The specification of changes in inflation for the purposes of the welfare cap

1.1 The welfare cap, a limit on the amount the government can spend on certain social security benefits and tax credits, is an important tool for managing welfare spending and ensuring it is sustainable in the medium term. The current welfare cap is based on the Office for Budget Responsibility (OBR) Budget 2020 forecast of all welfare spending, except the state pension and benefits most closely linked to the economic cycle (Jobseeker's Allowance and associated Housing Benefit, and Universal Credit payments to jobseekers), and applies to spending in 2024-25. The government's performance against the welfare cap will be assessed by the OBR at the first fiscal event of the next Parliament. In the interim years, the OBR will monitor welfare spending against the pathway and cap.

1.2 To manage unavoidable fluctuations in welfare spending, the effects of changes in inflation which directly affect the uprating of benefit rates and thresholds are excluded from the welfare cap. This means that increases in inflationary uprating assumptions will not increase pressure on the welfare cap, and nor will decreases create headroom within it. In addition, there is a margin rising to 3% above the welfare cap; there will only be a breach if spending exceeds the welfare cap plus the margin at the point of assessment.

Table 1.A: Welfare cap

£ billion	2019-20	2020-21	2021-22	2022-23	2023-24	2024-25
Cap	-	-	-	-	-	126.8
Interim pathway	119.2	119.4	119.2	121.2	124.1	-
Margin (%)	0.5	1.0	1.5	2.0	2.5	3.0
Cap and pathway plus margin	119.8	120.6	121.0	123.6	127.2	130.6

1.3 The Charter for Budget Responsibility sets out the operation of the welfare cap, alongside the government's other fiscal rules. It requires the Treasury to specify the definition of the changes in inflation which should not be taken into account in the OBR's monitoring and assessment of spending against the cap.

1.4 This note sets out the Treasury's specified inflation definition and subsequent methodology, which are applied in the accompanying spreadsheet that the OBR will use.

1.5 The accompanying spreadsheet has been updated for the current welfare cap, which was reset at Budget 2020, and for the change in the expenditure forecasts for Universal Credit (UC) and the legacy benefit it replaces from a 'counterfactual' to an 'actuals' basis. Previously, under the 'counterfactual' approach, the legacy benefit forecast assumed UC had not been introduced, and the UC forecast captured the marginal difference in expenditure between the two systems. Since the OBR's November 2020 Economic and Fiscal Outlook, the forecasts have been produced on an 'actuals' basis, now that UC is sufficiently established and of the scale that it can be presented as a benefit in its own right.

Defining the impact of changes in inflation

Intended effect

1.6 Most benefit rates and thresholds are uprated each year in line with the Consumer Prices Index (CPI). The intention is for the assessment and monitoring of the welfare cap to ignore the impact of any changes in the CPI inflation rates that are used for the annual uprating of rates and thresholds, compared to those assumed when the cap was set. It is not intended that the wider macroeconomic impacts of changes in inflation, such as changes to the income of welfare claimants, or the impacts of changes in other uprating assumptions be ignored. So, if unadjusted spending against the welfare cap rises by £2 billion in a given year, and £0.5 billion of this is due to higher inflationary uprating of benefit rates and thresholds, the OBR should report that spending against the Cap has only risen by £1.5 billion.

1.7 As such, it is not possible to achieve this intention by carrying out a top-down deflation of the welfare cap and welfare spending by inflation, be that CPI or otherwise. This would exclude some wider effects from the welfare cap, which is not the intention, as well as over-deflating the value of benefits that would ordinarily be uprated by CPI.

1.8 Instead, to assess and monitor spending against the welfare cap, a bottom-up approach should be taken, which adjusts each individual element of welfare spending to remove the impact of changes in CPI inflation uprating assumptions since the cap was set. This will mean that only the intended effects are captured, that is, any increases in the assumptions for the uprating of benefit rates and thresholds will not increase pressure on the welfare cap, and equally, any decreases in the assumptions will not create additional headroom within the cap.

Table

1.9 To allow for the effects of changes in inflation assumptions to be excluded from the welfare cap, a table setting out the elasticities of changes in the CPI uprating assumptions on each element of welfare spending within scope of the cap has been produced. This table enables the OBR to determine the overall impact in each year of the pathway and cap that changes in the uprating assumptions for benefit rates and thresholds have had on spending, so that they can remove this effect when assessing and monitoring spending against the cap. The table is set out in the accompanying spreadsheet, with the methodology behind the figures in it set out below.

1.10 The table sets out the impact on each element of welfare spending, in any year of the pathway and cap, of a 1% change in the underlying CPI uprating assumptions index. The base is 2019-20, as the welfare cap was reset at Budget 2020. For example, if the index is 1% higher in 2020-21 than was assumed at Budget 2020, the first table says that we should expect spending on Housing Benefit in 2020-21 to be 1.24% higher as a result of changes to the uprating of rates and thresholds relating to Housing Benefit. This would mean that forecast spending on Housing Benefit in 2020-21 should be increased by a corresponding amount for comparison against the welfare cap.

1.11 The elasticities are not all equal to 1%, because uprating can do more than simply uprate the main rate of payments. For example, in UC, the amount of benefit is reduced pound-for-pound in respect of unearned income received by the claimant (above a disregard). This means that the amount of benefit paid out is often lower than the published benefit rate. Therefore, if the benefit rate increases by 1%, with no change in the income received, then the benefit paid out will increase by more than 1%.

1.12 The elasticities are assumed to be linear. There is a floor, however, since uprating in any given year cannot be negative. This should be reflected in the calculation of the CPI uprating assumptions indexes, such that if actual CPI inflation is negative in a given year the indexes assume it is zero.

Methodology

1.13 The accompanying spreadsheet contains the table described above. It also allows the latest CPI uprating assumptions and spending forecasts for each element of welfare to be input, and calculates the total adjustment to be applied to the level of the cap and pathway when spending is assessed or monitored.

1.14 The spreadsheet calculates CPI uprating assumption index with a 2019-20 base. Using the differences between these and the Budget 2020 CPI uprating assumption index, it scales the elasticities on a linear basis to derive an adjustment percentage for each element of welfare spending for each year of the pathway and cap. These are then applied to the spending on each element, to work out how much they should be adjusted by in each year. This enables the adjustment to total spending in each year to be calculated, so that spending can be correctly compared against the welfare cap.

1.15 Figures are unrounded for all calculations, but typically expressed to 1 decimal place for presentation.

Assumptions and limitations

1.16 The methodology set out in this note and the accompanying spreadsheet has been developed jointly between HM Treasury, HM Revenue and Customs and the Department for Work and Pensions. It provides a pragmatic and credible way to remove the impact of changes in inflation from the welfare cap. It is transparent, responsive, simple to operate, and does not rely on the retained access and understanding of Budget 2020 models.

1.17 The approach does rely on some broad assumptions:

- it is assumed that the impact of inflation on spending (i.e. the elasticities in the tables) does not materially change, meaning that there are no major changes to the composition of benefits spending and eligibility or caseloads, over and above that already assumed in the Budget 2020 forecasts
- it is assumed that impact of inflation on spending is linear
- it is assumed that changes in inflation do not lead to more or fewer people claiming, where benefits are related to income. Over the degree of variation being considered here, such impacts are unlikely to be material as claimants affected will have very small entitlements

1.18 These are reasonable assumptions. However, in the unlikely event that these assumptions become less credible, HM Treasury, HM Revenue and Customs and the Department for Work and Pensions will revisit the tables and methodology to assess whether to make any required updates.