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BRIEFING

Time for revision

Why the Chancellor needs to look again at his plans for tax cuts in the Budget

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Summary

When the OBR published its Economic and Fiscal Outlook alongside last November's Autumn Statement, it noted that the Chancellor was set to achieve a budget surplus of 0.5 per cent of GDP by 2019-20 – thereby meeting his new fiscal mandate. Global economic conditions have deteriorated somewhat since then and there is widespread anticipation that this week's update from the OBR will look less rosy. Based simply on past experience, we estimate that there is a 38 per cent chance that the new projection will show the fiscal mandate being broken in 2019-20.

With major reform of pension tax relief no longer on the table, the Chancellor's options for raising additional revenue appear somewhat limited – particularly given the fact that he can no longer raise income tax, National Insurance (NI) or VAT rates. In addition, he is yet to set out how he plans to fund £7 billion of cuts to income taxes that he has pledged.

Raising the personal tax allowance to £12,500 and the higher rate threshold to £50,000 by the end of the parliament would be both expensive and highly regressive. Reaching these targets in equal steps would involve spending a further £2 billion over the next two years; rising to £5 billion by 2019-20. Yet they would provide no benefit at all to the 4.6 million lowest paid employees in the country. Instead, approximately 85 per cent of the gains would go to households in the top half of the income distribution. Roughly one-third of the £5 billion giveaway would flow to the richest 10 per cent of households.

Any deterioration in the public finances would highlight the decision to prioritise these tax cuts, particularly if implementing them involved making cuts or raising other revenues in a way that exacerbated the regressive nature of these policies. By way of illustration, we show that using the same £5 billion to boost Universal Credit work allowances - thereby more than reversing planned cuts - would result in roughly £4½ billion flowing to the bottom half of the income distribution. This would provide a much more targeted means of supporting lower income working households.

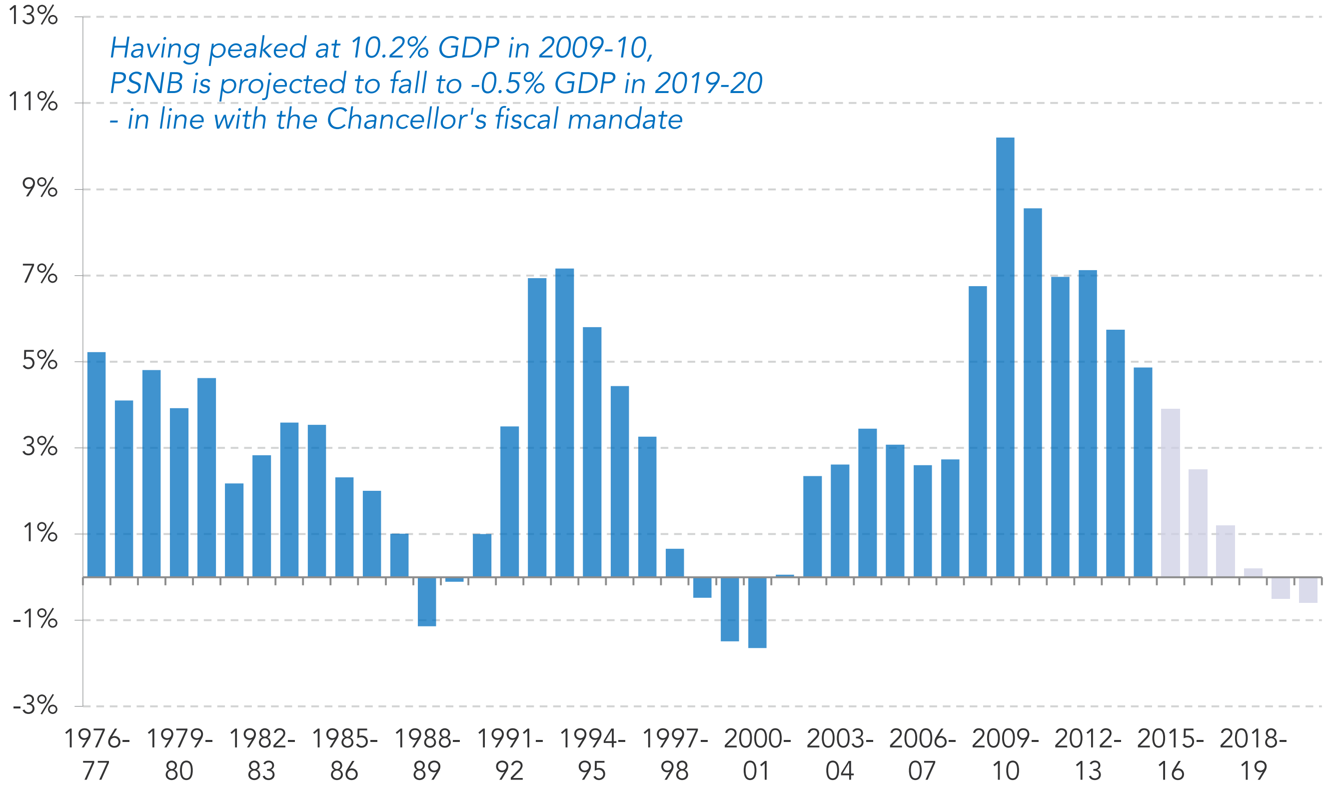
The last set of OBR projections pointed to a 0.5 per cent budget surplus by 2019-20

Public sector net borrowing (PSNB) – the difference between government revenues and government receipts – increased from 2.7 per cent of GDP in 2007-08 to 10.2 per cent in 2008-09. That's an increase of £124 billion in just two years in 2015-16 prices.

