning *works 20 hours a week at £9.35*	£9,750	£18,550	-£1,000	£3,400	44%
Couple (2 kids), low earning, renters *main earner works 37.5 hours a week, second earner works 16 hours, both earn £9.35, rent £150 a week*	£26,100	£31,450	-£850	£2,700	15%
Couple (3 kids), low earning, renters *main earner works 37.5 hours a week, second earner works 16 hours, both earn NMW, rent £150 a week*	£23,000	£34,350	-£250	£1,650	9%
Couple (2 kids), mid earning *main earner works 37.5 hours a week earning £12 an hour, second earner works 16 hours earning £9.35, no housing costs*	£31,250	£27,750	+£50		
Couple (no kids), mid earning *both work 37.5 hours a week earning £15 an hour*	£58,650	£45,350	+£350		
Couple (no kids), high earning *both work 37.5 hours a week main earner earns £35 an hour, second earner earns £15 an hour*	£97,750	£69,650	+£800		

In short then, the changes to the living wage are not sufficiently large to offset the welfare cuts for those on low pay with children. Either the living wage would need to substantially rise or the extent of the cuts to tax credits would need to be reduced. These cuts are likely to have a disproportionately negative impact on incomes across Northern England whose populations rely more heavily on benefits and tax credits than other regions. In the North East for example, nearly a quarter of household income is from benefits and tax credit. Reducing welfare spending without also addressing the causes of systemic unemployment and low wages across this region could result in a significant rise in poverty for working age people.

Table 2: Percentage of total household income by region, Source: Family Resources Survey

					Percentage of Total Income
	Sources of income				
Region / Country	Employment (inc. Self-Employment)	Benefits and Tax Credits	Private pensions	Other sources	All
North East	64	23	9	3	100
North West	69	18	8	5	100
Yorks and the Humber	70	19	9	3	100
East Midlands	68	17	10	5	100
West Midlands	69	20	8	3	100
East of England	72	14	9	5	100
London	79	12	4	5	100
Inner London	83	10	2	6	100
Outer London	77	14	6	4	100
South East	78	10	8	5	100
South West	66	16	12	6	100
England	72	15	8	5	100
Wales	68	20	9	3	100
Scotland	71	17	8	4	100
Northern Ireland	69	22	7	3	100
Great Britain	72	15	8	5	100
United Kingdom	**72**	**15**	**8**	**5**	**100**
Sample Size					*20,142*

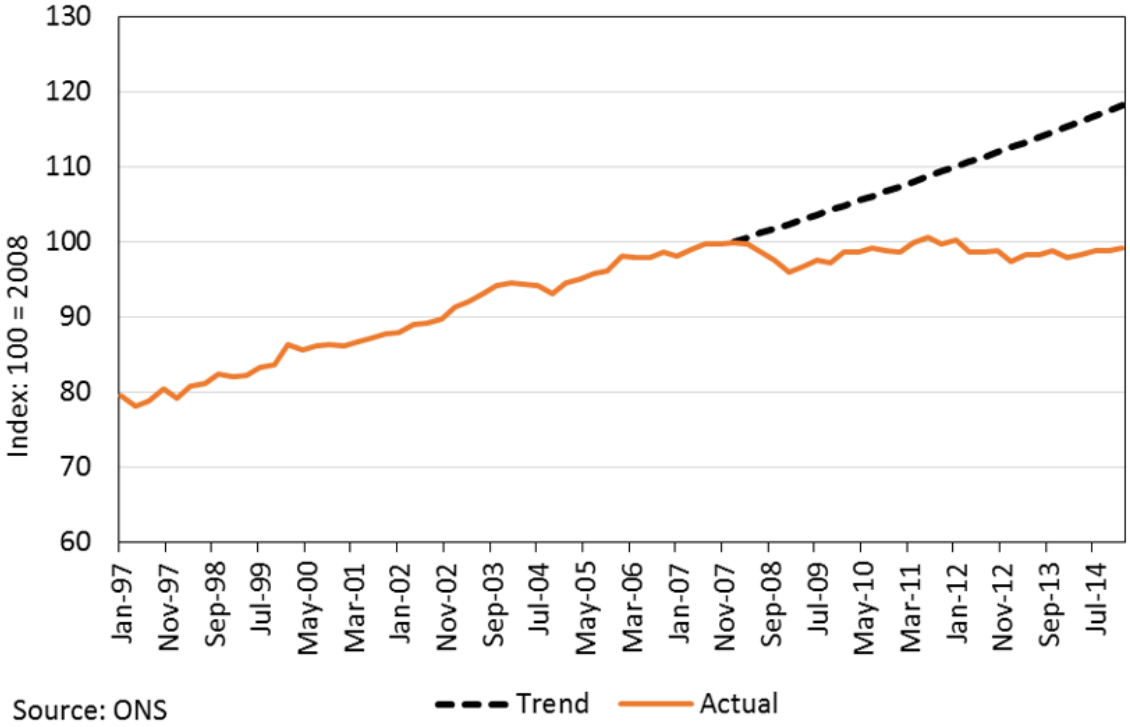
Finally, there are some big unknowns associated with the living wage policy including how it will effect unemployment levels and productivity. The Office for Budget Responsibility – the official independent economic forecaster - thinks that it will result in a small rise in unemployment (+60,000) over the forecast period as companies come to terms with having to pay their staff more. But there is also the potential impact on productivity – if introducing the living wage makes labour more expensive relative to capital, then companies may be more inclined to invest which could help to raise workforce productivity. Clearly however, given that the projected impact on unemployment is relatively small, the impact on productivity is also likely to be negligible.

