Resolution Foundation

BRIEFING

Budget 2016 response

March 2016

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Summary

At the centre of the yesterday's Budget documents is a major deterioration in the OBR's forecast for the public finances over the coming years: the £27 billion fiscal windfall from the Autumn Statement transformed into a £55 billion fiscal hole.

While the global backdrop has undoubtedly raised new challenges for the UK economy, the OBR was clear that its most significant forecast change relates to a downward revision in potential productivity growth. This has major implications for the UK's growth capacity, for living standards and for the public finances. The OBR has consequently downgraded its GDP, earnings and household income projections – helping to drive a very large reduction in income tax receipts over the forecast period. The downward effect of this on public finances is only partially offset by falling debt interest payments.

Faced with this deteriorating backdrop, the Chancellor rightly chose to delay any policy response until the back end of the parliament. Instead, he announced giveaways in the near-term, thereby adding to the fiscal hole in 2017-18 and 2018-19.

But in order to continue to deliver the budget surplus required under the fiscal mandate in 2019-20 and beyond, he pencilled in a sharp consolidation in 2019-20. This overall £32 billion tightening is by far the largest in this Parliament; £12 billion more than the next most significant reduction of £19.7 billion in this financial year and double the planned reductions over the next two years. In cash terms it is actually £10 billion more than any year to year reduction since George Osborne became Chancellor, or indeed any year since records began.

In order to meet this extremely difficult challenge in 2019-20 (made all the harder by its proximity to the next election), the Budget included £14 billion *of new policy tightening. This comprises net tax rises and departmental and welfare spending cuts. Some of this reflects movements between years, but some is as yet unspecified – with £3.5 billion of departmental cuts not yet allocated for instance.*

Given the backdrop of deterioration in the public finances, the Chancellor's decision to take further strides towards delivering on the pre-election pledge to raise the income tax personal allowance to £12,500 and the higher rate threshold to £50,000 by 2020 appears particularly misguided. The measures announced in the Budget – which relate to 2017-18 – will cost £2 billion (rising to £2.6 billion by 2020-21), making the job of getting the public finances back on track that bit harder. And they are highly regressive, with over 80 per cent of the gains going to the top half of the income distribution and roughly half (47 per cent) going to the top 20 per cent of households alone.

Taken together with other policy announcements made by the government since last year's election, we estimate that households in the bottom half of the income distribution stand to lose an average of £375 a year by 2020-21, while those in the top half are set to gain by an average of £235.

This note comprises seven sections:

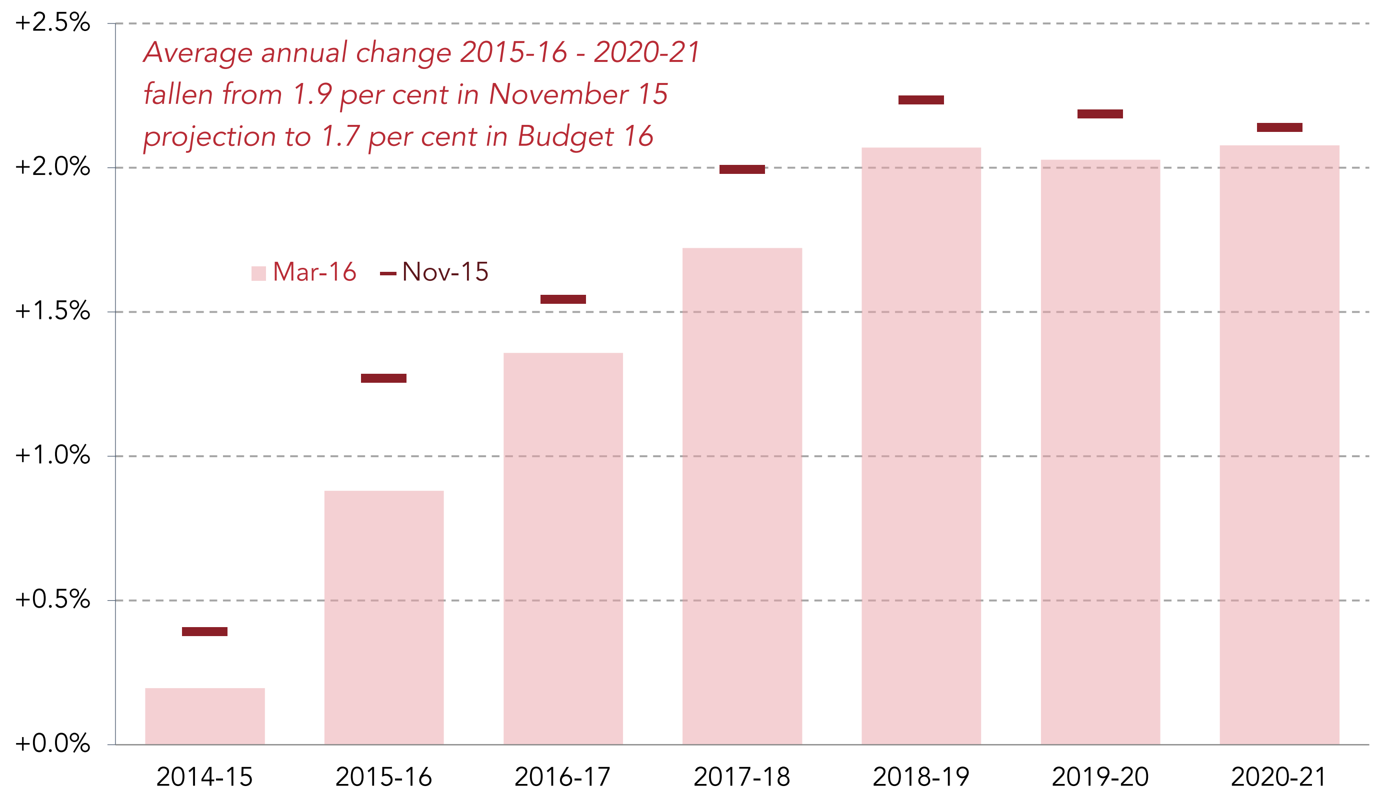
- In Section 1, we focus on the key change in the OBR's assessment of future productivity growth;
- Section 2 considers the implications of this for economic growth and earnings;
- Section 3 assesses the impact on government receipts;
- Section 4 looks at the consequences for the OBR's public finances outlook;
- In Section 5 we set out the Chancellor's decision to allow borrowing to rise in the short term;
- In Section 6 we discuss the scale and viability of the Chancellor's consolidation plan at the end of this parliament;
- In Section 7 we note the distributional effect of policy changes contained in the Budget and the cumulative impact of all post-election changes.

1. Trend productivity growth may be lower than we thought…

At the core of the OBR's *Economic and Fiscal Outlook* is a sharp downward revision in projected productivity growth in the coming years. In last year's Autumn Statement, the OBR projected that productivity per hour would grow by an average of 1.9 per cent between 2015-16 and 2020-21; that average now stands at 1.7 per cent.

Figure 1: Change in OBR productivity growth projections between November 2015 and March 2016

Annual growth in productivity growth: Nov 15 and Mar 16 OBR projections



Source: RF analysis of OBR, *Economic and Fiscal Outlook*

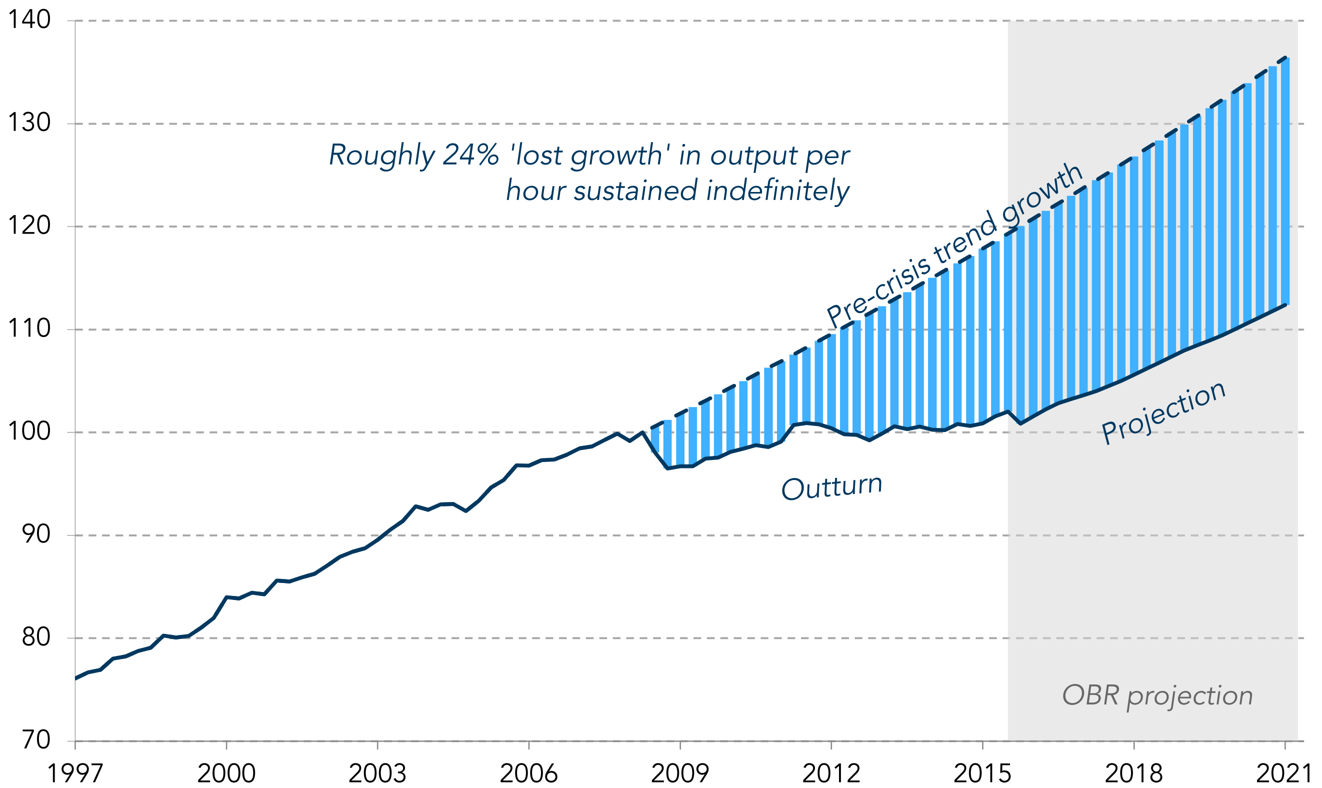
This change reflects the OBR's assumption that more of the weak productivity growth post-crisis represents a *permanent* shift in the UK's potential to grow, with the pick-up in productivity growth in mid-2015 now being described as a 'false dawn'.[1] This goes further than the concern that has dominated the productivity discussion to date – namely the scale of the productivity hit endured after the crisis. Instead, it implies that *trend* productivity growth has fallen.

