

UC it to believe it

With inflation expected to exceed [13%](#) later this year – and already reaching decades-high rates – we wanted to understand how some stylised economically vulnerable households would be faring. Income support available to households typically has some in-built flexibility to adjust payments in line with prices. A household finances model that we developed in 2021 provides a basis to understand the extent to which that flexibility might keep pace with the currently soaring prices. This post outlines the policy context, the illustrative modelling we did to answer this question, and the limitations (i.e. where further research could fill the gaps).

Policy context: The cost-of-living crisis

Annual inflation is currently spiking, with the change in the consumer price index that captures housing costs (CPIH) reaching [8.8%](#) in July 2022. Inflation is expected to continue rising, with the Bank of England now predicting a peak of 13% in the consumer price index (CPI). Bill payers are braced for dramatic increases in the energy price cap, which will be [£3,550](#) for an average household in October and could reach [£4,300](#) next January. The price increases are [driven](#) by energy, food and transport – things that poorer households typically spend the largest share of their budgets on. Analysis from the [IFS](#) suggests that whilst the overall economy can expect 13% inflation in October, the poorest fifth of households might experience inflation nearing 18%.

The rapidly rising cost of living, expected to be more acute among poorer households, raises crucial questions about how it can be mitigated. Blanket measures that give most or all households some respite would recognise that all are exposed to the crisis (and may shore up votes), but this would be a drag on the public purse – which has already experienced gargantuan costs from addressing the COVID-19 crisis. Moreover, some households may not strictly need that blanket support. Instead, targeted measures which recognise differences in financial resilience could be a more prudent use of public funds. There is also a case for reform of how existing income support is updated to account for inflation, given the rapidly changing context.

Here, we focus on the updating of Universal Credit (UC) for inflation. In April each year, UC is uplifted to reflect the change in prices over the 12 months to the preceding September. That is, UC undergoes a *lagged* adjustment. So, in April 2022 UC was uplifted for the CPI rate of 3.1% between September 2020 and September 2021. In contrast, the UC Local Housing Allowance (LHA), which is available to UC-receiving households to help with their rent costs, has remained [fixed](#) at the 2020-21 level for 2021-22 and 2022-23.

Our illustrative modelling

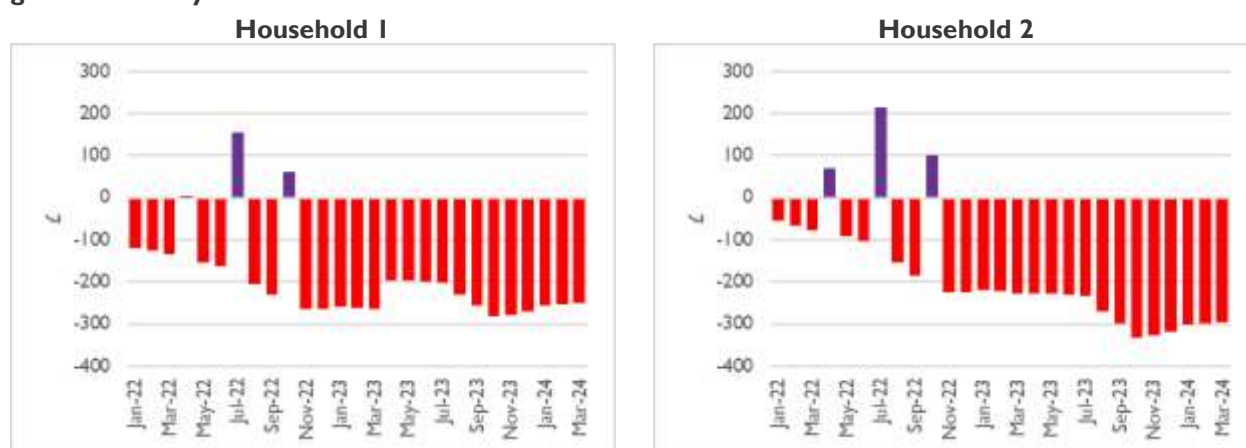
Last summer, we carried out some [research for the Local Government Association](#) (LGA) to analyse the potential impacts of the withdrawal of COVID-19 support policies on economically vulnerable households. One of the models we constructed estimated how the finances of some stylised vulnerable households could develop as pandemic support measures were introduced and later withdrawn. This model provides a basis for understanding whether current support is sufficient for economically vulnerable households to weather the cost-of-living crisis.

In our model, we account for savings and income adjustments to UC, benefit caps (including the associated [grace period](#)), [council tax rebate](#) in April 2022 and the [cost of living payments](#) expected later this year. We assume LHA rates remain frozen at the current level in 2023-24. With some assumptions about how inflation could evolve to and beyond the Q4-2022 peak expected by the [Bank of England](#), we derive an illustrative household balance sheet from January 2022 to March 2024.

The stylised vulnerable households are the same as those in the LGA research. The households are numbered according to their financial resilience from 1 (least resilient) to 6 (most resilient). Households 1, 3 and 5 are single-parent households with two children; whereas households 2, 4 and 6 are households comprising couples with two children.