In summary then, there are clear winners and losers from the government's welfare strategy. Pensioners will remain protected, while those on low incomes with children of working age will suffer from the proposed changes – and this will particularly affect the North of England where there is a higher reliance on income from welfare support. The living wage will only partially offset the welfare cuts to these groups and may result in a small rise in unemployment with negligible impacts on UK productivity.

Addressing the productivity puzzle

The UK faces a significant productivity problem. Despite record numbers of people in work, the amount being produced per hour worked is still no greater than it was before the financial crisis. What's more, if we assume that productivity had continued to grow in line with its long run trend since the crisis, output per hour would be 20% higher than its current level (see chart). This is some stagnation. Indeed, the level of productivity in the UK is second lowest amongst G7 countries[1] and has been for many years, which is often attributed to low levels of investment.

Figure 2: Output per hour (actual and trend)



Given this challenging backdrop it is not surprising that the word "productivity" cropped up many times in the Budget Statement. In order to tackle the endemic problem of productivity and associated issue of underinvestment the Chancellor announced a new roads fund, 3 million more apprenticeships and the end of maintenance grants for university students – replaced by loans for new students to generate more funding for the university sector. In addition, the government is lowering Corporation Tax to 18%, and increasing the annual investment allowance (capital allowances on investments used in business) to £200,000.

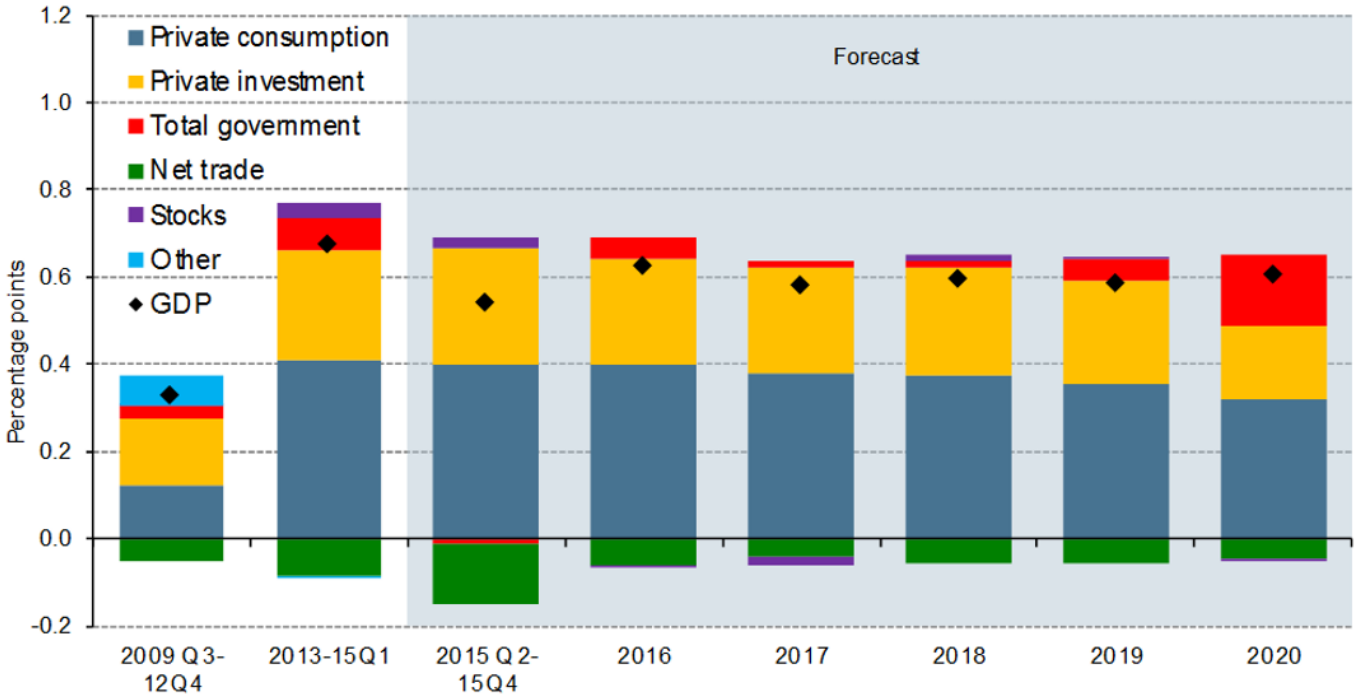
Will these measures shift the UK onto a more productive footing and support broad-based economic growth?

