HM TREASURY DWP Department for Work and Pensions HM Revenue & Customs

Spending Review 2010 policy costings

October 2010

HM TREASURY DWP Department for Work and Pensions HM Revenue & Customs

Spending Review 2010 policy costings

October 2010

Official versions of this document are printed on 100% recycled paper. When you have finished with it please recycle it again.

If using an electronic version of the document, please consider the environment and only print the pages which you need and recycle them when you have finished.

ISBN 978-1-84532-726-2
PU934

Contents

1 Introduction

Introduction

1.1 This document sets out detail on the assumptions and methodologies underlying costings for Annually Managed Expenditure (AME) policies announced at Spending Review 2010. This provides similar information on policy costings as the Budget 2010 document '*Budget 2010 policy costings*' and reflects the Government's commitment to increase transparency in the public finances. This follows the establishment of the Office for Budget Responsibility (OBR), which provides independent forecasts of the public finances and the economy to inform fiscal policy decisions. These changes are part of the Government's wider commitment to increased transparency in public life.

1.2 Chapter 1 briefly explains the methodology and general principles for calculating the cost or yield of policy decisions. Chapter 1 of *'Budget 2010 policy costings'* sets this out in greater detail. Chapter 2 includes detailed information on the key assumptions applied in all major policy costings in the Spending Review that affect the AME forecast. Chapter 3, by the OBR, sets out the approach the OBR has taken to scrutiny and certification of the costings, and highlights areas of particular uncertainty.

Policy costing methodology

1.3 The Spending Review AME policy decisions with a fiscal impact are summarised in the Spending Review 2010 scorecard. This shows estimates of the cost or yield of each policy decision for the years 2011-12 to 2014-15. The direct impact of policy decisions on the AME forecast is shown for all years.

1.4 Policy costings are produced by a number of different departments, based on the best available data. The Department for Work and Pensions (DWP) produce most benefit costings; HM Revenue and Customs (HMRC) produce tax credit and Child Benefit costings, and Department of Energy and Climate Change (DECC) produce environmental levy costings. HM Treasury oversee the costings as part of the Spending Review process.

1.5 All economic determinants and underlying assumptions in the Spending Review 2010 policy costings are based on the latest OBR forecast published alongside Budget 2010 in June. The OBR will incorporate all AME measures announced at the Spending Review in its next forecast. They have also scrutinised and certified the Government's assessment of the direct cost or yield of AME policy decisions. These costings may change once they take account of the updated economy and fiscal forecast.

1.6 Where the costing of one policy change is affected by the implementation of others, the measures are costed in the order in which they appear in the Spending Review 2010 scorecard. So for example, a change in the eligibility rules for the Working Tax Credit is costed against freezing the basic element and the 30 hour element of the Working Tax Credit announced in Spending Review 2010.

1.7 All costings are shown on a UK basis. Social security is devolved in Northern Ireland, so costings for social security measures are calculated on an England, Scotland and Wales basis and then adjusted to include equivalent cover for Northern Ireland. This is done by scaling the England, Scotland and Wales costing by 3.3 per cent, which is the average spend on social security in Northern Island over the past five years compared with similar spend in England, Scotland and Wales.

Behavioural effects

1.8 The policy costings take account of direct behavioural effects on the base that the policy applies to or closely related bases. They do not include indirect behavioural effects on employment, wages and salaries or general consumption, for example. Any indirect effects will be incorporated in the OBR's next forecast.

1.9 Direct behavioural effects describe the way in which individuals and businesses change their actions as a result of a policy change. In the case of benefits, changes in the rates or conditions may alter the take-up levels. Direct behavioural effects not only have an impact on the revenues from the benefit base the policy is applied to, but also revenues and expenditure from close substitutes or complements.

1.10 Benefits in the social security system interact both with each other and with the tax credits system administered by HMRC. These interactions can be substantial and need to be allowed for in any social security policy costing. For example a change in Basic State Pension can lead to an offsetting change in Pension Credit entitlement and both can subsequently have an impact on entitlements to Housing Benefit and Council Tax Benefit.

1.11 There are different levels of uncertainty with different assumptions around the size of direct behavioural effects or the determination of the tax base. Where possible, research evidence from academics or external bodies is available and used to inform judgement about the size of these behavioural effects. Any significant uncertainties are highlighted in Chapter 2. In addition, there may be other behavioural effects the scale of which it is not possible to estimate.

Impact on tax receipts

1.12 The costings shown in the Spending Review 2010 scorecard only show the direct effects on Annually Managed Expenditure and do not take account of direct effects on receipts. The direct effects on receipts are shown in this document for transparency, and amount to around £250 million in higher receipts, which will be taken on in the next forecast.

2 Policy costings: AME policy decisions

This chapter includes short notes explaining the calculation of the policy costings for AME policy decisions in the Spending Review 2010 scorecard. The public finances baseline for these costings assumes allowances, thresholds and specific benefit rates will be increased in line with relevant price indices, or any pre-commitments (policies announced in previous Budgets).