As Figure 1 shows, it has since fallen to 4.9 per cent of GDP (in 2014-15). At last November's Autumn Statement, the Office for Budget Responsibility (OBR) projected that it would fall to -0.5 per cent by 2019-20 and -0.6 per cent in 2020-21. That's equivalent to surpluses of £9 billion and £13 billion (£10 billion and £14 billion in nominal terms).

Figure 1: Public sector net borrowing: outturn and projections: UK 1976-2020

Public sector net borrowing as a share of GDP



Source: OBR, *Public finances databank*, January 2016

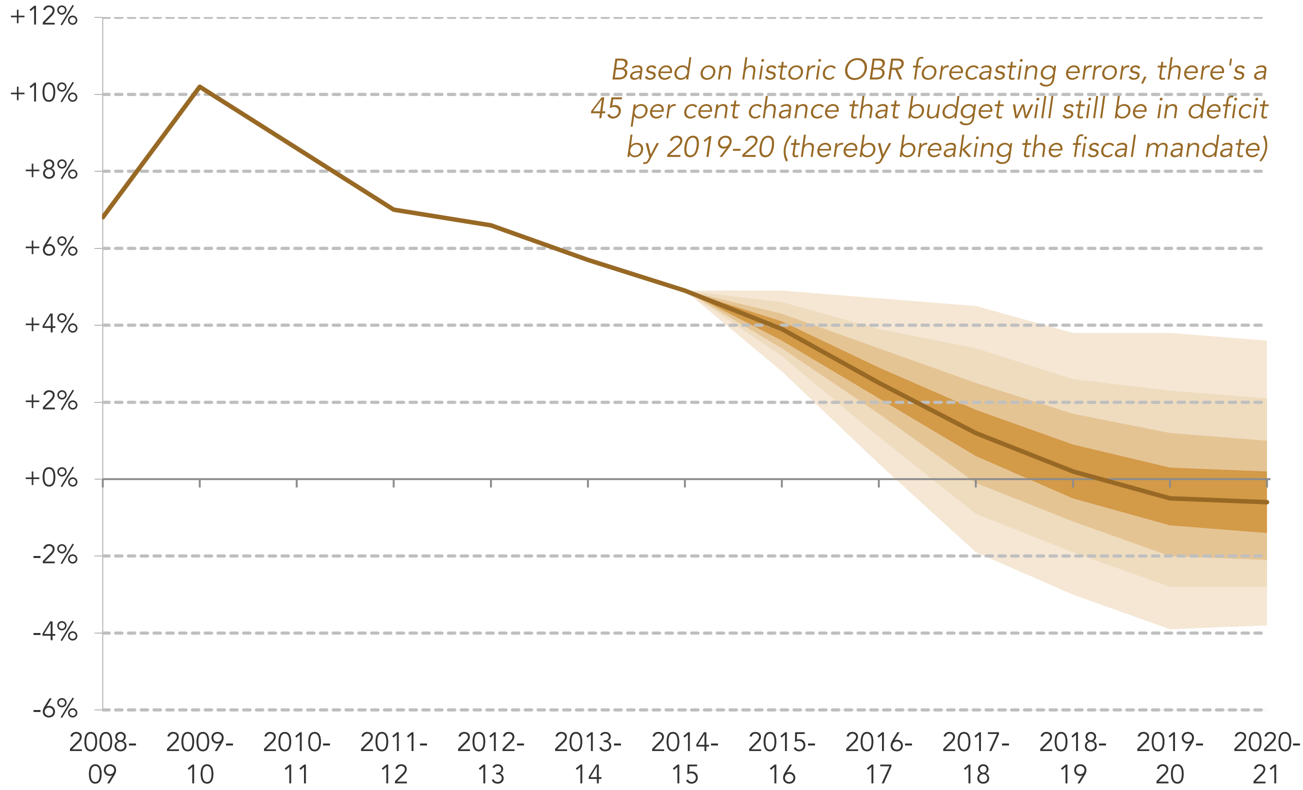
Such a trajectory meets the government's fiscal mandate, which stipulates that the budget should be in surplus in 2019-20 and in all subsequent years "during normal economic times". This qualifying criterion relates to periods in which growth in rolling four-quarter GDP is above 1 per cent (and is not projected to fall below this over the forecast horizon).

But much uncertainty remains, with a 45 per cent chance deficit will persist

However, much may change before 2019-20. In setting out the central case depicted in Figure 1, the OBR made clear that there is significant uncertainty. Figure 2 re-creates the PSNB fan chart presented by the OBR in the last *Economic and Fiscal Outlook*. It uses past forecasting errors to establish probabilities around the central case.

