

## 4 Modelling outcome based contracting

Due to its responsibilities for social security expenditure, DWP has one of the largest Annually Managed Expenditure (AME) budgets of all Government Departments. For 2006-7 it is estimated to spend around £37 billion on working age benefits<sup>47</sup>.

The Department is also responsible for an estimated Departmental Expenditure Limit (DEL) programme budget of £420 million in 2006-7 for New Deals and Action Teams, designed to support claimants make the transition into employment<sup>48</sup>. This is centred around the successful New Deal programmes introduced in 1998. Alongside this is an additional budget of around £132 million for the administration of these programmes and further amounts for specialist employment programmes designed to help disabled people such as Remploy.

Clearly, given the active labour market policies now pursued in the UK, there is a close link between effective expenditure on employment programmes and expenditure on working age benefits. Effective spending by the Department on labour market policies or administration can result in real reductions in benefit expenditure (and vice versa).

In practice, however, the two have not been strongly linked. Given the impact of the economic cycle and other factors on benefit expenditure, benefit spending is managed on an annual basis and the associated risks lie with HM Treasury. Three-year Departmental Expenditure Limits are set in spending reviews on the basis of the best value for money use of public expenditure to meet Government priorities.

The recommendation in this paper is for the Department to build a coherent outcome based model against which it can assess all interventions in the labour market and which can eventually be the basis of an 'open architecture'. Such an architecture would allow all elements of the system to be individually assessed. It would be based on benchmarking outcomes for particular groups of individuals and be refined as information flows built up. As set out in Part 3, this could then be used as a basis for more effective targeting of early support for the hardest to help.

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<sup>47</sup> Benefit figures are consistent with Pre-Budget Report 2006 and are published on the DWP website ([www.dwp.gov.uk/asd/asd4/expenditure.asp](http://www.dwp.gov.uk/asd/asd4/expenditure.asp)).

<sup>48</sup> DWP Departmental Report 2006 available at [www.dwp.gov.uk/publications/dwp/2006/dr06/pdf/DWP\\_Departmental\\_Report\\_Full.pdf](http://www.dwp.gov.uk/publications/dwp/2006/dr06/pdf/DWP_Departmental_Report_Full.pdf)

There are three main functions of such a model once it is robustly developed. It would:

- 1) Produce a detailed assessment of the fiscal benefits from reduced caseloads with which to make outcome based payments;
- 2) Provide a measure against which bids by external operators for outcome-based contracts would be assessed;
- 3) Help provide a common set of targets within and across various programmes involved with helping people back to work, both those operated by the State and those contracted out.

## The fiscal benefits of increased employment

The advantages of employment to individuals have already been discussed in Part 2 of this review. The fiscal gain of a year-long move into employment by a claimant on one of the three main benefits is substantial. My preliminary estimates of the *gross* saving to the Department of moving an average recipient of incapacity benefit into work is £5,900, with wider exchequer gains (offsetting direct and indirect taxes paid with additional tax credits) raising this figure to £9,000. The equivalent figures for Jobseeker's Allowance are £4,100 and £8,100 respectively. On lone parents the Department's *gross* savings are £4,400, with no further Exchequer savings because of the weight of extra childcare elements of the tax credit system balancing other tax revenues.<sup>49</sup>

The full annual Exchequer saving of getting a person on incapacity benefits into work is around £9,000. To the extent that the person would not have otherwise worked for many years, the saving to the State is a multiple of this figure. Once a person has been on incapacity benefits for a year, they are on average on benefit for eight years. So a genuine transformation into long term work for such an individual is worth a net present value of around £62,000, per person to the State<sup>50</sup>.

Under the structure proposed in this report, the Department would retain its responsibility for benefit payment and also for engagement with claimants at the early stages of their benefit claim (Parts 3 and 5 refer). However, delivering the contracting regime set out in Part 3 would require an integrated and transparent contracting model that is based on the fiscal benefits discussed above. It would also require a robust measurement of the additional employment outcomes achieved by the private and voluntary system over and above those that the State could have achieved with current policy. As the model develops it should incorporate sophisticated assessments of the relative difficulty and costs of helping variously disadvantaged groups into the labour market. In addition, of course, it would need to reflect the Government's own priorities in respect of different disadvantaged groups.