Productivity is already around 17 per cent below where it might have been in the absence of the post-crisis stagnation. If the trend rate of productivity growth has fallen, then this gap will widen – rising to 24 per cent by the end of the forecast horizon.

[1] OBR, *Economic and Fiscal Outlook*, March 2016, para 1.3

Figure 2: Productivity growth projection relative to pre-crisis trend

Index of non-oil output per hour (Q2 2008 = 100)



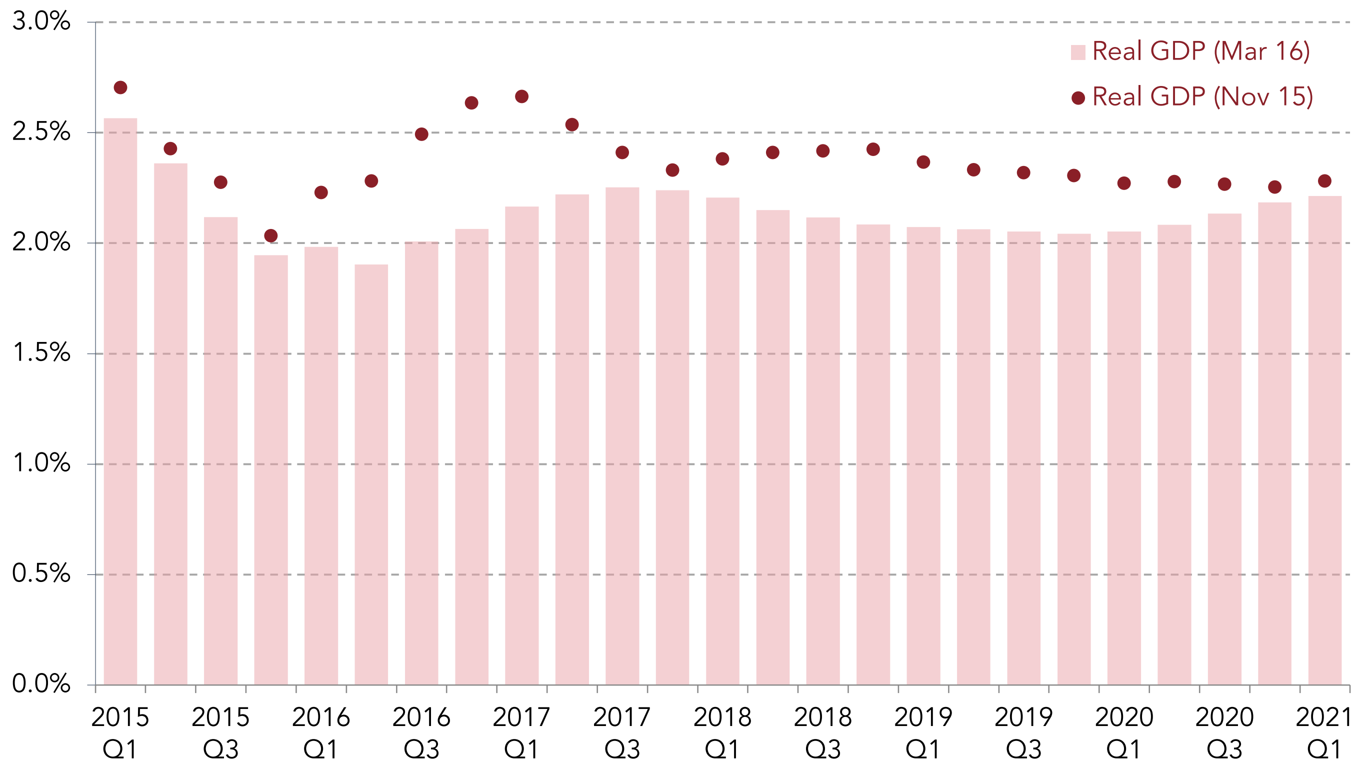
Source: RF analysis of OBR, *Economic and Fiscal Outlook*

2. Driving down projections for growth and for earnings

These changes in assumed trend productivity have important implications for economic growth and for living standards. The OBR states that it has prompted it to revise down its GDP growth forecasts by around 0.3 percentage points a year. As Figure 3 shows, the projected annual growth rate has been reduced in every quarter from the start of 2015.

Figure 3: Change in OBR GDP projections between November 2015 and March 2016

Annual growth in real GDP: Nov 15 and Mar 16 OBR projections



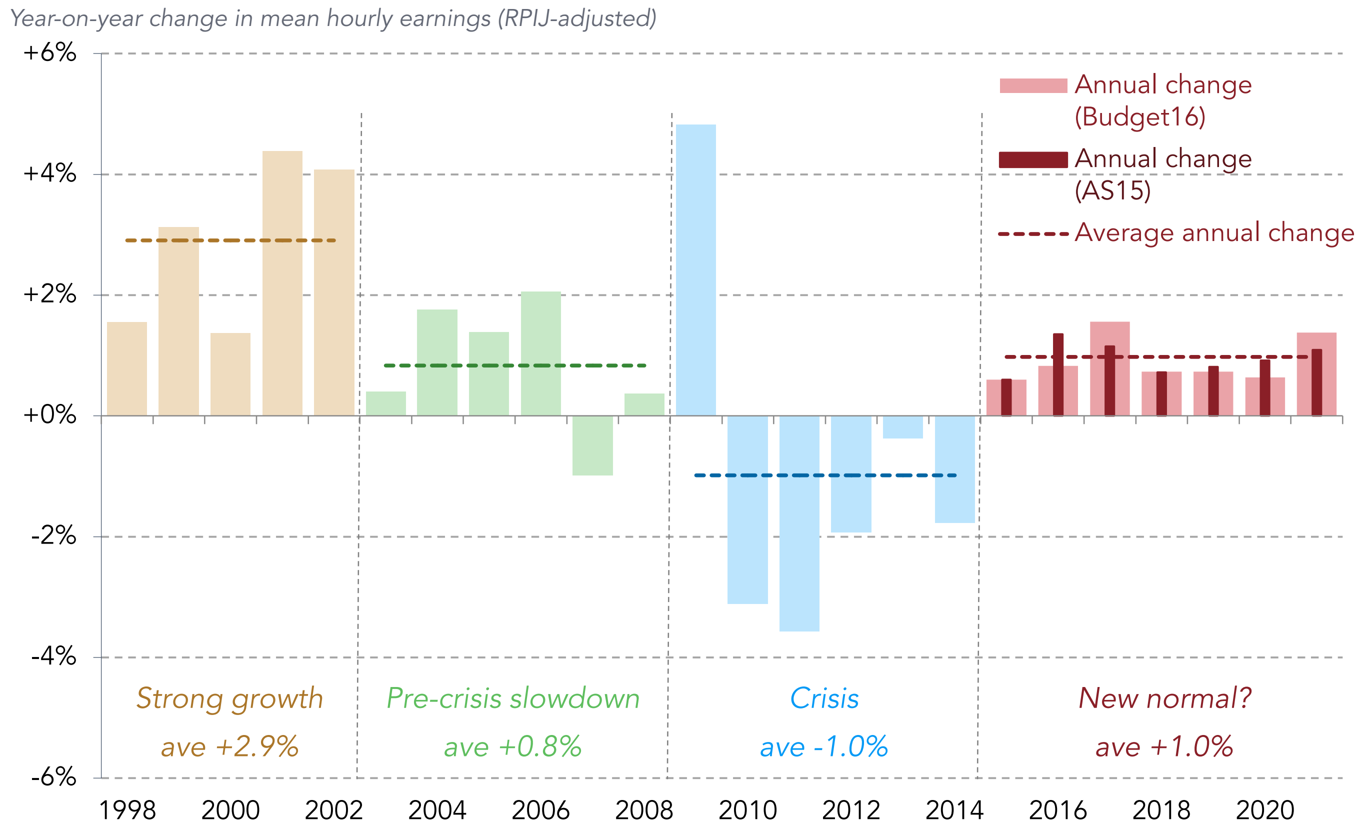
Source: RF analysis of OBR, *Economic and Fiscal Outlook*

Wage growth projections have similarly been revised down. Even in November, average annual real growth in mean hourly pay was set to be just 1.1 per cent from 2015 onwards – down from an average of 2.9 per cent in the late-1990s and early-2000s. Following today's update from the OBR, the projected average has fallen to just 1 per cent a year.

This comprises a near-term pick-up in pay, with nominal growth rising even as inflation remains subdued. Between 2018 and 2020 however, nominal pay growth is projected to remain largely unchanged. With inflation returning towards its target rate, real terms growth is set to *fall* – back to just 0.7 per cent a year.