Figure 2: Public sector net borrowing fan chart: UK 2008-2020

Public sector net borrowing as a share of GDP



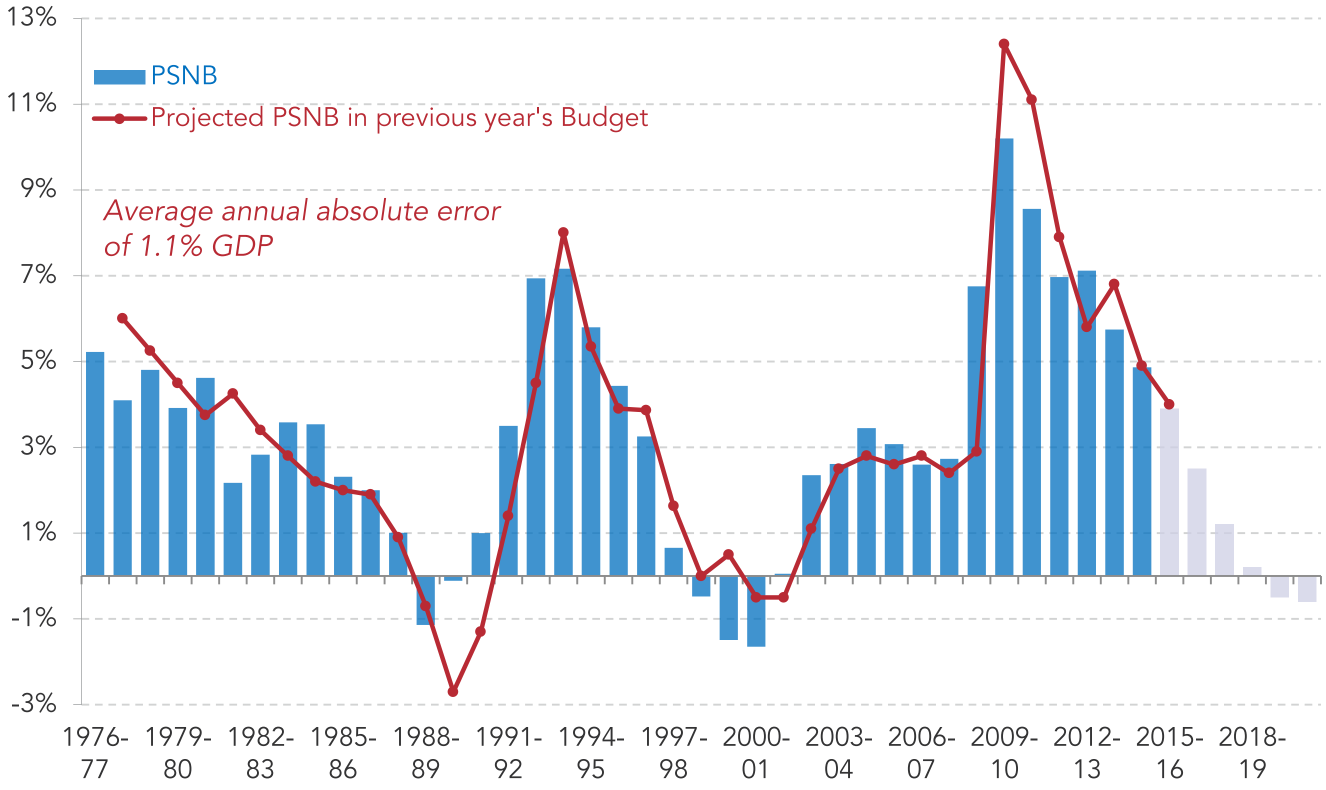
Source: OBR, *Economic and Fiscal Outlook*, November 2015, Chart 5.3

At the extremes, the OBR figures imply that there are 10 per cent chances of the 2019-20 budget (PSNB) being either 3.9 per cent in surplus or 3.8 per cent in deficit. Overall, the fan chart suggests that there is a 45 per cent chance of the government missing its fiscal mandate in 2019-20 (though of course, some of the downside risk would be associated with growth falling below 1 per cent, meaning the mandate would no longer apply).

Even short-term projections are subject to significant error. Figure 3 compares recorded PSNB with the projections made by the Treasury and OBR at the start of the same fiscal year. For example, the 1977-78 outturn figure is compared with the forecast set out in the 1977 Budget. While the forecasts tend to move in the right direction, the magnitude of change is often over- or under-stated. Looking across the entire period, the average absolute error in the one-year ahead projection is around 1.1 per cent of GDP.

Figure 3: Short-term projection errors for public sector net borrowing UK 1976-2020