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<sup>49</sup> Full take up of Working Tax Credit and Child Tax Credit is assumed although there is no estimate of childcare costs (and therefore the childcare element of tax credits) contained within the estimates. The actual Exchequer saving would be lower than presented here if estimates of childcare elements of tax credits were included.

<sup>50</sup> This figure is the Net Present Value of 8 years' worth of total Exchequer savings from an incapacity benefits recipient, discounted at HMT's recommended Social Time Preference Rate of 3.5%.

This means that the costs of helping individuals move into work need to be understood. Once the proposed regime is fully developed, both the State and the provider would then have a fuller knowledge of the expected cost of the support needed for an individual claimant. If the private and voluntary sector is prepared to deliver an additional employment outcome on a contract worth less than this fiscal benefit, then the State will make an immediate fiscal gain even in the year of the successful intervention.

In the proposed regime providers would receive outcome-based payments that reward them for ensuring that individuals find and remain in work. Illustratively, this could be for a period of up to, say, 3 years. Benefit savings after the 3 year period would accrue entirely to the State. In this analysis, only the direct benefit savings to the Department are incorporated. The State would still gain from any additional income tax and national insurance contributions, off-set against increases in tax credit payments. Outcome based payments (which are potentially informed by additional benefit savings from a particular cohort) could secure the significant and commercially viable upfront investment needed to establish successful new welfare programmes. However these payments would only be made if the provider is able to achieve benefit exits over and above a specified benchmark. This benchmark would be built on the existing knowledge of benefit exit rates and could be revised and updated as the involvement of the private and voluntary sector develops over time.

The focus on additionality in the proposed outcome based contracting model would give the private and voluntary sector the incentive to maximise the effectiveness of their interventions and so improve job outcomes overall.

#### **A potential payment structure**

Once a provider has successfully supported a move into employment they would receive separate payments for:

- The initial move off benefit
- Continuous, or near continuous employment for 13, 26, 52, 104 and 156 weeks
- Personal pay progression, possibly reflected in a lower requirement for tax credits
- Improvements in the person's qualifications
- Bonus payments linked to targeted outcomes across all client groups
- Bonus payments for specific outcomes linked to wider Departmental objectives (such as the Child Poverty target)

Payments would also need to be weighted to reflect the complexity of needs of claimants so that the hardest to help would yield the greatest payments for successful outcomes. This would ensure that the incentives exist to extend the opportunity of support to everyone within the system.

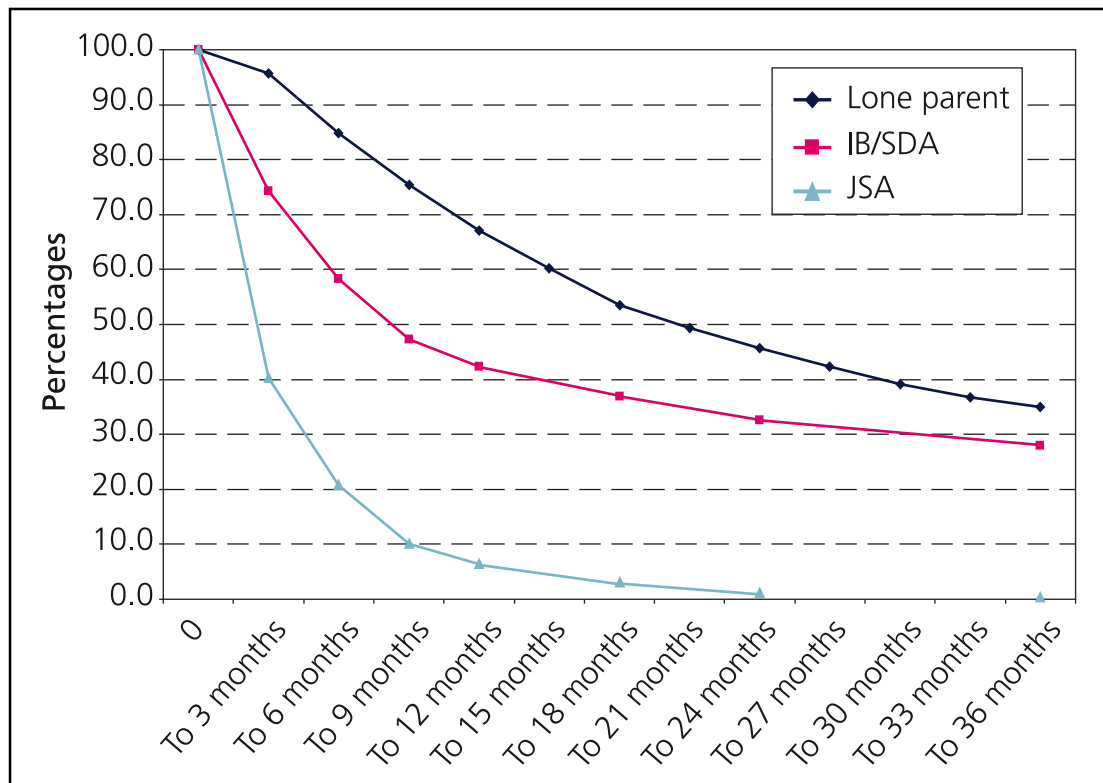
It may be necessary to make further payments if the Department opts for a degree of additional prescription in the support delivered. For example, the Department may wish to place a requirement that all claimants are seen at least once every three months to ensure that everybody has a minimum level of engagement, or that every jobseeker be required to participate in some form of activity. This would add to the costs and would need to be priced in by the Government and providers.