The following policy decisions are included in this chapter:

- Time-limit contributory Employment and Support Allowance for those in the Work Related Activity Group from 2012-13;
- Housing Benefit: extending the shared room rate to single claimants under 35 years old from 2012-13;
- Household cap on total benefit income from 2013-14;
- Removal of Disability Living Allowance (DLA) Mobility Component from Care Home Residents from October 2012;
- Savings Credit uprating from 2011-12;
- Increase Cold Weather Payments (CWP) to £25 in 2011-12;
- Support for Mortgage Interest (SMI): extending temporary rule changes from January 2011;
- Withdrawal of Child Benefit from higher rate taxpayer families from January 2013;
- Changes to the Child and Working tax credits from 2011-12;
- Using real time PAYE information to inform tax credits calculations;
- Increasing public service pension contributions from 2012-13;
- Changes to Renewable Heat Incentive (RHI) from 2011-12;
- No revenue recycling in the Carbon Reduction Commitment Energy Efficiency Scheme from 2011-12;
- Reform of council housing finance from 2011-12; and
- Increasing Public Works Loan Board (PWLB) interest rates from October 2010.

Time-limit contributory Employment and Support Allowance for those in the Work Related Activity Group from 2012-13

Measure description

This measure places a time limit on contributory Employment and Support Allowance (ESA) for those in the Work Related Activity Group (WRAG) to one year – commencing in April 2012:

- for existing contributory ESA customers, the time limit will apply at the point they reach one year including the assessment phase. Those with a claim duration of one year or more when legislation comes into effect will have their benefit time-limited immediately and will have at least 12 months to prepare for the change;
- those on Incapacity Benefit (IB) who migrate to the WRAG in ESA will be limited to one year entitlement following reassessment. For those reassessed first this will take effect from 2012-13;
- all new claims will be subject to the 13 week assessment phase, those in the WRAG will be time limited to one year contributory ESA which will include the assessment phase. This will start to take effect from 2013-14; and
- after the one year period, customers will be able to receive income-related ESA if they fulfil the conditions of entitlement, otherwise they will either claim another benefit or move off benefits.

Those in the ESA Support Group are exempt from this policy on the basis that they are the most severely ill or disabled.

The cost base

The steady state costing is calculated using DWP’s Policy Simulation Model (PSM) which is a static micro-simulation model used to assess changes to tax and benefit policy at the micro-level.

The underlying data source is the Family Resources Survey (FRS).

Static costing

The static costing is calculated using the steady state estimates. Steady state is assumed to be reached in 2016-17, when IB reassessment has been completed.

Savings prior to this are calculated on a pro-rata basis using the trend from a simple administrative savings data time-limiting model, which models the phased impact on the IB caseload as IB cases undergo reassessment.

This is then compared with the baseline estimate of the cost of continuing current policy. Savings are adjusted for inflation on the basis of CPI.

Table 1 – Exchequer impact (£m)

	2011-12	2012-13	2013-14	2014-15
AME	0	+1,025	+1,530	+2,010
Negative tax[1]	*0*	*-20*	*-30*	*-40*

Areas of uncertainty

There are a number of uncertainties around the assumptions and methodology used for this costing:

- The costing uses assumptions about the proportions of existing customers that will be assessed to be in the WRAG that are consistent with the OBR's June Budget ESA forecast. They are based on a range of analysis conducted for the IB reassessment programme, although they will remain uncertain until the results of the IB reassessment trial become available in January 2011.
- Some customers may be able to claim contributory Jobseeker's Allowance if they are able to comply with the work search requirements. It is difficult to quantify the number of people that will be in this category but given the particular circumstances required to qualify, the numbers are expected to be fairly small.
- It is likely that the change to the policy will increase the numbers appealing the decision to be in the WRAG rather than the Support Group.
- Customers may reduce their other income and/or capital so that they qualify for income-related ESA when their contributory benefit ends.

These behavioural impacts have not been modelled due to the uncertainty over their propensity to occur.

[1] The costings shown in the Spending Review 2010 scorecard only show the direct effects on Annually Managed Expenditure and do not take account of direct effects on receipts. The impacts on negative tax are shown here for transparency about the total impacts of the measure. Any implications for receipts will be taken on in the next forecast.

Housing Benefit: extending the shared room rate to single claimants under 35 years old from 2012-13

Measure description

The shared room rate (SRR) applies to single people aged under 25 years old living in the private rented sector who receive Housing Benefit under the Local Housing Allowance rules. The SRR restricts the maximum Housing Benefit they can receive to the rate for a single room in a shared house, rather than a self-contained one-bedroom property. This measure increases the age limit of the SRR to cover all single people aged under 35 years old.

This change will apply to new claimants from April 2012 and to existing customers on the next review after April 2012.

The cost base

Consistent with the OBR June Budget forecast, the costing uses the April 2009 snapshot of Housing Benefit recipients derived from the 100 per cent Single Housing Benefit Extract.

The Single Housing Benefit Extract, a 100 per cent monthly dataset of Housing Benefit recipients, is based on local authorities' administrative data which enables an assessment of the rent levels of Housing Benefit customers.

Static costing

Current 1-bedroom and shared room Local Housing Allowance rates were calculated and combined with the Single Housing Benefit Extract to see how average entitlement changes. This depends on how quickly the full private sector caseload migrates on to the LHA scheme; the proportion of LHA claimants that see a reduction; and how the overall private rented sector caseload changes. For these purposes, the modelling assumes the same estimates as used for overall HB forecasting.

The savings trajectory was derived from the June 2010 Budget private rented sector Housing Benefit caseload forecasts, adjusted to account for the disproportionately high number of Jobseeker's Allowance cases (50 per cent) in the affected population (compared with around 20 per cent in the entire LHA caseload).

Table 1 – Static exchequer impact (£m)

	2011-12	2012-13	2013-14	2014-15
AME	0	+135	+235	+225

Post-behavioural costing

This static costing assumes that the family composition of the Housing Benefit caseload would remain as it is currently. There may be a small impact on household composition from this measure, which is assumed to reduce savings by £5 to £10 million per annum.