Public sector net borrowing as a share of GDP

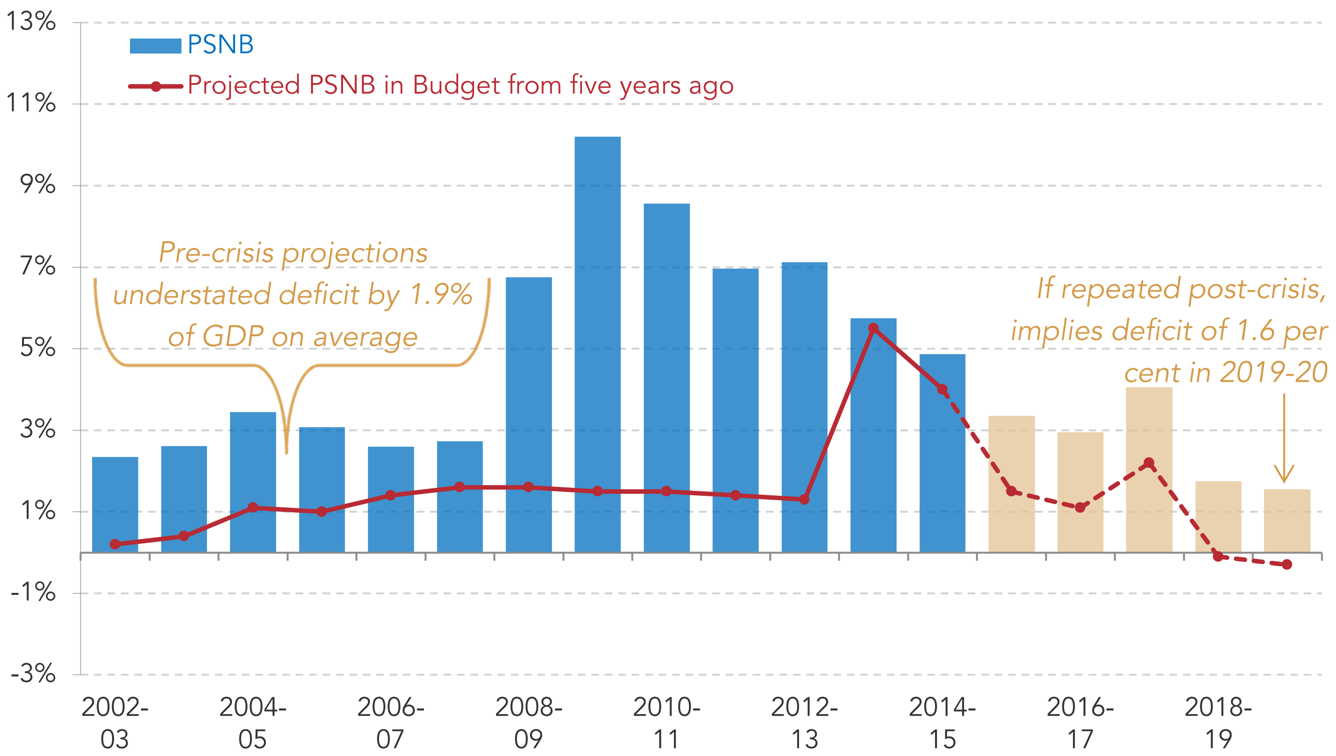


Source: OBR, *Historic official forecasts database*

And of course, such errors become amplified once we look further out. Figure 4 compares actual PSNB figures with the projections that were set out in Budgets five years ahead of time. For example, the 2004-05 PSNB outturn is compared with the projection for that year which was published in the 2000 Budget.

Figure 4: Medium-term projection errors for public sector net borrowing: UK 2002-2019

Public sector net borrowing as a share of GDP



Note: Series starts in 2002-03 because Budgets prior to 1998 did not provide five-year forward projections.

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

There is an unsurprisingly wide divergence between the projections and the outturns from 2008-09, with the financial crisis undermining all previous forecasts. However, even before the financial crisis struck, the average absolute forecast error amounted to 1.9 per cent of GDP (with the outturn deficit always being larger than forecast). Applying that magnitude of change to the Budget 2015 projections for 2019-20 would mean that the fiscal mandate was broken, with a deficit of 1.6 per cent[1] being recorded.

The 2019-20 projection could be subject to sizeable revision in the Budget

Significant though such changes are, we won't know just how accurate the current projections for 2019-20 are until we get outturn figures at the end of the decade. The real question for the upcoming Budget is whether the latest fiscal update will show the Chancellor to no longer be on course to meet his fiscal mandate, necessitating further action to remain on track. Digging into this question requires speculating as to whether or not the November 2015 projection for 2019-20 will be revised down or not. Therefore we need to look, not at the historic accuracy of projections as we have done above, but at evidence of the extent to which medium-term projections shift between consecutive fiscal events.

We also need to strip out past changes that have been associated with policy changes. By focusing on the 'forecasting changes' reported by the OBR in each *Economic and Fiscal Outlook*, we can isolate shifts that are largely driven by new projections of economic conditions and potentially

[1] That is, applying a 1.9 per cent of GDP change to the March 2015 Budget -0.3 per cent of GDP figure (rather than the 2015 Autumn Statement one of -1.5 per cent of GDP).