Funding and payments mechanisms will also need to become more sophisticated, so that incentives exist to develop programmes across the spectrum of claimants and not to focus on a narrow group. This could be achieved by providing higher payments for the hardest to help or by providing bonus payments where certain outcome levels have been delivered for multiple client groups. It is likely that a combination of the two will be required to provide a strong incentive. (This in turn raises an issue of “below baseline” performance – where providers achieve outcomes below those in the current system; should the Government be compensated for the additional benefit payments it will make?)

## Estimating an initial benchmark

As discussed, the benchmark against which private and voluntary sector outcomes could be based could initially be constructed using information on this likelihood for the various client groups. So-called “survival” or “persistence” rates describe the likelihood of remaining on benefit, so that an increase in the proportion leaving benefit for employment is represented by a reduction in benefit “survival rates”. The chart opposite shows this for a cohort of inflows in 2003 for Income Support lone parents, JSA and incapacity benefits.

A measure of success for the private and voluntary sector would be to reduce the likelihood of a given claimant remaining on benefit (equivalent to increasing benefit exits). The extent to which these rates can be improved will determine the overall outcome payments that could be made to the private and voluntary sector. It should be noted however that it will require significantly more than a *laissez-faire* approach to deliver these outcomes – the estimated benchmark is itself a result of large State support for these client groups.