Despite the proposed changes, the OBR has actually revised down its expectations for productivity growth over the next five years. Productivity growth is expected to be lower than previously thought. In the OBR's words, "the underlying trend rate of growth picks up slowly over the forecast, as productivity growth slowly returns to historically normal rates".

[1] http://visual.ons.gov.uk/productivity-puzzle/

With regard to the specific policies to raise business investment contained within the Budget, the OBR does anticipate some degree of success – “the net effect of these measures is to increase the level of business investment by around 0.6 per cent by the end of the forecast period”. But make no mistake – our economic recovery will continue to hinge on rising household consumption (see chart) supported by some business investment and some government spending towards the end of the forecast period. Exports will continue to disappoint.

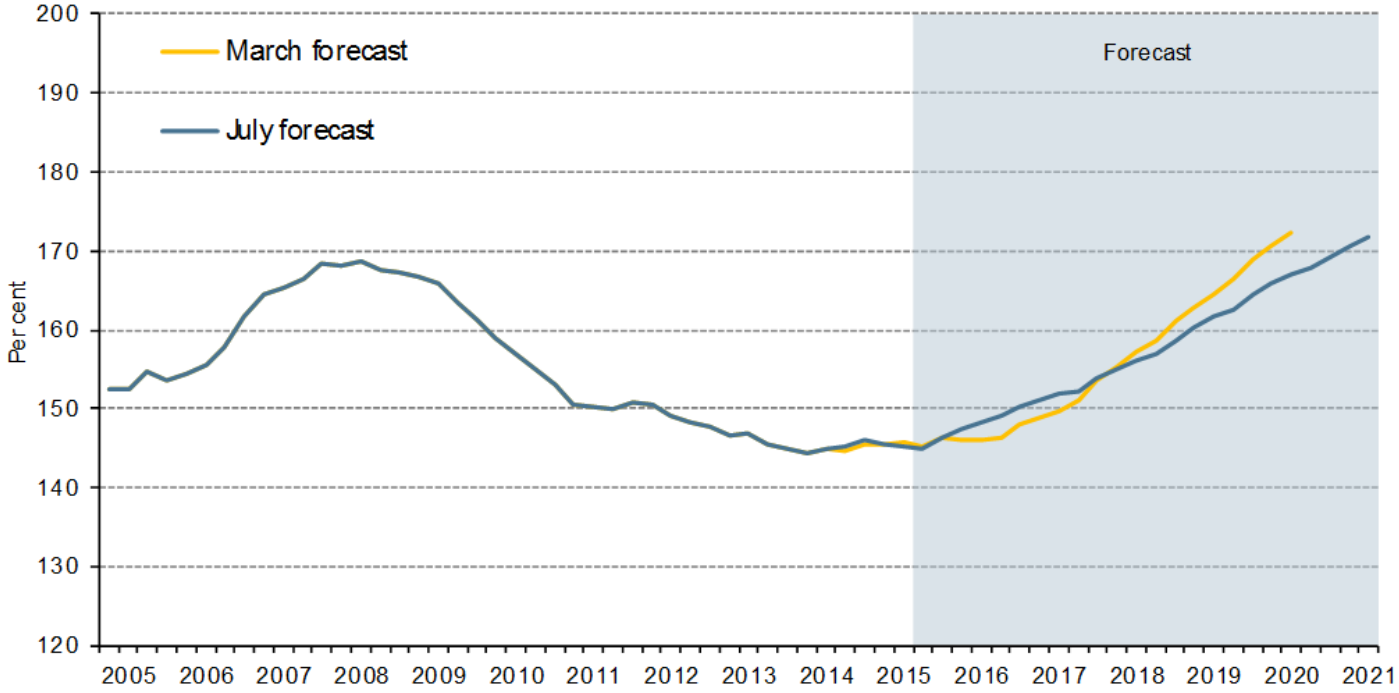
Figure 3: Changes in the components of GDP growth