Table 2 – Post-behavioural exchequer impact (£m)

	2011-12	2012-13	2013-14	2014-15
AME	0	+130	+225	+215

Areas of uncertainty

The area of uncertainty in this costing relates to the behavioural response of existing recipients.

Household cap on total benefit income from 2013-14

Measure description

This measure introduces a cap on the overall level of benefit a household can receive. In some cases households contain more than one benefit unit. In these cases the cap has been calculated at benefit unit level. The methodology sets the cap on the basis of median earnings after tax for working households, which is estimated to be around £500 per week for couples and lone parents and at around £350 for singles. Households with a recipient of DLA or a War Widows Pension are exempt from the cap. One off payments are excluded, as are non-cash benefits. The cap is only applied to workless working-age households.

The cost base

The costing model uses DWP's Policy Simulation Model (PSM), which is a static microsimulation model based on data from the 2008-09 Family Resources Survey, uprated to the relevant year's prices, benefit rates and earnings levels.

Static costing

Households total benefit income is calculated, and where applicable capped at the appropriate level based on the new policy.

Households were excluded from the estimation if they contained a pensioner, were not receiving out-of-work benefits or qualified for Working Tax Credits. Benefits in the cap include means-tested, contributory and universal benefits, Child Benefit and Child Tax Credit.

Using Housing Benefit administrative data, very similar costings were generated to those produced by the PSM.

This costing assumes no behavioural effects.

Table 1 – Exchequer impact (£m)

	2011-12	2012-13	2013-14	2014-15
AME	0	0	+225	+270

Areas of uncertainty

There are no significant areas of uncertainty in this costing.

Removal of Disability Living Allowance (DLA) Mobility Component from Care Home Residents from October 2012

Measure description

DLA care and mobility components are generally not paid when a claimant is admitted to a hospital or similar institution after a prescribed number of days. The claimant retains an underlying entitlement to DLA during their stay and payments can resume from the date they are discharged. This rule is applied to ensure that payment is not made twice from public funds to meet the same need. At present when a person is admitted to a residential care home funded by a public body only the care component is withdrawn and any mobility component remains in payment.

The proposed policy is to stop payment of the mobility component after 28 days (84 days for a child) resident in a care home funded by a public body. This would include those in the Motability scheme in both care homes and hospitals. Those who fully self-fund their own care would be unaffected by the change.

The cost base

The cost base includes those DLA recipients identified on the administrative data as currently in a care home. Quarterly updates on the DLA caseload have shown that this group is growing but at a decreasing rate each year.

Static costing

The AME savings were estimated by calculating the annual total of mobility component expenditure for the care home group. The caseload receives an average mobility award of £33.40. A caseload growth assumption of 3.5 per cent per year is based on the administrative data.

Also included in the savings are those in hospital who receive higher rate mobility under the Motability exemption (£4 million per year). The latest CPI forecasts have been used to uprate the average amount of mobility.

No behavioural effects have been identified.

Table 1 – Exchequer impact (£m)

	2011-12	2012-13	2013-14	2014-15
AME	0	+60	+130	+135

Areas of uncertainty

No significant uncertainties in this costing. The size of the care home group identified is increasing over time but the growth rate is decreasing and appears to have levelled off. The data collected on admission dates, discharge dates and establishments is self-reported by customers.

Savings Credit uprating from 2011-12

Measure description

Savings Credit is available to individuals with some income above the savings credit threshold (in 2010-11 the savings credit threshold is £98.40 for individuals, £157.25 for couples).

This measure freezes the maximum Savings Credit award in cash terms from April 2011 to April 2014 inclusive.

Housing Benefit and Council Tax Benefit personal allowances for those aged 65 or over are adjusted accordingly.

The cost base

Forecasts of Pension Credit, Housing Benefit and Council Tax Benefit are consistent with the OBR's June Budget 2010 forecast.

Static costing

The costing for this measure can be broken into two steps: calculation of the savings from Pension Credit; and the 'knock-on' savings from Housing Benefit and Council Tax Benefit.

Pension Credit entitlement is calculated for each year under the base and reform scenarios. From this the 'typical' change in each recipient's Savings Credit as a result of the measure can be calculated. This is multiplied by the caseload to obtain an estimate of Pension Credit savings, and an adjustment is then made for those people receiving less than the typical amount.

The personal allowances for Housing Benefit and Council Tax Benefit for those 65 and over are higher than for those under 65 by an amount related to the maximum Savings Credit award and so will be adjusted accordingly. The Housing Benefit and Council Tax Benefit impact is calculated in the same way as the Pension Credit costing.

Post-behavioural costing

The costing assumes no change in take-up of Pension Credit, Housing Benefit and Council Tax Benefit. Those already receiving Pension Credit are expected to continue receiving it. Those who would move onto Pension Credit (with Savings Credit) could theoretically choose not to take it up as a result of the reduction in their benefit entitlement. However, it seems likely that there would be very few such cases given the impact on Savings Credit awards and that less than 5 per cent of the caseload flow onto Pension Credit (with Savings Credit) every year.

The costing does not assume any change in the work or savings behaviour of those who receive Pension Credit.

Table 1 – Exchequer impact (£m)

	2011-12	2012-13	2013-14	2014-15
AME	+165	+215	+260	+330

Areas of uncertainty

The major area of uncertainty in this costing is around the economic assumptions for earnings growth over the period.