Figure 4: Mean hourly earnings growth: outturn and projections

Year-on-year change in mean hourly earnings (RPIJ-adjusted)

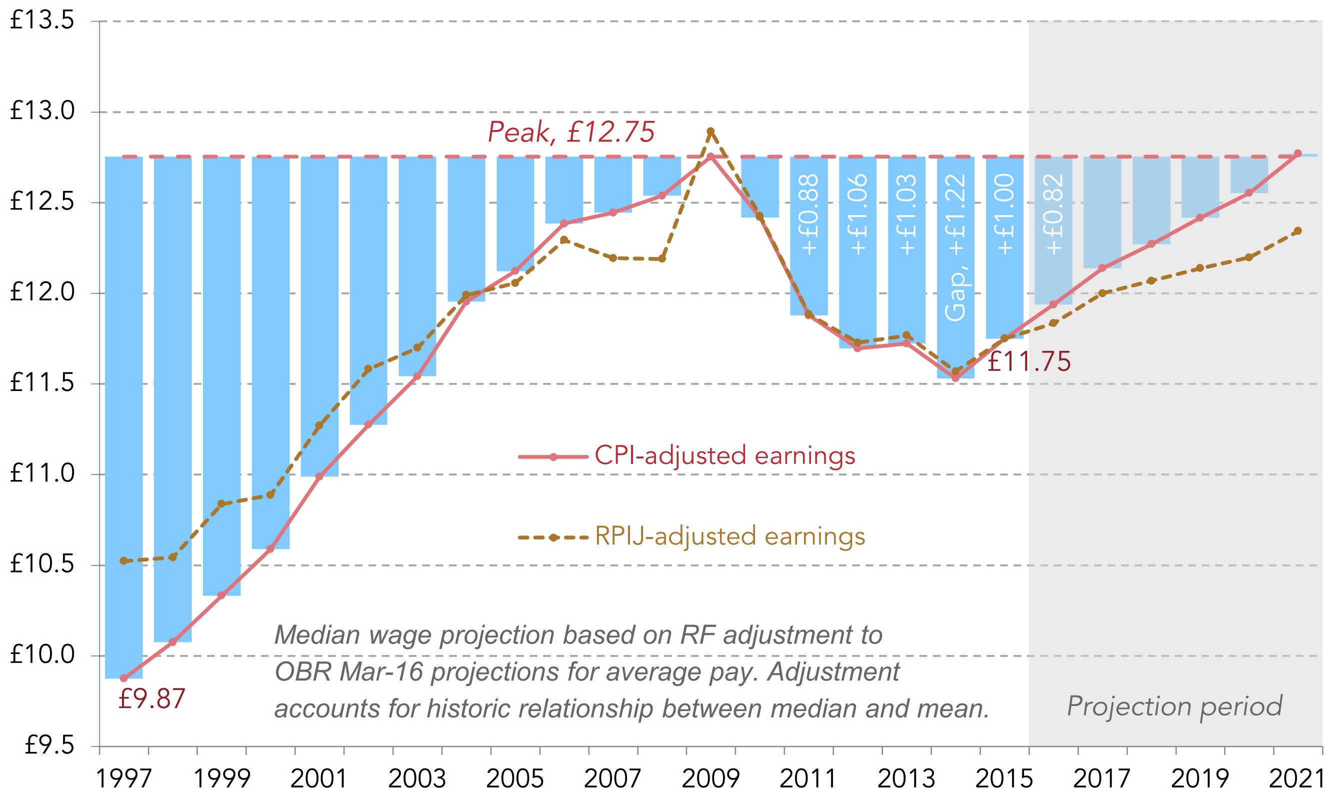


Source: RF analysis of OBR, *Economic and Fiscal Outlook* and ONS, *Annual Survey of Hours and Earnings*

The implication of these changes in *average* wage projections is that *typical* (median) wages won't return to their pre-crisis level until 2021 when deflated using CPI, and later still when using RPIJ which includes a housing cost element.

Figure 5: Median hourly earnings: outturn and projections

Median hourly earnings (excluding overtime): all employees (2015 prices)

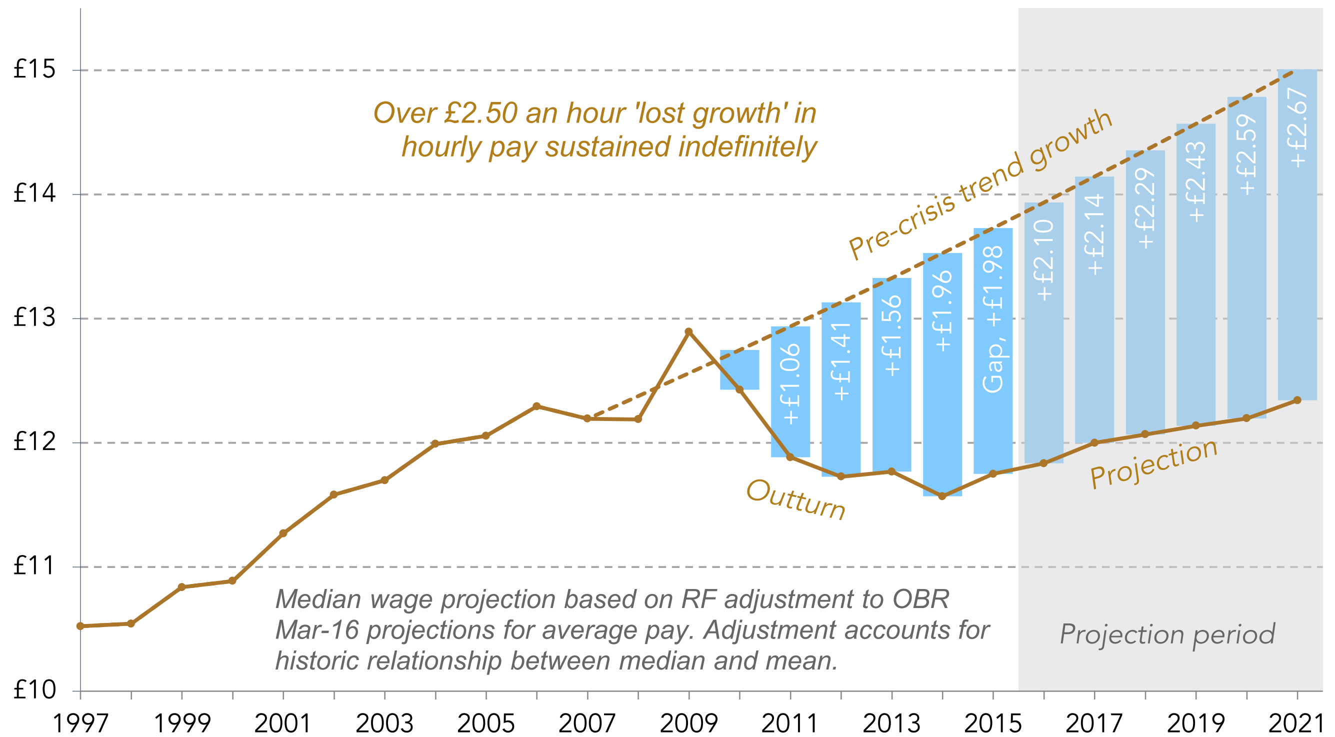


Source: RF analysis of OBR, *Economic and Fiscal Outlook* and ONS, *Annual Survey of Hours and Earnings*

The downgrade means that the gap from where median hourly pay would have been in the absence of the post-crisis pay squeeze continues to widen over the forecast horizon. By 2021, our projection puts the hourly gap at £2.67.

Figure 6: Median hourly earnings projection relative to pre-crisis trend

Median hourly earnings (excluding overtime): all employees (2015 prices, RPIJ-adjusted)



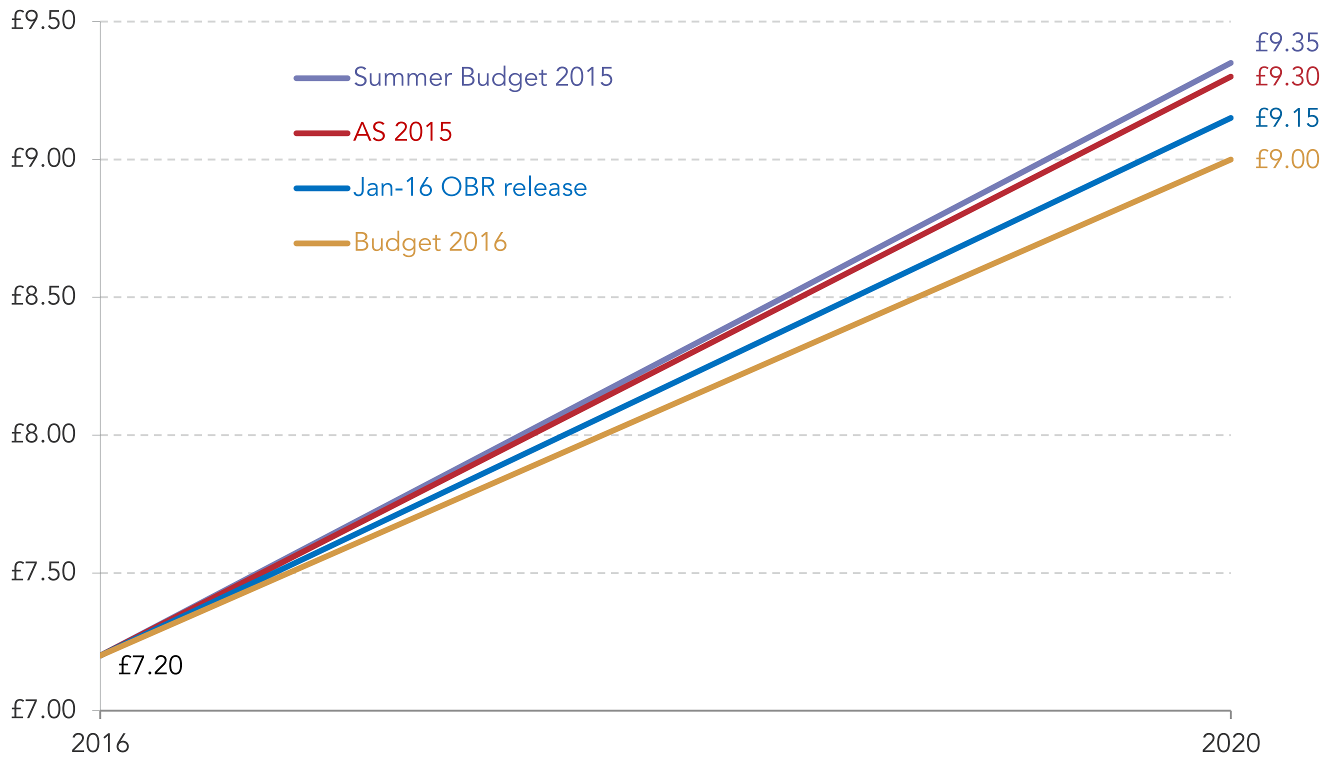
Source: RF analysis of OBR, *Economic and Fiscal Outlook* and ONS, *Annual Survey of Hours and Earnings*

