

Resolution Foundation

BRIEFING

Economy drive

Prospects and priorities ahead of the last Spring Budget

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Summary

Back in November, Philip Hammond's first fiscal statement was dominated by news of a £100 billion deterioration in the public finances outlook, reflecting significant levels of uncertainty in the light of the vote to leave the European Union. Rather than reacting to that news by implementing a new phase of tightening, the Chancellor opted for a fiscal 'reset' – setting himself a new, sensibly loose, fiscal target and announcing a modest additional and discretionary increase in borrowing over the remainder of the parliament.

That pragmatic approach is likely to be vindicated at next week's Budget. Public finances have performed better than expected in the three months since the Autumn Statement, meaning that the Chancellor is likely to be presented with a new outlook from the Office for Budget Responsibility which reduces the projection for borrowing both this year and over the coming years.

This improvement reflects the fact that – armed with clearer data on the performance of the economy since last June – we can now see that the Brexit vote has had little immediate impact. A combination of stronger-than-expected growth in tax revenues and some methodological changes mean that public sector net borrowing (PSNB) is likely to come in around £12 billion lower in 2016-17 (at £56 billion) than Autumn Statement 2016 suggested. That would be almost exactly in line the OBR's pre-referendum forecast from George Osborne's last Budget in March 2016

Looking further out, the scale of improvement in borrowing relative to the last forecast is likely to fall back somewhat. Despite better-than-expected near-term performance, growth is still expected to slow over the medium-term as the Brexite-related squeeze on living standards, most directly via higher inflation, bites.

Nevertheless, borrowing is likely to be lower in every year of the forecast horizon than previously thought, and we estimate that the cumulative improvement could rise to £29 billion by 2020-21. That would be well within the average revision made across 14 previous OBR outlooks and would represent only modest improvement relative to the £55 billion and £100 billion deteriorations set out at the last two fiscal statements. But it would still represent good news for the Chancellor, raising the prospect of the first reduction in the government borrowing forecast for three years.

Coming on top of an already loose fiscal rule which stipulates that cyclically-adjusted net borrowing should be below 2 per cent of GDP by 2020-21, this improved outlook would provide the Chancellor with very substantial fiscal headroom. Our estimate is that the structural borrowing figure would be £13.7 billion, some £31 billion (or 1.4 per cent of GDP) below where it would need to be to meet the rule and reinforcing that for this Chancellor the fiscal rules act as a ceiling rather than a target.

There is no indication that the Chancellor will be rushing to use up this fiscal windfall, and nor should he. Despite the forecast improvement, the PSNB is set to remain well above the pre-crisis average relative to GDP over the next three years. And the trajectory for borrowing would remain much higher than the one in place just 12 months ago at the last Budget before the referendum.

But this is not to say that the Chancellor should do nothing at next week's Budget. Spending increases would be welcome in a number of areas, with social care looking almost certain to have more money allocated. He can also reprioritise within his existing envelope, reining back on some expensive and undesirable tax cuts for instance in order to reallocate support to other areas.

The Chancellor can also use his last Spring Budget to make headway on a number of big structural problems facing the UK economy, many of which pre-date the financial crisis and the decade of austerity.

For example, there is a pressing need to wean the economy off its reliance on consumption and household debt. GDP growth in 2016 was entirely driven by private consumption. This was underpinned by the 'mini boom' in household incomes that held for roughly two years from mid-2014. But, as income growth slowed in the second half of 2016, so household spending became increasingly reliant on borrowing,

with the household saving ratio turning negative at the end of the year. With income growth very likely to slow further in 2017 as inflation continues to rise in reaction to the fall in the value of sterling, the downsides of a growth model based narrowly on household spending is likely to become clearer.

Associated with this challenge is the need to address the UK's chronic under-investment. Fixed capital formation as a share of GDP has fallen from 23 per cent in the mid-1970s to just under 17 per cent today. Businesses themselves recognise the UK's problem, with one-in-three admitting to under-investing over the past five years relative to the opportunities they have had.

Approaching nine-in-ten of these under-investing firms cite economic uncertainty as a key barrier to investing more. Notably, average 'hurdle' rates (the minimum rate of return a year that businesses require before embarking on an investment project) appear somewhat elevated relative to a falling cost of funds in the post-crisis years. With the Brexit process set to evolve over the coming years, uncertainty will inevitably remain high for some time to come. But the Chancellor can do more to reassure firms – particularly with clarity of intentions on trade and migration rules.

Access to funds also matters for investment, but it is potentially worrying that 44 per cent of the 'under-investing' firms point to 'short-termism' as another obstacle – indicating that opening up access to funds may not be enough. Among the publicly listed members of the group, four-in-five said that financial market pressures for short-term returns were an issue.

The Chancellor should also take the opportunity to reassess the government's tax policy. By 2020-21, post-2010-11 cuts in fuel duty, corporation tax and income tax are set to cost the Treasury £45 billion a year. That's almost three times the expected deficit in that year. In the absence of these three policies, PSNB would be in surplus by 2018-19.

Tax revenues are also increasingly dependent on the performance of a small group of the very highest earners. The top 1 per cent of taxpayers (who comprise less than 0.5 per cent of the total population) accounted for 28 per cent of all income tax in 2014-15, up from 21 per cent at the turn of the century. With annual incomes in the top 1 per cent increasing by an average of £159,000 in the first decade of the century and then falling by £52,000 between 2009-10 and 2014-15, the vulnerability of the tax take to the volatility of the economic cycle is concerning.

There is a further need to review the appropriateness of tax policy in the light of a much-changed labour market landscape. Self-employment has increased sharply both before and since the financial crisis, with 15 per cent of the workforce now working for themselves. Given this backdrop, the Treasury appears to be missing out on increasing amounts due to lower national insurance liabilities for the self-employed compared to employees. The annual cost of this foregone national insurance (after accounting for reduced pensions eligibility associated with self-employment) is already forecast by HMRC to reach £5.1 billion in 2016-17; our estimate is that it will rise to £6.7 billion by 2020-21.

While some argue that special tax treatment is a fair reflection of the extra risk taken on by would-be entrepreneurs, there is a sense that the decision process is too often working the opposite way around – with employment status being determined on the basis of tax arbitrage and a commitment to tackle this in the Budget would be welcome.

Next week's Budget must also set out a clear plan for addressing Britain's regional, generational and income divides. The tax and benefit policies inherited by the new government are currently expected to drive the biggest increase in inequality since Thatcher. Aligned with a relatively weak economic outlook, our projection is that incomes will fall sharply for households in the bottom half of the income distribution, producing an unprecedented combination of income reductions and increasing inequality.

Reversing cuts to Universal Credit and other working-age benefits would go some way to countering this unwelcome outcome and would be essential to the Conservative's hopes of establishing themselves as the "workers' party".

Tackling regional disparities by delivering on the industrial strategy, devolution of powers to the new 'Metro Mayors' and getting to grips with housing policy should also be central to the Chancellor's approach. Likewise, it's imperative that the Chancellor does more to support the apparently fraying intergenerational contract.

Successes in terms of growing pensioner incomes over recent decades have not been replicated for working-age households, meaning that median pensioner household incomes are for the first time now higher (measured after housing costs) than working-age ones. The response to this situation is obviously not to restrict pensioner income growth, but rather to act in a way that boosts working-age incomes. Yet the public policy default looks increasingly out of kilter with reality. For example, it is notable that recent policy has focused spending cuts almost exclusively on working-age households (and indeed lower income working-age families in particular).

Reprioritisation of tax and benefit policies can help to flatten growth across the income distribution – mitigating the worst of the regressive nature of the inherited outlook. Going further and lifting income growth, so that all households benefit from more rapidly rising incomes, requires more structural reforms centring on investment and productivity.

With two Budgets this year, the Chancellor has a clear opportunity for setting a strong sense of direction and purpose that will inform the rest of the parliament. The result of such action would be a fiscal statement next week that was short on headlines or rabbits, but high on radical reform.

The Chancellor is likely to be presented with some good fiscal news at the Spring Budget

There is normally little economic news between a late Autumn Statement and a March Budget, ensuring that headlines are grabbed not by forecasting revisions but by policy decisions. However, just over three months on from Autumn Statement 2016, the (last ever) Spring Budget means 60 per cent more time since the vote for Brexit and the arrival of more real economic data that is definitively about the post-referendum world.

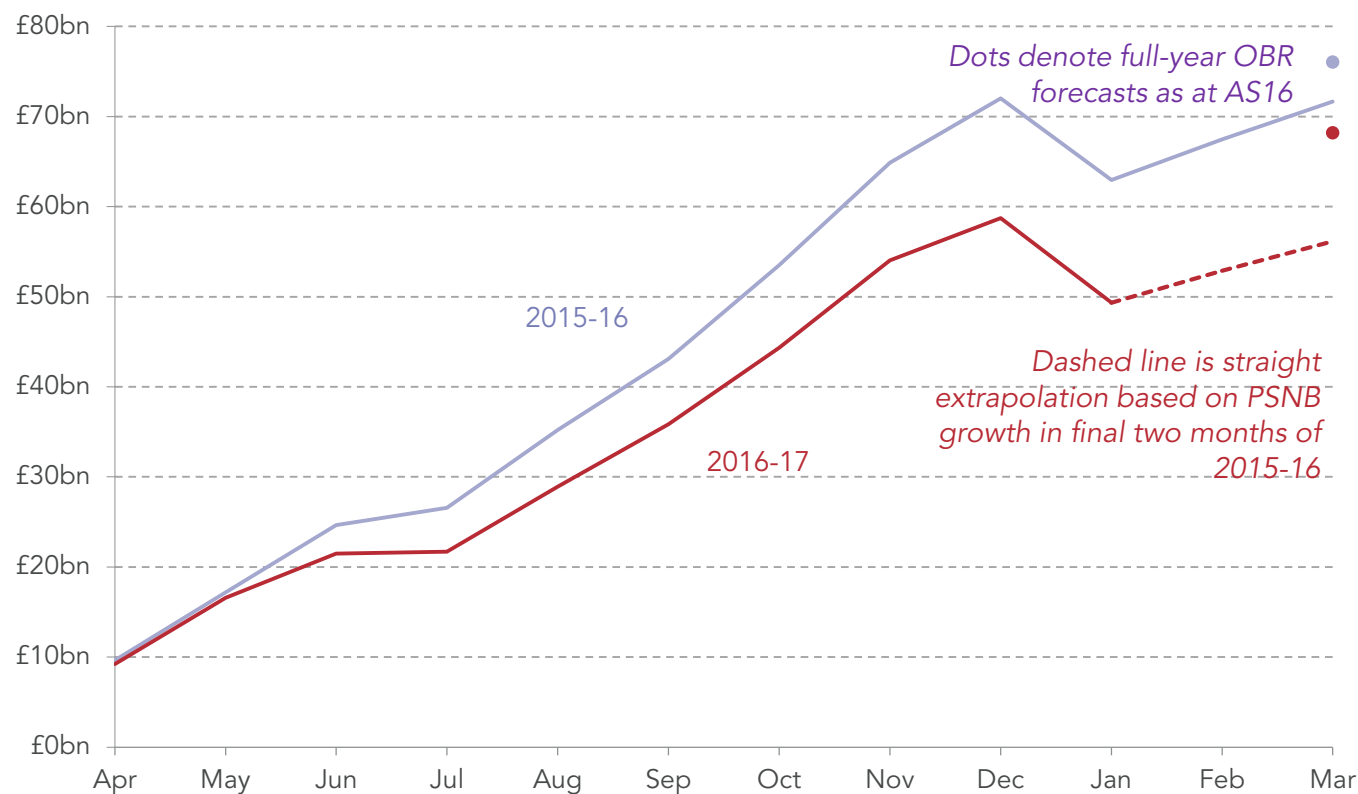
Faced with significant uncertainty in November, Philip Hammond sensibly opted to create a sizeable amount of fiscal headroom for himself. Heading into the Budget, we now know something for sure – there has been no immediate slowing of the economy. The public finances also look to have performed better than expected, raising the prospect of a modest windfall on 8 March. But this doesn't mean the Chancellor can relax. Stepping back, the public finance picture remains incredibly tough, with little scope for any significant loosening. And several underlying challenges – both Brexit-related and longer-established – still need tackling.

The potential good news on the public finances stems from both economic changes and methodological ones. One such technical change introduced from January 2017 – altering the way Corporation Tax revenues are recorded in order to more accurately reflect the period in which liability is accrued – has had a noticeable effect on the net borrowing figures. In addition to affecting the in-year picture and the outlook, this shift has resulted in a lowering of the public sector net borrowing (PSNB) back-series over a number of years. Adding in other revisions, the 2015-16 PSNB baseline is now estimated to be around £4.4 billion lower (at £71.7 billion) than the OBR assessed at the time of the Autumn Statement.

In addition, tax revenues have performed a little better than expected since the Autumn Statement. This has had the effect of further lowering in-year borrowing compared to expectations. As Figure 1 shows, cumulative net borrowing over the first ten months of 2016-17 has amounted to £49.3 billion. That's 21.6 per cent lower than in the same ten-month period in 2015-16, which is a much larger proportional fall than the full-year one of 10.3 per cent forecast by the OBR at the Autumn Statement.

Figure 1: Public sector net borrowing outturns and forecasts: 2015-16 & 2016-17

Cumulative public sector net borrowing: outturn and forecast
(nominal, ex. public sector banks)



Source: ONS, Public Sector Finances and OBR, Economic and Fiscal Outlook

If the final two months of 2016-17 were to progress as they did in 2015-16, PSNB would end the financial year at £56.2 billion. That would represent a £12.0 billion (or 18 per cent) improvement on the OBR's forecast at the Autumn Statement (with £1.6 billion of that stemming from the Corporation Tax measurement change). Such a forecast revision would mean that borrowing this year was set to come in broadly in line with the level predicted a year ago in George Osborne's last Budget, three months before the EU referendum took place.

Looking further out, most independent forecasters have improved their borrowing outlooks over the medium term.^[1] Applying the average revision recorded across nine such forecasters and adding this to the potential £12 billion improvement in 2016-17 discussed above, we estimate that the OBR's next *Economic and Fiscal Outlook* might provide a cumulative reduction in borrowing in the order of £29 billion between 2016-17 and 2020-21.

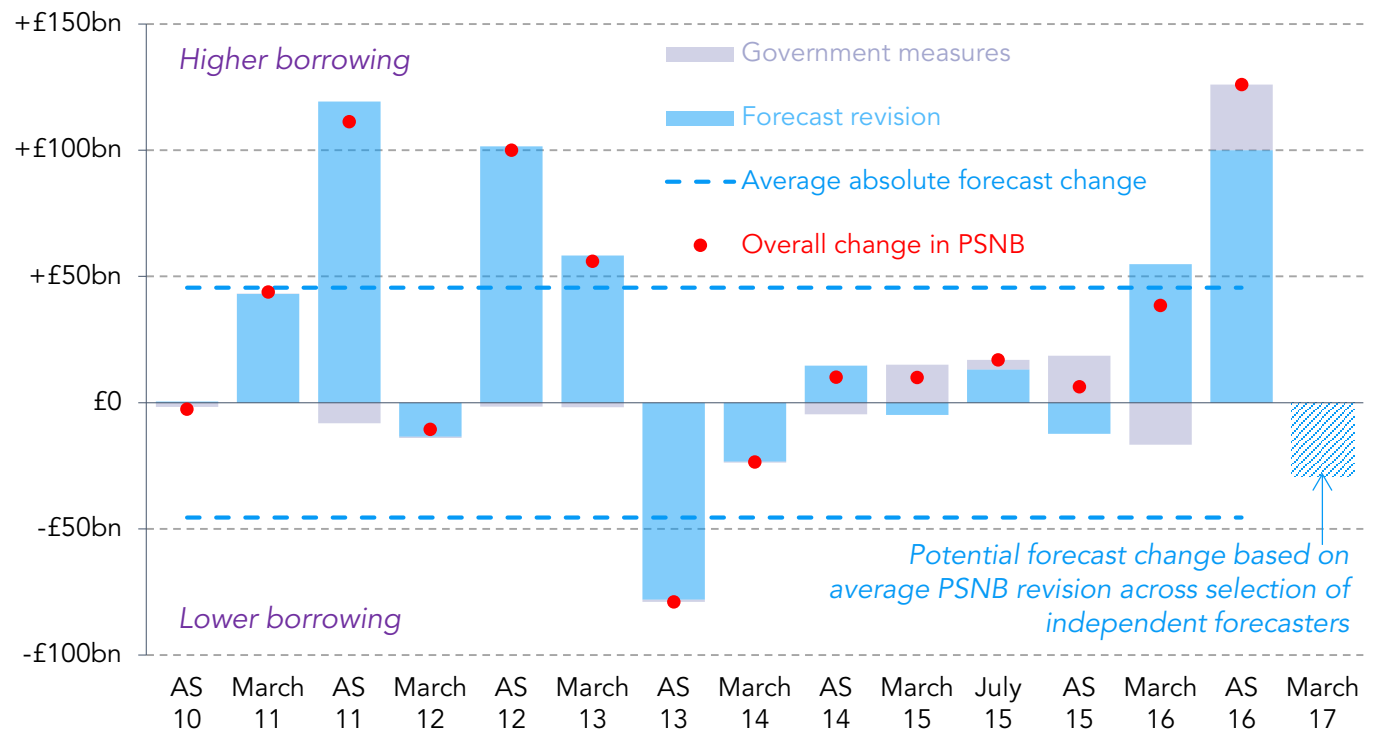
To put this into context, Figure 2 details the OBR forecast revisions made at each fiscal event since Autumn Statement 2010. It shows that the average absolute six year^[2] cumulative revision across 14 previous publications stands at £45.5 billion.

[1] Based on comparing medium-term outlooks as published by HMT in November 2016 and February 2017. Because the November forecasts arrived ahead of the Autumn Statement, we remove the effect of additional government borrowing announced in that statement from the February forecasts in order to isolate the impact of economic/forecasting changes. See HMT, [Forecasts for the UK economy](#), various.

[2] Five forecast years plus the baseline.

Figure 2: Change in cumulative public sector net borrowing forecasts in successive OBR statements

Change in cumulative PSNB over forecast horizon in successive OBR statements (nominal)



Notes: Our March 2017 forecast covers five years from 2016-17 to 2020-21, whereas the other periods cover six-year periods. We exclude 2021-22 from our forecast due to a lack of any independent projections for that year. Our best estimate – based on rolling forward the annual reduction we have estimated for 2020-21 into the subsequent year – is that inclusion of this additional year would raise the cumulative reduction in borrowing by a further £4 billion.

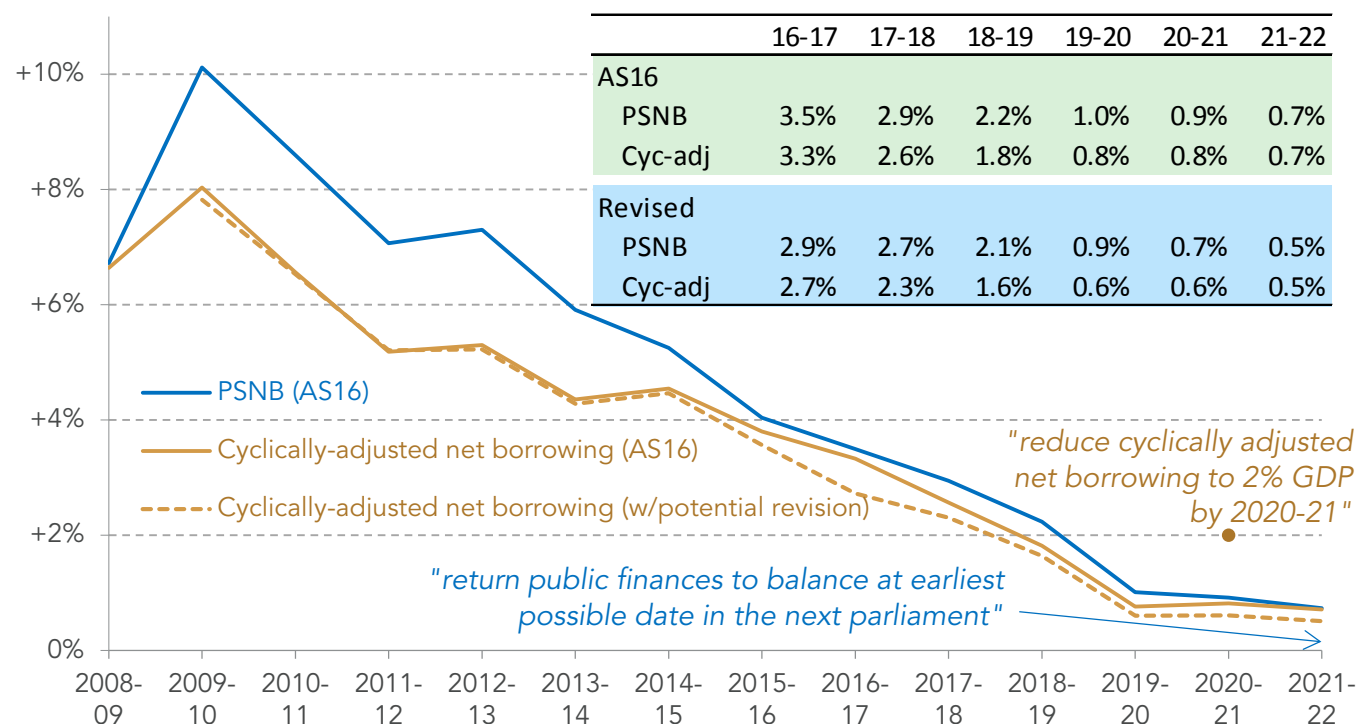
Source: RF analysis of OBR, *Historic official forecasts database*

The chart also shows the overall change in PSNB recorded at each fiscal event, once changes in government measures from one statement to the next are accounted for. Each of the last six fiscal events have resulted in higher cumulative borrowing over the forecast horizon. While we of course won't know how the Chancellor will react to an improved fiscal outlook (or indeed if this is what the OBR will present him with) until 8 March, the Spring Budget looks set to be the first fiscal set-piece in three years to deliver an overall reduction in borrowing.