**Figure 25 Survival rates for 2003 inflow cohorts<sup>51</sup>**

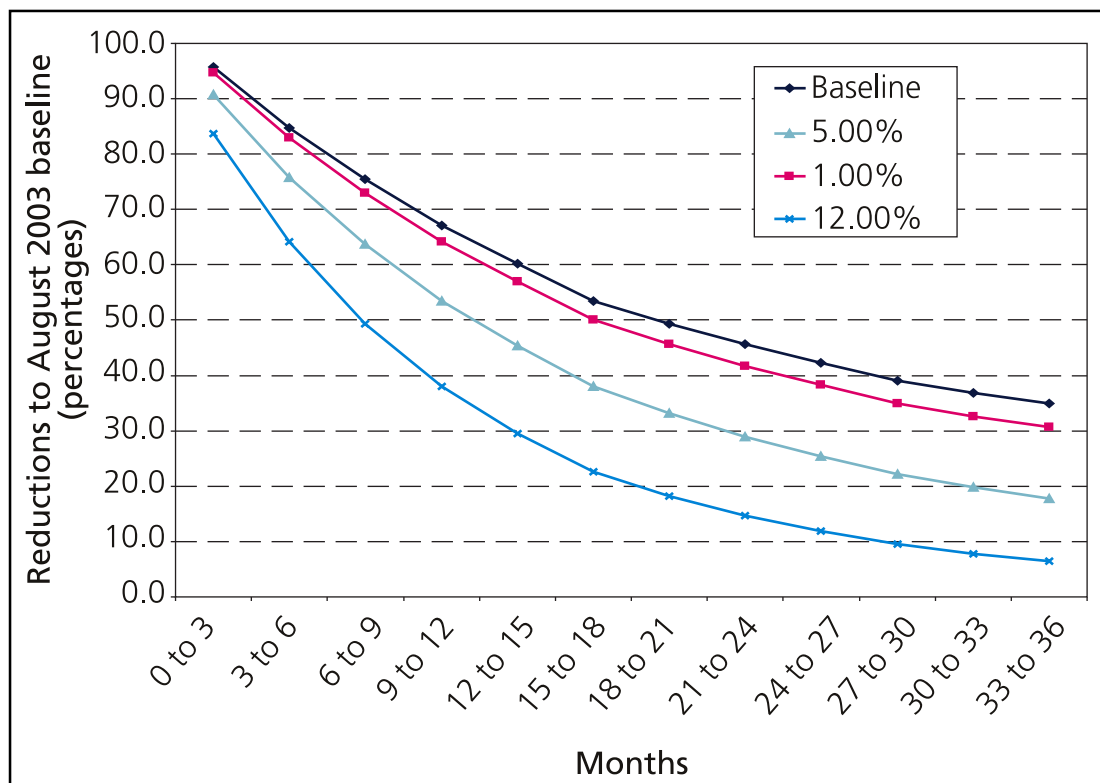
## Modelling for a cohort of inflows to IS, IB and JSA

The modelling to date simply provides a framework upon which a fuller and significantly more sophisticated model could be built. At this early stage, the analysis that follows is illustrative of the potential volume effects of successful private and voluntary sector interventions. The analysis segments the claimant population into the three groups discussed previously and this could be used to guide the terms of a contract that might be acceptable to the State. The model deals only with a cohort of inflows to benefit rather than the existing stock of claimants – extending the model will require further more detailed analysis that the Department should undertake.

### Lone parents

Using the benchmark above for a cohort of 57,000 inflows from August 2003, the chart overleaf shows the changes to the likelihood of remaining on benefit from one quarter to the next following hypothetical improvements of 1 percentage point, 5 points and 12 points.

<sup>51</sup> Inflows for ISLPs and IB relate to August 2003. JSA inflows are for April 2003.

**Figure 26 Lone parent hypothetical survival rates**

In the benchmark, of the 57,300 IS lone parent inflow just over 20,000 remained on benefit up to 3 years. In the scenarios, reductions in the likelihood of remaining on benefit from one quarter to the next by 1 point, 5 points and 12 points per quarter lead to around 17,500, 10,200 and 3,700 claimants respectively remaining on benefit up to 3 years.

Assuming that payments are made for a period of up to three years following the initial benefit exit then it is possible to estimate the potential gross benefit savings for this cohort that would accumulate over 3 years.<sup>52</sup> The table below shows the estimates under three scenarios:

- All benefit exits are for 3 years.
- 50% benefit exits are for 3 years, 25% are for 2 years and 25% are for 1 year.
- 60% are for 3 years, 6% are for 2 years, 8% are for 1 year and 9% are for 6 months.<sup>53</sup>

<sup>52</sup> A fiscal benefit of £4,400 from a lone parent entry into employment is used in these calculations. The overall Exchequer benefit would be lower than presented here if childcare elements of the tax credit system were included.

<sup>53</sup> The last scenario is based on the evidence of lone parent return to benefit rates in the existing system.

