National Audit Office

Report
by the Comptroller
and Auditor General

HM Treasury, Department for Work & Pensions and HM Revenue & Customs

Managing the welfare cap

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Key facts

Overview of the welfare cap

How the welfare cap works

Aim	To increase control over future spending on some benefits – by encouraging the government to make decisions that will keep future benefit spending within the cap.
Nature of the cap	The cap consists of cash amounts for benefit spending for the next five years. Some flexibility – a 2% margin is allowed for factors outside the government's control, eg forecasting changes such as inflation, but not for policy decisions.
Scope	The cap includes just over half of spending on benefits and tax credits (see Appendix Three for details). The main exclusions are the State Pension, Jobseeker's Allowance and Housing Benefit for jobseekers (and equivalent payments under Universal Credit).
Independent scrutiny	The Office for Budget Responsibility (OBR) assesses each year whether benefit spending is forecast to stay within the cap for each of the next five years. There is no assessment of actual spending against the cap.
Response to a breach	If the OBR declares that the welfare cap has been breached then the government must either propose savings, raise the level of the cap, or justify the breach. The government's proposals must be debated in Parliament with a vote.
Timing	The government publishes the welfare cap at the beginning of each Parliament. The OBR carries out its assessment at the Autumn Statement and HM Treasury updates the cap to remove the current year and add a new fifth year at the first fiscal event of the year (usually the Autumn Statement).
Lead departments	Department for Work & Pension (DWP) and HM Revenue & Customs (HMRC) produce forecasts of spending on benefits and tax credits, on which OBR then bases its own forecasts. HM Treasury monitors the cap. DWP is accountable to Parliament for the cap. The OBR owns the forecast and the assessment of the welfare cap.
Legislation	The cap process is set out in the *Charter for Budget Responsibility* which is secondary legislation passed under the Budget Responsibility and National Audit Act 2011.

Overview of the welfare cap *continued*

The welfare cap for 2016 to 2021

	2016-17 (£bn)	2017-18 (£bn)	2018-19 (£bn)	2019-20 (£bn)	2020-21 (£bn)
Welfare cap	115.2	114.6	114.0	113.5	114.9
2% margin	2.3	2.3	2.3	2.3	2.3
Forecast welfare cap spending at Autumn Statement 2015 (official assessment against welfare cap)	119.2	117.7	115.9	115.3	117.1
Forecast welfare cap spending at Budget 2016	119.8	118.0	116.4	116.2	118.1
Benefit spending that is not included in the cap (Budget 2016)	98.4	101.2	104.8	108.1	111.4

Notes

1 The official assessment against the welfare cap takes place at the Autumn Statement. In Autumn Statement 2015, the OBR announced a breach of the cap. This was because the terms of the cap were breached in 2016-17, 2017-18 and 2018-19.

2 In the Budget 2016, the OBR announced that based on current forecasts, in 2019-20 and 2020-21 the forecast is above the cap plus 2% margin, but there is no formal assessment against the welfare cap at the Budget. The official assessment against these forecasts will take place at the Autumn Statement 2016.

3 The recent reversal of the Personal Independence Payments: aids and appliances measures – all else equal – would add £0.5 billion – £1.3 billion a year from 2017-18 to 2020-21.

Source: National Audit Office summary of Office for Budget Responsibility documents

Summary

1 In April 2014, the government introduced a cap on elements of benefit spending, which it calls the welfare cap. The welfare cap aims to improve spending control and financial management and to ensure that benefit spending remains affordable. It sets overall annual limits on certain types of spending, including many benefits and tax credits. In 2016-17, the cap is £115 billion with a further 2% margin for allowable changes in forecast assumptions. The welfare cap is not to be confused with the 'benefit cap' that limits the benefits a household can receive each week.

2 HM Treasury most recently set the welfare cap at the Summer Budget 2015. It sets the cap for a rolling five-year period, with an additional year added at the first fiscal event of the financial year. The Department for Work & Pensions (DWP) manages most of the spending within the cap, with HM Revenue & Customs (HMRC) and HM Treasury being responsible for tax credits and Child Benefit. The Department for Business, Innovation & Skills and the Government of Northern Ireland are also responsible for small amounts of the cap (see Appendix Three).