Figure 3 considers what such a revision might mean for the trajectory of borrowing over the coming years and for the fiscal headroom that the Chancellor has. We adjust the OBR's existing forecast for GDP growth using the same technique described above – that is, by considering the scale of revisions made by a selection of independent forecasters in the period since November 2016. In keeping with the government's new fiscal target, we set out a potential trajectory for *cyclically-adjusted* net borrowing (with no change in the OBR's assumptions for the output gap as a share of GDP). What's clear is that, outside of 2016-17, borrowing forecast revisions of the scale we have identified would mean modest but welcome reductions in annual borrowing as a share of GDP.

Figure 3: Net borrowing and the government's fiscal targets

Share of GDP



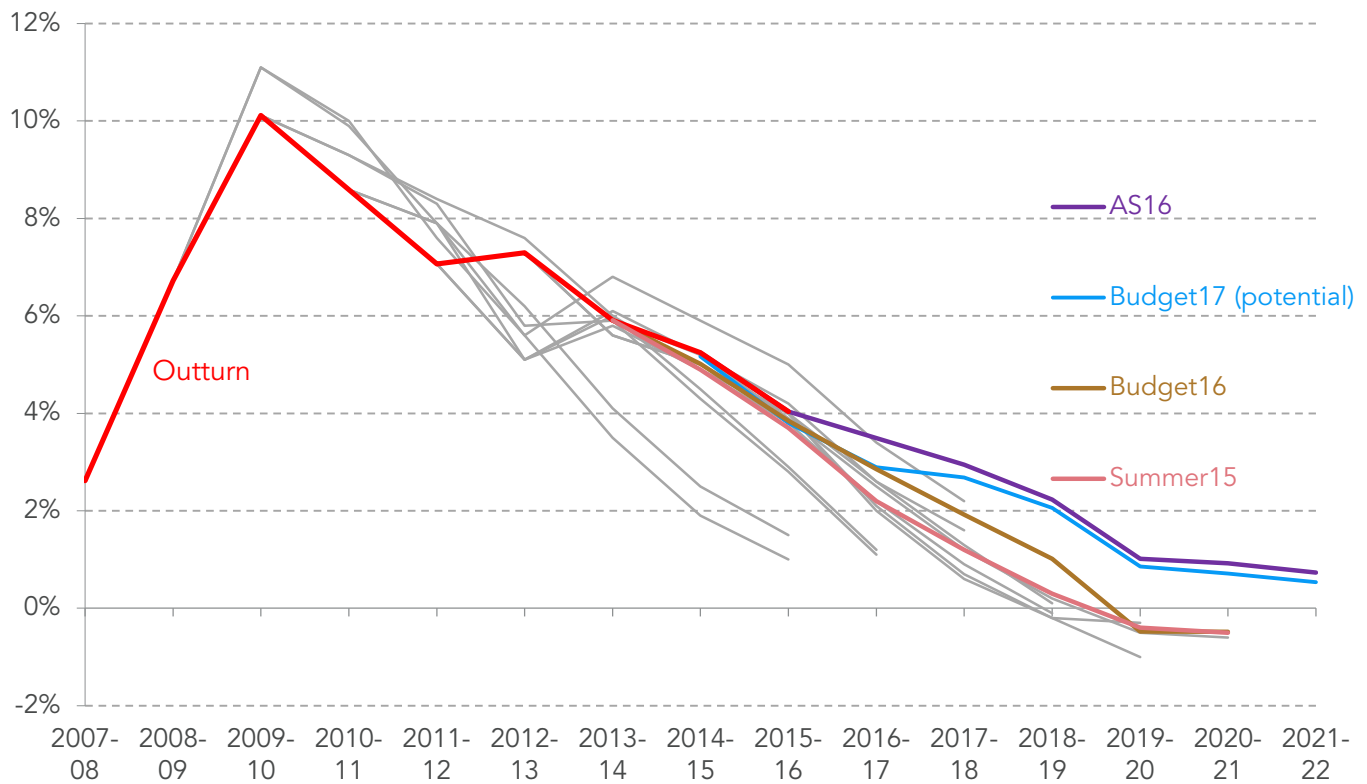
Source: RF modelling based on OBR, PSF aggregates database and HMT, Forecasts for the UK economy, various

This small medium term fiscal improvement would mean that the Chancellor would retain very significant headroom against his main fiscal target of reducing cyclically-adjusted net borrowing to 2 per cent of GDP by 2020-21. Even before any improvement in the fiscal outlook, he had headroom equivalent to 1.2 per cent of GDP (or £27 billion). Based on our illustrative new trajectory, he would have headroom of 1.4 per cent of GDP (or £31 billion).

But the broader fiscal position remains difficult, cautioning against a flurry of giveaways

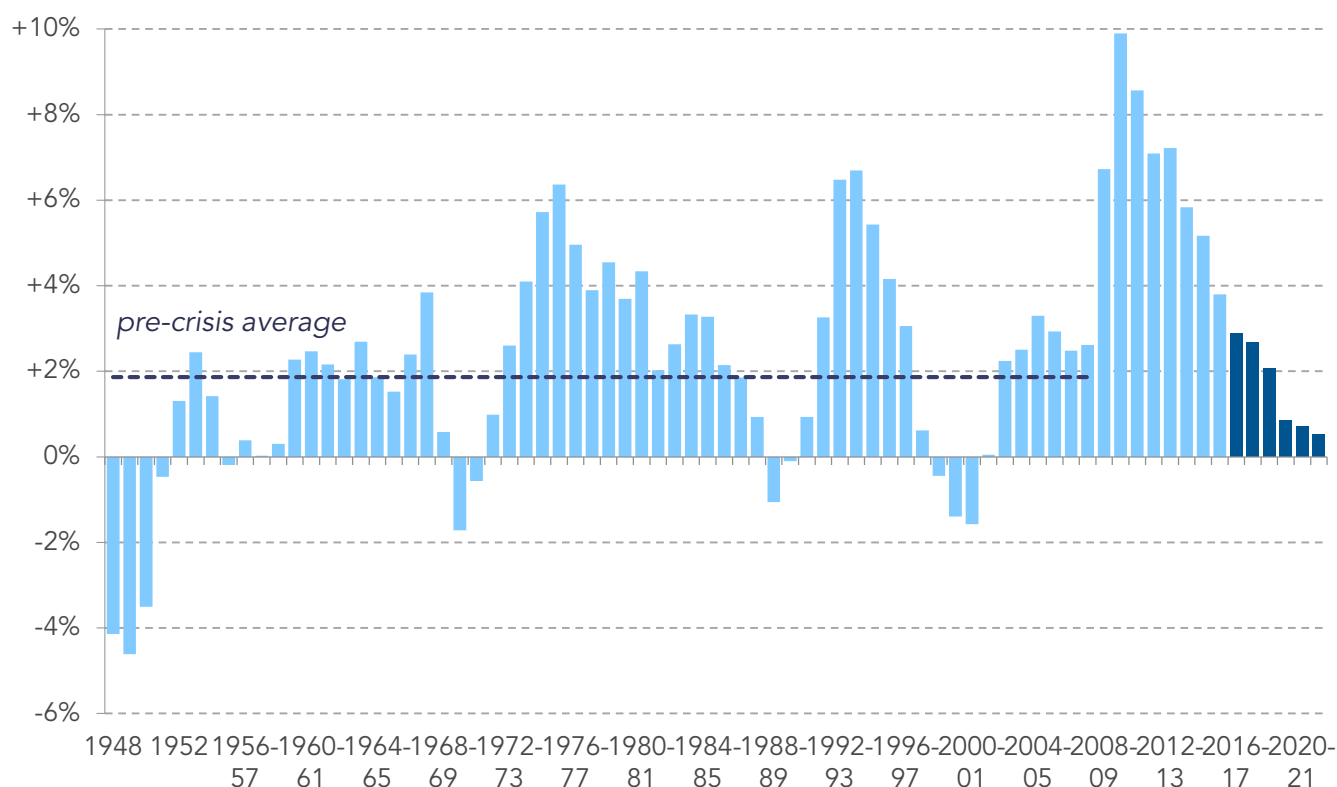
While news of a fiscal improvement and widening of already significant headroom will be welcome to the Chancellor, he is unlikely to be in a rush to spend the windfall. Nor should he. As Figure 2 highlights, a potential improvement in the region of £29 billion comes on the back of deteriorations of £52 billion and £100 billion reported by the OBR at the last two fiscal statements.

Indeed, as Figure 4 shows, the potential trajectory for PSNB as a share of GDP as implied by the adjustments we make would still look significantly worse than the picture presented by the OBR alongside the first post-election fiscal statement at Summer Budget 2015. The implication is that the OBR would be undoing much of its post-referendum pessimism from this year's outlook, but broadly retaining it for subsequent years. This would be in keeping with the evolution of many projections over recent months, which have generally been adjusted in the short-term to reflect the absence of any significant immediate post-vote effect but which have maintained expectations of slower medium-term growth.

Figure 4: Successive OBR projections for public sector net borrowing*Public sector net borrowing as a share of GDP: outturn and successive OBR projections*

Source: RF analysis of OBR, Historic official forecasts database

As Figure 5 makes clear, it is also worth remembering that potential deficits relative to GDP of 2.9 per cent, 2.7 per cent and 2.1 per cent in the three years from 2016-17 would leave borrowing above its pre-crisis average almost a full decade on from the run on Northern Rock. The Chancellor may have significant headroom against his most immediate fiscal target, but that's not because the public finances are in good shape; rather it reflects the fact that he has – sensibly – set himself a target that provides a lot of room for manoeuvre.

Figure 5: Public sector net borrowing as a share of GDP*Public sector net borrowing as a share of GDP: outturn and forecast*

Source: OBR, Public finances databank

The Chancellor chose to look through the sizeable fiscal deterioration presented to him by the OBR at Autumn Statement 2016, implementing a ‘fiscal reset’ and actually choosing to borrow *more* rather than attempting to tighten and maintain his predecessor’s deficit reduction plan. That always looked like a sensible decision given the level of economic uncertainty prevailing so soon after the EU referendum. Any rowing back on the previous OBR forecast in the next *Economic and Fiscal Outlook* will provide further justification for this pragmatic stance.

He would do well to adopt a similar position in relation to the next set of revisions. While there are many valid claims for additional resources – from the NHS, to social care, to support for living standards – continued economic uncertainty and the substantial fiscal challenges remaining should caution against the production of any major deficit-funded giveaways in the Spring Budget. Recent history suggests that any improvement in the OBR’s outlook this time around could be more than reversed by the time of the Autumn Budget.

There is still a strong case for some radicalism in the Budget, reprioritising within the existing envelope and tackling some long-standing problems

But this is not to say that the Chancellor should do nothing on 8 March. Increases in spending in specific areas would be sensible, with social care almost certain to benefit from such an increase. As we discuss below, current tax and benefit plans look set to produce highly regressive outcomes and the government must make different choices if it wishes to support low and middle income families and deliver on the intention of being the “workers’ party”.

More fundamentally, the opportunity of a relatively benign Budget on the economic and fiscal forecast side means attention could usefully be turned to four of the UK economy's key structural problems – long-recognised, but too infrequently tackled:

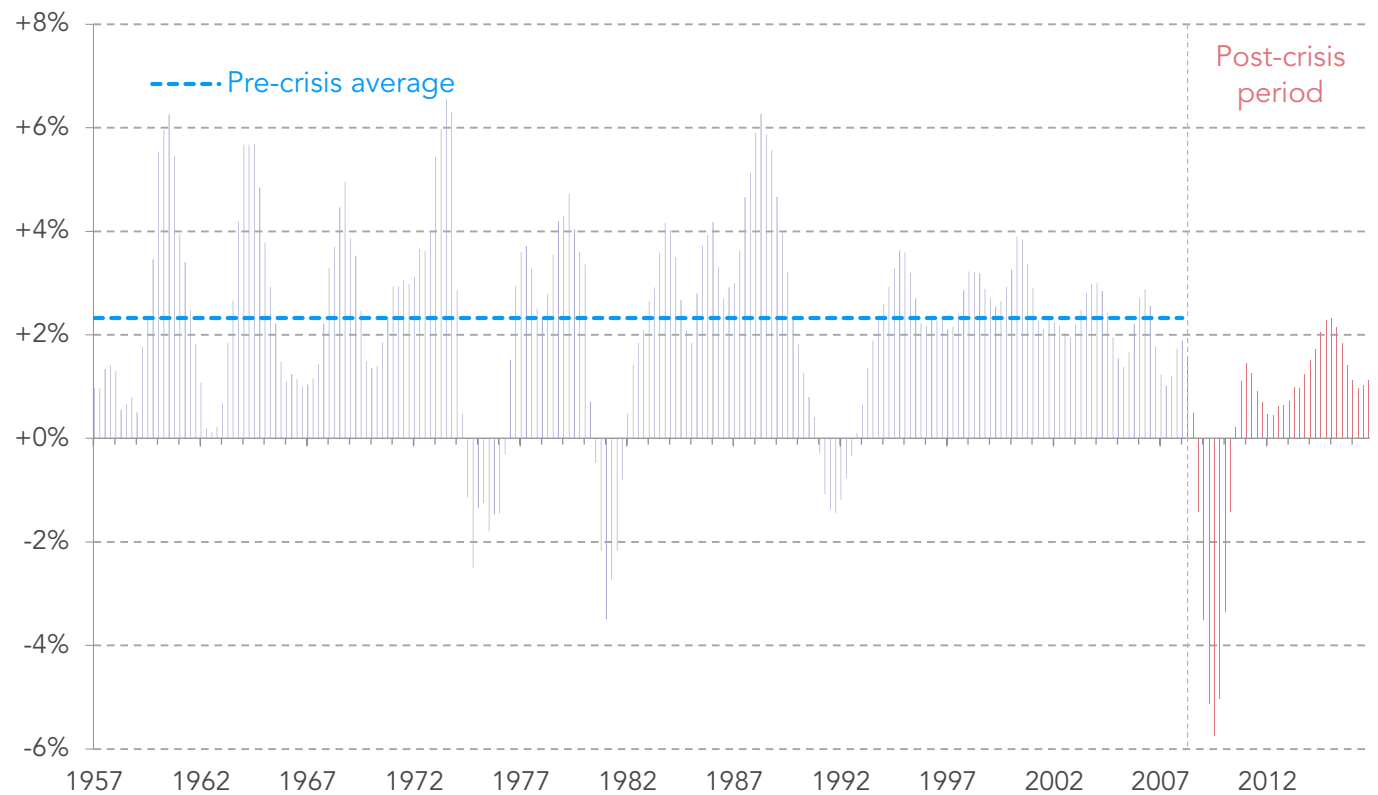
- » Economic growth is too reliant on household consumption, which in turn is often driven by debt;
- » Under-investment by firms (and the government) has contributed to weak productivity growth which is holding back earnings growth;
- » The tax take has narrowed in recent years, coming to rely much more on the performance of a minority of very high-income individuals and failing to reflect changes in the world of work such as the significant increase in self-employment; and
- » Disparities – across regions, age groups and incomes – persist in the UK and look set to widen by an alarming scale in the coming years.

Taking action designed to rise to these challenges in the Budget would set a clear tone for the remainder of the parliament and mark the Chancellor out as a serious reformer – albeit a pragmatic one.

Growth continues to disappoint

Measured in pure output terms, UK GDP has performed relatively well in recent years – especially when compared with other advanced economies. But on a per capita basis, growth has been more modest.

As Figure 6 shows, annual growth in GDP per capita fell dramatically following the financial crisis, before picking up modestly in 2013 and more robustly in 2014. It has since slowed though, standing at just 1.1 per cent in Q4 2016. Tellingly, the annual growth rate hasn't once surpassed its pre-crisis trend rate of 2.3 per cent in 35 quarters since the financial crisis; indeed, that record stretches back 41 quarters in total, or just over ten years.

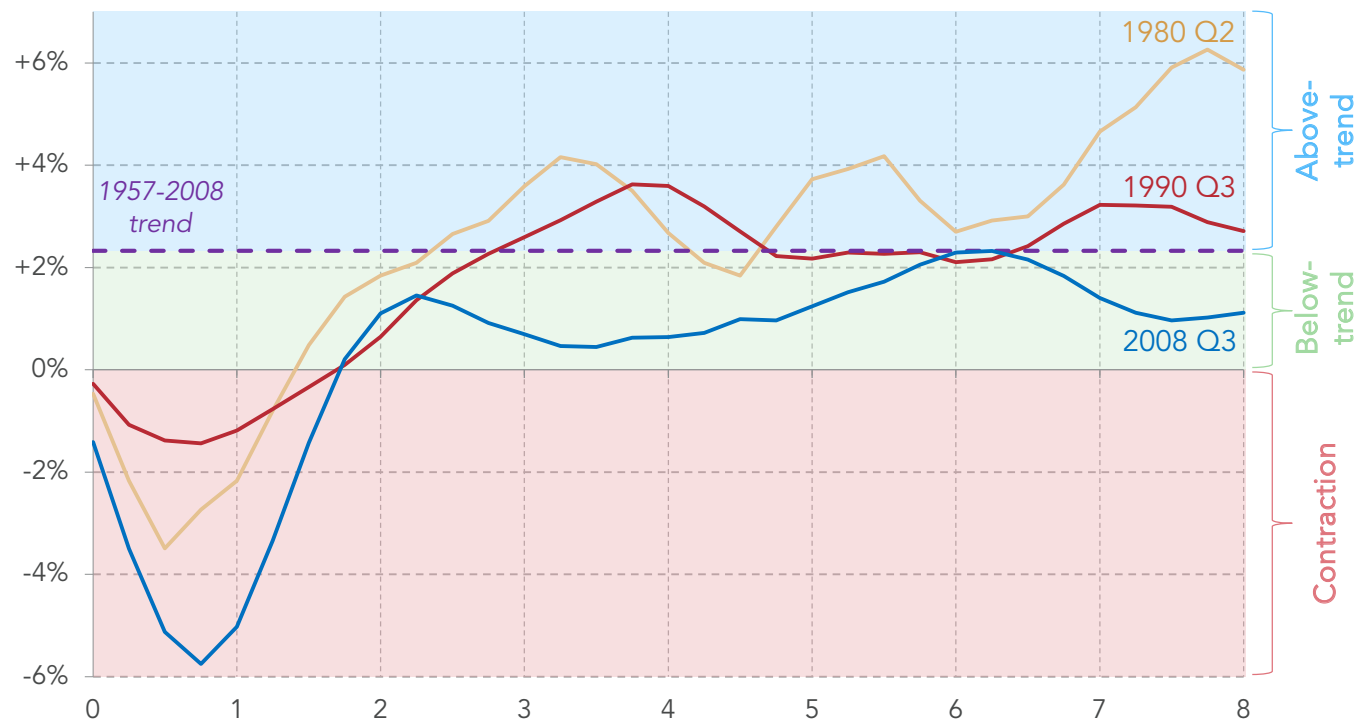
Figure 6: GDP per capita growth*Year-on-year growth in real-terms annualised GDP per capita*

Source: ONS, series IHXW

Such modest growth is more remarkable when compared with past recoveries from recession. Figure 7 plots growth in GDP per capita in the eight years following the start of the recessions in 1980, 1990 and 2008. The first two periods are marked by lengthy periods of 'rebound' growth, in which output per person expanded more rapidly than the historic trend. But the 2008 trajectory stands out for both the depth of the initial fall in GDP per capita and the failure to ever move out of the 'below trend' zone in subsequent years.