Increase Cold Weather Payments (CWP) to £25 in 2011-12

Measure description

CWP are paid to people on certain benefits when the average temperature falls or is forecast to fall below a certain level for 7 consecutive days.

This measure is to permanently increase the value of the CWP award from £8.50 to £25 in 2011-12.

The cost base

DWP currently forecast CWP as £26 million of AME spend every year, as an average of CWP spend over the past 10 years, though there was significant fluctuation during that period. This uses a rate of £8.50 per week of cold weather. It is based on the average number of payments made.

Static costing

Increasing the value of the award is forecast to cost an additional £50 million a year. Actual outturn will depend on the weather.

The costings are based on the Social Fund White Paper Account CWP expenditure for 2009-10 (provisional) and 2007-08.

This costing assumes no significant behavioural effects.

Table 1 – Exchequer impact (£m)

	2011-12	2012-13	2013-14	2014-15
AME	-50	-50	-50	-50

Areas of uncertainty

The realised cost is dependent on the severity and geographic spread of cold weather.

Support for Mortgage Interest (SMI): extending temporary rule changes from January 2011

Measure description

Help towards homeowners' mortgage costs is available through the housing costs rules (known as SMI) for customers in receipt of certain income-related benefits. This covers eligible interest on loans (up to prescribed capital limits) taken out to purchase a home and on certain home improvement loans. From 5 January 2009, changes to the rules for working age claimants were introduced on a temporary basis:

- The period from the date of the claim to the first SMI payment (known as the waiting period) was reduced from 39 or 26 weeks to 13 weeks;
- The limit on mortgage capital eligible for support was increased from £100,000 to £200,000; and
- A two-year time limit on receipt of SMI was introduced for those claiming through income-based Jobseeker's Allowance (JSA).

This measure will extend these temporary changes for a further twelve months from 5 January 2011 to 4 January 2012.

The cost base

The costing is based on JSA projections from the social security forecast included in the OBR's June Budget forecast, as well as drawing on the following data sources:

- The Work and Pensions Longitudinal Study (WPLS) for benefit survival rates; and
- The DWP Quarterly Statistical Enquiry (QSE) for average weekly SMI awards, and data on customers with mortgage capital in excess of £100,000.

Static costing

The value of the average weekly SMI award was estimated by applying the interest rate forecasts to historical SMI awards data from the QSE.

The cost of the reduced waiting period was calculated by applying the estimated average weekly SMI award to the estimated number of people receiving additional awards as a result of the reduced waiting period. This is estimated to cost £60 million in 2011-12 and £20 million in 2012-13.

The cost of the increased capital limit was calculated by applying the interest rate payable to the average eligible mortgage capital in excess of the previous £100,000 limit, multiplied by the number of claimants receiving additional awards as a result of the increased capital limit. This is estimated to cost £20 million in 2011-12.

The savings from the two year time limit were calculated by applying the estimate of the percentage of people affected to JSA/SMI expenditure forecast for the year. This is estimated to save £10 million in 2011-12.

No behavioural effects have been included in this costing.

Table 1 – Exchequer impact (£m)

	2011-12	2012-13	2013-14	2014-15
AME	-70	-20	0	0

Areas of uncertainty

There are no significant areas of uncertainty in this costing.

Withdrawal of Child Benefit from higher rate taxpayer families from January 2013

Measure description

This measure withdraws Child Benefit from families where there is at least one adult with an income above the higher rate threshold from January 2013.

The cost base

The cost base for this measure is estimated using the Inter-Governmental Tax and Benefit Model (IGOTM). This is a model of individual households and their incomes, taxes and benefits, based on data from the Family Resources Survey 2007-08. It is used for this costing because it combines estimates of the tax status of individuals with information on whether Child Benefit is being received within their family units.

Static costing

The static Exchequer impact is calculated by applying the pre- and post-Spending Review Child Benefit systems to the base data described above.

The maximum Exchequer savings are calculated by multiplying the numbers of children described above by £1,060 or £700 per year, depending on whether the first or subsequent child rate is being claimed for each child.

The costing allows for the possibility that a small number of families will not be correctly identified and reduces savings by £90 million for the first full year.

Post-behavioural costing

The costing includes assumptions for two behavioural responses: for the first full year 2013-14 these have an effect of approximately £280 million per year to allow for possible tax planning and approximately £60 million per year for possible non-compliance that may not be detected by compliance checks that apply.

Table 1 – Post-behavioural Exchequer impact (£m)

	2011-12	2012-13	2013-14	2014-15
AME	0	+590	+2,420	+2,500

Areas of uncertainty

Areas of uncertainty within these costings include:

- IGOTM estimates of policy costs are survey-based and generally assume full take-up of income-related benefits and tax credits; the survey data may not always be fully representative of actual populations eligible for particular benefits and, for some benefits, take-up is significantly lower than 100 per cent.
- The costing assumes that savings recovered through the tax system will be classified in the National Accounts as negative Annually Managed Expenditure (AME) rather than tax receipts and that savings will be attributed back to the year in which Child Benefit was originally paid rather than to the year in which savings are recovered. This assumption is based on initial consultation with the Office for National Statistics, but a formal decision on classification is yet to be made.
- The size of the behavioural effects are subject to significant uncertainty.