**Table 6 Possible gross benefit savings**

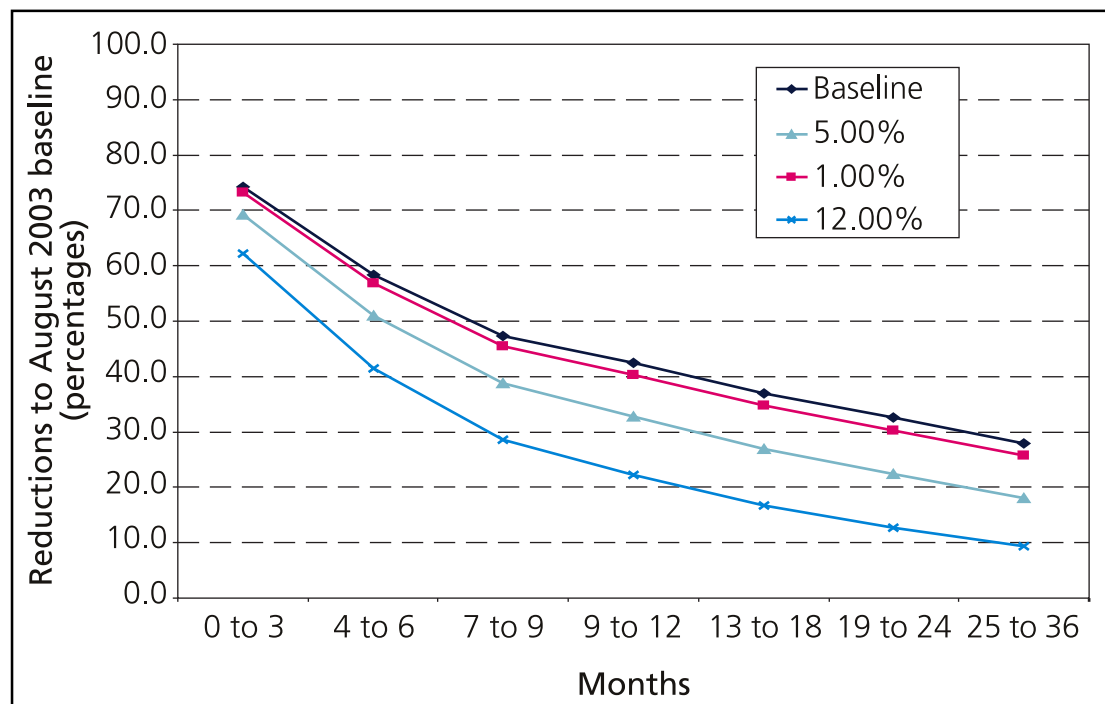
	Quarter to quarter survival rate reduction (£m)		
	1%	5%	12%
Duration assumption 1	£32.7	£129.9	£216.0
Duration assumption 2	£24.5	£97.5	£162.0
Duration assumption 3	£22.3	£88.6	£147.2

If the provider was able to reduce the likelihood of remaining on benefit from one quarter to the next by 5 points and was able to maintain existing return to benefit rates, then a potential £88.6 million would be available in gross benefit savings.

### Incapacity benefits

The same framework can be applied to incapacity benefits claimants, again using an inflow cohort from August 2003.

In the incapacity benefits benchmark, nearly 49,000 of the original inflow remained on benefit for up to 3 years. Reducing the likelihood of remaining on benefit from one quarter to the next by 1 point, 5 points and 12 points results in around 44,900, 31,700 and 16,400 claimants respectively remaining on benefit after 3 years. This is shown below.

**Figure 27 Incapacity benefits hypothetical survival rates**

Again assuming varying employment retention rates (as for lone parents) it is possible to estimate the potential gross benefit savings. The table below shows that a 5 points reduction in the likelihood of remaining on benefit from one quarter to the next and maintaining existing return to benefit rates would yield a potential £225 million in gross benefit savings.