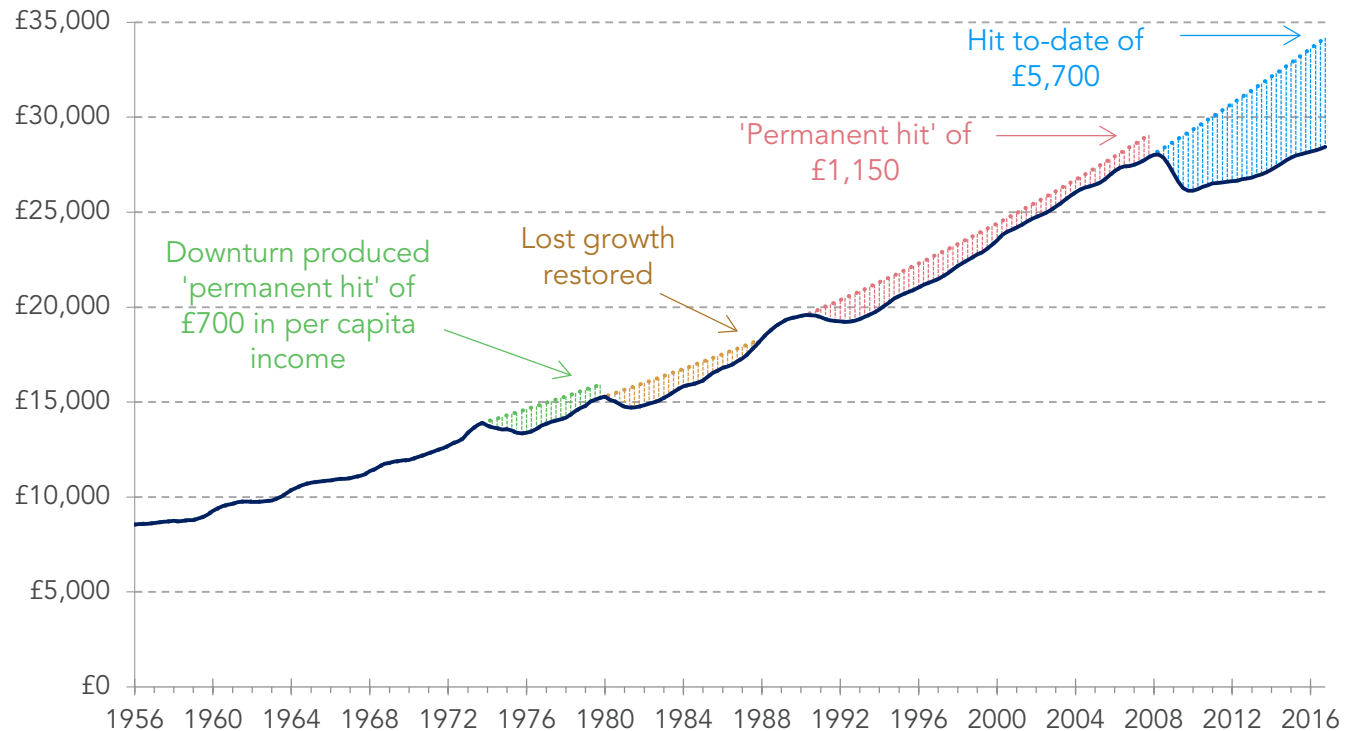
Figure 7: Comparison of the evolution of growth in GDP per capita following recent downturns

Year-on-year growth in real-terms annualised GDP per capita by number of years since last quarter of positive growth



Source: ONS, series IHXW

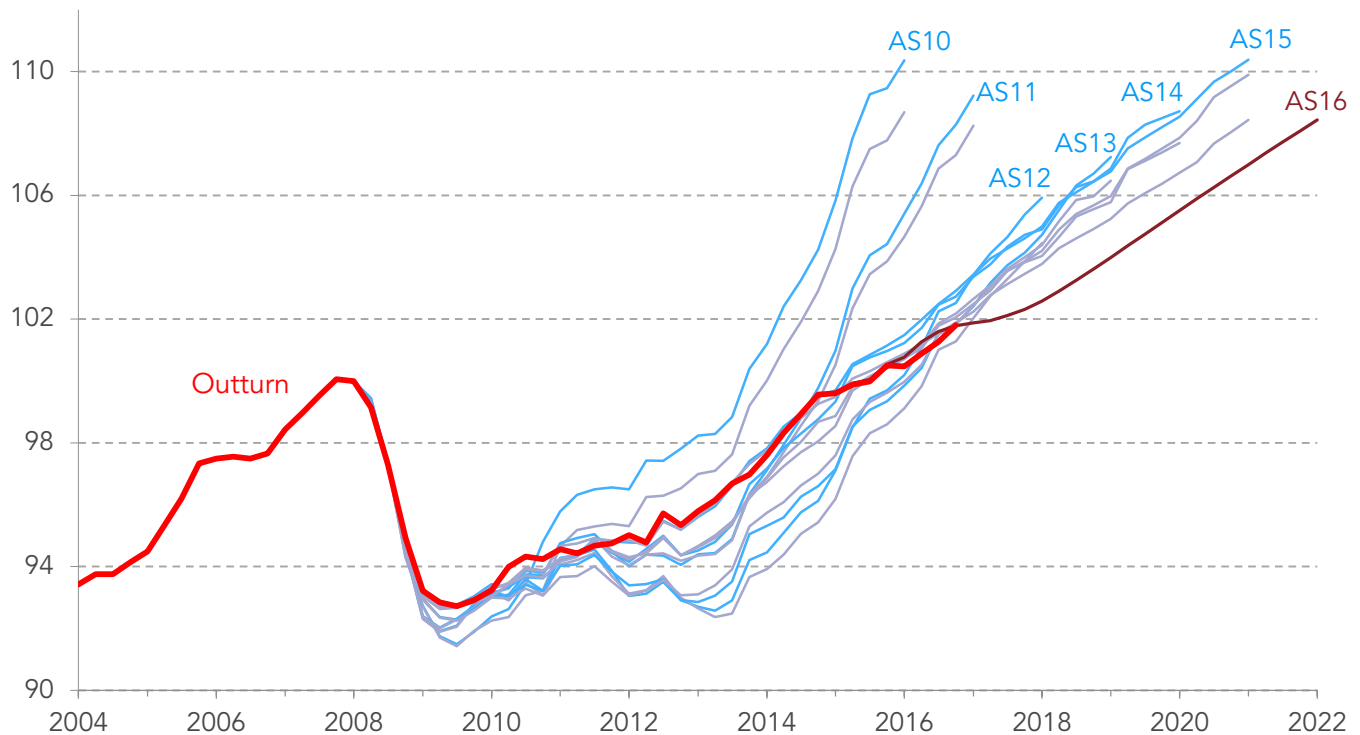
The lack of any bounce this time around means that more of the – severe – hit to GDP per capita experienced at the start of the financial crisis has become permanent than was the case following previous downturns. Figure 8 highlights this by setting out a very simple thought experiment: namely, how much higher would GDP per capita be in the absence of periods of downturn and subsequent recovery.

Figure 8: 'Lost' GDP per capita following recent downturns*Real-terms GDP per capita: actual, and in absence of downturns*

Source: ONS, series IHXW

It shows that most downturns result in some 'lost' growth relative to this hypothetical counterfactual –with the 1980s being the exception, where a particularly strong rebound meant GDP per capita was restored to its counterfactual position by the end of the decade. The recent period again stands out though, with a 'permanent hit' of roughly £5,700 per person – much higher than the figures of £1,150 and £700 resulting from slowdowns in the 1990s and 1970s respectively.

The absence of any rebound has consistently confounded expectations, as highlighted in Figure 9. It shows successive OBR projections for growth in GDP per capita, with the line moving out to the right time and again as outcomes have failed to meet expectations. Such has been the downside disappointment that the latest outturn for GDP per capita is broadly in line with where the OBR's projection from Autumn Statement 2010 expected it to be by the start of 2014.

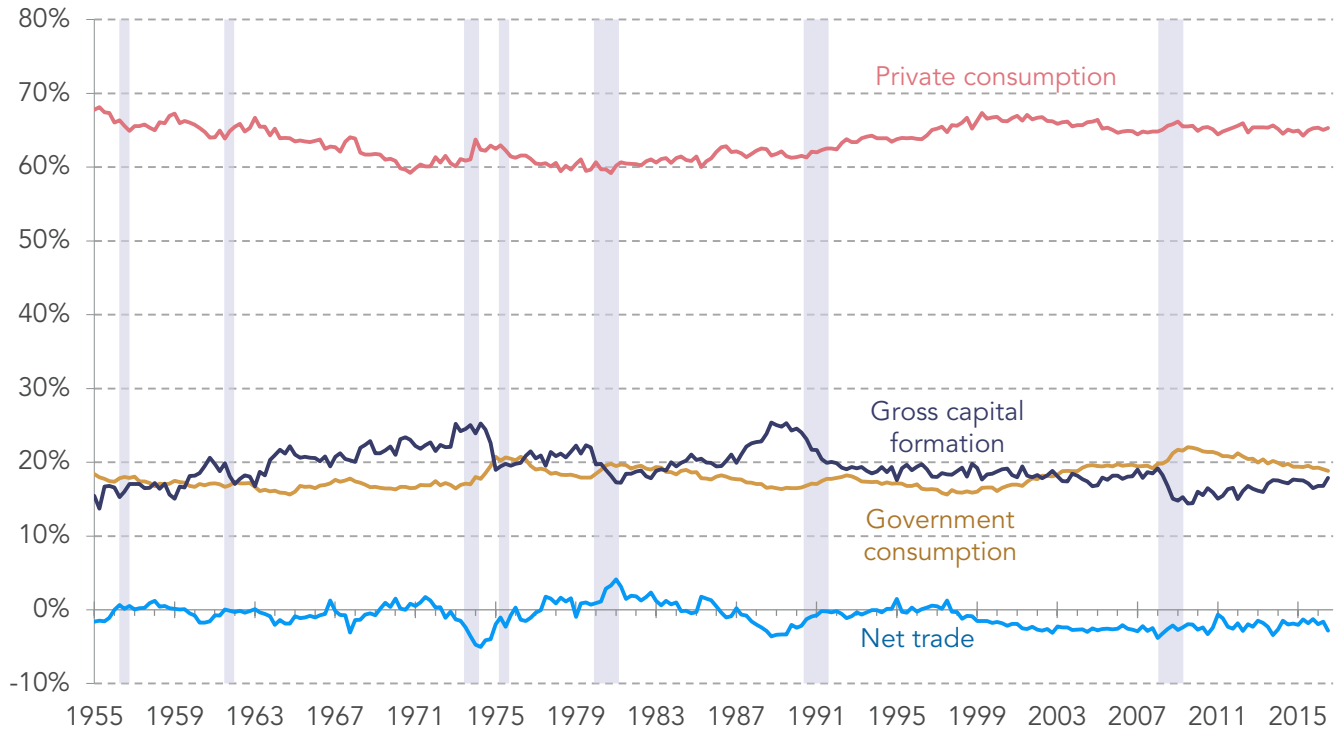
Figure 9: Successive OBR projections for real-terms GDP per capita*Indices of real-terms GDP per capita: outturn and successive OBR projections (Q1 2008 = 100)*

Source: RF analysis of OBR, Historic official forecasts database

Similarly, the Autumn Statement 2016 projection implies a level of GDP per capita at the start of 2022 that is broadly equivalent to where the OBR thought it would be in the middle of 2015 back in November 2011. That would mean achieving a given level of GDP per capita took nearly three times as long as expected, reinforcing quite how disappointing the post-crisis phase has been.

And has been too reliant on consumption and borrowing

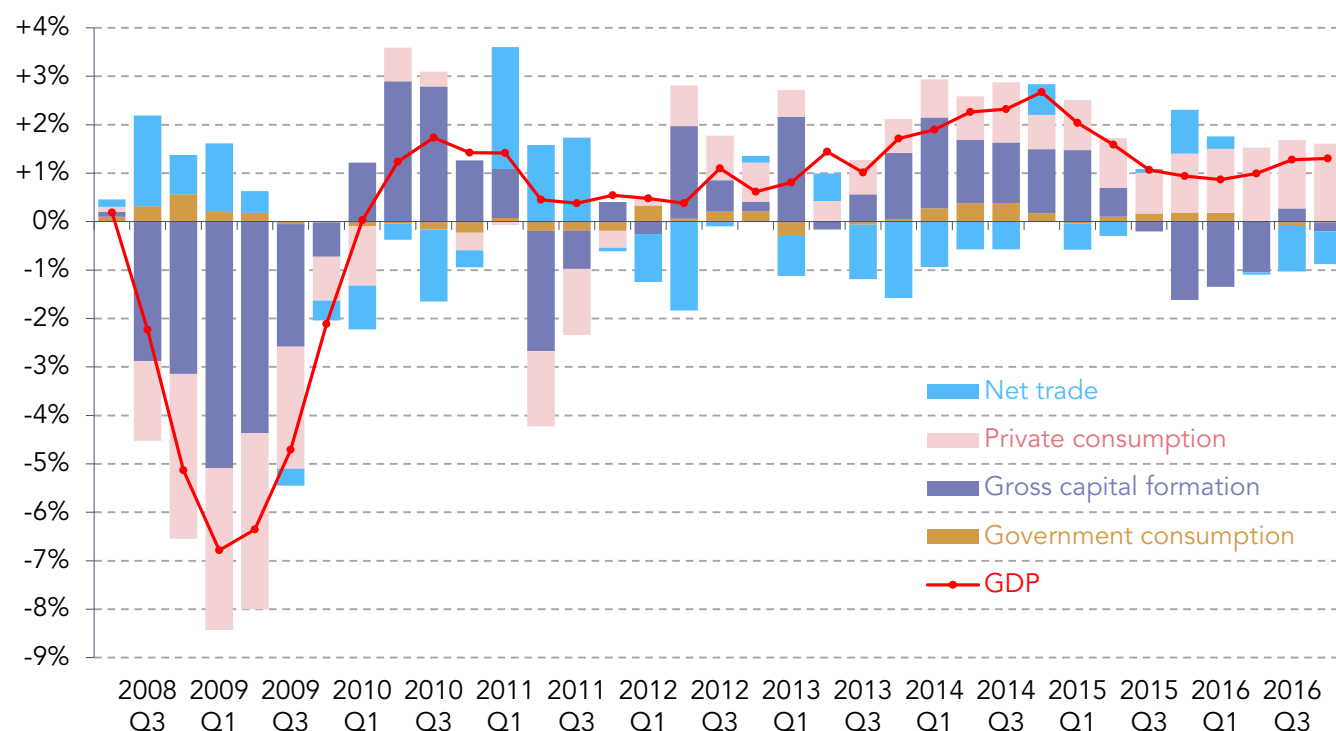
Despite talk of 'rebalancing' in the aftermath of the financial crisis – shifting economic growth towards investment and trade – Figure 10 shows that the composition of GDP has changed little in recent years.

Figure 10: Composition of GDP*Expenditure contributions to GDP*

Source: ONS, National Accounts

The chart shows that private and government consumption tend to account for larger shares of (falling) output during recessions, with the contribution coming from gross capital formation (public and private sector capital spending) falling. This pattern held during the 2008-09 recession, with government consumption and gross capital formation subsequently moving gradually back to their pre-crisis shares of GDP – though gross capital formation remains down on its 2007 level.

Figure 11 details the contributions made to overall GDP growth per capita in each quarter since the start of the 2008-09 recession. While different expenditure elements have come to the fore at different points since the crisis, what's clear is that the strongest period of overall expansion – in 2014 – was the product of an alignment of growth in several elements. In contrast, as per capita growth in 2015 and 2016 slowed, what growth did occur was much more reliant on private consumption. Indeed, over the course of 2016, private consumption accounted for more than 100 per cent of total GDP growth with all other elements acting as drags on output.

Figure 11: Share of GDP per capita growth accounted for by different expenditure components following the financial crisis*Contribution to year-on-year change in quarterly real-terms GDP per capita*

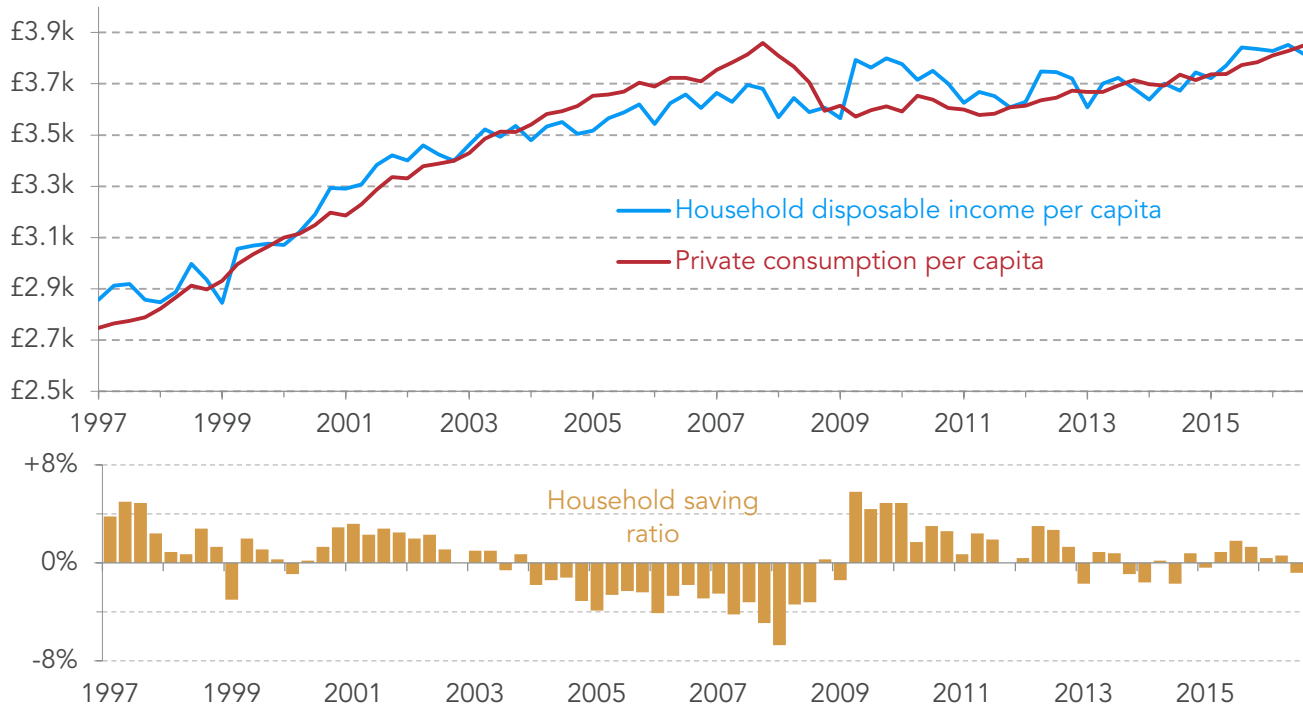
Source: ONS, National Accounts

Strong growth in private consumption has been supported in recent years by relatively good household income growth, as depicted in Figure 12.^[3] But there is some reason to believe that income growth has slowed in recent months. This has been driven by both a plateauing in employment growth and a pick-up in inflation from its ultra-low position in response to the sharp fall in the value of sterling since the EU referendum. With consumption continuing to grow strongly in 2016, the household saving ratio has fallen and – in the final quarter of 2016 – turned negative.

[3] See also A Corlett & S Clarke, [Living Standards 2017: The past, present and possible future of UK incomes](#), Resolution Foundation, Feb 2017 for a more detailed look at household survey data on incomes and living standards.