Changes to the Child and Working tax credits from 2011-12

Measure description

This package makes the following changes to the Child and Working tax credits from 2011-12 onwards:

- freeze the basic element and the 30 hour element of the Working Tax Credit for three years from 2011-12;
- reduce the percentage of childcare costs that parents can claim through the childcare element of the Working Tax Credit from 80 percent to its previous 70 percent level from 2011-12;
- increase the child element of the Child Tax Credit by an additional £30 above indexation in 2011-12 and by a further £50 above indexation in 2012-13; and
- change the eligibility rules so that couples with children must work 24 hours between them, with one partner working at least 16 hours a week in order to qualify for the Working Tax Credit from 2012-13.

The impact of each measure has been estimated by modelling it in the order in which it is presented above.

The cost base

For these changes, the base affected can be taken directly from the OBR's June 2010 tax credits forecast. In 2011-12, the value of total awards was projected to be £30.8 billion.

Static costing

The static Exchequer impact is calculated by applying the pre- and post-Spending Review tax credit systems to the base data described above.

Post-behavioural costing

An adjustment is included in the costing of £50 million per year for the possibility that some parents change their childcare to informal care.

No other behavioural effects are included in the costings.

The policy costings do not include indirect behavioural effects, which if judged to be significant will be captured in the OBR's Autumn 2010 economic forecast.

Table 1 – Post-behavioural Exchequer impact (£m)

		2011-12	2012-13	2013-14	2014-15
Freeze the basic element and the 30 hour element of the Working Tax Credit for three years from 2011-12	AME	+195	+415	+575	+625
	Negative tax[2]	*+65*	*+140*	*+185*	*+195*
Reduce the percentage of childcare costs paid through the Working Tax Credit from 80 per cent to 70 per cent from 2011-12	AME	+270	+320	+350	+385
	Negative tax	*+100*	*+110*	*+115*	*+115*
Increase the child element of Child Tax Credits by £30 above indexation in 2011-12 and by a further £50 above indexation in 2012-13	AME	-190	-510	-545	-560
	Negative tax	*-45*	*-125*	*-120*	*-120*
Restrict eligibility to the Working Tax Credit to 24 hours for couples with children from 2012-13	AME	0	+380	+385	+390
	Negative tax	*0*	*+130*	*+125*	*+120*

Areas of uncertainty

There are no significant uncertainties in the direct effects of these measures.

[2] The costings shown in the Spending Review 2010 scorecard only show the direct effects on Annually Managed Expenditure and do not take account of direct effects on receipts. The impacts on negative tax are shown here for transparency about the total impacts of the measure. Any implications for receipts will be taken on in the next forecast.

Using real time PAYE information to inform tax credits calculations

Measure description

This package seeks to link real time PAYE information of individuals' earnings to the tax credits system, reducing the emphasis on the customer to notify HMRC of any changes. Using the information recorded on the PAYE system will reduce error and fraud and subsequent overpayments, reducing AME on both counts.

The cost base

The cost base is the tax credits forecast from the June Emergency Budget, but does not include any tax credit recipients assumed to have migrated to Universal Credit. So the cost base is the total set of tax credit recipients in the June forecast minus those assumed to leave tax credits onto Universal Credit.

The overpayments costing is based on the expenditure forecast, however the error and fraud costing is based on an assumption that tax credit error and fraud will be 4 per cent of entitlement in 2014-15.

Static costing

The static Exchequer impact is calculated by estimating, first the amount of error and fraud that will be eliminated, and therefore not paid out, due to the use of real time PAYE information, and second the subsequent reduction in overpayments because of improved income information.

By introducing real time PAYE information, the level of expenditure that would ordinarily be attributed to error and fraud is expected to reduce by £90 million in 2014-15. This will stop the payments from going out in the first place and will all score as immediate AME savings.

The level of overpayments will also reduce due to more accurate and timely income information, which would reduce entitlement during the year rather than at finalisation. Taking into account the value of debt that would normally have been collected in 2014-15, the use of PAYE information is expected to save a further £210 million in AME savings that year.

Post-behavioural costing

The costing assumes that evidence about previous error and fraud and overpayments is representative of future trends, and that these do not change significantly. This is based on evidence from the Error & Fraud Analytical Programme.

Table 1 – Post-behavioural Exchequer impact (£m)

	2011-12	2012-13	2013-14	2014-15
AME	0	0	0	+300

Areas of uncertainty

The costing assumes that 25 per cent of tax credit customers migrate to Universal Credit during 2014-15, predominantly out-of-work claimants.

To be consistent with other packages the costing assumes that the PAYE data has an accuracy rate of 90 per cent.

Finally, as with all IT projects there is always a level of risk associated with delivery, which could affect the final design (and implementation) of the policy.

Increasing public service pension contributions from 2012-13

Measure description

This policy is an increase in employee contribution rates, in response to the recommendations from the interim report of the Independent Public Service Pensions Commission.

The Government will implement progressive changes to the level of employee contributions equivalent to an average of three percentage points, to be phased in from April 2012. The armed forces will be exempt from this increase. Full details, including consideration of Lord Hutton's recommendation to phase in the increase and provide protection for the low paid will be announced at Budget 2011.

This policy applies to unfunded public service pensions schemes, with the exception of the Armed Forces Pension Scheme (it also applies to the funded Local Government Scheme, but this does not result in AME savings). Within unfunded schemes contributions are paid to the Exchequer and used to pay pensions to public servants who have retired. In years where contributions received are less than the benefits due to be paid a top up is made from AME. This is the Net Public Service Pensions Line in the OBR June Budget forecast.

This policy will increase the contribution employees pay for their pension, and so result in a reduction in net public service pensions expenditure in AME.