Note: ‘Other category includes the statistical discrepancy and the residual between GDP and the expenditure components prior to the base year (2011)
Source: ONS and OBR

The OBR predicts that rising debts as a proportion of household income will fuel consumption over the period, but as a result of stricter regulations on mortgage lending introduced in the wake of the financial crisis, debts are not expected to rise as quickly as they once were. The savings ratio is also expected to fall, but again not quite as dramatically as previous forecasts have implied. Nevertheless, household leverage is still expected to return to levels last seen just before the financial crash by the end of the forecast period (see chart). The sustainability of household finances therefore remains a key concern, especially if we see interest rate rises over the coming years as the recovery continues to gain momentum.

Figure 4: Debt to income ratio



Source: ONS and OBR

Why do we care so much about productivity?

Productivity growth is everything. Not only is it necessary for a full and sustainable economic recovery, but it's also key to getting our national debt down. The OBR estimates that the Government would miss all of its spending targets under a "history repeats itself" scenario where productivity growth is just 0.4% per annum. In this situation, Government debt as a proportion of GDP would still be 77% by the end of this parliament (it's currently around 80%) by comparison to 68.5% in the OBR's central scenario where productivity growth rises to 2% per annum. **In other words, despite deep cuts to the welfare budget and tax rises over the course of this parliament, unless productivity growth rises towards its historical trend, we will make little progress in reducing our national debt burden. For this reason, the Government's Productivity Plan which is being published on Friday, must set out bold measures to help shift our economy towards a high productivity future.**

Pensions and saving

Trailing in the wake of the announcements around freedom and choice in pensions in last year's Budget, the Treasury has published a Green paper into the future of pensions including tax relief and whether pensions should be treated like ISA accounts. While details are sketchy, this could mean that individuals would pay in income they'd already paid income tax on, and then they would be able to take it out tax-free, along with any growth in savings they'd accrued at various points over their lifetime. The Green paper also looks at tax relief and whether reforms are needed in order to make it a more explicit incentive to save.

Whatever set of reforms are ultimately delivered, the critical tests must be 1) whether they will increase the aggregate amount saved and 2) whether they will deliver incomes in retirement. Future proposals must consider both elements for it is no use having a large pool of savings only to spend it all ahead of retirement – at which point no further income through employment can be gained. On the other hand, if it can be shown that a lack of flexibility in pensions acts as a disincentive to save, then there is a real case for building some form of flexibility into pension savings vehicles. What this trade-off might ultimately entail requires careful and detailed research into peoples' behaviours and biases.

What is certain however, is that tax relief needs an overhaul. It is an incentive to save that is poorly understood. The final settlement must be one that is simple to understand and provides real benefits for pension saving across all income quintiles. In our view the "Buy 2 Get 1 Free"[2] approach is a good start. This means for every £2 an individual saves the Government would contribute £1. As Aviva have argued, matched contributions like this have been shown to encourage higher savings elsewhere - for example employer contributions are seen as a key incentive to save. Rebranding tax relief as the "Government contribution to pension saving" may also be helpful in this regard.

Somewhat ironically, the changes to tax relief that were announced in this Budget – the so called taper to the annual allowance for pensions tax relief for those with total income over £150,000 - is in the words of one previous Minister, "ludicrously complicated"[3]. The annual allowance for tax-relieved pension contributions is currently £40,000. From April 2016 onwards, those earning £150,000 will have their annual allowance tapered away down to a minimum of £10,000. The Government expects this measure to bring in over £1.2bn in 2020-21 – more than paying for their cuts to inheritance tax on homes worth up £1m.