Figure 12: Household income, spending and saving

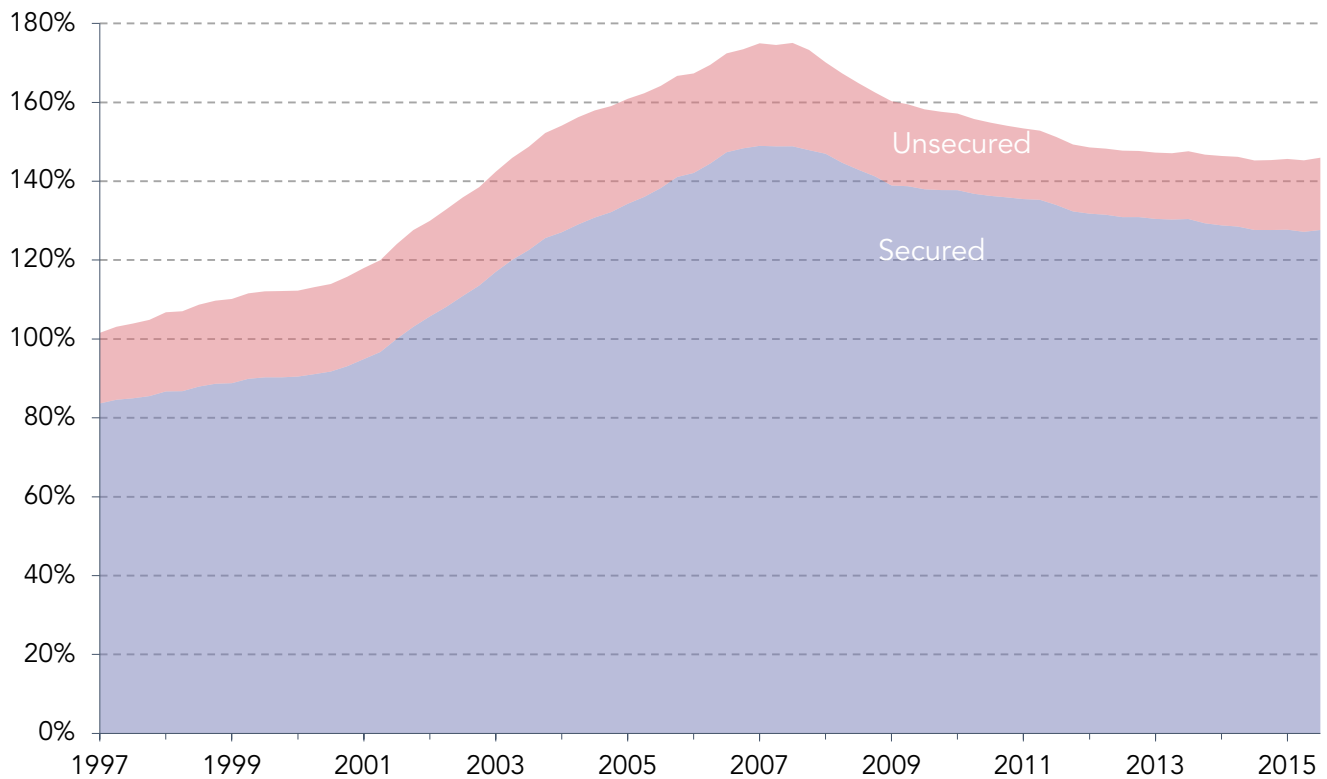
Quarterly consumption spending and household income per capita:
(chained volume measures, reference year = 2013)



Notes: Figures are taken from the ONS' experimental *alternative measures of real households disposable income and saving ratio* release. National Accounts figures are adjusted to remove 'imputed' (or unobserved) transactions and thereby better reflect households' experience of income and spending. The data covers households and non-profit institutions serving households (NPISH) such as trade unions. The saving ratio estimates the amount of money households and NPISH have available to save (known as gross saving) as a proportion of their total disposable income (known as total available resources).

Source: ONS, National Accounts

Following a number of years in which the saving ratio has been positive and overall household debt has fallen relative to income there may be room for some modest re-leveraging – particularly while the cost of borrowing remains so low. As Figure 13 shows, the debt-to-income ratio stands at around 146 per cent, significantly down on its pre-crisis peak of 175 per cent (and occurring despite increases in house prices).

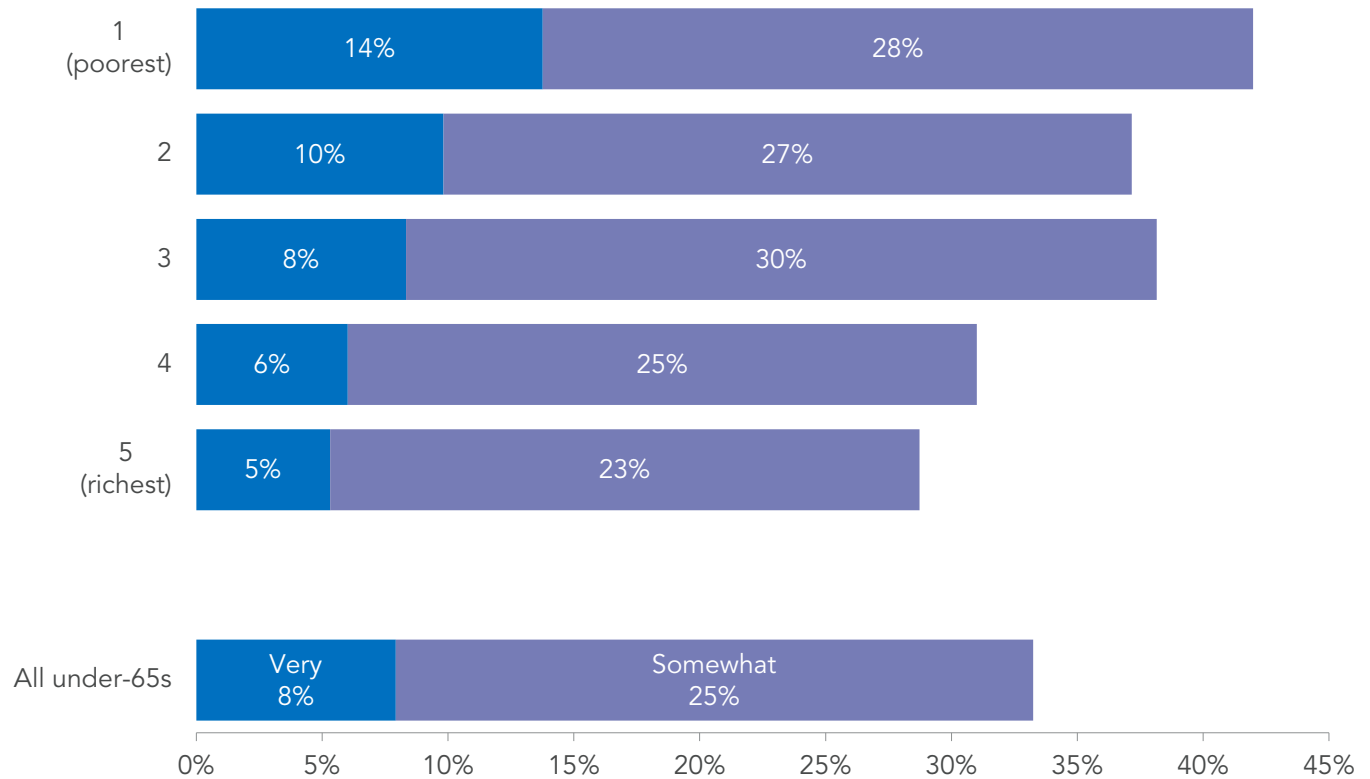
Figure 13: Household debt as a share of income*Outstanding credit as a share of disposable household income*

Source: Bank of England

However, debt remains elevated relative to historic levels. And there is evidence to suggest that a sizeable minority of borrowers are experiencing some difficulty. For example, Figure 14 shows that around one-in-three (33 per cent) working-age households say they are concerned with their current level of debt. This figure rises above two-in-five among the poorest fifth of working-age households – with 14 per cent in this group saying they are “very” concerned – highlighting the extent to which the *distribution* of debt matters as much as the overall level.

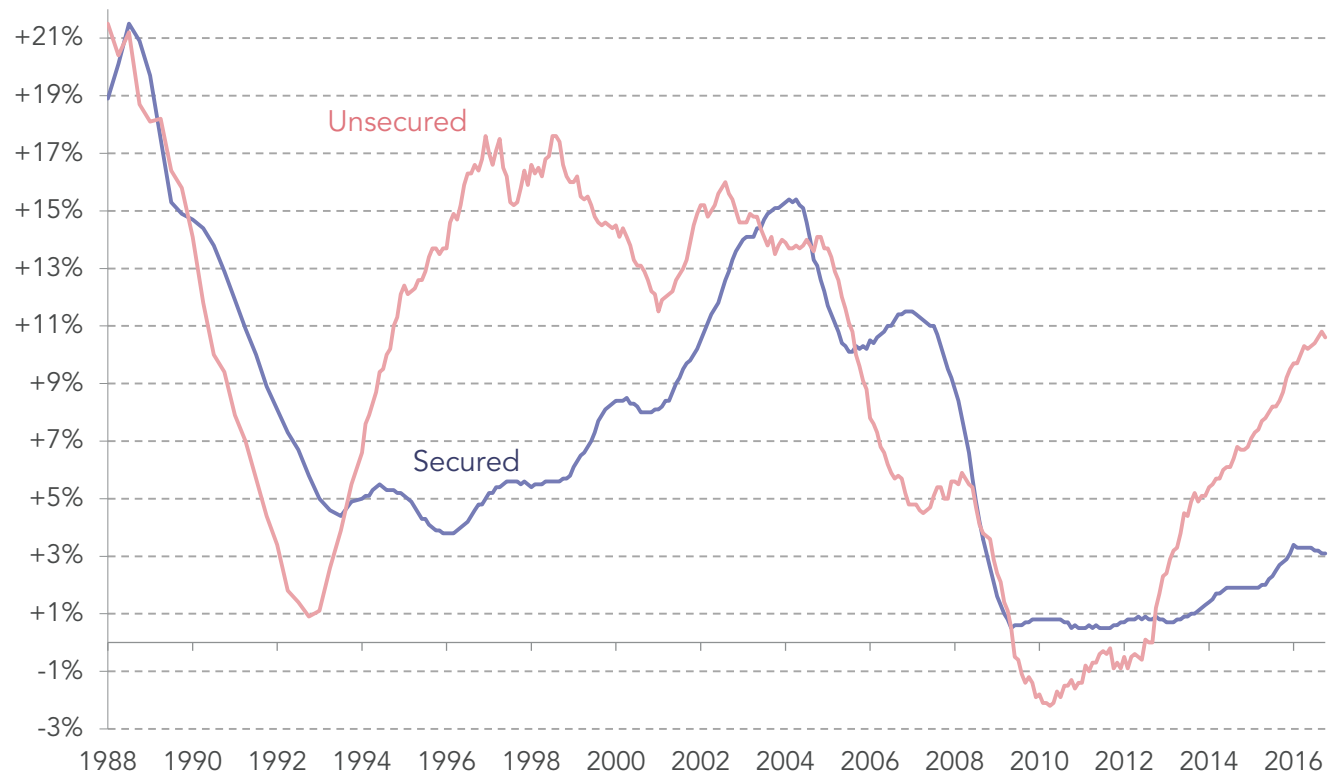
Figure 14: Level of concern with debt: GB H2 2016

Level of concern with current amount of debt (secured and unsecured), by equivalised gross household income quintile: working-age



Source: Bank of England, NMG Survey H2 2016

With housing transactions relatively subdued in recent years, secured lending growth is yet to return to anything close to the rates posted pre-crisis – as Figure 15 confirms. Unsecured lending has been rising sharply however. Annual growth reached 10.8 per cent in November 2016, a level last recorded in 2005.

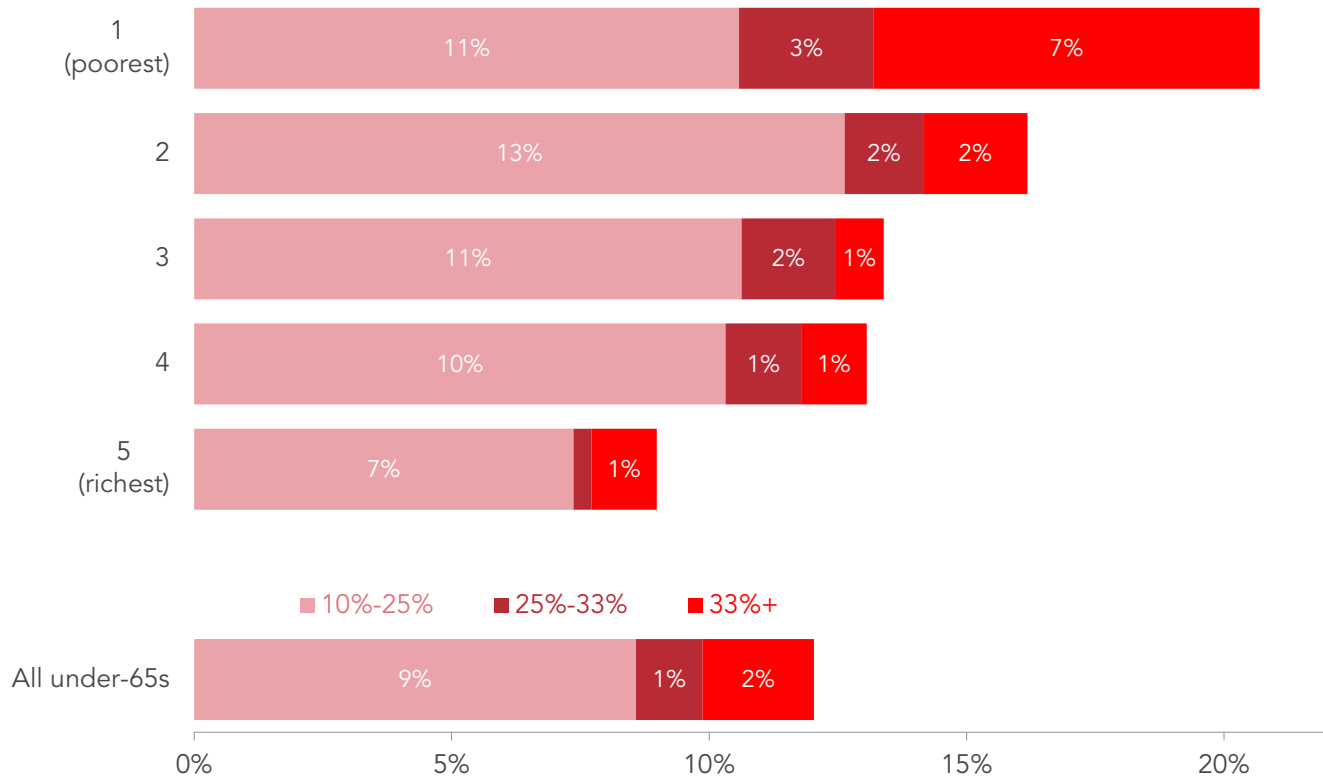
Figure 15: Annual growth in net lending to individuals*Year-on-year growth in net lending to individuals (nominal)*

Source: Bank of England

Against this backdrop, Figure 16 shows that 13 per cent of working-age households reported spending more than 10 per cent of their pre-tax income on unsecured debt repayments in the second half of 2016. This figure rose to one-in-five (21 per cent) among the poorest fifth of working-age households, with 7 per cent allocating more than one-third of their gross income to repayments.

Figure 16: Consumer credit repayments: GB H2 2016

Proportion of households spending >10% of their gross household income on unsecured repayments, by equivalised household income quintile: working-age



Source: Bank of England, NMG Survey H2 2016

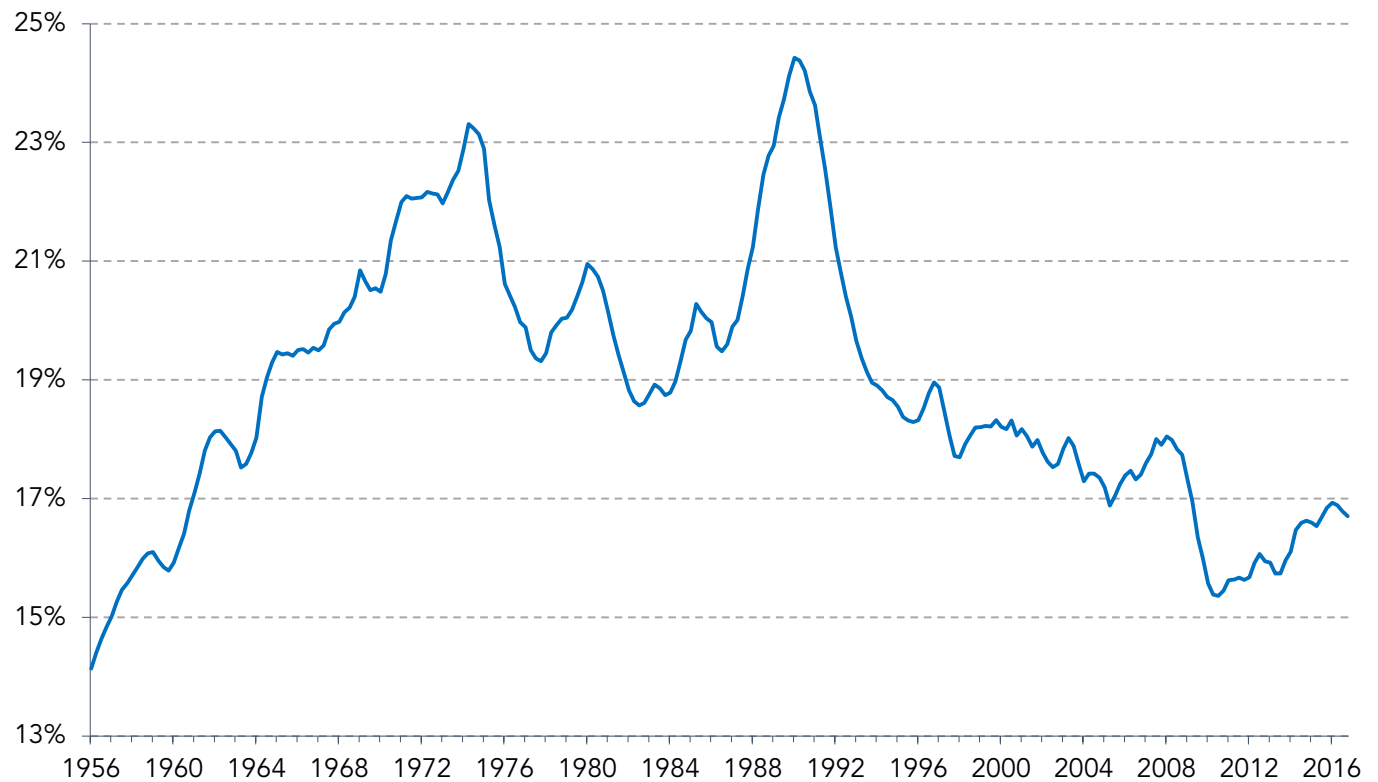
The sustainability of growth based on debt-fuelled household consumption is of course questionable. Relative to the position immediately before the financial crisis hit, household debt appears to be less of an immediate problem – particularly with little sign of any imminent sharp increase in borrowing costs. But consumption growth can only outpace income growth for so long.

The fact that significant numbers of households feel concerned about their debts even with interest rates at historic lows highlights the potential vulnerability of a growth model based on consumer borrowing. With the prospect of a fresh wage squeeze in 2017 very real, the Chancellor would do well to refocus attention on the need to rebalance the UK economy away from household spending.

Providing businesses with the stability and macroeconomic conditions most conducive for strong investment in the future will be difficult against a backdrop of Brexit negotiations, but it is crucial that Britain fixes its chronic problem in this area.

Investment growth has been weak, following a pattern established long before the financial crisis

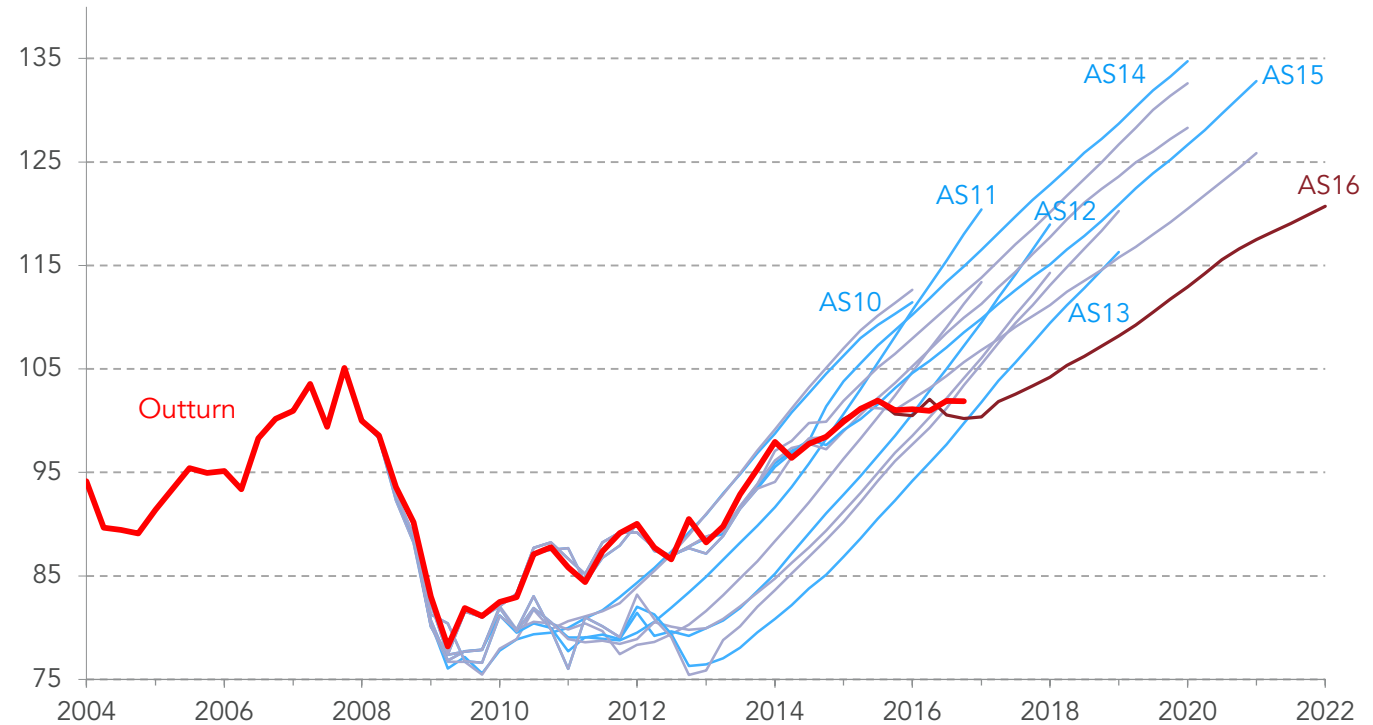
One flipside of the economy's overreliance on consumer spending is underperformance on investment. Digging into the gross capital formation figures presented in Figure 11 to focus on the more productivity-enhancing fixed capital formation element (rather than that part of gross capital formation associated with stockpiling of outputs by firms), Figure 17 shows that investment has fallen sharply as a share of GDP over recent decades.