The cost base

The cost base used is the forecast public service pensionable paybill excluding the Armed Forces; that is the paybill for members of the NHS, Teachers, Civil Service, Police, Firefighters and Judges pension schemes as well as smaller schemes and those administered by the Devolved Administrations (e.g. the NHS Scotland pension scheme).

Static costing

The static costing for this measure is based on the forecast paybill over the spending review period. It represents an increase in contribution rates equivalent to an average of three percentage points, that is phased over three years from 2012-13. Once the armed forces are exempted, this rises slightly for the remaining workforces.

The 2009 Pre-Budget Report announced savings of £1.0 billion per annum from 2012-13 from cap and share reforms to public service pensions. This policy will subsume these savings.

Table 1 – Static exchequer impact (£m)

	2011-12	2012-13	2013-14	2014-15
AME	0	+200	+1,400	+1,990

Post-behavioural costing

It is possible that a small number of individuals will choose to leave their pension scheme as a result of these changes, though given the generosity of the schemes there is little economic rationale to do so, and policy will be designed to mitigate these impacts. This costing assumes an increase in the opt-out rate equal to one per cent of total paybill.

Table 1 – Post-behavioural Exchequer impact (£m)

	2011-12	2012-13	2013-14	2014-15
AME	0	+160	+1,270	+1,760

Areas of uncertainty

The main area of uncertainty in the costing is the behavioural response. Assumptions about opt-out behaviour are inherently uncertain, and will additionally depend on the detail of how the policy is implemented. The details of the policy will be announced at Budget 2011.

Changes to Renewable Heat Incentive (RHI) from 2011-12

Measure description

The aim of the policy (to be launched in 2011-12) is to provide financial support to encourage individuals, communities, businesses and the public sector to switch from using fossil fuel for heating, to renewable technologies and sources.

DECC are still developing the final policy proposals and has committed to finding savings of 5/10/15/20 per cent from 2011-12 to 2014-15 respectively.

The cost base

The RHI costs base is based on extensive analysis and modelling of renewable technology costs and potential uptake under different support levels. The RHI cost base was published alongside the RHI consultation in February 2010. More information on the cost base calculation can be found in the relevant Impact Assessment:
(http://www.decc.gov.uk/en/content/cms/consultations/rhi/rhi.aspx)

Static costing

DECC is still finalising the policy proposals and considering some changes to the cost base as a result of the consultation, tariff levels, automatic reductions of tariffs for new installations over time (degression), and the phasing of introduction of support for more complex technologies. Preliminary modelling, based on the same behavioural assumptions as used for the RHI consultation, has shown that such savings could be achievable without a significant impact on the ability to achieve 12 per cent of heat demand from renewables sources by 2020. Details on these changes and the design of the RHI will be published before the end of the year.

As the costing is based on a commitment to a certain proportion of savings from forecast spend it does not include behavioural assumptions; however behavioural effects will be incorporated when determining the final policy design that will deliver these savings.

Table 1 – Exchequer impact (£m)

	2011-12	2012-13	2013-14	2014-15
AME	+5	+15	+45	+105

Areas of uncertainty

There are no significant areas of uncertainty in this costing as the savings have been agreed.

However, there are significant areas of uncertainty around projections of RHI costs (given its demand-led nature) and the final specification of policy design is still to be determined.

No revenue recycling in the Carbon Reduction Commitment Energy Efficiency Scheme from 2011-12

Measure description

This measure ends revenue recycling in the Carbon Reduction Commitment Energy Efficiency Scheme (CRC).

The cost base

The CRC is a new UK-wide energy efficiency scheme that applies to non-energy-intensive organisations. Participants are required to purchase allowances from Government in respect of the carbon emissions associated with their energy use.

Estimates of emissions coverage for the CRC were produced in 2006 by NERA/Enviros.[3] The estimates were based on data from a survey of energy use amongst organisations with a half-hourly meter, which is a qualification criterion for participation in the CRC.

The allowance price will be £12/tCO_2 during the first phase. For the costing it has been assumed the price will rise to £16/tCO_2 during the second phase, planned to begin in 2013-14.

Static costing

No revenue from allowance purchases will be recycled to participants, removing baseline forecasts for that expenditure. The static costing estimates of removing revenue recycling in each year of the scheme until 2014-15 are:

Table 1 – Exchequer impact (£m)

	2011-12	2012-13	2013-14	2014-15
AME	+715	+730	+995	+1,020

Areas of uncertainty

There are no significant areas of uncertainty in this costing.

However, there are significant areas of uncertainty around the original forecast for CRC revenue.

[3] http://www.decc.gov.uk/assets/decc/what%20we%20do/a%20low%20carbon%20uk/crc/policy/nera-enviros-report-060428.pdf

Reform of council housing finance from 2011-12

Measure description

This measure announces the abolition of the Housing Revenue Account (HRA) subsidy system and its replacement with a devolved system of self-financing for council housing.

The cost base

The costings takes the HRA subsidy forecast and the capital LASFE forecast for Large Scale Voluntary Transfers (LSVT) from the OBR's June Budget forecast.

The model used is the Department for Communities and Local Government (CLG) financial model, which calculates the NPV of the local authority housing business over thirty years.

Static costing

The principle behind reform of the HRA subsidy system is that the change is fiscally neutral provided that the loss of the negative subsidy is equal to the interest payments from local authorities to central government.

Post-behavioural costing

The costing considers the effect that a new system for council housing finance will have on local authorities' behaviour with regards to decisions about future LSVT after taking account of those LSVTs that are already committed.

