Funding the Future

Ending the two-child benefit will pay for itself

https://www.taxresearch.org.uk/Blog/2025/05/29/ending-the-two-child-benefit-will-pay-for-itself/

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The Labour government claims that it cannot afford to pay benefits for the elderly, children in poverty, and people with disabilities. That is nonsense. Simple economic analysis shows that these benefits pay for themselves.

https://www.youtube.com/watch?v=b3GFjLR0Wjs?si=CbRAP4P7KGIvfQcH

This is the audio version:

https://www.podbean.com/player-v2/?i=8t6ea-18bf87a-pb&from=pb6admin&share=1&download=1&rtl=0&fonts=Arial&skin=f6f6f6&font-color=auto&logo_link=episode_page&btn-skin=c73a3a

This is the transcript:

Why is Rachel Reeves refusing to remove the two-child cap on benefit payments when, according to the Office for Budget Responsibility in the UK, doing so would actually significantly increase GDP on the basis of the spend that would be involved, and as a consequence, she would better meet her growth targets.

I ask the question because I genuinely do not understand what Rachel Reeves is doing when she is refusing to either restore the Winter Fuel Allowance for old age pensioners, or remove the two child benefit cap with regard to those who are now suffering it because they have three children or more, or generally unfreeze benefits, which is a policy that she's also pursuing.

The spend for achieving these goals would come to around £8 or £9 billion at the moment, although there is some debate as to the precise numbers involved, and I accept that the estimates will be a little inaccurate because they always are. But the point is, in total, this is less than 1% of government spending.

But more importantly than that, and more importantly from Rachel Reeve's perspective, because let's be honest, there is absolutely no evidence that Rachel Reeves thinks in the slightest bit about the hardship of pensioners who can't pay their fuel bills, or the hardship of children and their parents who can't afford to eat properly, or anybody else who might be on benefits come to that; if we just look at it from the economic perspective that apparently matters to her, then we are discussing fiscal multipliers and fiscal multipliers matter.

A multiplier effect records the amount by which the gross domestic product, the national income of a country, increases based upon an increase in government spending.

So, if you increase government spending by 1% and you increase gross domestic product by 1% as a result, you basically have a fiscal multiplier of one. 1% increase for 1% increase.

If you have a 1% increase in government spending, but you only get a 0.8% increase in GDP as a consequence, the fiscal multiplier is less than one. It's actually 0.8.

And if you spend 1% extra and you get a 2% increase in GDP, you've got a net positive effect of that spend and a multiplier of two.

Now, I won't go into the technicalities of multiplier effects more than that because it's going to be the subject of another video fairly soon in the future, but just understand that point at the moment.

The fact is that when the government spends money, it does not pour it into a black hole. Far from it. In fact. Somebody gets the money.

If you listen to many politicians, you wouldn't understand that. It is as if they do genuinely believe that every single pound of government spending is wasted with no further consequence for anyone whatsoever. But of course, that is simply untrue.

And the group in society who will spend every single penny that they receive from the government, and therefore inject it straight back into the economy, are those with the lowest levels of income. That obviously follows because we do know from government issued data that those with the lowest level of income have almost no savings at all, and therefore we can guarantee that if they get more income, they will spend it all because they need the things that they're going to buy and have suffered poverty because they have been denied them.

So, a pensioner who gets a £200 winter fuel allowance will spend it. They may not spend it all on winter fuel. They might spend it on buying Christmas presents for their grandchildren. It doesn't really matter.

Those who get an additional benefits payment because we remove the two-child cap may not spend it directly on the child. They might clear their rent arrears. They might spend it on having a warmer house, but they will indirectly improve the well-being of that child, and that does matter.

The point is, whatever we do in this category of spending, whatever is spent by the government goes via the recipient, the pensioner, the person on benefits, straight into the rest of the economy, because these people have what is called a very high marginal propensity to consume.

Basically, everything they get, they spend.

Now that matters because the higher, the marginal propensity to consume that somebody has, the bigger the multiplier effect is of giving them money to spend because the moment somebody starts saving out of the money they receive, you reduce the multiplier effect because the money is set aside and no longer fuels increased activity in the economy. Saving is dead money. So, as a consequence, for the government to spend money with the people who are going to spend it makes absolute economic sense.