Weaker median earnings growth also affects the path of the National Living Wage (NLW), because the government's policy is for the new higher wage floor to be worth 60 per cent of median pay for over-24s in 2020. When it was first announced at the Summer Budget, the OBR projected the NLW would stand at £9.35 in 2020. Disappointing wage growth since then and today's bleaker outlook means the NLW is now expected to be £9.00 in 2020 – exactly in line with the Chancellor's stated ambition for the NLW in cash terms that year.

The precise figure is likely to continue to rise and fall over the coming years as new data are released but whatever the future figures, the NLW still represents a major boost to the UK's lowest earners.

Figure 7: Successive OBR projections for the National Living Wage

Successive OBR projections of National Living Wage rate in 2020, cash



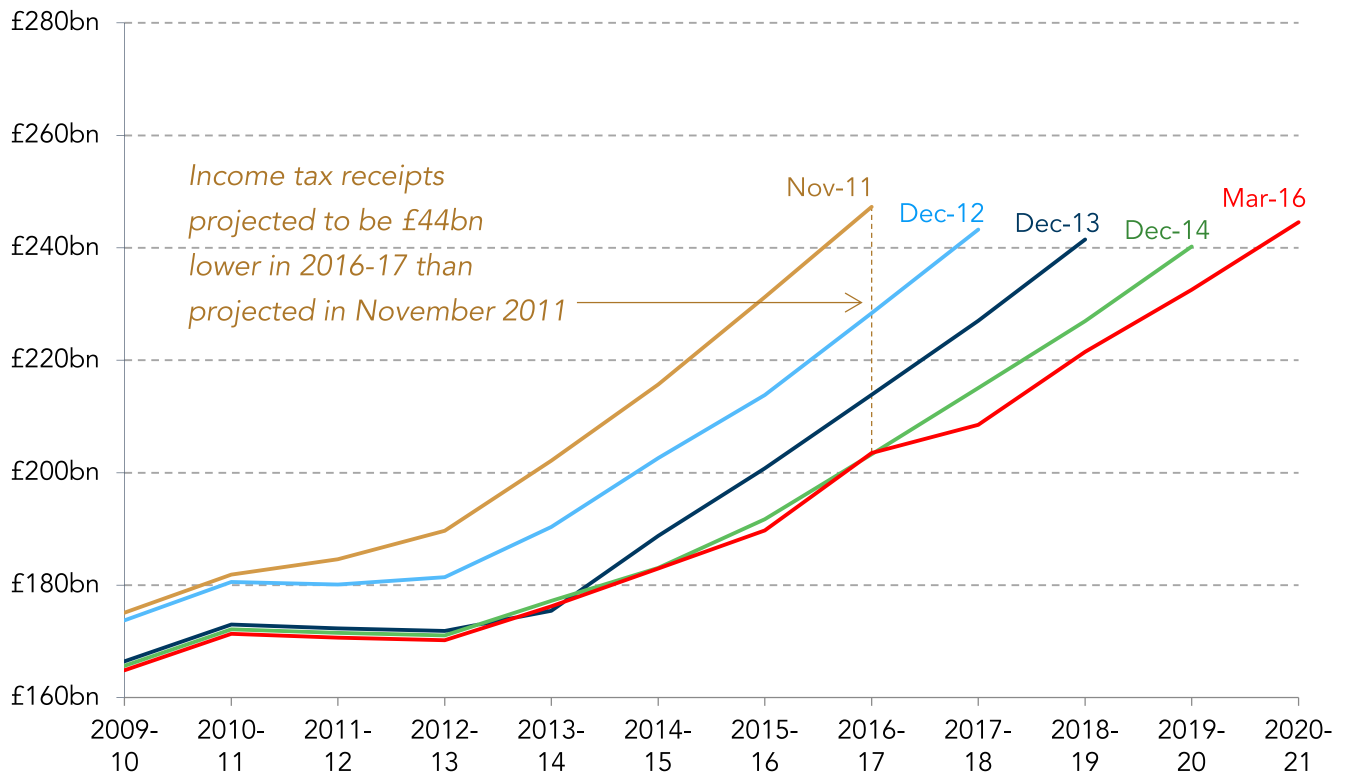
Source: RF analysis of OBR, *Economic and Fiscal Outlook* and ONS, *Annual Survey of Hours and Earnings*

3. Together, these factors explain reductions in projections for revenues – especially income taxes

Weaker growth and weaker pay growth has obvious implications for the public finances. For example, projections for income tax receipts have been revised down again, with the total set to be £44 billion lower in 2016-17 than had been projected in November 2011.

Figure 8: Successive OBR projections of income tax receipts

Successive OBR income tax receipts projections (2015-16 prices, GDP deflated)



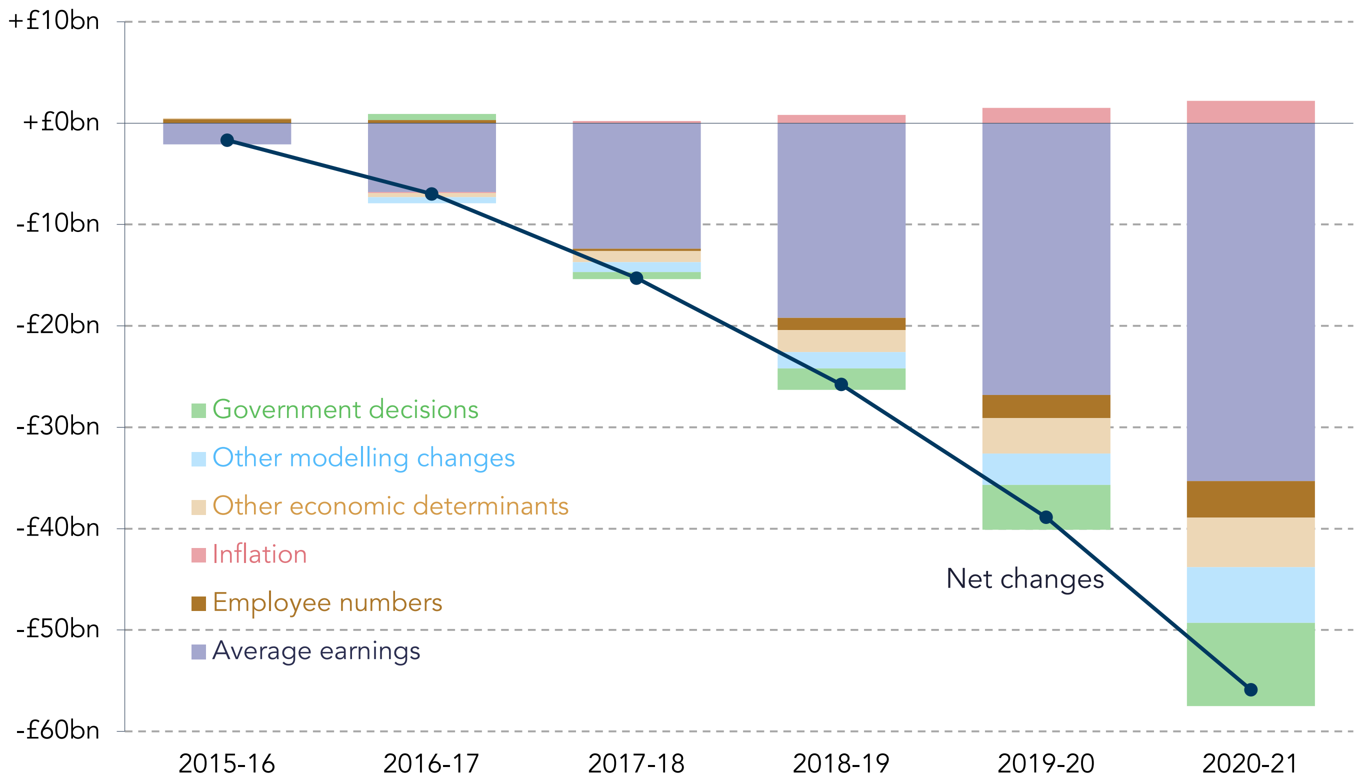
Source: RF analysis of OBR, *Economic and Fiscal Outlook*

Relative to the November projections, combined income tax and NICs forecast changes represent a £13 billion annual reduction by 2020-21. Cumulatively, these changes amount to £56 billion between 2015-16 and 2020-21. Perhaps surprisingly, just £8 billion (15 per cent) of this is due to policy changes (most notably the decision to increase the personal tax allowance and higher rate threshold). Instead, £48 billion (85 per cent) relates to OBR forecasting changes: £42 billion (75 per cent) is due to changes in economic assumptions and £6 billion (10 per cent) is due to other modelling changes.

Of all of these factors, the change in the average earnings projection plays the biggest role. It accounts for close to two-thirds (63 per cent) of the overall £56 billion reduction over the period, with a reduction in employee numbers accounting for a further 6 per cent.