Table 1 – Post-behavioural Exchequer impact (£m)

	2011-12	2012-13	2013-14	2014-15
AME (capital)	+25	+25	+25	+25

Areas of uncertainty

The financial parameters of a new self-financing system are subject to confirmation at the Spending Review. The actual interest rate on the PWLB loans to local authorities will be determined by the rates at the point of implementation of a new self-financing system.

Increasing Public Works Loan Board (PWLB) interest rates from October 2010

Measure description

This measure increases Public Works Loan Board (PWLB) interest rates, from 20 October 2010, to an average one per cent above UK Government gilts.

The cost base

The OBR June Budget forecast for local authority (LA) borrowing in 2010-11 was £5.3 billion. As 76 per cent of outstanding LA debt is with the PWLB, a base of £4 billion per annum has been applied.

Static costing

The costing is based on PWLB interest rates, set on 20 September 2010, for a 25-year maturity loan (4.25 per cent per annum). The static costing was calculated as; the difference in the amount of principal LAs would be able to borrow in order to maintain existing interest repayments given average increased interest rates of 1 per cent on gilts (above 4.25 per cent) on a base of £4 billion per annum.

Post-behavioural costing

The static costing estimates the AME saving by applying an average increased interest rate (above gilts) of one per cent (on 4.25 per cent) on PWLB loans for the current level of borrowing. It does not account for those LAs with pre-agreed borrowing plans that would borrow regardless of increased PWLB interest rates (bearing in mind they would still remain competitive) and the LA sector has indicated strongly that it will continue to undertake Prudential Borrowing despite increased pressure on revenue budgets. It is estimated that one third of authorities would be unaffected by the increase in PWLB interest rates, which nets off savings to the Exchequer.

Until LAs utilise PWLB loans to finance capital investment, they do not begin to impact on the public finances. Capital expenditure tends to peak in the final quarter of each financial year and 65 per cent takes place in quarter three and four. Assuming the borrowing takes place (on average) mid-financial year, and expenditure broadly takes place in two tranches (up-front and completion payments), the expenditure profile is 66 per cent of the current year and 33 per cent in the next year. Given that this measure will be introduced from October 2010, the assumed carry over is seven-twelfths of the assumed one third.

An increased interest rate would create other AME pressures to offset lower LA borrowing. There are two main sources to finance this; stock of unused capital receipts and revenue reserves. As revenue reserves are already under pressure and the stock of capital receipts has been impacted by the downturn, it is estimated that other AME sources could offset increased interest rates by up to 10 per cent (£400 million) of overall forecast borrowing levels. However, this is unsustainable in the medium term and pressures are assumed front loaded, due to contractual obligations etc.

Table 1 – Post-behavioural Exchequer impact (£m)

	2011-12	2012-13	2013-14	2014-15
AME	+150	+310	+380	+450

Areas of uncertainty

The costing uses best estimates for LA borrowing, although there is uncertainty around the quantum and timing, as LAs are free to borrow in advance of need.

Office for
Budget
Responsibility

Certification of policy costings

3 Office for Budget Responsibility: certification of policy costings

3.1 The Office for Budget Responsibility (OBR), led by the Budget Responsibility Committee (BRC), has provided independent scrutiny of the Government's estimated costings of Annually Managed Expenditure (AME) policies as part of the Spending Review. This is consistent with the Terms of Reference published by the Chancellor on 12 October 2010.

3.2 The OBR has certified that the costings of the Spending Review AME policies presented in this document represent a reasonable and central view given the information currently available. The OBR has not scrutinised the costings of policies within Departmental Expenditure Limits (DEL), or AME policies not presented in this document, where the total cost or yield is wholly determined by a Government policy decision, such as Equitable Life payments.

Methodology

3.3 For this Spending Review, the OBR has scrutinised costings produced by the Government using the methodology set out in this document, and in further detail in the Treasury's *Budget 2010 policy costings document*. These costings take into account the direct effects of a policy on the component of spending to which the policy applies, and closely-related components. They do not take into account the indirect effect of policy measures on the wider economy.

3.4 The costings have been produced on the basis of the interim OBR's most recent economic and fiscal forecast, published at the June Budget. The direct costings may therefore change when the OBR produces its Autumn forecast on Monday 29 November. In addition, in its Autumn forecast for receipts and spending, the OBR will take account of any broader economic impact from the indirect effect of the measures.

3.5 As set out in the *Budget 2010 policy costings document*, the Treasury's costings methodology starts from an initial static costing which reflects the impact of the difference between the pre-measure regime and the post-measure regime on the spending base. Behavioural effects are then added to the static costing. These reflect the expected response of consumers and firms to the measure. While behavioural effects on the spending base are included, indirect effects on the wider economic forecast are excluded. To take the example of a change in benefit policy, the behavioural effect on take-up rates would be included in the policy costing, but any impact on labour supply would not.

3.6 This can be contrasted with a fully dynamic ('dynamic scoring') approach where all costings and economic determinants interact simultaneously. Dynamic scoring has potential benefits since in theory it could fully incorporate the effects of all measures on each other and on the economic forecast. However, dynamic scoring is highly complex, involves a significant degree of uncertainty, and can make costings less transparent and harder to explain. The OBR will work with HM Treasury as they continue to develop their costings methodology in the future.