[2] http://blog.ilcuk.org.uk/2015/07/01/how-to-incentivise-pension-saving/

[3] http://citywire.co.uk/new-model-adviser/news/webb-attacks-gov-t-pension-tax-relief-simplicity-claim/a825533#i=1

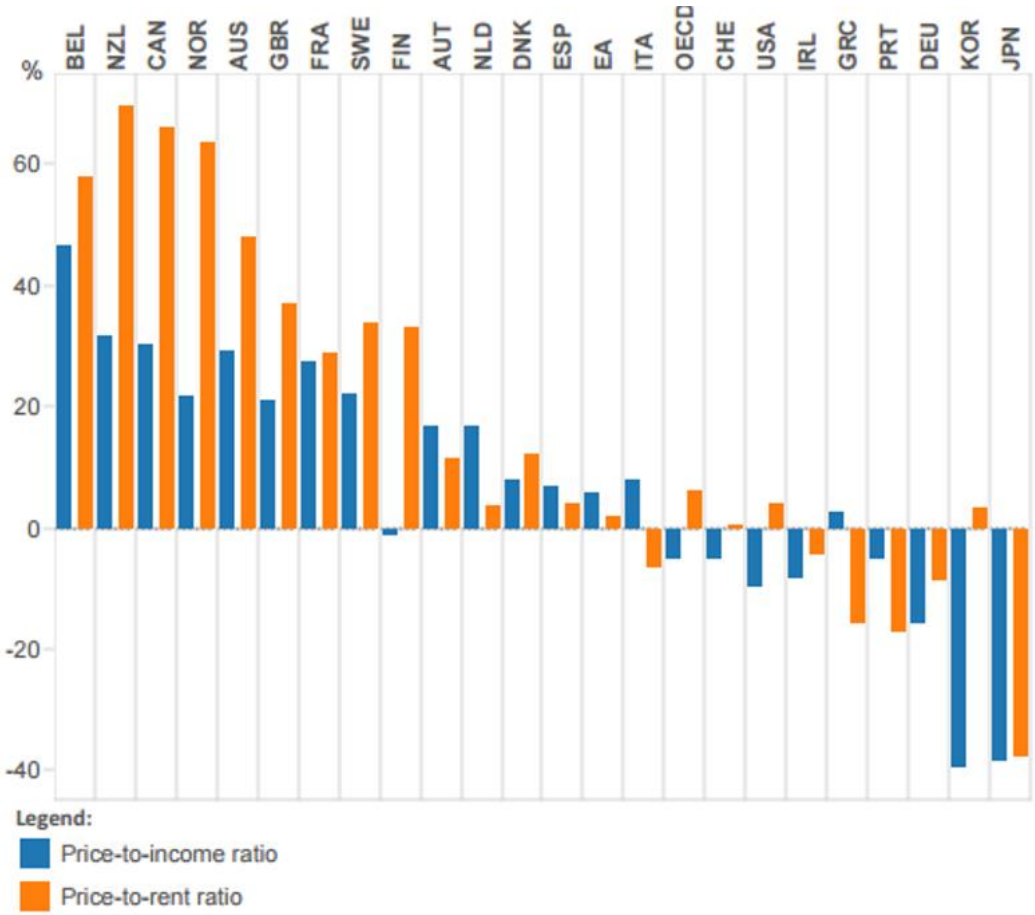
Housing

The Government announced a number of policies which are likely to affect the housing market over the coming years.

- The government will reduce rents paid by tenants in social housing in England by 1% a year for 4 years from 2016.
- Taking the home out of inheritance tax altogether for those with homes worth up to £1m.
- A review of the use of lifetime tenancies in social housing to limit their use and ensure that households are offered tenancies that match their needs and make best use of the social housing stock.
- Social housing tenants with household incomes of £40,000 and above in London, and £30,000 and above in the rest of England, will be required to “Pay to Stay”, by paying a market or near market rent for their accommodation.

A massive social policy challenge facing the UK is undersupply of housing relative to demand. This helps to stoke of prices and make housing costs – both for those who are buying and for those who are renting – unaffordable. Relative to other advanced economies, UK house prices are both overvalued and rising at a fast rate (see chart). Yet the measures contained within Budget are more likely to continue to stoke up price pressures by raising demand and limiting supply.

Figure 5: House Prices across the OECD - Percentage over or under valuation relative to long run averages



Note: Countries are ranked by the average of the two indicators, from highest to lowest.
Source: OECD, Housing Prices database; and OECD Economic Outlook database.