Figure 9: Change in OBR income tax and NICs receipts projections between November 2015 and March 2016

Components of cumulative changes in annual projections for income tax and NICs receipts in March 2016 relative to November 2015



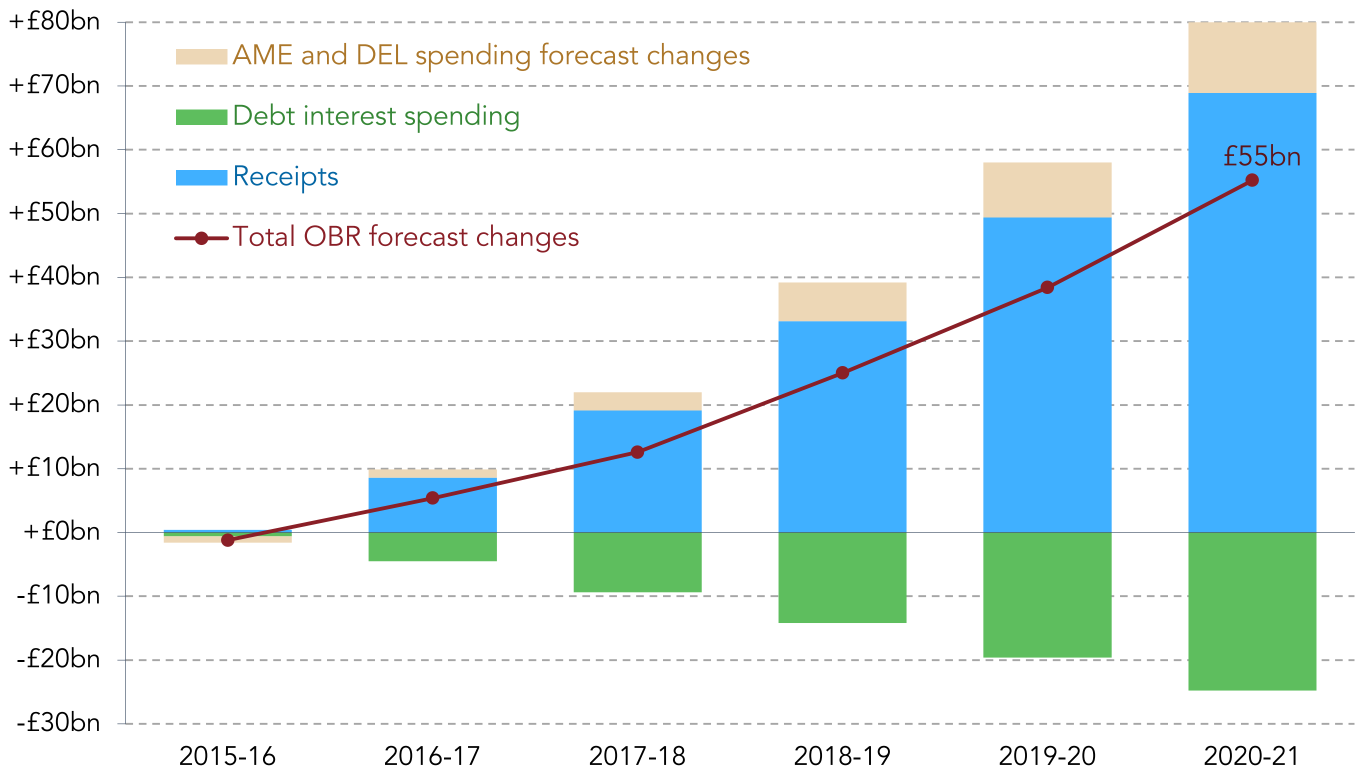
Source: RF analysis of OBR, *Economic and Fiscal Outlook*

4. Falling tax receipts drive a significant deterioration in the public finances outlook, creating a £55 billion fiscal hole

The cumulative £48 billion reduction in income tax and NICs receipts accounts for 81 per cent of an overall cumulative reduction in government receipts relative to the November 2015 projection of £69 billion. Other elements of the underlying forecast have also been altered, with a total £80 billion deterioration being partially offset by a downward revision in debt interest projections of £25 billion. Overall, the £27 billion 'fiscal windfall' of the Autumn Statement has transformed into a £55 billion 'fiscal hole' this time around.

Figure 10: Change in underlying OBR PSNB projections between November 2015 and March 2016 associated with forecast changes

Cumulative OBR forecast changes in public sector net borrowing since November 2015



Source: RF analysis of OBR, *Economic and Fiscal Outlook*

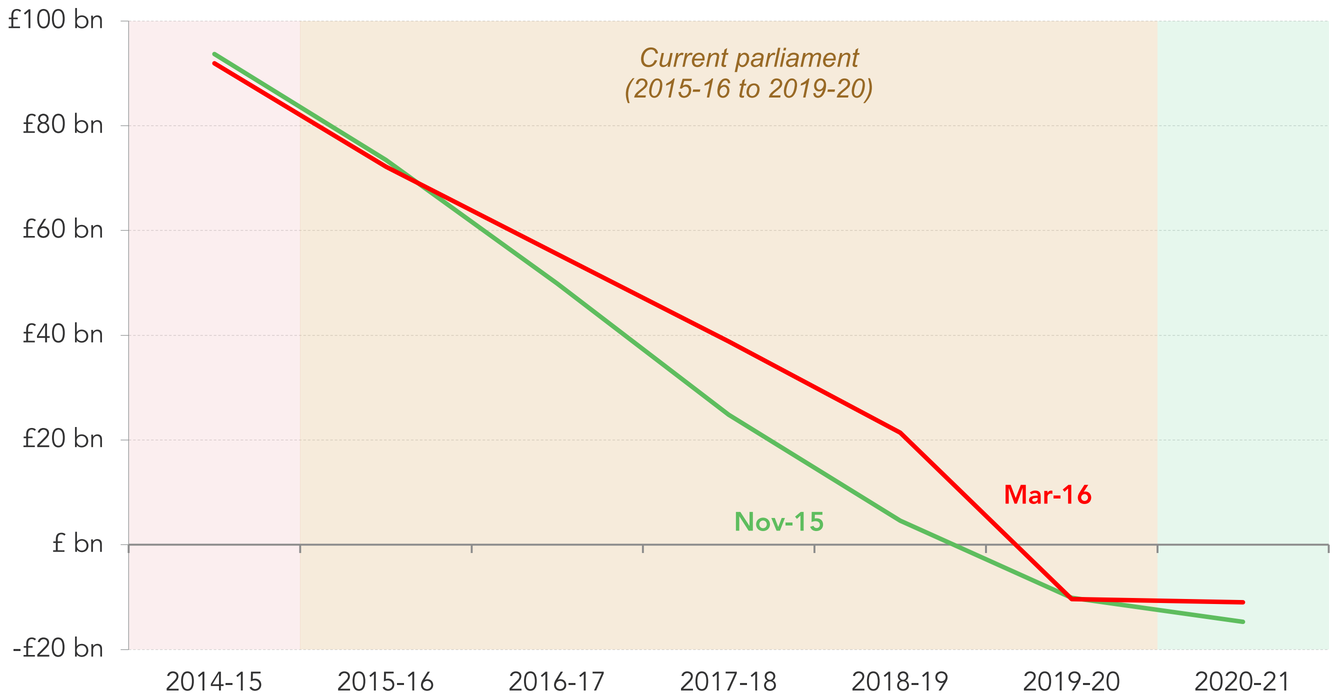
5. The Chancellor is accommodating the rise in borrowing for most of the Parliament, at a cost of £38bn and a broken fiscal rule

In the face of this £55bn deterioration in the underlying public finances the Chancellor is choosing to tolerate extra borrowing over the next few years, indeed to increase it with givaways including income tax cuts. As the next section discusses he then plans a major consolidation to achieve a surplus in 2019-20.

The result is that, over the period as a whole, he intends to borrow £38 billion more than was previously the case. In effect, he is tolerating 70 per cent of the £55 billion fiscal hole while filling 30 per cent of via policy changes that are heavily weighted towards the end of the period.

Figure 11: Change in OBR PSNB trajectory projections between November 2015 and March 2016

OBR projections for the deficit Autumn Statement compared to Budget Public sector net borrowing