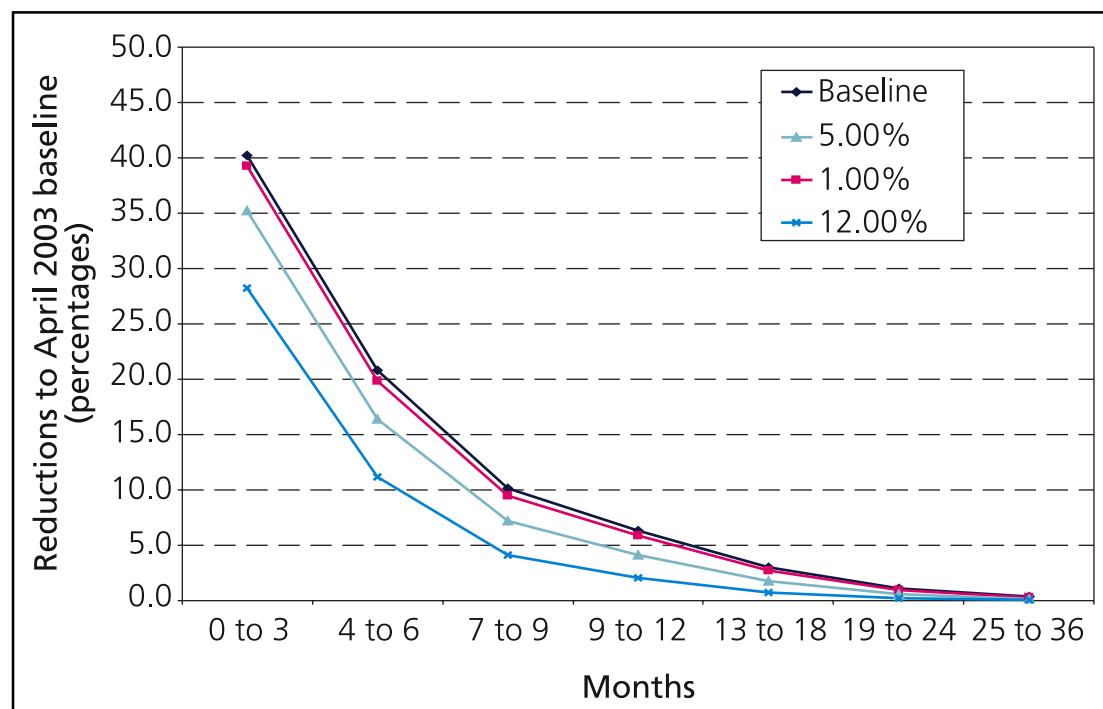
**Table 7 Possible gross benefit savings**

	Quarter to quarter survival rate reduction (£m)		
	1%	5%	12%
Duration assumption 1	£70.8	£307.0	£579.0
Duration assumption 2	£53.1	£230.2	£434.2
Duration assumption 3	£51.9	£225.1	£424.6

### Jobseeker's Allowance

Despite having the largest inflow volume, the overwhelming majority of the JSA inflow leaves benefit within 12 months. While the early analysis presented here has abstracted from the discussion of the point in the claim at which the individuals start to receive support from providers, it is clear that providers would likely be providing support to a very small number of jobseekers.

Of a JSA inflow cohort of 670,000 in April 2003, just 2,600 remained on benefit for up to 3 years in the benchmark. Reducing the likelihood of remaining on benefit from one quarter to the next by 1 point, 5 points and 12 points results in around 2,200, 1,100 and 300 claimants remaining on benefit after 3 years respectively. This is shown below.

**Figure 28 JSA hypothetical survival rates**

Once more assuming that the existing expected durations off-benefit are maintained and the private and voluntary sector delivers a 5% point reduction in the likelihood of remaining on benefit from one quarter to the next, gross benefit savings to the value of £13.2 million could be made.

**Table 8** Possible gross benefit savings

	Quarter to quarter survival rate reduction (£m)		
	1%	5%	12%
Duration assumption 1	£4.7	£18.0	£28.3
Duration assumption 2	£3.5	£13.5	£21.2
Duration assumption 3	£3.4	£13.2	£20.7

## Outcome based contracting

Significant further work is needed although initial modelling suggests that there is a strong case for developing this outcome based model in more detail. The Government will also need to explore:

- better segmentation of the client base including stock claimants;
- market testing that the value of the potential outcome payments is sufficient to secure long run engagement by the private and voluntary sector;
- developing the model and incentives to adequately reflect structural changes to the macro economy – effectively “recession-proofing” the system;
- analysis of the contractual incentive structure to minimise “creaming” and “parking”.

Detailed work is required on all of these areas in order for a comprehensive working model to be developed.

## A market of significant scale

The scale of the potential market is large. Once it matures, it will be made up of the flow of new hard to help clients from Jobcentre Plus. In the early years it could be further swollen as existing customers on incapacity benefits participate in work-related activity. Based on the analysis in this report, I have no doubt that this will be an annual multi-billion pound market. Such scale would attract commitment from a wide range of private sector providers and voluntary groups.

The fiscal prize is considerable. Achievement of the 80% employment aspiration would boost GDP, reduce benefit spending and increase Exchequer revenues to a material extent.