Figure 17: Fixed capital formation as a share of GDP*Fixed capital formation as a share of GDP: rolling four-quarter average*

Source: ONS, National Accounts

Performance has been especially weak in the post-crisis period. On a per capita basis, fixed capital formation remains 4.5 per cent below the level prevailing in the first quarter of 2008.

This weak performance is emphasised in Figure 18, which details successive OBR projections for fixed capital formation. The consistent rightward shifting of the lines highlights the extent to which investment has under-performed relative to expectations. The latest outturn is a little better than was projected at Autumn Statement 2016, but it is only equivalent to the level of investment projected to have arrived by mid-2014 in the OBR's Autumn Statement 2010 outlook.

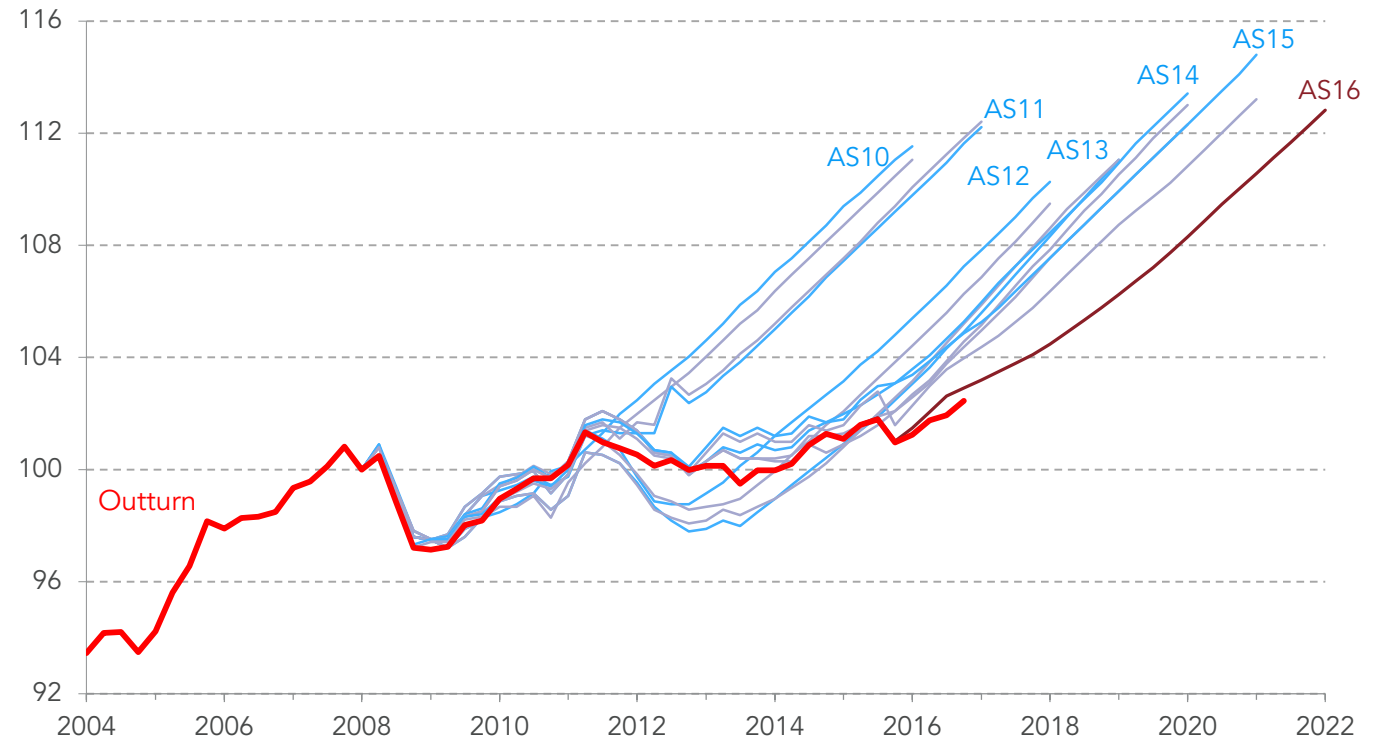
Figure 18: Successive OBR projections for gross fixed capital formation*Indices of fixed investment: outturn and successive OBR projections (Q1 2008 = 100)*

Source: RF analysis of OBR, Historic official forecasts database

This weak investment growth has undoubtedly been a factor in weak productivity growth post-crisis. Figure 19 highlights the extent to which productivity growth has similarly underperformed. The latest outturn for output per hour worked is just 2.5 per cent higher than at the start of 2008, a position that the OBR expected to be reached at the beginning of 2012 when publishing its Autumn Statement 2010 forecast.

Figure 19: Successive OBR projections for productivity growth

Indices of non-oil GVA productivity per hour: outturn and successive OBR projections (Q1 2008 = 100)



Source: RF analysis of OBR, Historic official forecasts database

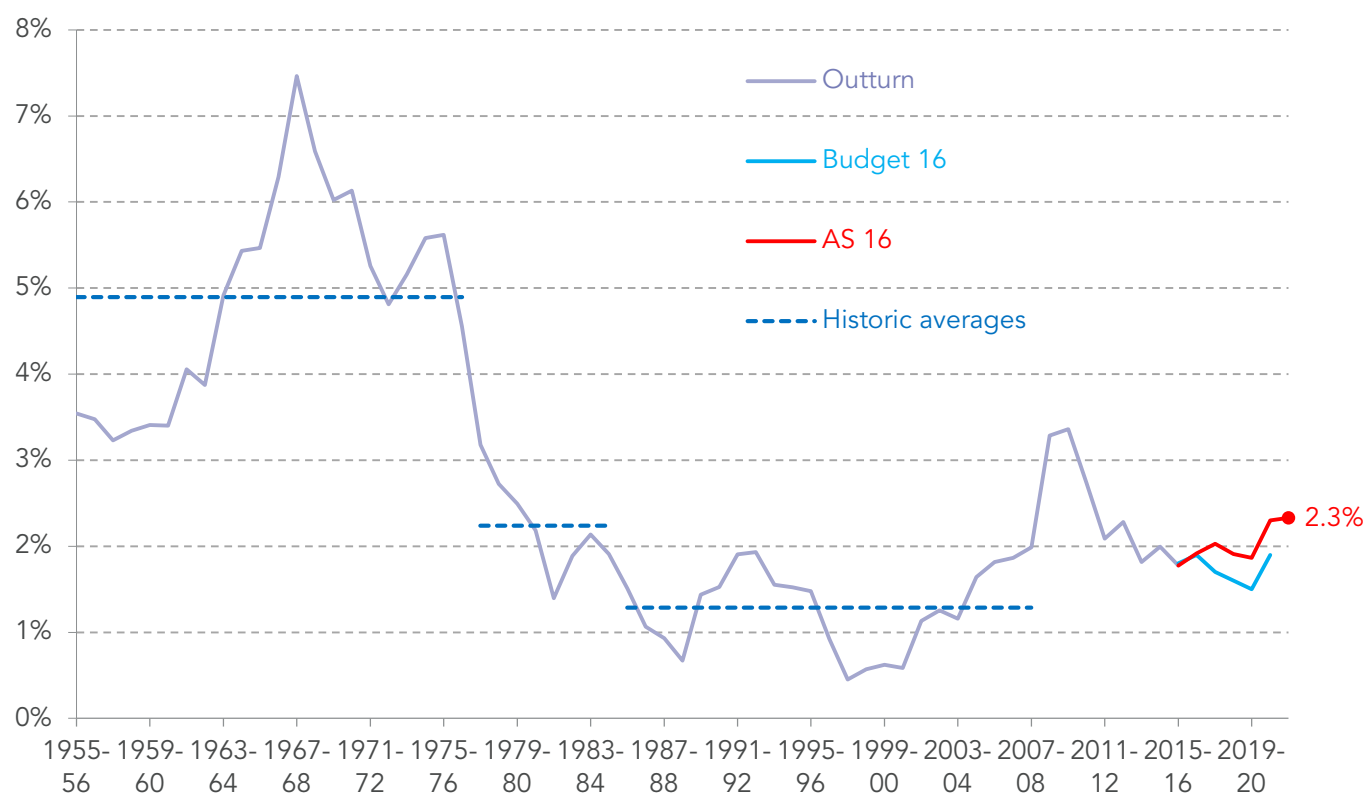
Crucially, the OBR downgraded its assessment of the *trend* rate of productivity growth at Budget 2016, accepting that the persistence of the post-crisis flat-lining implied that there had been a permanent shift in the UK's growth capacity. At Autumn Statement 2016 it further downgraded trend productivity growth in the medium-term because of a belief that uncertainty surrounding the Brexit process would lower investment. However, it did not include any assessment of the potential reduction in productivity growth that might be associated with lower international trade once the UK has left the EU.

Of course, the government can take direct action – by raising its own level of investment spending. Ahead of Autumn Statement 2016, Philip Hammond made clear his determination to boost investment, arguing that the UK's "stock of public infrastructure... languishes near the bottom of the developed-countries' league table after decades of under-investment".^[4] As Figure 20 shows, the plans he subsequently set out in the Autumn Statement are set to raise public sector net investment to 2.3 per cent of GDP by 2020-21, up from a projection of 1.9 per cent in Budget 2016. This would mark only the second time (after 2008-2011) since the 1970s (a time of major nationalised industries) that such a level of investment has been secured.

[4] P Hammond speech, [An economy that works for everyone, Speech to Conservative Party Conference](#), 3 October 2016

Figure 20: Public sector net investment

Net investment as a share of GDP

Source: OBR, *Economic and fiscal outlook*, various

Welcome though this is, government spending makes too small a contribution to overall investment for the extra funds earmarked at Autumn Statement 2016 to offset the downward revision made to the OBR's projections for business investment over the next five years. If the Chancellor wants to tackle the UK's chronic under-investment then he will need to build on his previous commitment to providing more funds by also tackling the real and perceived barriers facing firms.

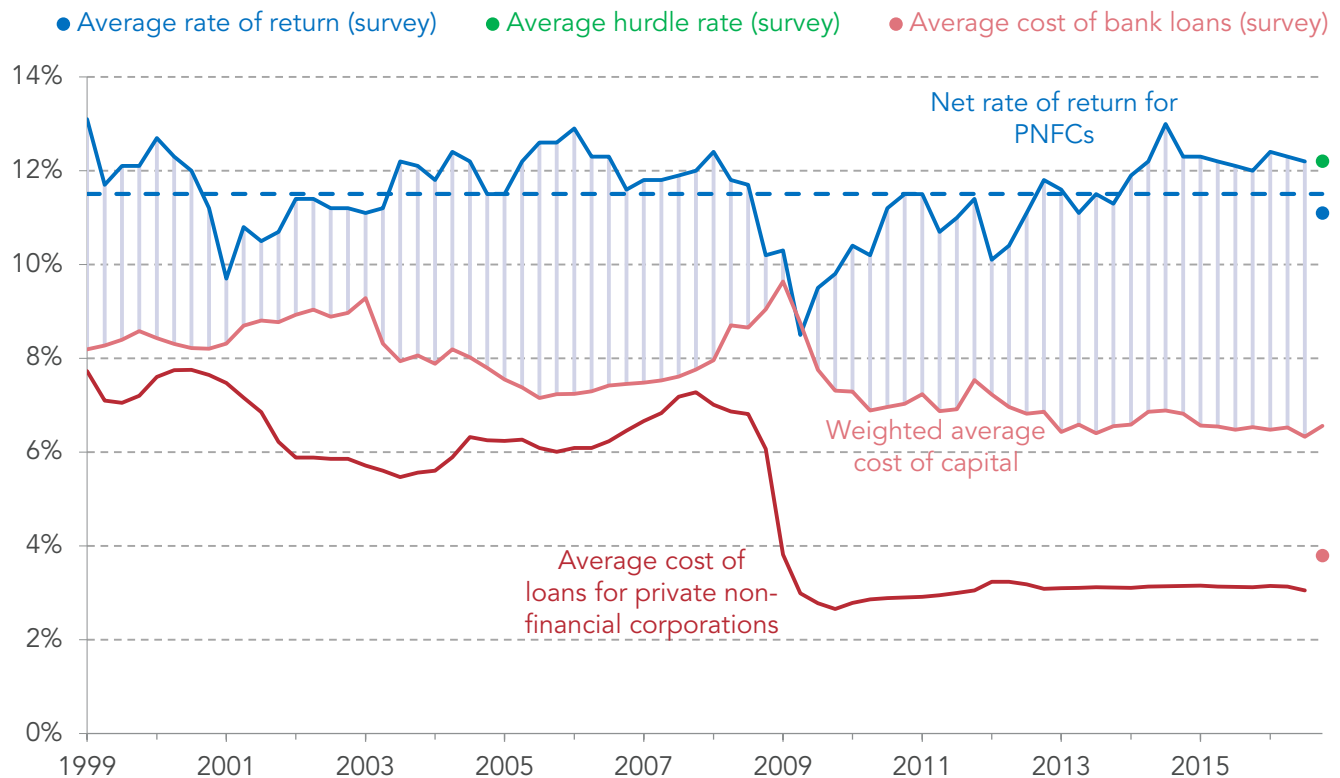
So why has investment performed so badly in recent years? A new Bank of England survey provides some insight.^[5] Among the 1,220 firms surveyed – in November 2016 – one-in-three (34 per cent) acknowledged that they had under-invested over the past five years relative to the opportunities they faced.^[6]

Interestingly, the average 'hurdle rate' (the minimum rate of return a year that businesses require before embarking on a new investment project) among respondents was 12 per cent – broadly in line with the rates of return achieved by firms in recent years (11 per cent) and well above historically low levels of borrowing costs. As Figure 21 shows, the spread between rates of return and cost of capital is somewhat elevated at the moment, suggesting that firms are more risk averse than usual. But the fact that achievable rates of return broadly match respondents' hurdle rates implies that there are opportunities available for those who wish to take them.

[5] Bank of England Finance and Investment Decisions Survey as reported in J Saleheen, I Levina, M Melolinna & S Tatomir, ["The financial system and productive investment: new survey evidence"](#), *Quarterly Bulletin*, 2017 Q1, Bank of England

[6] It should be noted that the survey under-represents newer firms and is thereby likely to understate investment to some degree.

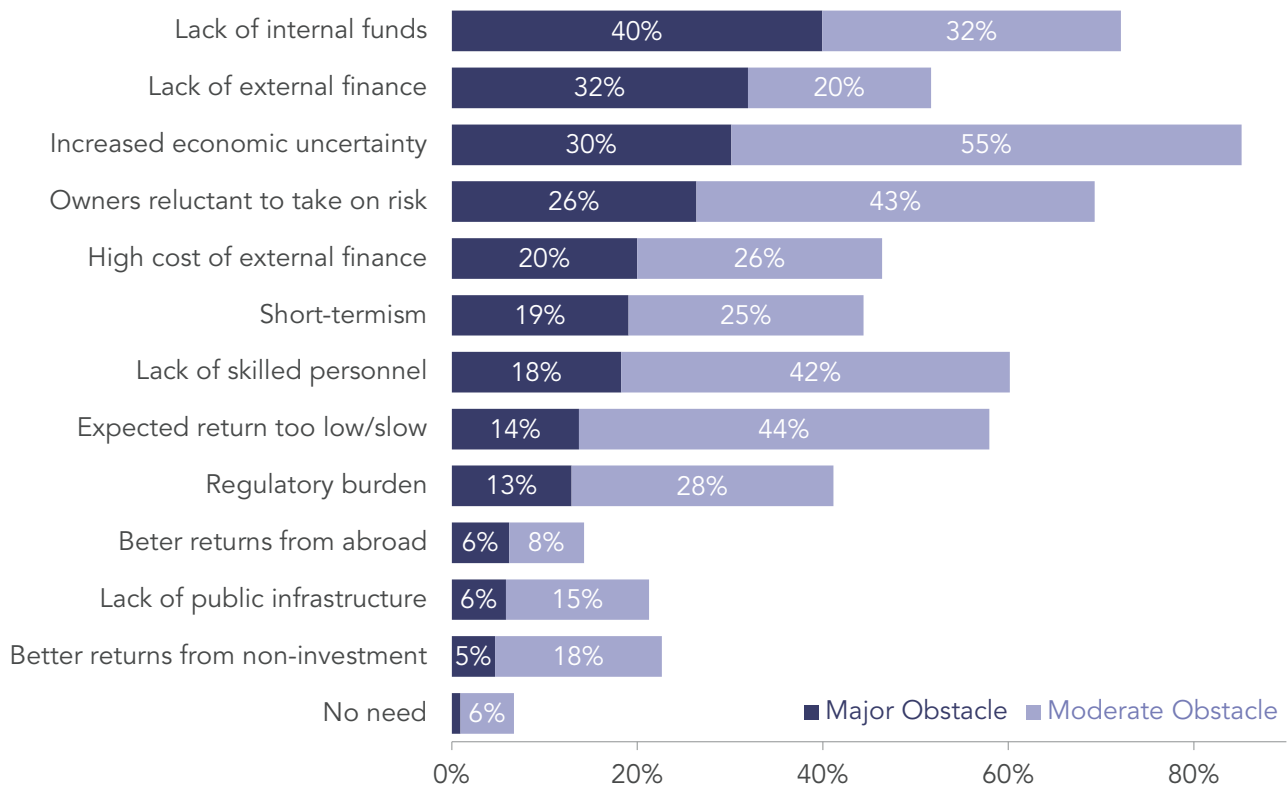
Figure 21: Cost of capital and rates of return: outturn and survey responses



Notes: Net rate of return for PNFCs covers net operating surplus/net capital stock (per annum). Weighted average cost of capital is partly based on estimates of the equity risk premium, which come with considerable uncertainty. Average cost of loans is based on weighted average interest rate of sterling loans made to PNFCs by UK resident monetary financial institutions. Survey responses based on three questions: 'If you set an investment hurdle rate, what is it?'; 'On average, what is the total rate of return realised on investment projects completed in the past five years?'; and 'Over the past year, approximately at what cost were you able to raise bank finance?'.

Source: Bank of England, "The financial system and productive investment: new survey evidence", Quarterly Bulletin, 2017 Q1. We are grateful to the authors for making the data available.

Digging into what held back those one-in-three firms admitting to under-investing, Figure 22 shows that uncertainty has weighed heavily. Around 85 per cent of the under-investing group said that it had acted as an obstacle to investment over the past five years, with 30 per cent describing it as a "major" obstacle. 'Risk aversion' was cited as a major obstacle by a similar number of respondents.

Figure 22: Reported obstacles to investment over the past five years*Proportion of business reporting under-investment over past five years*

Notes: Based on question: 'If your business invested 'too little' over the past five years, what were the main obstacles to investing?'. 'Shorttermism' arises when companies value shortterm returns above investment that typically yields returns over a longterm horizon.

Source: Bank of England, "The financial system and productive investment: new survey evidence", Quarterly Bulletin, 2017 Q1. We are grateful to the authors for making the data available.

Of course, we can expect Brexit uncertainty to persist for a number of years to come and – as noted above – it is one of the key factors underpinning the OBR's assessment of business investment prospects.

One area of particular concern for long-term planning in some firms is the future access that UK businesses will have to migrant labour. EU-born employees make up one-in-five (20.8 per cent) workers in the accommodation sector and a similar proportion (18.4 per cent) in leather manufacturing.^[7] The figure rises to one-in-three (32.8 per cent) in food manufacturing.

What stands out when looking at the sectors that are most reliant on EU workers is the division between those that appear to have scope for responding to any reduction in labour supply via increased use of automation and those that appear to have fewer such options. But in the absence of any sense of what form of migrant worker policy might exist a year or two down the line, firms are unlikely to be in a position to finalise sensible – and productivity-enhancing – investment decisions.^[8] With that in mind, it's important that the government enters into conversations with business sooner rather than later.

Returning to Figure 22, we see that lack of finance – both internal and external funds – also served as a clear barrier to firms' approach to investment over the past five years. Smaller businesses were

[7] RF analysis of ONS, *Labour Force Survey*.