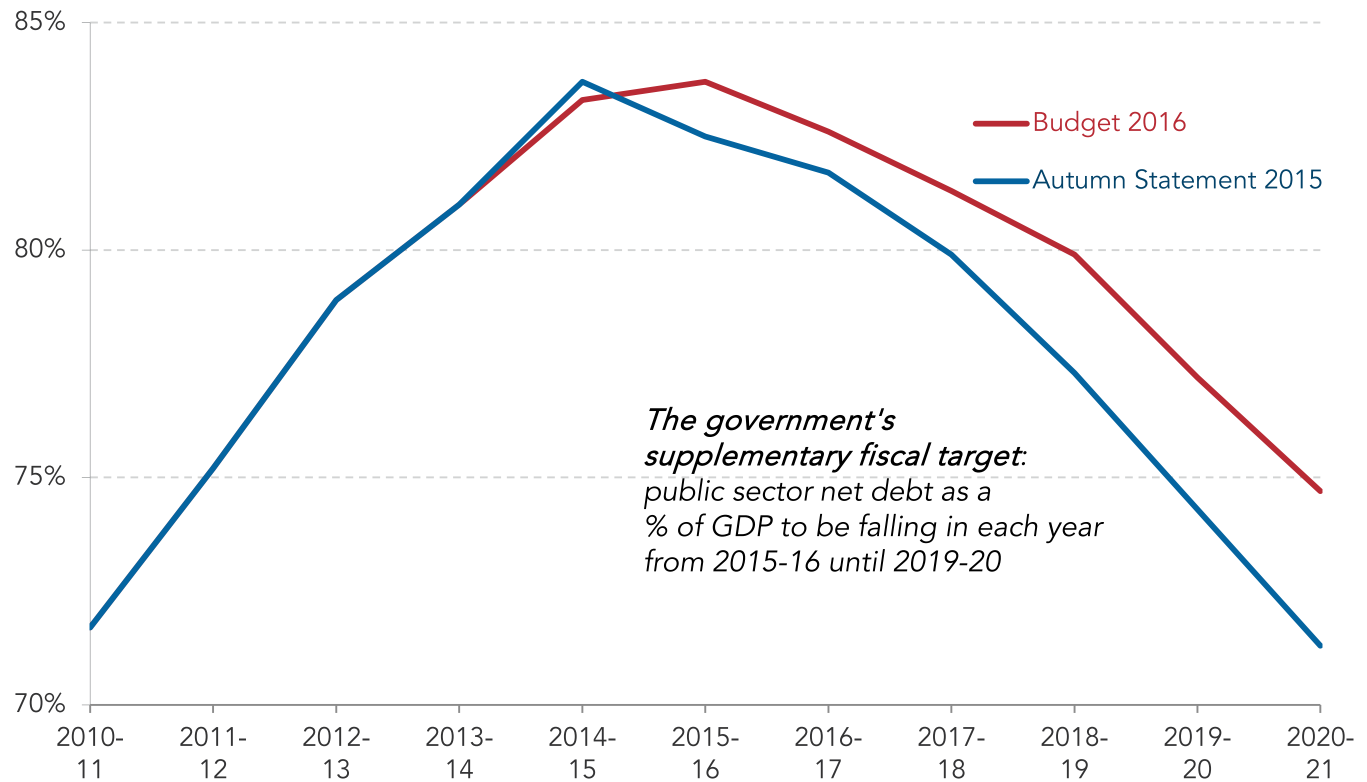


Source: RF analysis of OBR, *Economic and Fiscal Outlook*

While remaining on course to meet the fiscal mandate under this plan he is, however, set to miss his supplementary target. Net debt is projected to rise in 2015-16, before falling over the remainder of the forecast period. By 2020-21 it is projected to be 3 per cent of GDP higher than had been projected in November.

Figure 12: Change in OBR public sector net debt trajectory projections between November 2015 and March 2016

Public sector net debt as a proportion of GDP



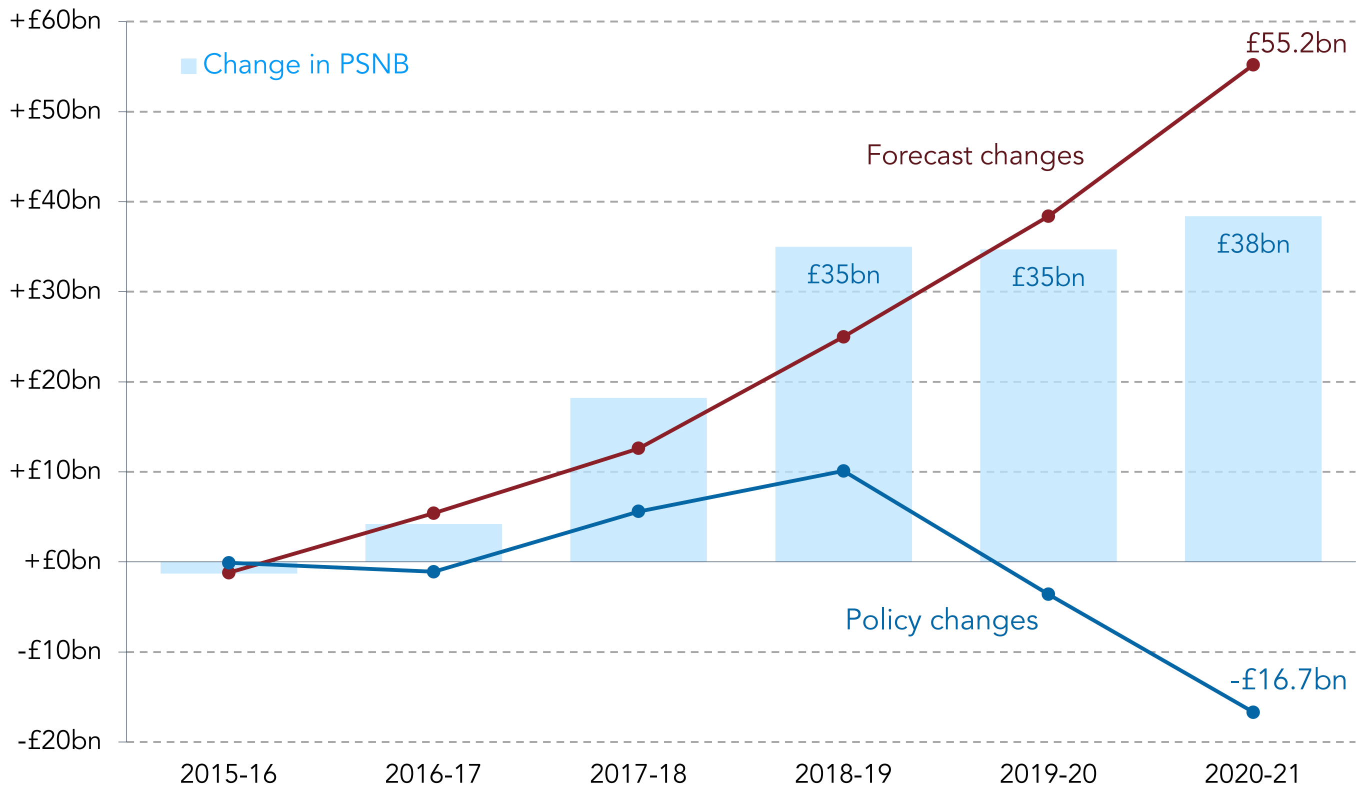
Source: RF analysis of OBR, *Economic and Fiscal Outlook*

6. To continue meeting the fiscal mandate for a surplus in 2019-20 the Chancellor has pencilled in a historically large consolidation in that year

While the updated trajectory for the public finances means that government borrowing is set to be much higher than had previously been planned in the years to 2018-19, the Chancellor then aims to return close to previous plans from 2019-20 by cutting borrowing sharply in that year. The Chancellor is still targeting a surplus of £11 billion in 2019-20 (in line with the November 2015 position), though the 2020-21 surplus has been reduced from £15 billion to £11 billion.

Figure 13: Cumulative change in OBR PSNB projections between November 2015 and March 2016

Cumulative changes in PSNB projections since November 2015, by component



Source: RF analysis of OBR, *Economic and Fiscal Outlook*

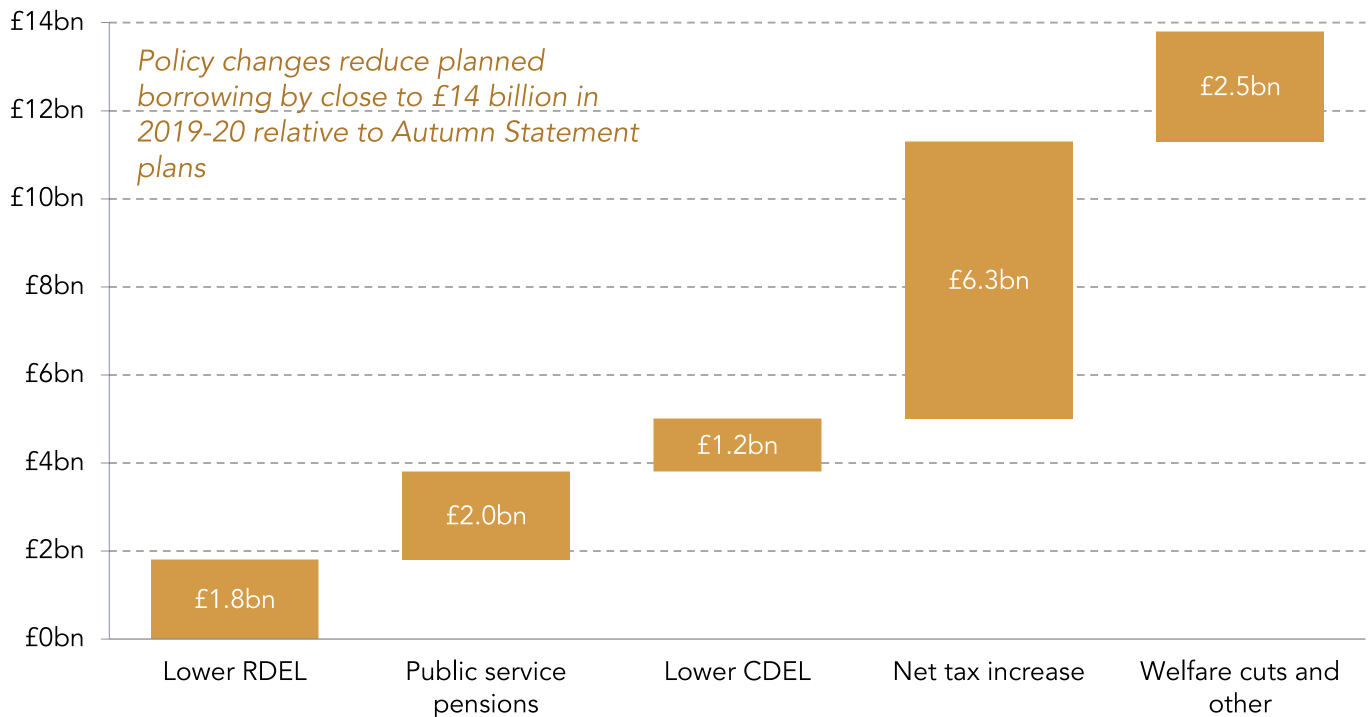
The policy changes behind the sharp reversal in borrowing in 2019-20 include:

- A £1.8 billion reduction in departmental current spending (RDEL). The Chancellor has detailed a further £2 billion of spending commitments in 1920. These are more than offset by the fact that lower GDP has allowed the government to reduce the overseas aid budget by £650 million while meeting the 0.7% GDP ODA target, alongside a – as yet unallocated – cut in resource DEL of £3.5 billion;
- A £2 billion reduction relating to the decision not to compensate public sector employers for the need to increase their pension contributions in the face of a lowering of the discount rate. This must be met within existing DEL envelopes and equates to a receipt for the Exchequer;
- Capital DEL is reduced by £1.2 billion, with investment spending being brought forward into the previous two years instead;
- A £6.3 billion net tax increase, £6 billion of which relates to an implementation delay in the policy announced in July 2015 that altered the timing of when large companies pay quarterly corporation tax. On this particular measure, the OBR has been clear that the scorecard costing "is not representative of the longer-term":[2] that is, it shifts tax receipts that had previously been planned for 2017-18 and 2018-19; and
- £2.5 billion of welfare cuts and other factors, including £1.3 billion in relation to Personal Independence Payments.