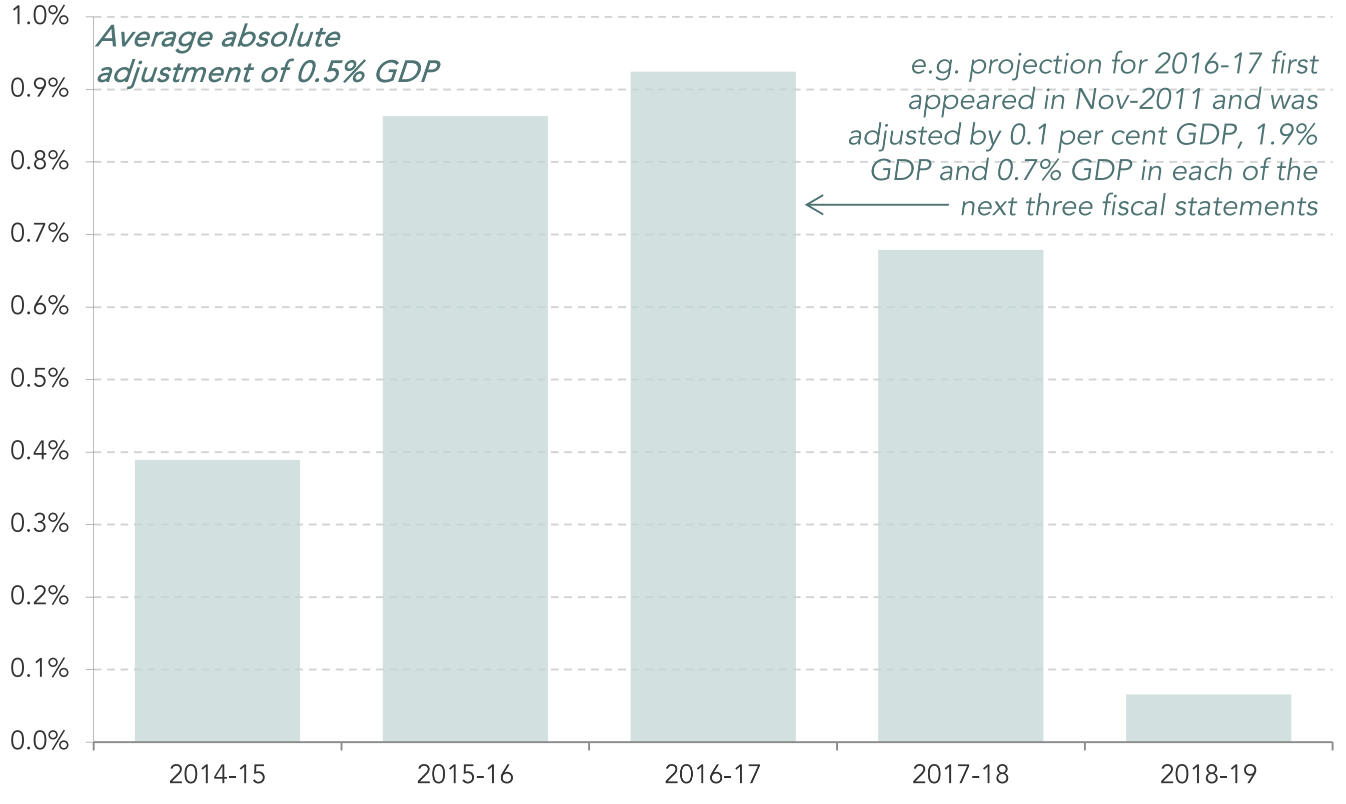
due to revised approaches to modelling (such as the revisions to forecasts of VAT revenue at the 2015 Autumn Statement). These ignore both policy changes and reclassifications of items within the public accounts.

Projections for PSNB in 2019-20 first appeared in the December 2014 Autumn Statement. They have undergone revision in March 2015 and November 2015, and will be revised again later this month. That is, the next set of data will represent the fourth iteration of 2019-20 PSNB projections. By way of illustrating the potential scale of change between November 2015 and Budget 2016, we can consider the average revision to PSNB projections in recent years from their first appearance (usually at up to five financial years ahead of the current period) and over the three subsequent fiscal events.

Figure 5 does this, setting out the average absolute change over four iterations for each year between 2014-15 and 2018-19. It shows that changes in economic conditions and OBR assumptions drive changes of 0.5 per cent of GDP on average between fiscal events.

Figure 5: Medium-term projection changes for public sector net borrowing due to forecasting changes: UK 2014-2018

Average absolute fiscal event-to-fiscal event forecasting change in PSNB as a share of GDP after four appearances in OBR figures



Note: 2014-15 figure ignores changes reported between Autumn Statement 2009 and Budget 2010 in order to focus on the OBR period.

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

There is much variation around this average of course, and there is no automatic reason why 2019-20 figures will follow a similar pattern in the upcoming Budget. But, if they did, then it would imply that November 2015's projection of a 0.5 per cent surplus in 2019-20 might either be doubled or wiped out.

Once we account for the direction of revisions over these past cycles, we find that the four-year out deficit projection has been increased by 0.5 per cent of GDP or more between successive fiscal events on 38 per cent of occasions. In other words, past experience suggests that there is a roughly two-fifths chance of the budget being projected to be in deficit in 2019-20 in this month's Budget.

Especially given the gathering economic clouds

This is purely an illustrative exercise, but there is reason to think that the upcoming fiscal update will indeed provide disappointing news for the government – not least given the Chancellor's own warnings of a "dangerous cocktail of new threats".[2]

Borrowing in the first ten months of 2015-16 is higher than had been projected, with a simple extrapolation of these trends implying that it would be around £6 billion higher than the OBR's November 2015 expectation. Even so close to the end of the financial year there is significant uncertainty however.[3]

Perhaps more troubling is the medium-term outlook for global growth, which will have obvious implications for the PSNB forecast through to 2019-20. As the Bank of England reported last month:

> *"Global growth has fallen back further over the past three months, as emerging economies have generally continued to slow and as the US economy has grown by less than expected... Developments in financial markets seem in part to reflect greater weight being placed on the risks to the global outlook stemming from China and other emerging economies."*[4]

Across the independent forecasters recorded each month by the Treasury, average GDP growth projections for 2016 were revised down from 2.4 per cent in November 2015 (at the time of the Autumn Statement) to 2.2 per cent in February 2016. Similarly, average earnings growth expectations – a key determinant of income tax receipts – were reduced from 3.4 per cent to 3 per cent.[5]

Indeed, ahead of the Budget the Chancellor has stated that the "more difficult and dangerous" nature of the global economy means that he will need to set out further cuts on Wednesday equivalent to 50p for every £100 of government spending.[6] Taking the OBR's projections for total managed expenditure (TME) at the time of the last Autumn Statement, that implies cuts of just over £4 billion from the government's overall £857 billion spending plans for 2020-21. However, it's not clear at this stage whether this level of cuts is designed to leave the planned surplus unchanged, or whether it will be associated with delivering a smaller or larger surplus.