The reduction in rents paid by tenants in social housing is likely to reduce the incomes of housing associations and the OBR forecast that this will reduce the level of private residential investment by 0.7 per cent. As a result the OBR project that 14,000 fewer affordable homes will be built in the period up to 2020-21.

While the Government are set to outline their strategy for increasing housebuilding shortly, the loss of 14,000 affordable homes cannot be ignored given that previous ILC-UK forecasts show that we need to be building at least 200,000 new homes a year[4]. Indeed, without local authorities or housing associations building new homes, the onus will lie firmly with the private sector to pick up the slack – something it has failed to do over the last decade. While the challenge of supplying new homes just got tougher, demand for homes will actually increase as a result of the Budget proposals. The OBR acknowledges that 'changes to the inheritance tax regime could make it more likely that the co-existence of under-occupation among older owners and over-crowding among younger renters will become even more prevalent'[5]. This is because the tax changes will make it more economically efficient to invest in larger homes and stay there rather than downsize and live off the proceeds.

For younger generations, this is likely to make getting onto the housing ladder harder and the cost of renting more expensive. And if they get on the housing ladder they are likely to be at greater risk of house price corrections – due to increased borrowing costs or falling incomes.

For older people, there is an increased risk of becoming asset rich and income poor in retirement – which is already a typically British disease.

Unseen and unheard: adult social care

One area which got no mention in yesterday's budget was the adult social care sector – a sector which is already in crisis.

What is the care crisis?

Despite increasing numbers of older people, the numbers receiving formal care has actually been falling – a direct result of funding pressures on the sector. According to analysis from Age UK[6], between 2005/6 and 2012/13 the number of people aged 65 and over in receipt of social care services dropped by more than 27 per cent - from 1,231,000 to 896,000 - even though this age group has grown by more than one million over the same period. This is because, despite demand rising, the amount spent on social care services for older people has fallen nationally. Partly as a result of underfunding, almost 900,000 older people have unmet care needs. Nearly a third of people who have difficulty in carrying out some essential activities of daily life do not receive any help formally from care workers or informally from family, friends or neighbours. These everyday tasks include but are not limited to getting out of bed, washing, using the toilet or eating. Over the medium to long term, some of these problems can be solved by increased investment in new homes and adaptations to existing homes that better cater for those with chronic illness and disability. But in the short term, many of these individuals will need daily support from a care worker.

[4] http://blog.ilcuk.org.uk/2014/07/03/new-homes-needed-at-fastest-rate-since-the-1970s-to-meet-population-growth/
[5] http://cdn.budgetresponsibility.independent.gov.uk/July-2015-EFO-234224.pdf
[6] http://www.ageuk.org.uk/latest-press/archive/older-people-care-needs-not-getting-help/

What does the future hold?

As noted by Association of Directors of Adult Social Services (ADASS) in England, while health spending increased from £97.5 billion in 2010-11 to £116.4 billion in 2015-16, an increase of 19.3%, social care funding has decreased from £14.9 billion to £13.3 billion, a reduction of 10.7 per cent[7] - and more in real terms when the ageing population is taken into account. The big question is not whether there will be more funding cuts to social care but how big they will be given the ring fencing of other government departments.

So while many may consider this to have been the Budget where older people benefitted because their benefits were not cut when working age benefits were, underfunding of the care sector poses a grave threat to the quality of life for a great many older people. Having some assets or income in retirement is one thing, but it doesn't mean that they will not face an uncertain future whereby they have serious support needs and few options for formal support. And, with many care homes struggling to pay the National Minimum wage and stay afloat, the new living wage may actually make the current situation even more unsustainable for private providers. Ultimately the funding pressures on the care sector will result in more older people falling back on family and friends reducing overall economic activity, falling back on the NHS diminishing its ability to find efficiency savings and rising levels of unmet need, reducing quality of life and dignity for older people.

Final remarks

So some progress but much still to do. The challenge of population ageing will need a concerted effort over many years and innovative policy initiatives. Yesterday's Budget set the tone for this parliament, but more radical thinking is needed to face up to the big questions facing us. To read more on the ILC-UK views about how to address population ageing and the associated challenge of later life funding please visit our website – www.ilcuk.org.uk

[7] http://www.adass.org.uk/uploadedFiles/adass_content/blogs/presidents_blogs/2015-

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