[8] See A Corlett, [Robot Wars: automation and the labour market](#), Resolution Foundation, July 2016 for a fuller discussion of how different sectors are affected by migration and automation.

particularly likely to raise this as an issue (more than twice as likely as larger firms in relation to external finance for instance). What is less clear from the survey is whether the barriers faced by those saying that they have under-invested reflect the fact that they don't represent good returns opportunities for investors or a market failure in the provision of funds.

From the Chancellor's perspective, perhaps the most intriguing response set out in Figure 22 is the fact that more than two-in-five (44 per cent) of those firms saying they'd underinvested over the past five years pointed to 'short-termism' as an obstacle, with around one-in-five (19 per cent) describing it as a "major" barrier. The proportion saying that financial market pressures for short-term returns were an obstacle to investment increased to four-in-five (80 per cent) among publicly listed members of the 'under-investing' group.

More generally, looking across all firms, the survey found that just one-in-four (26 per cent) prioritised internal funds for investment.^[9] The implication is that it is not enough to ensure access to finance; incentives matter too. If corporate governance rules and norms are holding back investment, then the government could choose to take action.

The government's Industrial Strategy Green Paper^[10] suggests there is appetite for considering such issues, identifying the need to improve long-term finance and review market norms and business incentives. Similarly the Corporate Governance Green Paper^[11] raises interesting questions about the link between company performance and executive pay and incentives. As ever though, outcomes will depend ultimately on how the government takes any proposals forward. What's clear is that there is scope for more radical thinking than has occurred over recent decades.

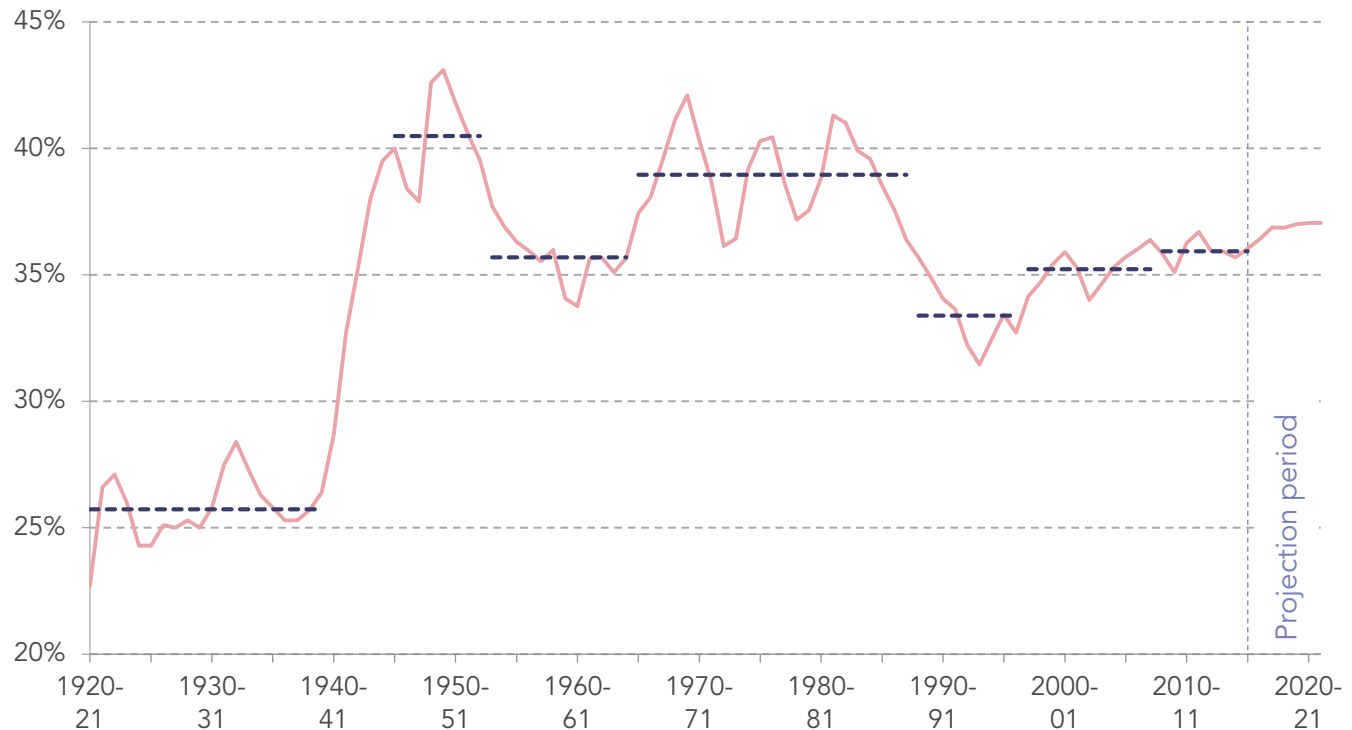
The UK's tax base has narrowed and hasn't responded to a changing world of work

Government receipts fell sharply when the financial crisis hit, reflecting the large correction in output that took place. Yet, as Figure 23 shows, receipts held up much better when measured as a share of GDP. Indeed, receipts have been steadily rising as a share of GDP since the early-1990s and the latest set of OBR projections suggest that they will reach 37.1 per cent by 2021-22 – their highest level since 1986-87.

[9] Other options included the purchase of financial assets, distribution to shareholders and holding funds as cash balances.

[10] HM Government, [Building our Industrial Strategy](#), Green Paper, January 2017

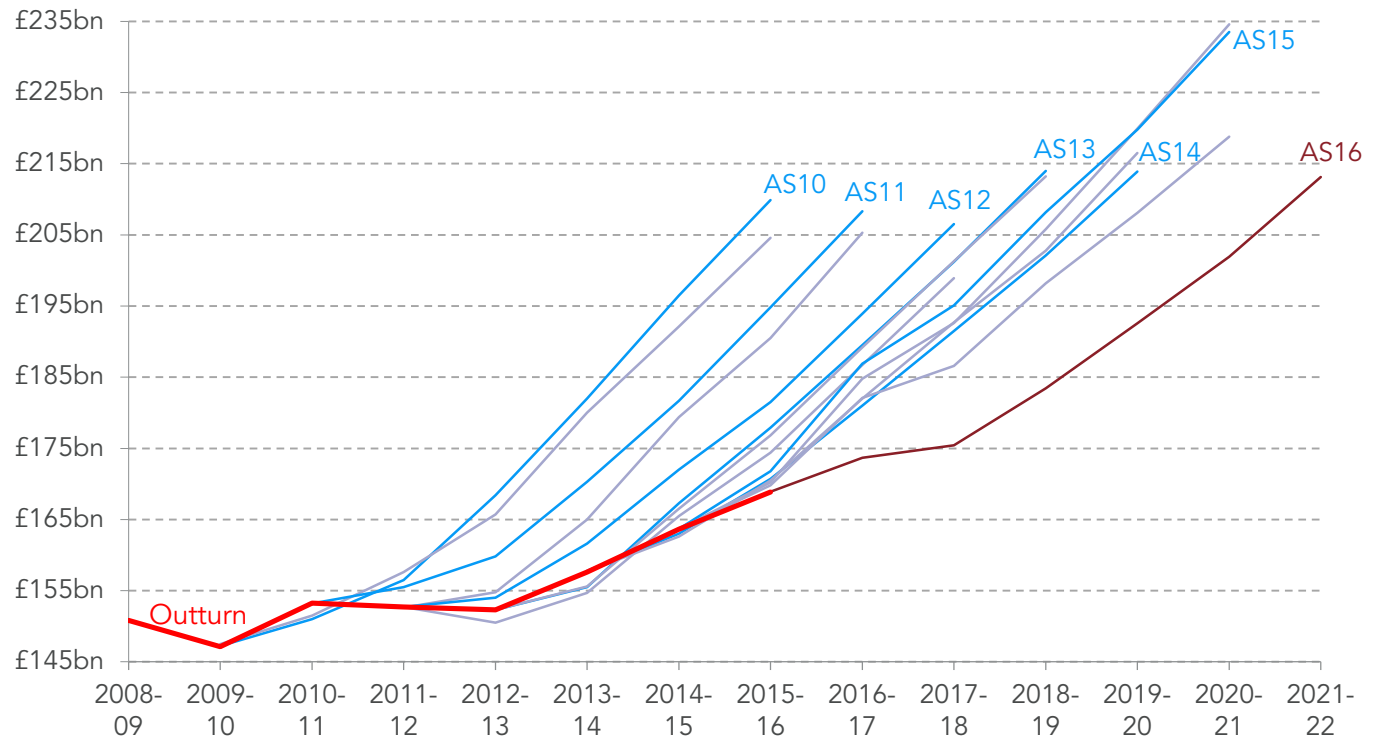
[11] HM Government, [Corporate Governance Reform](#), Green Paper, November 2016

Figure 23: Government receipts*Receipts as a share of GDP*

Source: OBR, Public Finances Databank

However, as with so many of its other projections, the OBR has consistently revised its expectations down at successive fiscal statements. At Autumn Statement 2016, the OBR projected total receipts of £735 billion by 2015-16; yet the latest estimate for the outturn puts the figure at £680 billion instead. The latest projections should therefore be treated with the usual caution.

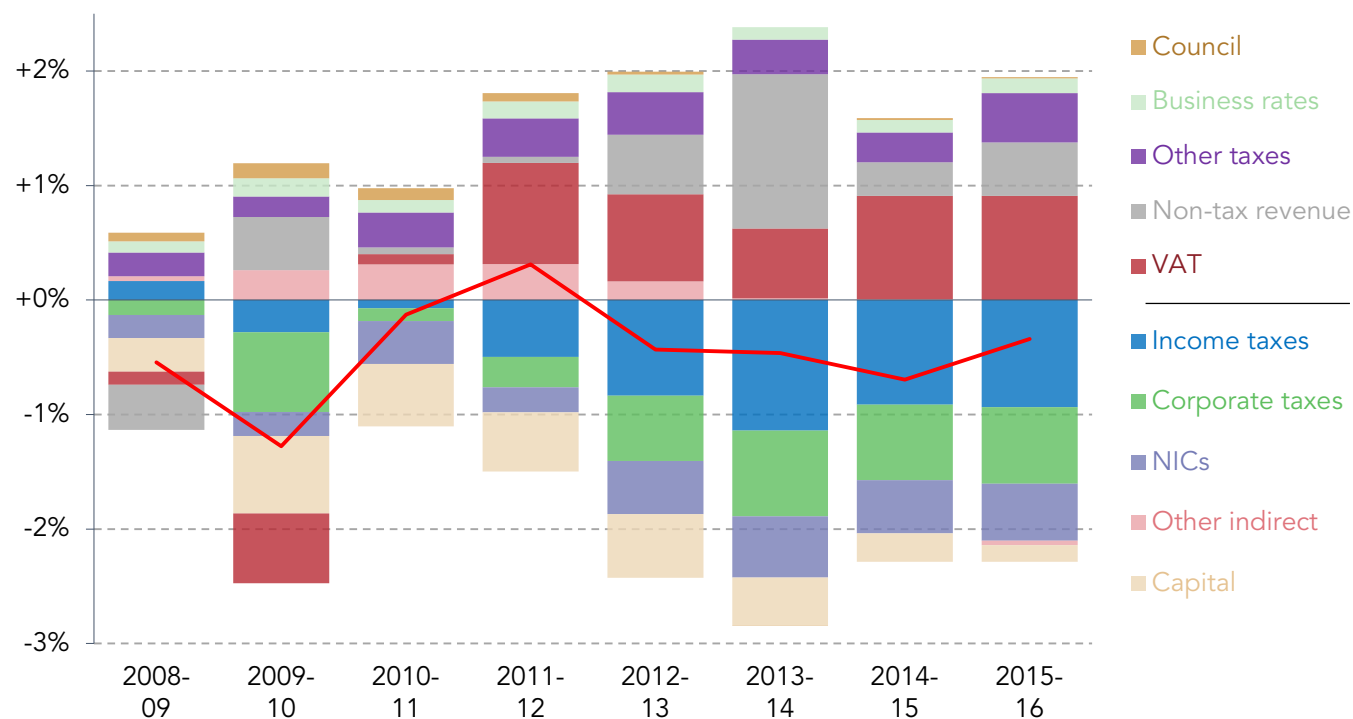
Within the overall movement in receipts over recent years, some elements have proved more likely than others to come in below expectation. Income tax stands out in this regard, as highlighted by Figure 24. It shows that the 2015-16 outturn came in some £41 billion lower than the OBR's projection at the time of Autumn Statement 2010. Similarly, the Autumn Statement 2016 projection for 2020-21 (of £201.9 billion revenue) was £31.6 billion lower than the forecast provided just 12 months earlier at Autumn Statement 2015.

Figure 24: Successive OBR projections for income tax receipts*Income tax receipts: outturn and successive OBR projections (nominal)*

Source: RF analysis of OBR, Historic official forecasts database

Of course, economic underperformance is not the only factor affecting outturn versus projection (though disappointing productivity and pay performance is a very significant factor in this instance) – policy changes also matter.

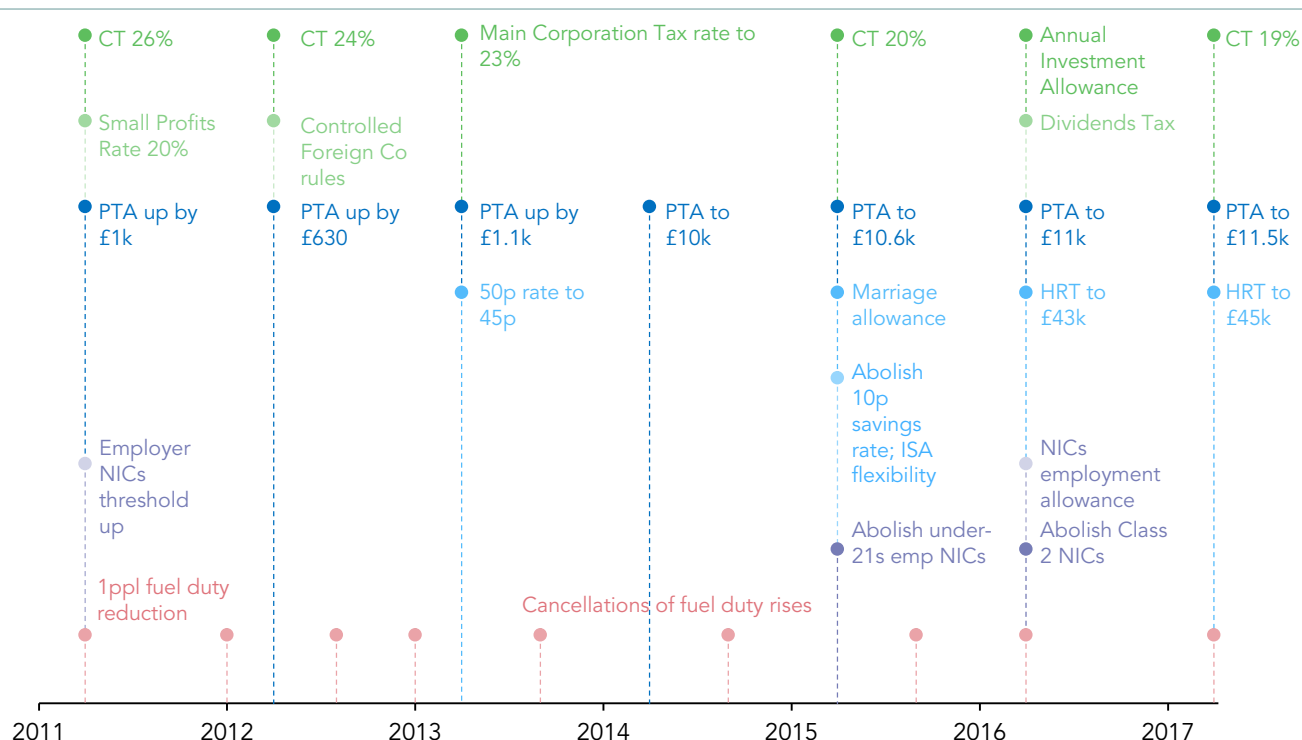
Much has changed in the UK tax landscape in recent years, as indicated in Figure 25. It shows the contribution of different forms of revenue to the overall change in government receipts as a share of GDP in the period since 2007-08. It highlights the negative contribution made by some large taxes such as income tax, corporation tax and national insurance – with VAT providing the largest partial offset following the increase in the main rate in January 2011.

Figure 25: Contribution of different taxes to cumulative change in receipts as a share of GDP since 2007-08*Contribution to cumulative change in receipts as a share of GDP since 2007-08 baseline*

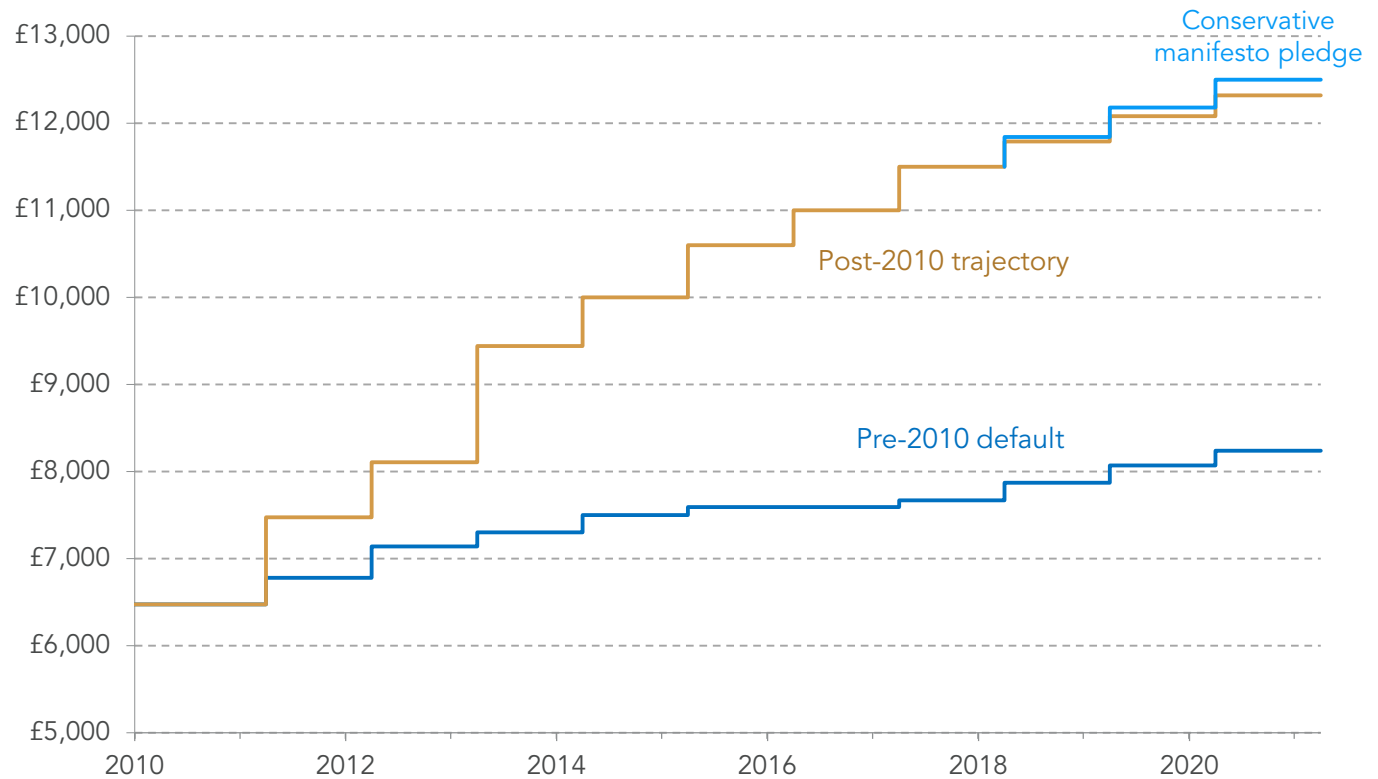
Source: OBR and HMRC

As Figure 26 notes, these patterns owe much to the range of tax cuts that have been introduced since Summer 2010. Chief among these have been very significant reductions in the main rate of corporation tax, above-inflation increases in the point at which both the basic and higher rates of income tax become payable and a succession of cancellations of fuel duty increases.