Scrutiny and challenge

3.7 The OBR invited the officials responsible for producing each costing to attend a series of challenge meetings, at which the assumptions, judgements and methodology used in the costing were scrutinised by the BRC and OBR staff. The OBR was provided with detailed analysis and had full access to the information used in the costings. In the cases where the BRC felt a different methodology or judgement was required, changes were made to the costing in line with BRC views, and a further set of discussions took place. Through this iterative process of scrutiny, the BRC were able independently to challenge the Government's costings in detail, and ensure its views were fully reflected in the Treasury's final costings.

Uncertainty

3.8 In its June Budget forecast the OBR emphasised the uncertainty which surrounds forecasts of the public finances. Policy costings are subject to a similar, if not greater, level of uncertainty for a number of reasons. In many cases, costings are highly sensitive to assumptions about the future behavioural responses of benefit or tax credit recipients. Some behavioural responses may be determined by social attitudes (such as stigma around benefit take-up) which are especially hard to quantify. Policies can have an unpredictable effect on the levels of error and fraud in the welfare system. In addition, it is difficult to analyse the accuracy of previous policy costings to draw lessons for future costings, as it is not generally possible to separate the eventual cost or yield associated with a particular measure from total expenditure.

3.9 In respect of the specific policy costings at this Spending Review, the OBR identified the following areas of particular uncertainty:

- Time-limit contributory Employment and Support Allowance for those in the Work Related Activity Group: as set out in Chapter 2, there are uncertainties surrounding the assumptions around migration from Incapacity Benefit (IB) to the Employment and Support Allowance (ESA), along with the behavioural effects of the policy. As ESA has only recently been introduced and migration of IB recipients to the new regime has not yet taken place, assumptions must be based on the behaviour and characteristics of IB recipients who will migrate to ESA in the future. The number of IB migrants who are placed in each ESA group, and changes in this distribution over time, is particularly uncertain. Given the significant differences between the IB and ESA regimes, this is a key source of uncertainty in the costing;
- Withdrawal of Child Benefit from higher rate taxpayer families: the costing in Chapter 2 includes a behavioural effect for taxpayers near the higher-rate threshold reducing their taxable income. Taxpayers with children and incomes just above the higher-rate threshold have an incentive to reduce their hours worked or find other ways of reducing their taxable income, such as increasing pension contributions, taking part in salary sacrifice schemes or making donations subject to Gift Aid. The ability of such taxpayers to forecast their income and adjust their behaviour accordingly is highly uncertain. There are also uncertainties around the delivery model which could affect the costing;
- Increasing public service pension contributions: as set out in Chapter 2, the final costing is based on an assumption that the opt-out rate increases by one per cent (in terms of total paybill). While in general it is economically rational over the long term for public sector employees to remain in the schemes, at the lower end of the income scale some employees may be liquidity-constrained and may therefore choose to opt out anyway. The extent to which this is the case is difficult to predict, and therefore the change in the overall opt-out rate is uncertain. In addition, it is hard to predict the year in which those who intend to opt out will do so, which leads to uncertainty around the profile of the costing; and
- Increasing Public Works Loan Board (PWLB) interest rates: local authorities have substantial freedom over the quantum and timing of borrowing, and control over when the borrowing is spent. In addition, some local government bodies have access

to other sources of funding which they may use in place of the PWLB. The behavioural response of local government to the changes in PWLB interest rates is therefore uncertain. The costing is also subject to uncertainty over future interest rates.

Indirect effects

3.10 In some cases, a policy could potentially have an indirect effect that is not included in the direct costings, consistent with the methodological approach. The OBR will take account of any broader economic impact from these indirect effects in the Autumn forecast. Two measures with potentially significant indirect effects are:

- Withdrawal of Child Benefit from higher rate taxpayer families: as set out above, taxpayers just above the higher-rate threshold who have children have an incentive to reduce their taxable income. One mechanism to achieve this is to work shorter hours, for example by reducing overtime. This would affect the total number of hours worked in the labour market. Other behavioural changes, such as couples altering the split of hours worked between them so as to both fall under the higher-rate threshold, may also have indirect effects on the economy forecast. In the opposite direction, the withdrawal of Child Benefit could have the effect of increasing labour supply for taxpayers above the threshold who choose to offset the reduction in their income by increasing their hours worked; and

- Reduce the percentage of childcare costs paid through the Working Tax Credit: reducing the childcare costs paid through WTC increases the incentive for families to take on childcare themselves, or rely on extended family members. If more time is spent on childcare, this could affect hours worked and participation in the labour market.

3.11 Other measures, particularly tax credit measures, may also have labour supply effects. The Autumn forecast of the economy and public finances will take all of these effects into account, and will also consider the effect of changes in the composition of DEL.

Impact on tax receipts

3.12 In addition to the macroeconomic effects identified above, measures can have effects on the fiscal aggregates beyond the direct AME costing used in the Spending Review. The element of tax credits expenditure which is classified as negative tax will be affected by the measures announced at the Spending Review. In addition, some of the changes to social security benefits will affect tax liabilities. There may also be changes in taxable income due to the behavioural effects of the Child Benefit and tax credits measures. Increased public service pension contributions would also reduce taxable income, which would affect receipts of income tax and National Insurance Contributions. The overall consequences of measures for the public finances will be included in the Autumn forecast.

HM Treasury contacts

This document can be found in full on our website at:
hm-treasury.gov.uk

If you require this information in another language, format or have general enquiries about HM Treasury and its work, contact:

Correspondence Team
HM Treasury
1 Horse Guards Road
London
SW1A 2HQ

Tel: 020 7270 4558
Fax: 020 7270 4861

E-mail: public.enquiries@hm-treasury.gov.uk

ISBN 978-1-84532-726-2