[2] OBR, *Economic and Fiscal Outlook*, March 2016, para A.19

Figure 14: Policy-related changes in OBR PSNB projection for 2019-20 arising in Budget 2016

Policy changes in 2019-20 in Budget 2016



Source: RF analysis of OBR, *Economic and Fiscal Outlook*

It is worth putting the scale of the proposed consolidation in some historical perspective. In cash terms, the £32 billion planned reduction in borrowing is by far the largest in this Parliament.

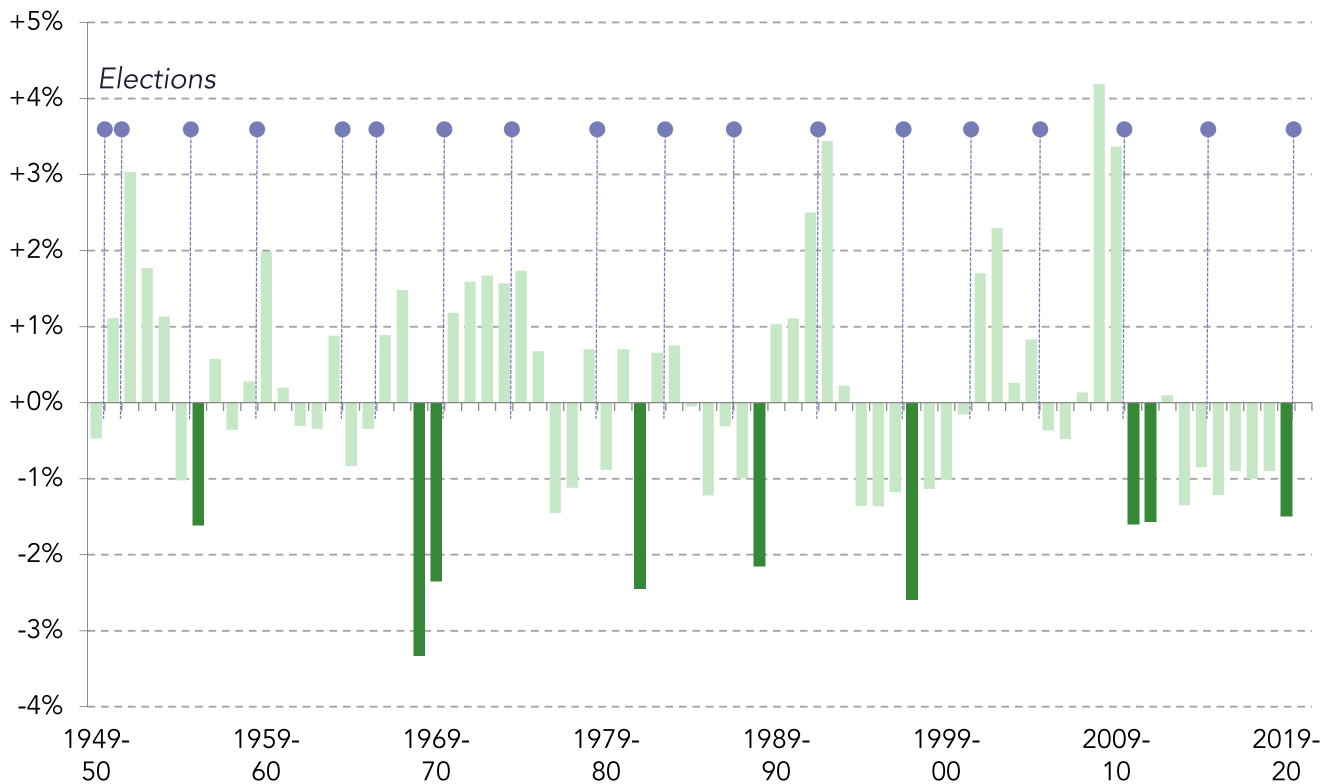
Looking at reductions in borrowing as a proportion of GDP also highlights the ambition of what has been pencilled in. Consolidation of 1.5 per cent of GDP in 2019-20 is equivalent to the major consolidations carried out in the first two years of the coalition government (1.6 per cent of GDP in both 2010-11 and 2011-12) when VAT was being raised and major school building programmes were being abandoned.

Reductions in borrowing were smaller during the 1990s consolidation, outside of the first year of the Labour government in 1997-98 when the combination of fast growth and a commitment to maintain Conservative spending totals delivered a rather bigger boost to the public finances than the then government may have expected.

Going further back, Margaret Thatcher oversaw two years of reductions on such a scale – but the first was soon after entering office in 1981-82 and the second was the year after the 1987 election. The Chancellor now proposes to achieve a similar feat on the eve of the next general election, after being in government for ten years, and without the usual excuse of entering office and discovering that the books are in fact worse than expected. To say that is would be a remarkable feat is to understate it.

Figure 15: Historic magnitude of year-on-year consolidations

Year-on-year change in PSNB as a share of GDP



Source: RF analysis of OBR, *Public sector finances aggregates databank*

7. Yet still the Chancellor has pressed ahead with major, re-gressive, income tax giveaways

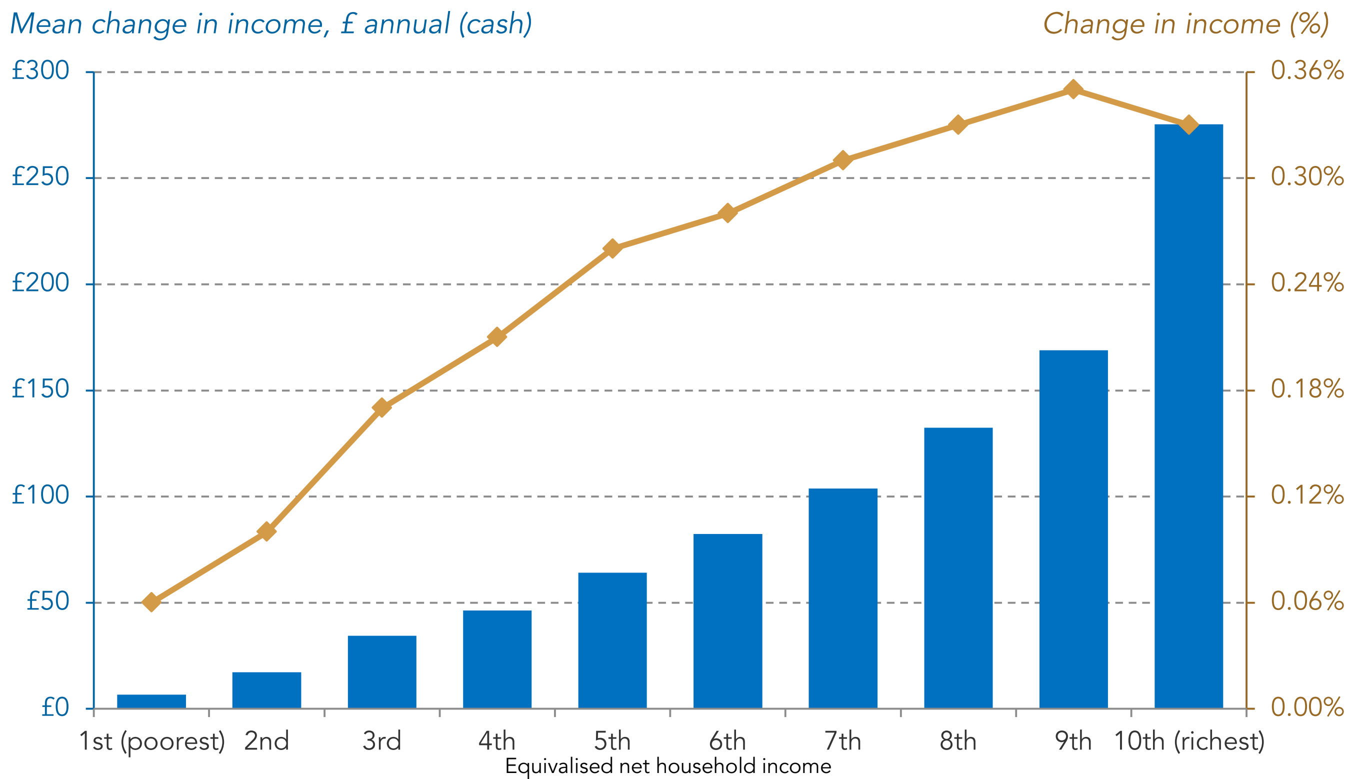
Despite making spending cuts elsewhere and the £38 billion increase in borrowing, the Chancellor also announced a major income tax giveaway. As part of the pre-election pledge to raise the personal tax allowance to £12,500 and the higher rate threshold to £50,000, the Chancellor announced increases from April 2017 to £11,500 (a £300 increase relative to previous plans) and £45,000 (an increase of £1,100) respectively.