Figure 26: Timeline of selected tax cuts announced since Summer 2010

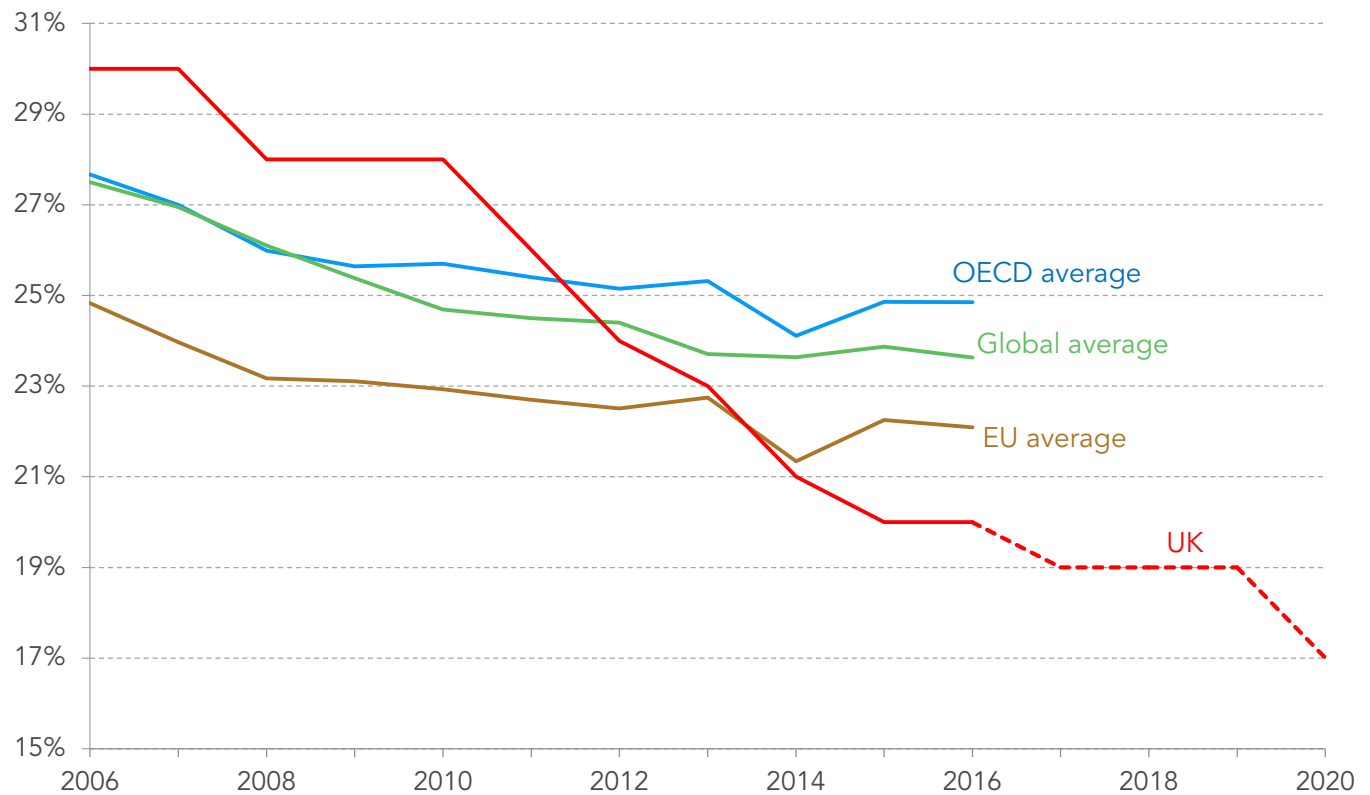


Looking at some of these in more detail, it is clear just how much of an impact each is likely to have had on government returns. For example, Figure 27 compares the path of the income tax personal allowance with the one that would have prevailed under the pre-2010 default uprating rule. It shows that the point at which income tax becomes payable is currently £3,410 higher than it might have been. By April 2020 it is on course to be £4,080 higher than it would have been had it just been increased in line with inflation. Indeed, the gap will be higher still – at £4,260 – if the government sticks to its manifesto pledge for raising the allowance to £12,500 by the end of the parliament.

Figure 27: Income tax personal allowance*Income tax personal allowance under different scenarios*

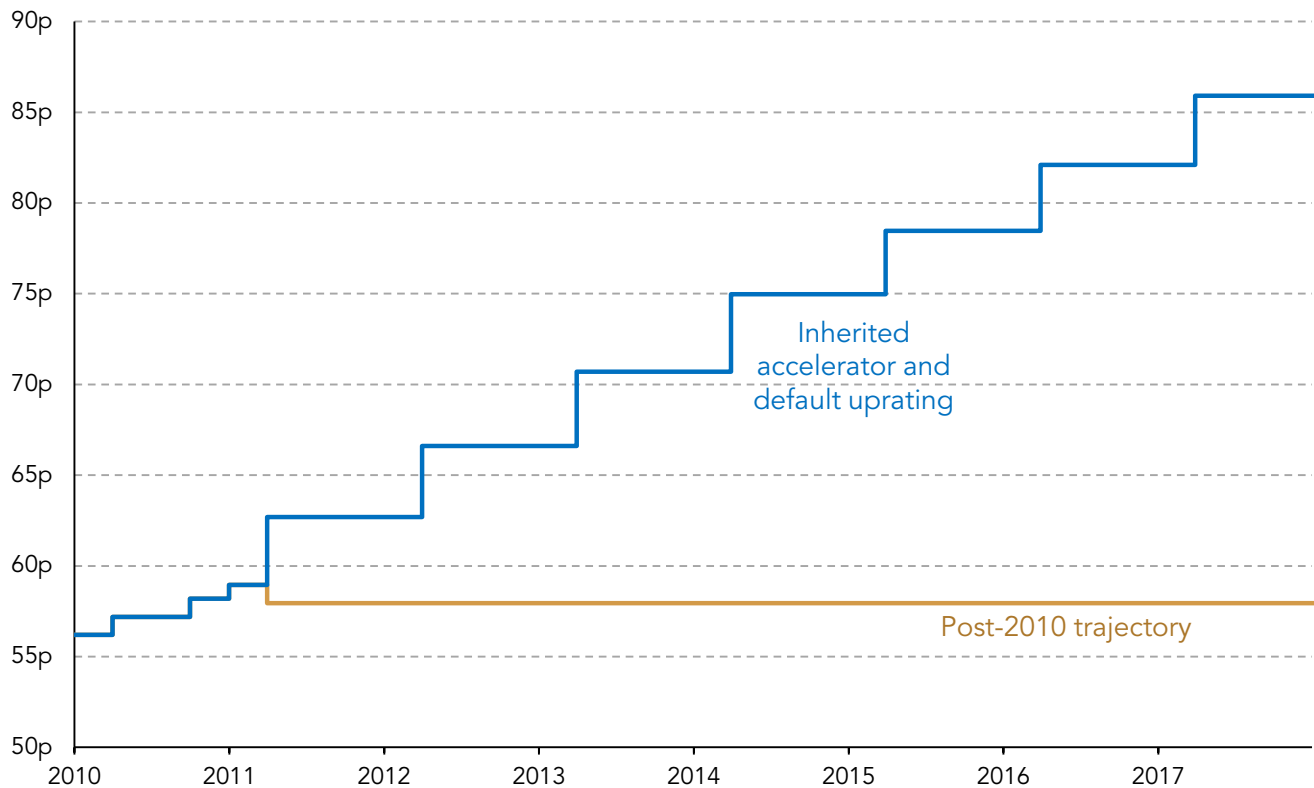
Notes: 'Default' assumption is that the PTA rises with RPI in 2011 and CPI thereafter, reflecting the change in direct tax uprating introduced at this point.

Figure 28 plots the existing and proposed path for the UK's main rate of corporation tax and compares this with international averages. At 20 per cent, the UK rate is already low by international standards. The plan to reach 17 per cent by April 2020 would leave the UK with the lowest rate of any major advanced economy (with no concrete details yet of President Trump's intentions) and well below the global average.

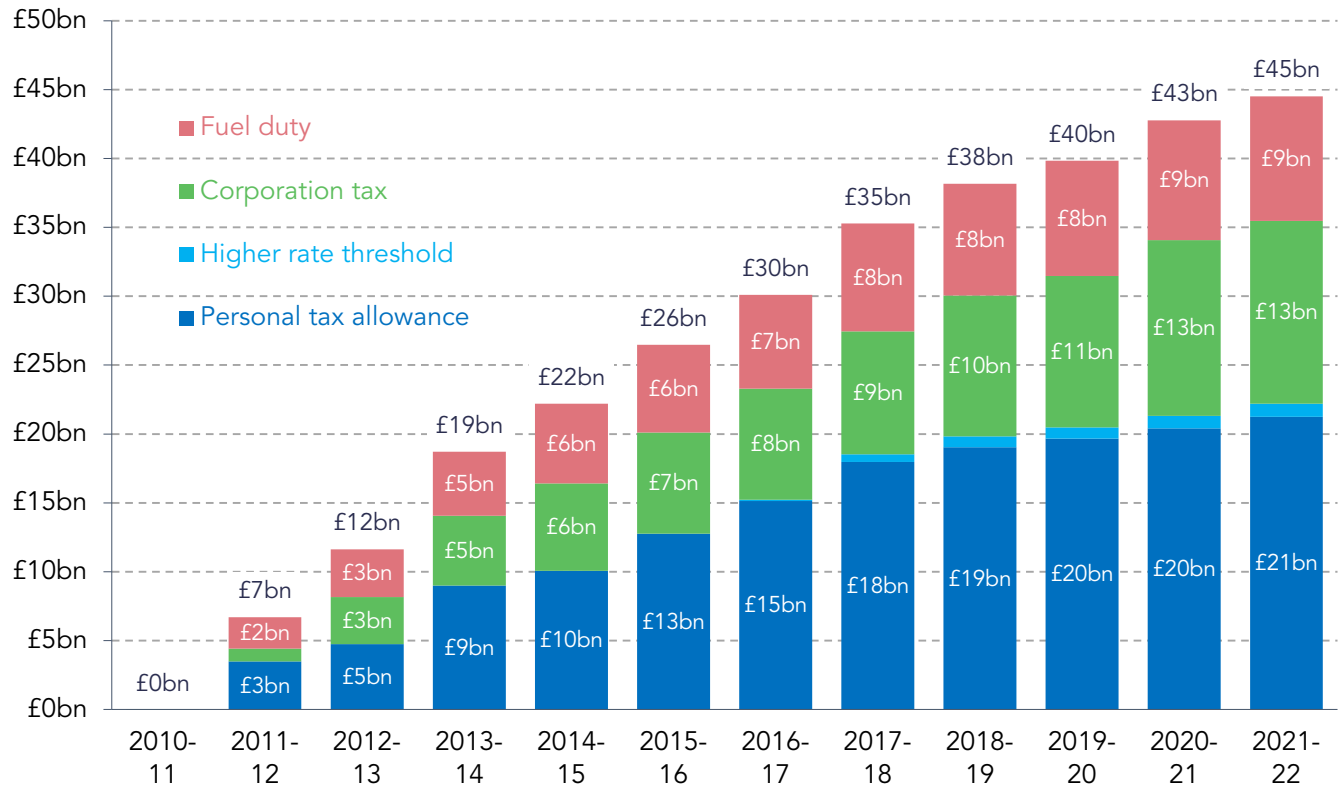
Figure 28: Corporation Tax*Headline corporation tax rate in selected countries*

Source: OECD

A third major tax cut relates to fuel duty, where both the ‘accelerator’ – whereby duty was to rise by 1 pence per litre above RPI inflation between April 2011 and April 2014 – inherited by the coalition government and the default index-link have been abandoned. As a result, fuel duty is currently more than 24 pence per litre lower than it would otherwise have been. With a further freeze to come this April the total tax cut will be just under 28 pence per litre.

Figure 29: Fuel Duty*Fuel duty (unleaded petrol and diesel) under different scenarios, pence per litre*

Such tax cuts have obviously helped to support living standards for different parts of society, but they have also come at a cost to the Exchequer. Using OBR estimates of the costs of income tax, corporation tax and fuel duty giveaways at the time they were made, we can construct a cumulative bill. As Figure 30 shows, the total cost is set to add up to £45 billion by 2021-22, which is almost three times the expected size of the deficit in that year. Indeed, in the absence of this suite of tax cuts, public sector net borrowing would be in surplus by 2018-19.

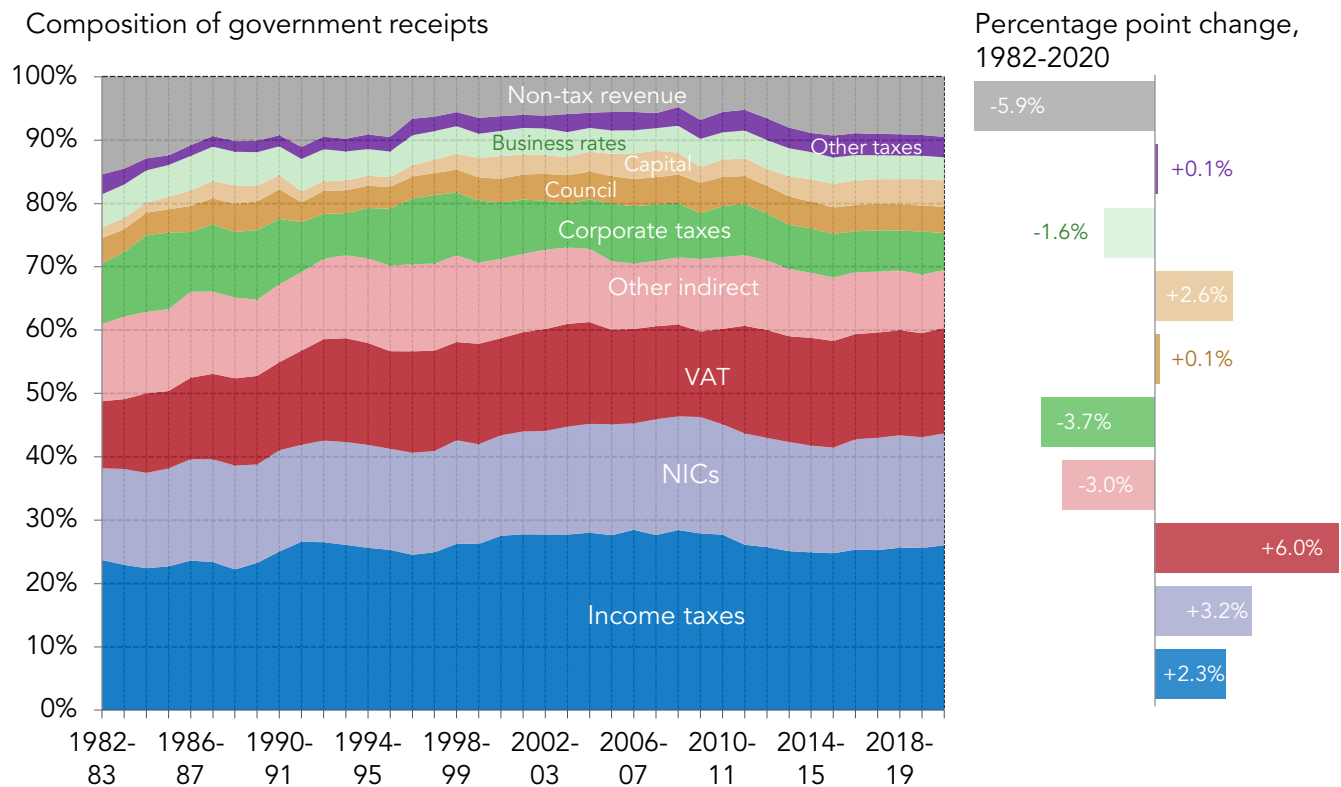
Figure 30: Annual cost of selected tax cuts introduced since Summer 2010*Annual cost of selected tax cuts introduced since June 2010 (nominal)*

Notes: Costings based on those estimated at the time of the policy announcement.

Source: OBR, *Economic and Fiscal Outlook*, various

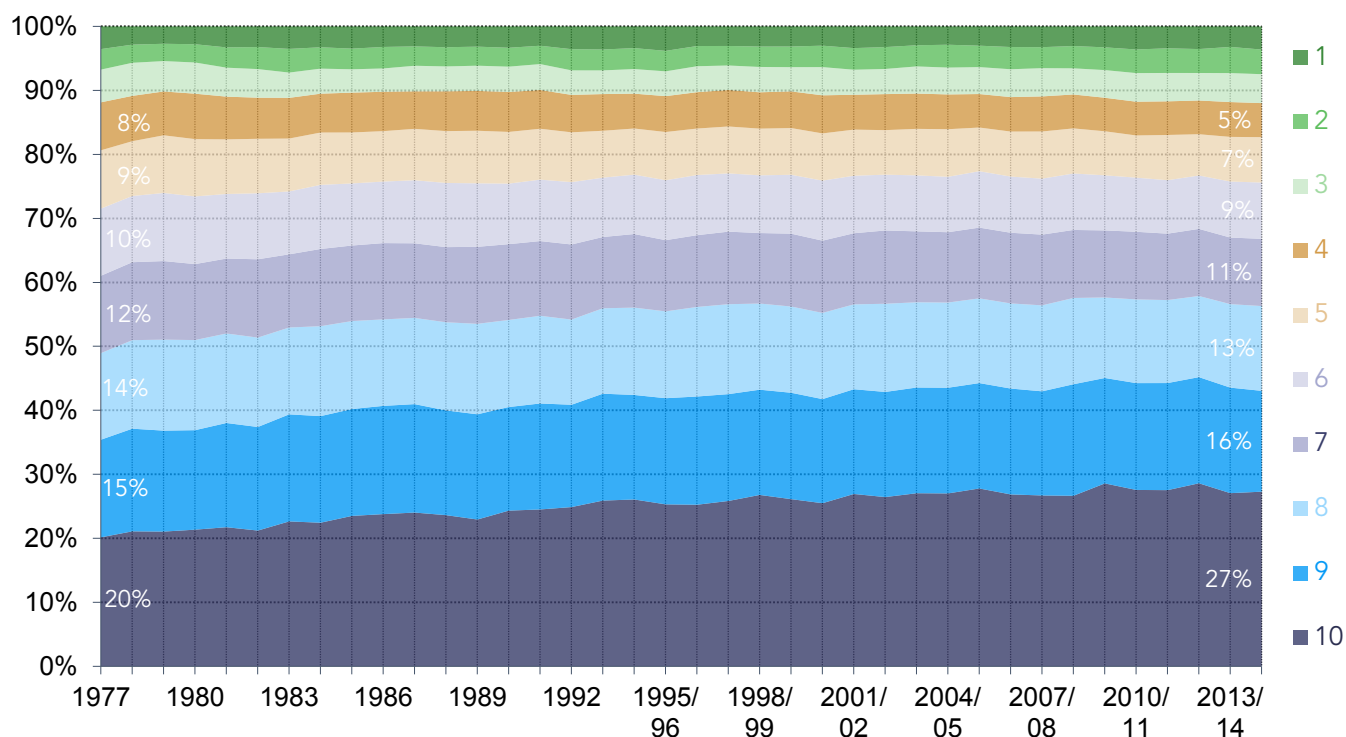
Even before the arrival of the financial crisis and subsequent deficit reduction plans, the composition of the government's receipts was shifting. Figure 31 shows the evolution since 1982-83, highlighting the larger role played by VAT and national insurance over this period and the contrastingly reduced role of corporate taxes and non-tax revenue. It's also worth noting that the post-crisis decline in corporate taxes would be starker still in the absence of the introduction of the bank levy, bank surcharge and diverted profits tax.

Figure 31: Composition of government receipts

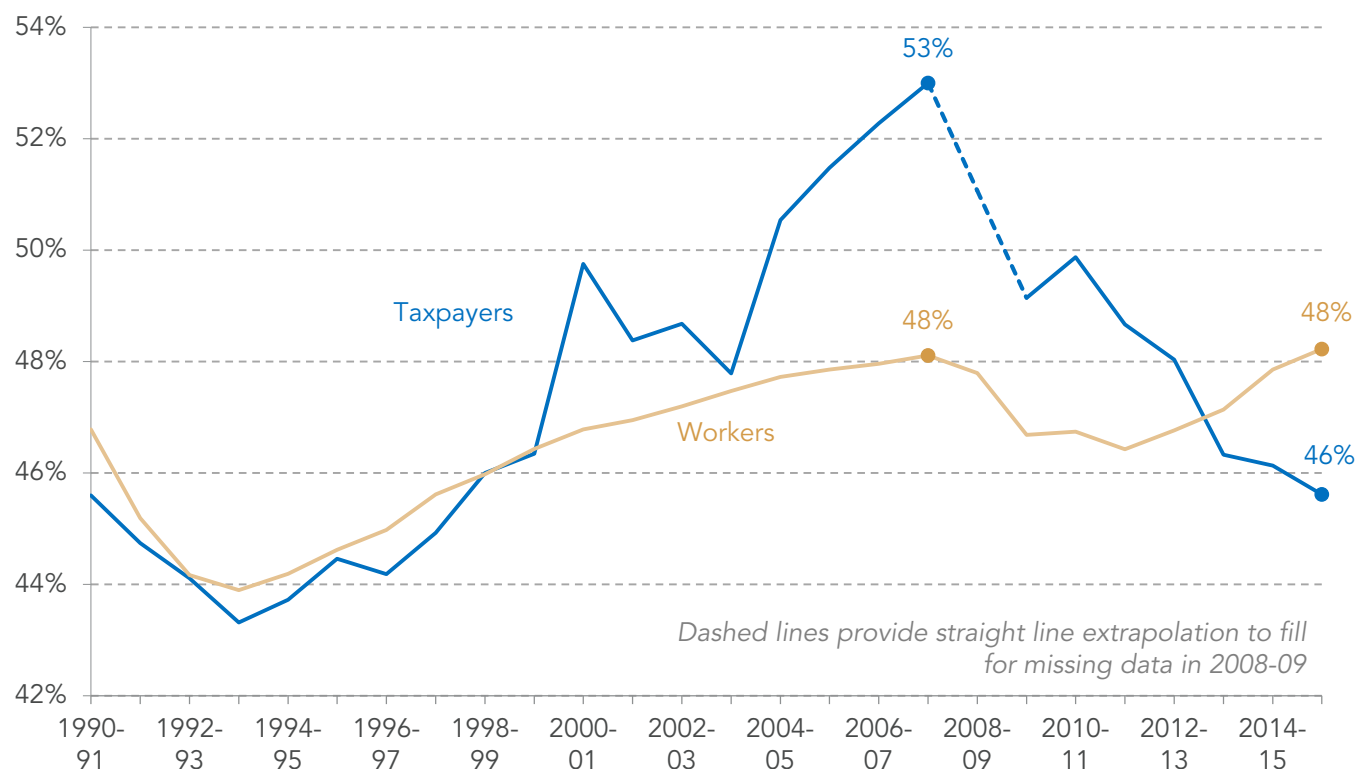


Source: OBR, HMRC and IFS

Figure 32 details how the incidence of tax has shifted across households over the longer term. Focusing on taxes charged to individuals or payable via price effects, we can see that the proportion accounted for by the richest 10 per cent of households increased from 20 per cent to 27 per cent in the three and a half decades after 1977. Of course, this broadly matches trends in income shares over this period: sharp increases in inequality of pre-tax income during the 1980s inevitably led to richer households contributing larger shares of the total tax take.