Now, we do not know precisely what the multiplier effect in question is because the government don't tell us what assumptions they make about this multiplier effect.

But think about it. First of all, all that money that the recipients of these benefits get goes straight back into the economy, and as many of these benefits will not be subject to tax, it is 100% per cent of the money will go into the rest of the economy.

But the moment that somebody else receives it, first of all, they will pay over VAT, because much of this will go on consumption expenditure. And then they will receive the money into their business. And in that business, they will pay staff who will pay tax, and the business itself will pay other taxes, for example, corporation tax on the profit that it makes, and on, and on. Because once the business has paid money to its employees, they will then spend out of their net earnings, and the vast majority of people in the UK, at least 50%, have very few savings. Therefore, the majority of the people the business pays will also have a very high marginal propensity to consume, so the money will circulate again.

Either some of it goes back to the government, or it goes into the economy, and it goes into the economy, and it repeats and it repeats.

In fact, look at this chart.

Table A: Fiscal multipliers

	Impact of a one per cent of GDP increase in category on real GDP					
	2020-21	2021-22	2022-23	2023-24	2024-25	2025-26
Tax	0.33	0.30	0.23	0.14	0.05	0.00
RDEL	0.34	0.31	0.22	0.10	0.03	0.00
CDEL	1.00	0.83	0.43	0.23	0.07	0.00
CJRS	0.15	0.14	0.11	0.06	0.02	0.00
Other AME	0.60	0.57	0.43	0.23	0.07	0.00

This was produced by the government's Office for Budget Responsibility in November 2020, and it is the latest indication that I can find of the multiplier effects that the government uses with regard to each type of expenditure that it undertakes.

Now, the only thing that really matters here with regard to what we are discussing is the bottom line on that chart, which is 'Other AME'. And like everything to do with government finance, this is riddled with jargon. AME stands for 'annually managed expenditure' and that includes things like pensions and benefits, where budgets aren't fixed in advance because the level of claim does depend to some extent on the level of economic activity in the economy.

So this is what we are looking at when we talk about the multiplier effects on benefit payments. And as you'll see, the pattern extends over five years.

In other words, in the first year in which money is spent, the Office for Budget Responsibility thinks that for every pound spent out in the first year, after that pound is spent, GDP will increase by 60p.

In the second year, it'll increase by 57p, and then in the year after that, by 43p, and then in the year after that, by 23p, and finally, five years after the initial spend, there will still be a residual effect of 7p.

In fact, for every one pound spent in the first year, a total of £1.90 will be recovered.

In other words, this is a strong, positive multiplier effect. In fact, if the government spends a pound on increasing benefit payments, £1.90 will come back, albeit over time, but GDP will increase. The benefits will flow through to the economy, and the government will therefore be able to recover tax as a consequence, directly and indirectly, as a result of this spend.

Now in practice, this, I believe, is understated, and there are two reasons for saying that.

Firstly, that is because this is an aggregate multiplier and I suspect that the multiplier effect with regard to payments of benefits to those on low pay is much higher than this because those on low pay have such a high marginal propensity to consume that I would expect these figures to be anything up to 50% higher than this.

Secondly, we also know that everyone associated with the UK Treasury has always historically understated multiplier effects, and there's a lot of academic research to suggest that is the case. Even the International Monetary Fund did once upon a time criticise the UK government for forecasting with too low an estimated multiplier effect.

So, I very much doubt that the yield from payment in this case is £1.90. I would strongly suspect that it's over £3, in fact. And if that yield is £3, and the overall rate of taxation in the UK economy is over a third, which it is, then £3 of GDP growth multiplied by an aggregate tax rate of around 35% will mean that the government will collect back in tax more than it's spent on benefits in the first place.

So, spending on removing the two-child cap will actually pay for itself. That's my critical point. We don't need to be mean, because being mean actually reduces growth and reduces overall net government finances. Not only is it petty, because people are in need and poverty, and children are suffering, and that is something that any government, let alone a Labour government, should not tolerate, but actually spending in this area will increase government revenues in the long term.

My argument is, frankly, one that every government minister should know, every journalist should know, every single commentator should know, because if as is likely this multiplier effect is as big as three, and it won't be less than the 1.9 that the OBR is using in aggregate for such rates, then there is no excuse for not removing the two child benefits cap now.

Come on, Rachel Reeves, just do it.