3 The welfare cap is a self-imposed cap on forecast spending, but not actual spending. A breach occurs when forecast spending in any future year exceeds the cap; actual spending is not assessed against the cap. The welfare cap is therefore a control on changes to government spending plans, while still allowing in-year spending to vary in response to demand and entitlements.

4 The welfare cap is new and processes are developing. But the introduction of the cap has highlighted that forecasts are necessarily uncertain and can contain errors. Given the significance of decisions related to the cap – both for claimants and government spending – departments need reliable forecasts and clear processes for analysing and responding to changes in spending.

Scope of this report

5 In this report we examine government's approach to forecasting and managing the welfare cap. We do not evaluate whether the cap is an effective or desirable policy, nor do we assess specific options for reducing spending when breaches are identified. We set out our recommendations for government as it develops its forecasts and management of the cap, and highlight limitations or risks to this new control on public spending.

6 In our past work we have highlighted the importance of five criteria for frameworks to control public spending: clear coverage; reliable forecasts; prompt reporting; robust controls; and clear governance.[1] In this report we:

- review the development of the welfare cap (Part One); and
- assess how well the government is managing the cap, against the criteria outlined above (Part Two).

Key findings

The development of the cap

7 **The cap has increased departments' oversight of spending on benefits and tax credits.** Since this spending is largely determined by individual entitlements, departments are not able to exercise control in-year in the way they might for other areas of spending. As a consequence spending on benefits and tax credits is not included in departments' expenditure limits. The introduction of the cap has increased the level of attention to benefit spending forecasts across government and at the Office for Budget Responsibility (OBR) (paragraphs 1.6, 2.18, 2.19 and 2.22).

8 **The welfare cap is new and processes for managing it are evolving.** In the Autumn Statement 2015 the OBR identified a breach of the terms of the welfare cap, only four months after HM Treasury had set the cap. This is the first time a breach has been identified since the cap was introduced (paragraphs 1.16 and 2.16–2.19).

9 **Recent fiscal events have exposed weaknesses in the way sensitive policy changes are costed.** There have been two notable errors in recent policy costings. In the Summer Budget 2015 the government made errors in its calculation of the savings from its proposed tax credit measures and a further error occurred when the tax credit measures were reversed in the Autumn Statement 2015. The OBR outlined the source of the Summer Budget 2015 errors as mostly due to a tight timescale combined with a large number of policy measures late in the process. It attributed the Autumn Statement 2015 errors to a restriction of knowledge about sensitive policy changes (paragraphs 1.16, 1.17, 2.16, 2.17, 2.27 and 2.28).

1 For example, Comptroller and Auditor General, *The Levy Control Framework*, Session 2013-14, HC 815, National Audit Office, November 2013.

The management of the cap

10 The coverage of the cap is clear and takes into account different factors affecting spending. It includes spending on most benefits and tax credits, but has two significant exclusions. The government has chosen to exclude the State Pension, which forms the largest share of all benefit spending. The cap also excludes spending which is highly dependent on the state of the economy, including Jobseeker's Allowance and related Housing Benefit payments (and the equivalent elements of Universal Credit). This reduces the level of uncertainty around unemployment assumptions in forecasts but there is a risk that the current scope of the cap may create an incentive for government to keep claimants on Jobseeker's Allowance, instead of encouraging claimants into work and increasing entitlement to in-work benefits, or on to alternative out-of-work benefits, both of which are inside the cap. Departments told us they believe this risk to be small and have no intention of using the cap in such a way (paragraphs 1.7, 1.8, 2.3, 2.4 and Appendix Three).

11 While the welfare cap builds on relatively well-established forecasts of social security and tax credit spending, there are several areas where analysis and forecasts could be improved:

- **There is ambiguity in the way some changes in spending are classified.** The cap allows for a 2% margin for forecasting errors such as changes in economic conditions. The OBR is responsible for distinguishing forecasting errors from policy changes or reclassification of spending. These distinctions are not always clear-cut, creating uncertainty about the scope of the cap (paragraphs 2.5, 2.6 and 2.23).
- **Interactions between benefits are not dealt with systematically.** At the moment DWP's forecasts are developed for individual benefit streams with separate manual adjustments to account for interactions between benefits. DWP has a model – known as INFORM – to account for interactions, but recent welfare reforms mean that the model is no longer considered fit for this purpose. DWP plans to invest in upgrading its models (paragraphs 2.10 and 2.11).
- **There is limited independent model review outside the OBR process.** The departments' analytical and policy teams and HM Treasury have informal links between individuals within and across departments. But in DWP there is heavy reliance on self-review with limited peer-review or independent review of these models. And it is not clearly documented how and when concerns about forecasts of the welfare cap as a whole should be escalated (paragraphs 2.12, 2.13 and 2.31).
- **Analysis and reporting of forecast uncertainty is limited.** Some benefit forecasts do not include quantitative estimates of uncertainty. Policy costings must include an assessment of uncertainty, and the OBR discusses risks in its reports (paragraph 2.26).

- **There is not always time for the OBR to review all the elements of the forecasts fully – in particular the government's policy costings – given the complicated reporting environment.** To make clear how it has made its assessments the OBR reports where it has challenged estimates, where it has departed from departmental assumptions, and where it has not had time to check estimates. The risk of errors occurring increases when timescales are tightly compressed (paragraphs 2.27 and 2.28).

- **The OBR believes the process around its scrutiny of policy impacts is improving generally but it has been hampered in some circumstances.** Information about the most sensitive policy measures is sometimes restricted to individual lead departments. This limits OBR's ability to call directly on the expertise of officials across DWP and HMRC. These restrictions make it more difficult to assess the impacts of policy changes across departmental boundaries and have led to errors which the OBR has not identified prior to certification (paragraphs 2.16, 2.17, 2.19, 2.27 and 2.34).

12 **Governance and decision-making around controls for the welfare cap are evolving.** Departments develop policy options and support ministers to make these policy decisions. It is not yet clear how the welfare cap could affect incentives for departments to control spending through discretionary or operational changes, or how to treat certain reclassifications of spending (paragraphs 2.29–2.33).

Concluding remarks

13 The welfare cap is encouraging greater oversight and understanding of spending. Forecasts will always be uncertain and there are many areas where modelling, processes and controls need to improve and are evolving. But the welfare cap is leading to better challenge of departments' modelling assumptions, and greater transparency about the factors and limitations that affect forecasts.

14 While the level of the welfare cap and any decisions about social security and tax credit spending are ultimately policy choices, it is important that processes for managing the cap are reliable and support informed and transparent decision-making. When – as is currently the case – spending is projected to be close to or over the cap, any weaknesses in forecasts are particularly important as they may affect real policy or operational decisions. All departments involved should therefore move quickly to improve their processes, including more complete assurance of models, better working across departments and greater clarity over how changes in forecasts are classified.

Recommendations

15 As departments continue to refine forecasts and processes for the welfare cap, we make the following recommendations:

a **HM Treasury should support the OBR better by increasing its access to expertise within departments and increasing the time it has to consider the impact of new policy on its forecasts.** The adjustments required to forecasts following the Summer Budget 2015 and Autumn Statement 2015 could have been avoided if the OBR had been able to discuss policy costings more openly with the departments involved and if the departments had more time to model the impacts properly. HM Treasury should review its process surrounding policy costings to support better forecasting of interdependencies of benefits.

b **DWP should introduce more rigorous quality assurance of models.** DWP has already adopted good practice in some areas recommended by HM Treasury's *Aqua Book: guidance on producing quality analysis for government,* March 2015. It should build on this by implementing periodic peer review and external review of all its business critical forecast models.

c **Improve model integration and analysis of uncertainty.** We encourage all departments to discuss uncertainty more openly and try to quantify this to an appropriate level. They should continue to increase transparency over the assumptions in models. The departments should consider publishing models or more details on their methodologies and their core assumptions as has been done in other areas of government.

d **DWP should introduce better documentation of models and assumptions.** There is currently too much reliance on self knowledge of policy areas which increases the risks of errors and loss of knowledge if staff move elsewhere. We recommend that all policy assumptions, models, interactions and quality assurance arrangements should be fully documented.

e **HM Treasury should set out clearer cross-departmental governance arrangements.** Better decision-making would be supported by strengthening and clarifying the role of the AME Risk Group which is the only body with attendance from all departments. The Group should have clearer terms of reference and should be able to call on experts across departments in all circumstances so that it can provide informed advice on the combined impact of proposed policy measures to ministers.