As-yet unfunded tax cut commitments add to the challenge facing the Chancellor

Whatever the fiscal outlook presented later this week, the Chancellor faces the additional challenge of having to meet the costs of further income tax cuts – pledged as part of the Conservative's election campaign and reiterated in last year's Summer Budget. These pledges cover two areas:

» Raising the personal tax allowance (PTA) - the point at which income tax becomes payable - to £12,500 by the end of the parliament (while ensuring that once the PTA reaches £12,500 it is then always set to be equivalent to at least 30 hours at the National Minimum Wage (NMW)); and

[2] K Ahmed, "George Osborne warns of 'dangerous cocktail' of economic risks", *BBC website*, 7 January 2016

[3] See for example, OBR, *Commentary on the Public Sector Finances release: January 2016*, 19 February 2016

[4] Bank of England, *Monetary Policy Summary and the minutes of the Monetary Policy Committee meeting ending on 3 February 2016*, 4 February 2016

[5] HMT, *Forecasts for the UK economy: a comparison of independent forecasts*, November 2015 and February 2016

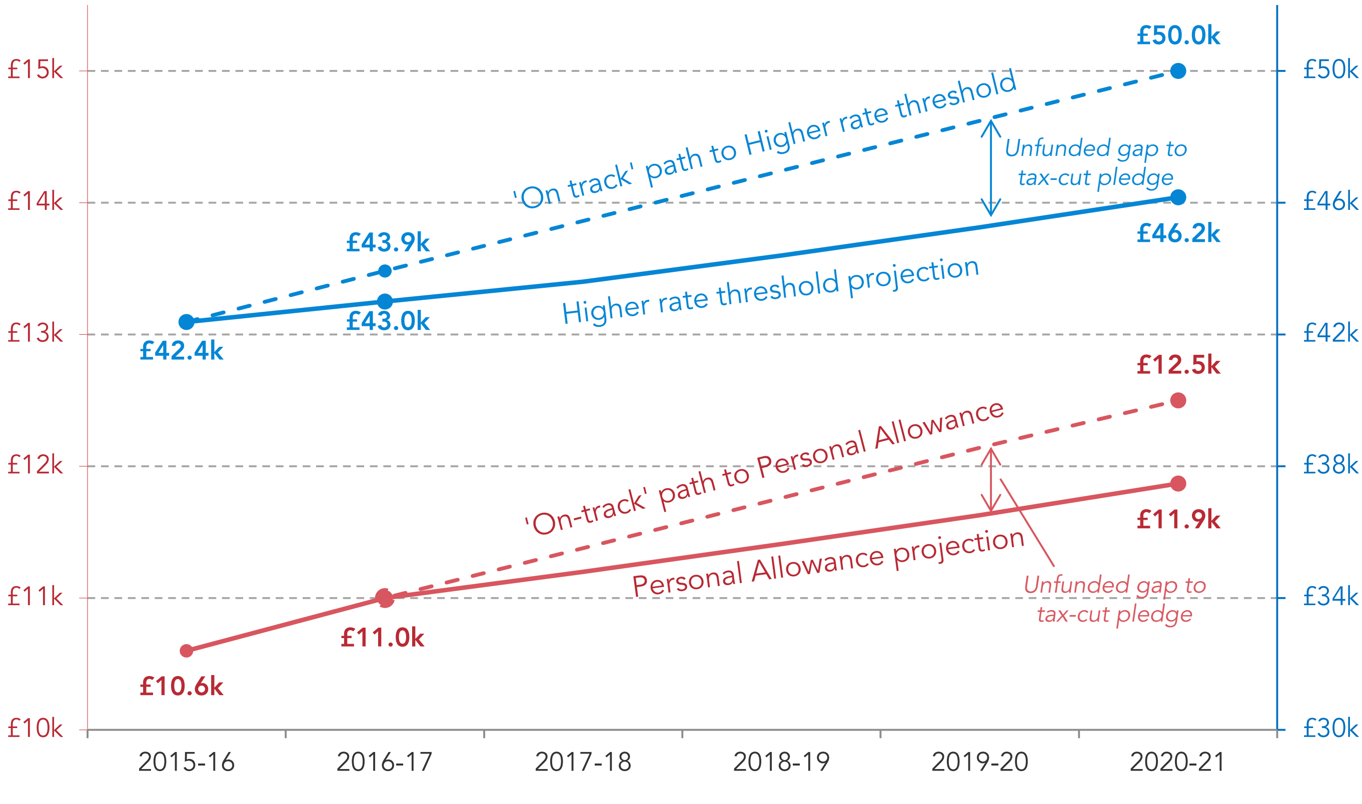
[6] "Budget 2016: George Osborne warns of cuts of 50p per £100", *BBC website*, 13 March 2016

» Raising the higher rate threshold (HRT)- the point at which the 40p 'higher' rate of income tax becomes payable - to £50,000 by the end of the parliament.

To date, the government has acted to increase the PTA to £11,000 in April 2016 and £11,200 in April 2017, while raising the HRT to £43,000 and £43,600 over the same period. Figure 6 compares the projected trajectories for both the PTA and the HRT beyond this point with the paths that would be required if the 2020 government pledges were to be met via a series of equal steps.

Figure 6: Income tax thresholds and potential trajectories

Projected path of income tax thresholds to 2020



Note: 'On-track' path takes a simple straight line route from 2015 rates to the 2020 pledge of a £12,500 personal allowance and a £50,000 higher rate threshold. The projected path is based on latest funded policy announcements (up to April 2017) and then CPI uprating (from April 2018) based on OBR projections at the time of Autumn Statement 2015

Source: RF analysis using IPPR Tax Benefit model

It shows that the April 2016 increase in the PTA keeps it broadly on track for £12,500, but that further discretionary increases will be required over the remainder of the parliament. Based on existing announcements and subsequent default CPI uprating, the PTA would be £180 short in April 2017, £350 in April 2018, £510 in April 2019 and £630 in April 2020.