The increase in the PTA will boost incomes for basic rate taxpayers by £60 a year (20 per cent of the £300 increase). Increasing the higher rate threshold will boost incomes for higher rate taxpayers by £200 a year (£340 from the tax cut but an increase in NI paid of £200 – because the upper earnings limit increases in line with the HRT – reduces the net gain).[3]

Taken together, these income tax measures represent a cost of £2 billion in 2017-18 (rising to £2.6 billion in 2020-21), with 80 per cent of the gains going to the top half of the income distribution and nearly half (47 per cent) going to the top 20 per cent.

[3] The Budget also announced the abolishment of Class 2 National Insurance payments, which will save the self-employed up to £148 a year from April 2018.

Figure 16: Distributional impact of income tax threshold changes in April 2017

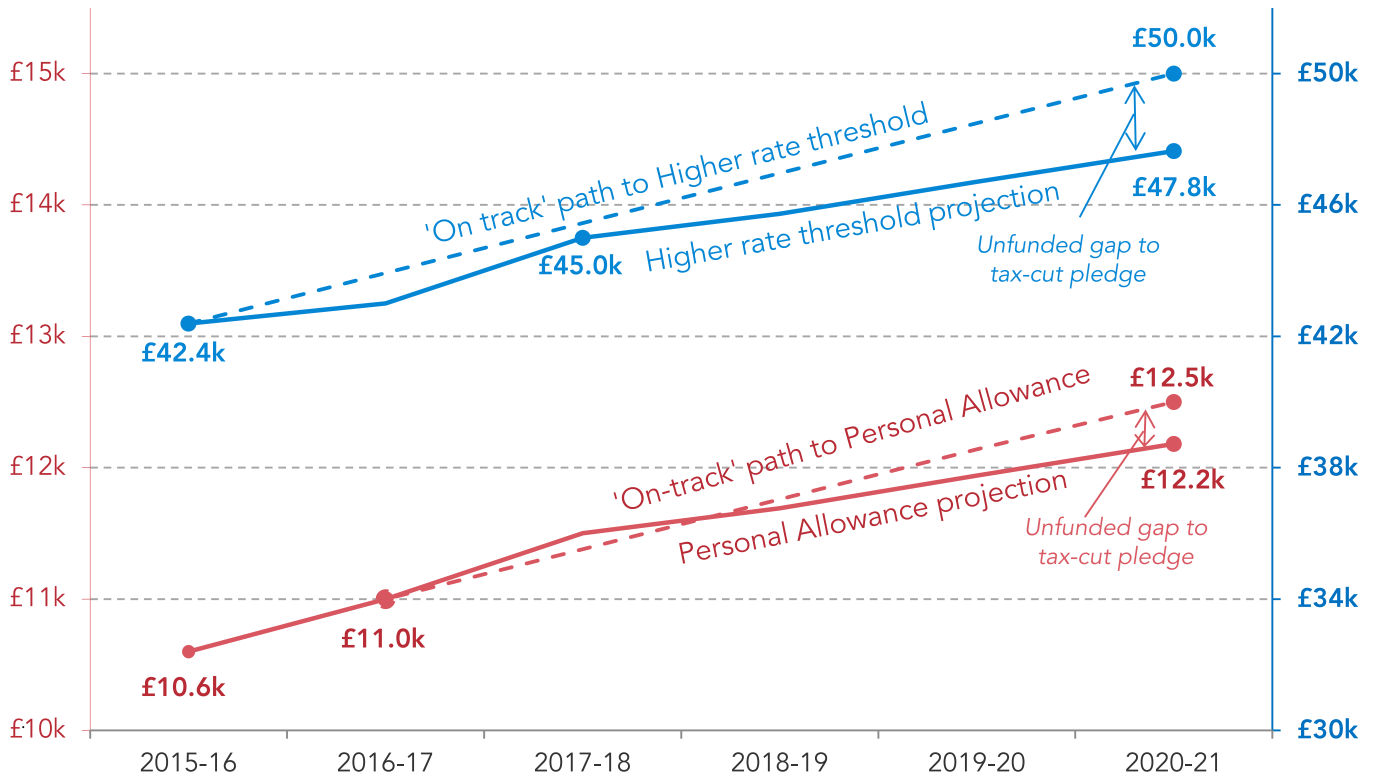


Source: RF analysis of OBR, *Economic and Fiscal Outlook*

The April 2017 moves shift the two thresholds towards (or beyond, in the case of the personal allowance) the paths that would be required if the Chancellor wanted to hit his 2020 targets via equal annual changes. As things stand however, reversion to the default uprating after 2017-18 would result in the personal allowance falling £300 short of the pledge and the higher rate threshold £2,200 short. Meeting the pre-election commitments therefore imply a further cost of £2.4 billion to be delivered by 2020-21.

Figure 17: Income tax thresholds and potential trajectories

Projected path of income tax thresholds to 2020-21

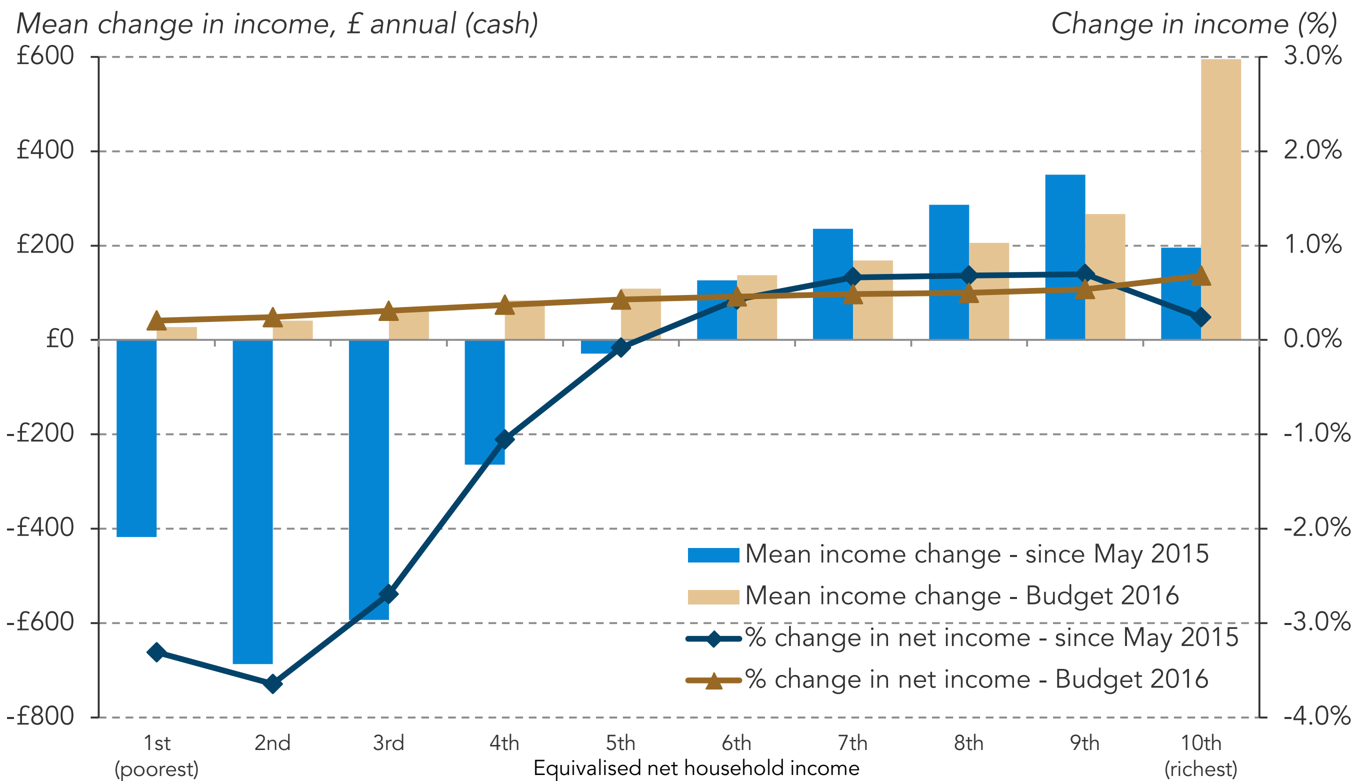


Source: RF analysis of OBR, *Economic and Fiscal Outlook*

Taking a longer view, the latest income tax changes further skew the distributional impact of policies announced since the 2015 election. After accounting both for previous announcements (relating to the National Living Wage, benefit freezes and cuts to Universal Credit and the tax credit system) and for those from the Budget that we can reasonably model (including the income tax threshold changes, a further reduction in the rate of Capital Gains Tax from next month and another freeze in the fuel duty) we find that households in the bottom half of the income distribution face being worse off in 2020-21 than they would have been in the absence of any policy changes.

We estimate their average loss to be £375 (or 1.8 per cent of their net income). In contrast, we estimate average gains of £235 (or 0.5 per cent of their net income) among households in the top half.

Figure 18: Distributional impact in April 2020 of all post-election policy announcements to date



Source: RF analysis of OBR, *Economic and Fiscal Outlook*

Note: Impacts are estimated in 2020-21 accounting for the transition to Universal Credit, the build-up of measures affecting flows to Universal Credit/Tax Credits; introduction of the National Living Wage and key changes to the tax and benefit system, including: increases to the personal tax allowance to reach £11,500 and higher rate threshold to reach £45,000 in April 2017 (thereafter increased by CPI inflation), restricting pensions tax relief, cuts to capital gains tax, freezing fuel duty, cuts to Universal Credit work allowances, freezing working-age benefits for 4 years from April 2016, measures to remove the family element & limiting support to 2 children in tax credits/UC, abolishing class 2 NICs. Estimates also account for the introduction of the National Living Wage. Economic assumptions are consistent with OBR projections published at Budget 2016.

Resolution Foundation

Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged. We do this by:

- *undertaking research and economic analysis to understand the challenges facing people on a low to middle income;*
- *developing practical and effective policy proposals; and*
- *engaging with policy makers and stakeholders to influence decision-making and bring about change.*

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