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, 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's (OBR's) forecast at Autumn Budget 2021 of all welfare spending except the State Pension and benefits most closely linked to the economic cycle (Universal Credit payments to jobseekers[1], and Jobseekers' Allowance and associated Housing Benefit), and applies to spending in 2024-25.

1.2 To manage unavoidable fluctuations in welfare spending, the effects of changes in inflation that directly affect the uprating of benefit rates and thresholds are excluded from the welfare cap. This means that increases in benefit 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 2% above the welfare cap; there will only be a breach if spending exceeds the welfare cap plus the margin at the point of assessment.

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 welfare spending should be adjusted for, to enable the OBR to assess and monitor spending in relation to the welfare cap.

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

Defining the impact of changes in inflation

Intended effect

1.5 Most benefit rates and thresholds inside the scope of the welfare cap are uprated each year in line with the Consumer Prices Index (CPI). The intention for the assessment and monitoring of the welfare cap is to ignore the impact of these changes. 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 the impact of higher inflation assumptions on the uprating of benefit rates and thresholds, the OBR should report that spending against the cap has only risen by £1.5 billion. It is not intended that the wider impacts of changes in inflation, such as changes to the income of welfare claimants, or the impacts of changes in other uprating assumptions (for example, where certain Pension Credit rates are linked to earnings) should lead to adjustments in the spending that is considered against the cap.

1.6 It is not possible to accurately calculate uprating adjustments to welfare spending by simply deflating total welfare spending by CPI, or another measure of inflation, in each financial year. This

[1] Claimants in the Intensive Work Search conditionality group - for those who are able to work but are either not working at the moment or are in work but earning low amounts below the Administrative Earnings Threshold.

would include adjusting for some of the wider effects of changes in inflation, which is not the intention. Instead, to assess and monitor spending against the welfare cap, a 'bottom-up' approach is taken. This adjusts each individual element of welfare spending to remove the impact of changes in CPI inflation uprating assumptions on the relevant rates and thresholds since the cap was set.

Methodology

1.7 A spreadsheet has been produced to calculate the adjustments needed to welfare spending as a result of changes in inflation assumptions. This sets out:

- the CPI uprating assumptions at the point the cap was set, in line with the OBR's inflation forecast at that time;
- the impact of inputted inflation assumptions and estimates for each element of welfare spending, based on the OBR's latest forecasts for each;
- the elasticities of changes in the CPI uprating assumptions on each element of welfare spending, derived from models produced by HM Revenue and Customs and the Department for Work and Pensions; and
- calculations to apply the elasticities to the differences in inflation indices and produce an adjustment percentage which is then applied to each element of welfare spending in each year of the forecast.

1.8 It is therefore possible through this spreadsheet to produce an accurate adjustment by entering the latest OBR inflation and welfare spending forecasts, so that spending can be correctly compared against the welfare cap. For example, this shows that if the CPI used to uprate benefits in 2023-24 is 1% higher than was assumed at Autumn Budget 2021, we should expect spending on Universal Credit in 2023-24 to be 1.10% higher as a result of changes to the uprating of rates and thresholds. This would mean that forecast spending on Universal Credit in 2023-24 should be decreased by a corresponding amount for comparison against the welfare cap.

1.9 As uprating in any given year cannot be negative, if actual CPI inflation is negative in a given year this is reflected in the calculation of the CPI uprating assumptions indices, such that the indices assume it is zero. Figures are unrounded for all calculations, but typically expressed to 1 decimal place for presentation.

Assumptions and limitations

1.10 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 models.

1.11 The approach does rely on some broad assumptions:

- it is assumed that the impact of inflation on spending (i.e. the elasticities in the spreadsheet) does not materially change over the period of the assessment. This means that there are no major changes to the composition of benefits spending and eligibility or caseloads, over and above that already assumed in the forecast;
- it is assumed that the impact of inflation on spending is linear.

1.12 HM Treasury, HM Revenue and Customs and the Department for Work and Pensions will continue to keep the spreadsheet and methodology under review in order to ensure they remain appropriate ways of calculating the required adjustments to welfare spending.