Meeting the HRT target requires even greater adjustment. The default approach would leave the threshold around £930 short from next month, rising to £1,850 in April 2017, £2,570 in April 2018, £3,240 in April 2019 and £3,830 by April 2020.

Closing these gaps inevitably costs money. Beyond April 2017 current OBR projections only account for the effect on tax revenues of increasing the PTA and HRT by CPI inflation (the default government position)[7] leaving the tax cut 'gaps' identified above to be closed at additional cost to

[7] HM Treasury, *Budget 2011 Policy Costings*, March 2011

the public finances. Importantly, the unfunded element of the cost on tax thresholds has increased in recent months due to low rates of inflation slowing the underlying path of the PTA and HRT.

Following the 'on track' paths set out in Figure 6 would cost the Exchequer roughly £300 million in 2016-17, rising to £2 billion in 2017-18 and £7 billion in 2020-21. The cost of the policy in 2019-20 would amount to around £5 billion – equivalent to 0.2 per cent of GDP. The scale of such spending commitments in combination with the almost two-fifths chance of the projected 0.5 per cent surplus in 2019-20 being wiped out mean that the Chancellor will need a sizeable buffer in the fiscal projections set out later this month in order to be on target to both meet his fiscal mandate and deliver his tax cut promises.

All of which implies Budget 2016 might have to include further spending cuts or tax rises

Having set out a target that applies from a fixed future point (2019-20), the Chancellor will be very keen to ensure that he appears on course to meet the mandate well in advance. Approaching 2019-20 with little or no room for manoeuvre will leave the public finances vulnerable to inevitable year-on-year movement. Implementing in-year spending cuts or tax rises does not make for good policy – especially so close to the next election. And the Chancellor has been clear that this should be a test of the UK's economic strength:

> *"A surplus will make our country more resilient, safe and secure. It means that next time we have the money to help us through the tough times when the storms come. Let me put it another way: if our country doesn't bring the deficit down, the deficit could bring our country down again. And that's why, for the economic security of every family in Britain, we must hold our nerve. And quite frankly, if we're not into a surplus after 10 full years of economic growth, when will we ever be?"*[8]

With this in mind, we might expect any downward revision in the OBR's public finance forecasts on Wednesday to be met with a new wave of spending cuts – reversing, at least in part, the easing of cuts that was announced at Autumn Statement following a windfall from OBR revisions[9] – or tax rises.

Yet, with the government having ruled out (via legislation) any increase in this parliament in income tax rates, Class 1 NICs or VAT, options for additional revenue are somewhat limited. Until recently, major reform of the pension tax relief system was expected to deliver significant savings.[10] However that appears to be off the table for now.

Fuel duty might be a contender - with a 2p increase estimated to raise around £900 million a year - but this is always unpopular. And at the household level it is somewhat regressive.

Given this backdrop, there is even more reason to revisit regressive income tax pledges

While it wouldn't raise *extra* revenue, with wider factors creating pressure on the Chancellor's commitment to move into surplus by 2019-20, revisiting the unfunded pledge for further income tax cuts would at least provide extra room for manoeuvre. It would also be more equitable.

The PTA pledge, set out in the Conservative's pre-election manifesto and re-iterated at the Summer Budget is in practice highly regressive. The lowest paid 4.6 million employees do not earn enough

[8] HM Treasury, *"George Osborne sets out his priorities for the Spending Review"*, speech by Chancellor of the Exchequer, 9 November 2015

[9] See M Whittaker, A Corlett & D Finch, *O, Blessed Revisions: Fiscal windfall and what to do with it*, Resolution Foundation, November 2015

[10] See A Corlett & M Whittaker, *Save it for another day: pension tax relief and options for reform*, Resolution Foundation, March 2016