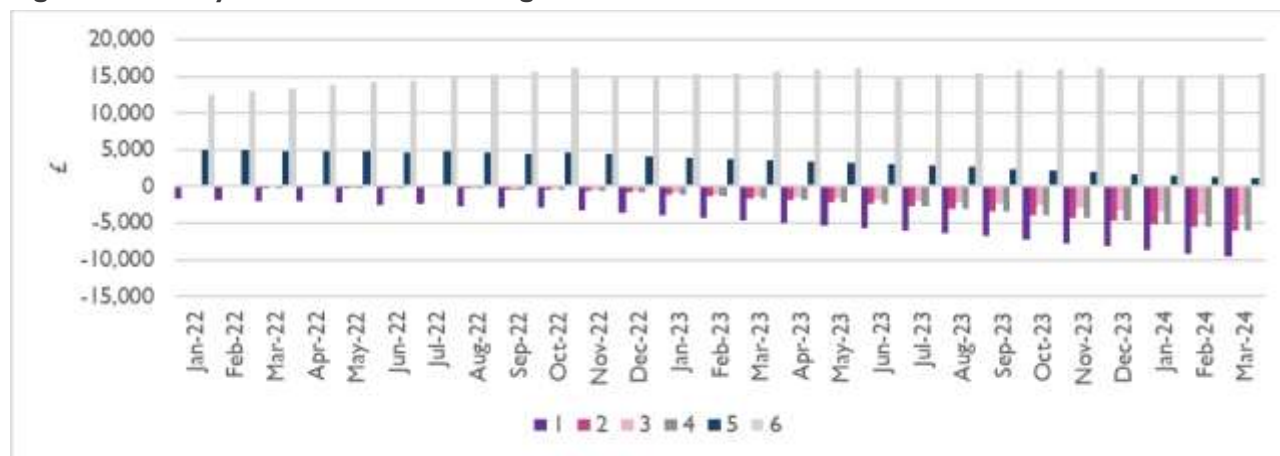
Referring to Figure 1, with a UK average level of income and expenditure, we find that the UC adjustments in April 2022, and again in April 2023, are not enough to offset the cost increases for the most vulnerable households. The negative net income (monthly income less expenditure) of these households increases sharply until UC rates are adjusted again in April 2023. The 2023 adjustment pushes Household 2 further up against the [benefit cap](#), restricting the LHA amount it can receive and in turn limiting the advantage of the inflation uplift. Both households receive some short-term respite in 2022 in the form of the council tax rebate and the cost of living payments (shown by the months in which net income briefly becomes positive).

Figure 1: Monthly net income – Households 1 and 2 – UK



The net income variations visible above affect the households' total debt and savings. This is shown in Figure 2. Household 1 – which we assume starts the period with some debt – is unable to repay its debt throughout the modelled period. Households 2-4 become increasingly indebted as their expenses rise over 2022-23. The more resilient households 5 and 6 – which start the period with some savings – experience different outcomes. Household 5 is just about able to hold onto its savings until mid-2022, after which these savings must be used to meet expenses (which the model assumes will happen before a household takes out credit). Household 6's savings are needed to pay expenses in the months where it becomes ineligible for UC because its savings exceed the limit, causing the threshold dynamics visible in the jagged series.¹

Figure 2: Monthly stock of debt and savings – all households – UK



¹ The results for Household 6 reflect a limitation of the model, which does not take account of the time lag involved in making a new application for UC.

Our illustrative modelling probably underestimates the impact of the cost-of-living crisis on our stylised households, as we have used the economy-wide inflation rate in our modelling rather than the higher inflation rate that is being experienced by low-income households.

Now you've seen it

This brief analysis underscores an important point about inflation-linked benefits: lagged inflation adjustments to UC are insufficient to help households during periods when inflation is rising rapidly. Adjusting for expected inflation rates is a plausible alternative to this approach, noting the obvious cost this would impose on the taxpayer and the risk that inflation expectations do not materialise. An urgent task for the next prime minister is to put additional support measures in place for low income households, which may include reforming the way in which existing support measures, such as UC, are adjusted for inflation.

The model we use here necessarily simplifies reality to focus on its objective. It excludes the following factors, which could be investigated more fully in further research:

- Discretionary changes in expenditure in response to rising prices. Consumers' spending habits are changing, which could mean that the distribution of expenditure is likely to be different to that assumed in the model.
- The monthly pattern of inflation as changes in the energy price caps are implemented. This could lead to a different monthly evolution of net expenditure throughout 2023 and 2024 than assumed in our illustrative modelling.
- The analysis shows the potential friction between periodic increases in benefits and the fixed cap on the total benefits a household can receive. Further modelling could identify appropriate mechanisms for adjusting the cap and the impact on government finances.
- As we note above, the inflation rates assumed are economy-wide averages, neglecting the fact that households are exposed to price pressures to varying degrees. Food and fuel costs tend to account for a larger proportion of poorer households' expenditure. So, the inflation rate actually *experienced* by our stylised households could be more or less than the headline rate.

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