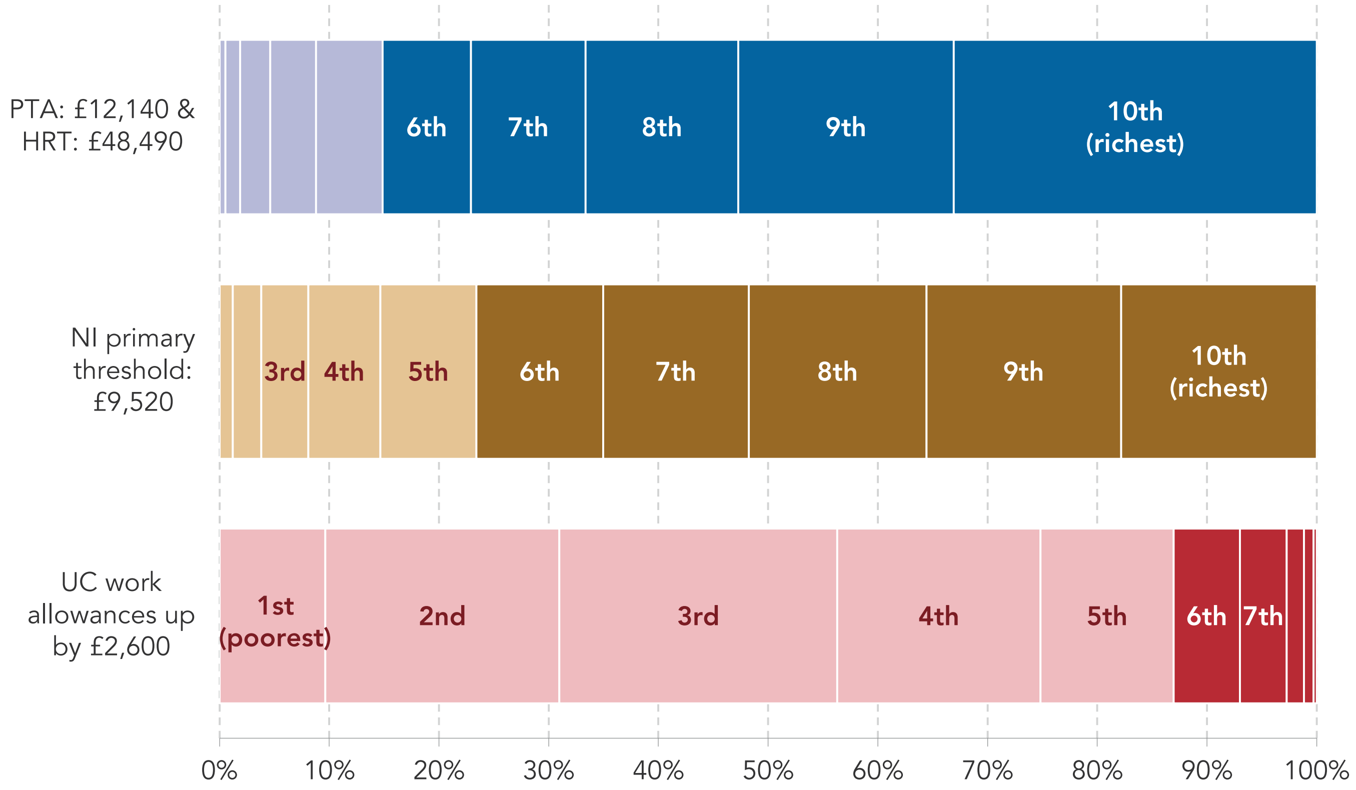
to pay income tax (though 1.3 million of them still pay NICs – with both of these figures having been increased by the rapid increase in the PTA over recent years) and therefore will not benefit from any further increases in the threshold. Most other taxpayers will gain in equal measure.

Increases in the HRT benefit even fewer employees, with just 15 per cent (or 3.9 million) earning above the current threshold (1.1 million of these earn between the HRT and £50,000). Raising the HRT is therefore a targeted tax cut on some of the country's highest earners.

The top part of Figure 7 shows the distribution of gains in 2019-20 associated with raising the PTA and HRT in line with trajectory set out in Figure 6. As discussed, this would cost roughly £5 billion. Approximately 85 per cent of that total would be directed to the top half of the income distribution, with the richest 10 per cent of households alone accounting for one-third (33 per cent) of the £5 billion.

Figure 7: Distribution of gains associated with policies with a net cost of around £5 billion in 2019-20

Distribution of gains associated with policy change by household income decile



Source: RF analysis using IPPR Tax Benefit model

By way of illustration, the middle section of Figure 7 considers the distributional consequences of using the same £5 billion to instead raise the primary NI threshold to £9,520 in 2019-20. This would also be regressive, but less so. In this instance, the top half would account for roughly three-quarters (77 per cent) of all gains and the richest ten per cent would account for just under one-fifth (18 per cent).

Neither of these options truly deliver for low paid working families and are particularly poorly targeted at a time of fiscal constraint. However, if the government really wants to support lower income working families, then the final part of Figure 7 sets out a much more targeted way of distributing the same £5 billion. It involves raising work allowances by £2,600 a year in 2019-20, effectively reversing the planned cuts in Universal Credit (UC) and then further boosting funding. This time, the gains are much better focused on low to middle income households, with the bottom half accounting for over 85 per cent (87 per cent) of the roughly £5 billion cost.

In addition to the financial gain, such an approach would also raise the incentive for UC recipients to move into work at longer hours. Increasing work allowances would also mean that some additional families would be brought into the system and have reduced incentives to earn more (but receive an income boost). However, changes could be designed in such a way to maximise numbers entering and progressing in work by, for example, introducing a work allowance for second earners, for whom financial incentives are particularly weak in UC, or reducing the taper rate in UC from 65 per cent.

Conclusion

Wednesday's Budget may be a little light on big policy announcements – particularly following the decision not to press ahead with pension tax relief reform. But the fiscal projections provided by the OBR will be watched with interest: even relatively small changes in the underlying economic outlook could threaten the fiscal mandate.

Any deterioration in the medium-term outlook will leave the Chancellor with difficult choices. If the revision is sizeable enough, he will face the prospect of being adjudged as being off course on his fiscal mandate of achieving a surplus in 2019-20. But even if the adjustment is more modest, he is likely to want to take action in order to maintain a buffer against inevitable in-year movements in borrowing over the course of the parliament – otherwise he faces the risk of needing to implement in-year spending cuts in the run-up to the next election.

He has already announced that the changing economic backdrop means that he will be implementing further spending cuts in the order of £4 billion on Wednesday. We may hear about plans for tax rises too.

Given this context, questions need to be asked about prioritising an additional £5 billion to fund these tax cut pledges. These highly regressive promises require significant funds that could instead be diverted back into supporting lower income working households via UC.

Resolution Foundation

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- *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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