Figure 32: Incidence of direct and indirect taxes across household income deciles*Incidence of all direct and indirect taxes by household income decile (1 = poorest 10%)*Source: ONS, *Effect of Taxes and Benefits on Household Incomes*

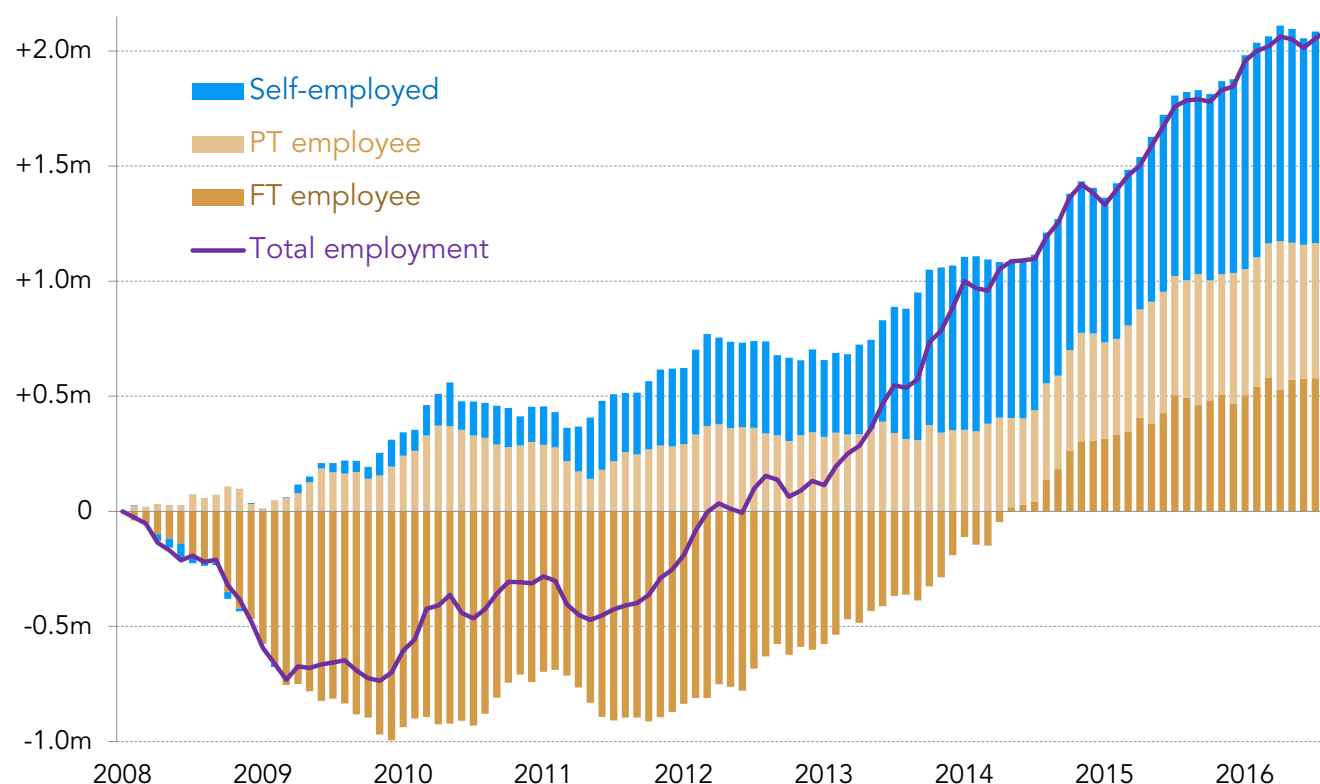
But policy has played its part too, with the raising of the personal allowance in recent years increasing the number of people paying *no* income tax. Figure 33 compares the proportion of the population (including children) paying tax with the proportion in work in the period from 1990-91. It shows the proportion contributing to income tax peaked at 53 per cent on the eve of the crisis. The subsequent sharp fall reflected a decline in the proportion of the population in work. However, the proportion paying tax continued to decline after 2011-12, even as the proportion in work recovered strongly. By 2015-16, just 46 per cent of the UK population paid income tax, the lowest level since 1997-98.

Figure 33: Taxpayers and workers as a share of population*Proportion of total UK population*

Source: HMRC, Survey of Personal Incomes

Alongside policy changes, the labour market backdrop has also been shifting. At the headline level, employment fell significantly at the start of the downturn but then recovered extremely strongly. The 16-64 employment rate is currently at a record high of 74.6 per cent and the absolute number in work stands at 30.6 million. But, within the overall trend, the nature of work has altered. There has been strong growth in non-standard forms of work in recent years, such as agency work and zero hour contracts.

As Figure 34 shows, there has been a particularly big increase in self-employment. Since May 2008, the number of self-employed people has increased by 943,000 – representing 45 per cent of total employment growth in that period. As a result, there are now 4.8 million self-employed in the UK (5 million when those who are self-employed in a second job are included), which is roughly one-in-seven workers.

Figure 34: Change in employees and self-employment since May 2008*Change in UK employee and self-employment numbers since May 2008*

Notes: Total includes unpaid family workers and those on government employment and training schemes.

Source: ONS, Labour Market Statistics

As with many of the other trends discussed here, this is a shift which appears to have been amplified by the economic downturn but which has in truth been in train for a much longer period. Self-employment has been growing as a share of total employment since the turn of the century, rising from less than 12 per cent then to more than 15 per cent today.

There is no simple answer for what has driven this increase. Many self-employed enjoy the flexibility and control it provides them, but there appears to be more at play. The UK is somewhat unusual in having experienced such a surge, suggesting that it is not an inevitable product of developing technology, globalisation or an ageing society. What's notable however, is the failure of public policy to keep pace with the change.

The absence of policy development is evident in the recent spate of court cases debating the legal status (and therefore rights) of self-employed workers engaged by firms such as Uber, Deliveroo and Pimlico Plumbers. But while such cases dominate the headlines, public policy is also lacking in relation to its tax treatment of the self-employed. While some argue that those taking on additional risk in the name of entrepreneurialism should receive special tax treatment, there is a sense that the decision is working the other way around too – with employment status being determined on the basis of the tax rules.

In some instances, these decisions appear to favour firms who engage large numbers of self-employed workers (and who therefore save on employer national insurance). In other instances it appears to be the individual who makes the call, with the option of lowering the level of tax payable on earnings via incorporation providing further incentive (especially given the cuts in

corporation tax discussed above).^[12]

The result is an apparent division within the self-employed population between those in sectors we might term relatively ‘precarious’ (such as cleaning, construction, taxi driving and hairdressing) and those who could be considered to work in relatively ‘privileged’ sectors (such as IT, consultancy and law).

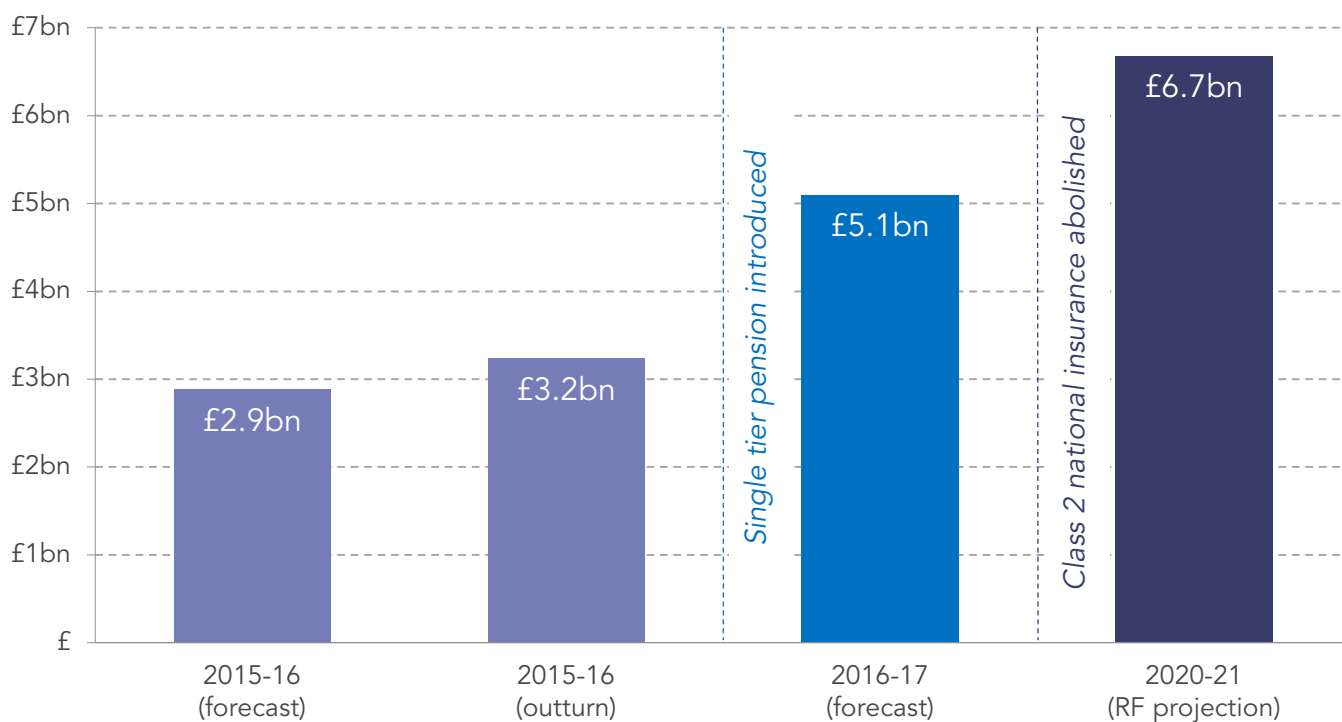
The distinction is somewhat crude – there are undoubtedly many more groups within the self-employed – but there are evident similarities among the ‘precarious’. They are typically younger than those in ‘privileged’ sectors, more likely to be underemployed, living outside the South East and less likely to own their own home. They are also less likely to have received any training in the last three months, raising questions over longer term opportunities for progression.

The Taylor review on modern employment practices is likely to bring much of this debate into the foreground,^[13] but it has no explicit remit in relation to taxation. If the potential for tax arbitrage is driving some of the increase in self-employment, then it is worth the Chancellor looking again at the appropriateness of current structures – particularly given the potential sums involved.

Figure 35 displays the amount of national insurance foregone by the Exchequer as a result of lower national insurance for the self-employed (accounting for the reduced pensions eligibility associated with self-employment). The HMRC forecast a total of £2.9 billion for 2015-16, but has now produced an outturn figure of £3.2 billion. Following the arrival of the single tier pension and further increases in the self-employment population, this national insurance cost is forecast to jump to £5.1 billion in 2016-17. Applying the same rate of growth in self-employment as has been recorded over recent years – and accounting for the abolition of Class 2 national insurance – our estimate is that this annual cost could rise to £6.7 billion by 2020-21.

[12] See OBR, [Economic and Fiscal Outlook](#), November 2016, Box 4.1 for a detailed discussion of recent trends in incorporation and the impact on the public finances.

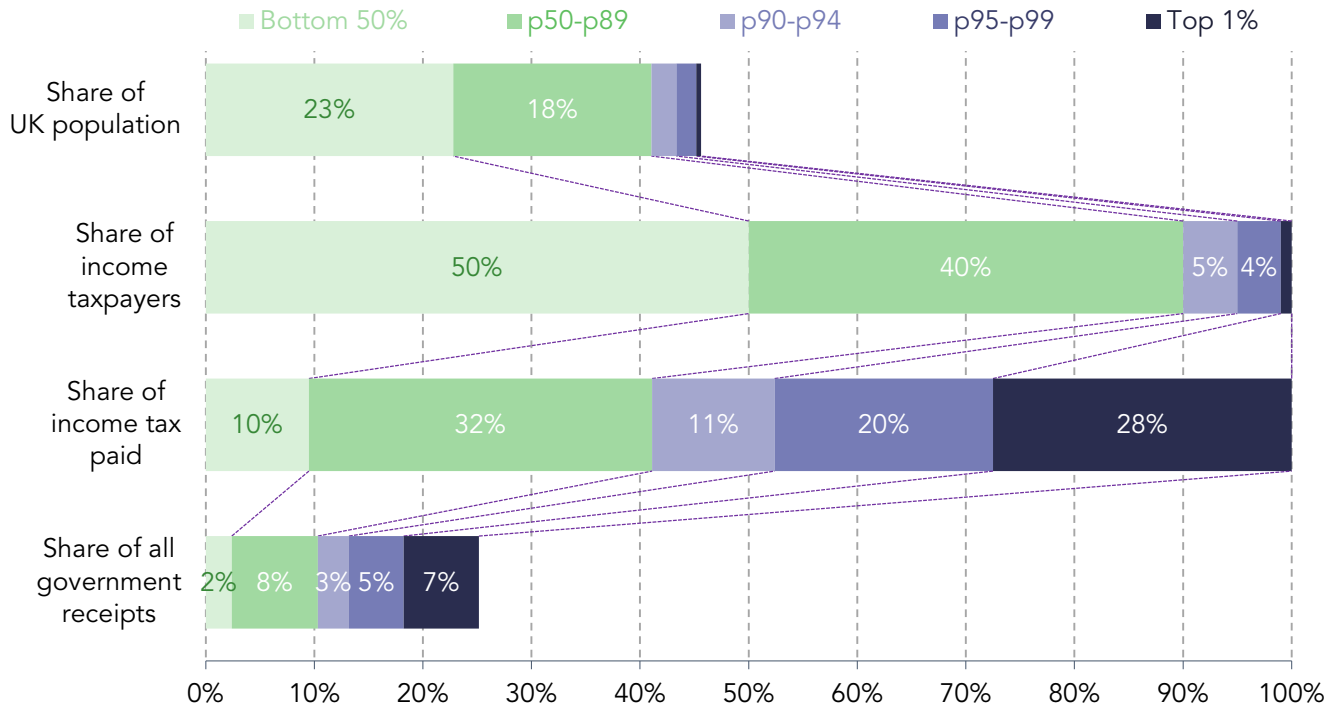
[13] BEIS press notice, [“Taylor review on modern employment practices launches”](#), 30 November 2016

Figure 35: Annual net reduction in national insurance paid due to self-employment*Real annual cost of reduced NI for self-employed not attributable to reduced pensions eligibility (nominal)*Source: HMRC, [Estimated costs of principal tax reliefs](#), December 2010

More generally, there is a sense that various economic and policy shifts over recent years have made the UK's tax base less coherent and more and vulnerable than it might be. As Figure 36 shows, the top 1 per cent of taxpayers (comprising less than 0.5 per cent of the total population) accounted for 28 per cent of all income tax paid in 2015-16 – up from 21 per cent in 1999-00.

Figure 36: Contributions to population, total income and income tax take by different parts of the taxpayer population: 2015-16

Size and contribution of different parts of the income taxpaying population

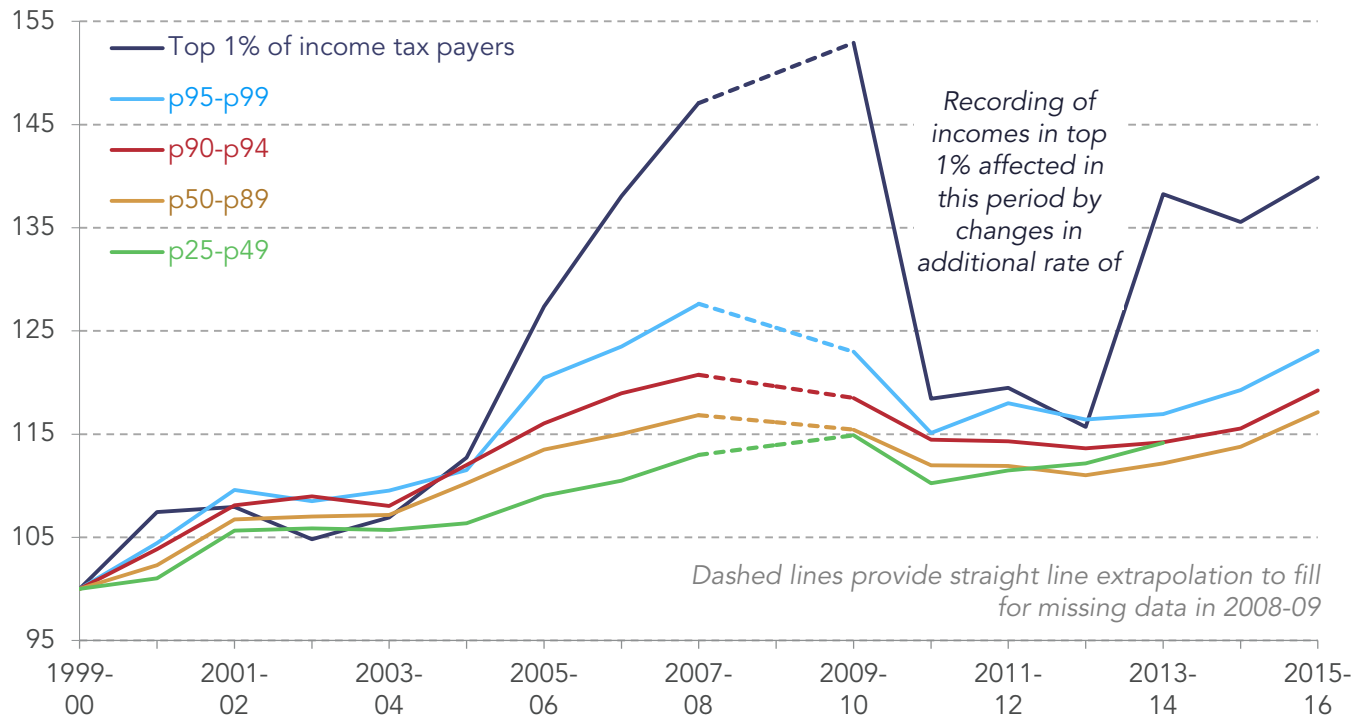


Source: HMRC, Survey of Personal Incomes

Such increased reliance on the very highest earners brings upside and downside risks due to the volatility of top incomes across the economic cycle. Figure 37 shows that average gross incomes among the top 1 per cent of income tax payers jumped by £159,000 in the decade after 1999-00. However, they then fell by £52,000 in the period from 2009-10 to 2014-15.

Figure 37: Indices of real-terms average incomes (before tax) by income tax payer group

1999-00 = 100 (CPIH-adjusted)



Notes: Break in the series in 2008-09 due to missing data. The raised personal allowance has a compositional impact on income growth at the lower end of the taxpayer population.

Source: HMRC, Survey of Personal Incomes

The erosion of significant elements of the tax take in recent years has been compensated for in part by the introduction of a plethora of small taxes. Alongside the apparently indefinite delaying of default fuel duty rises, this has given a sense of an ad hoc approach to policy. There may be merit in diversifying away from the big three of income tax, NICs and VAT – and the new taxes may be desirable for other reasons – but there are potential trade-offs in terms of efficiency and equity which have been under-explored. For reasons of equity, efficiency and economy, it is important that the Chancellor looks again at tax reform.

Alongside boosting growth, the Chancellor must aim to narrow the divides that remain too wide in Britain

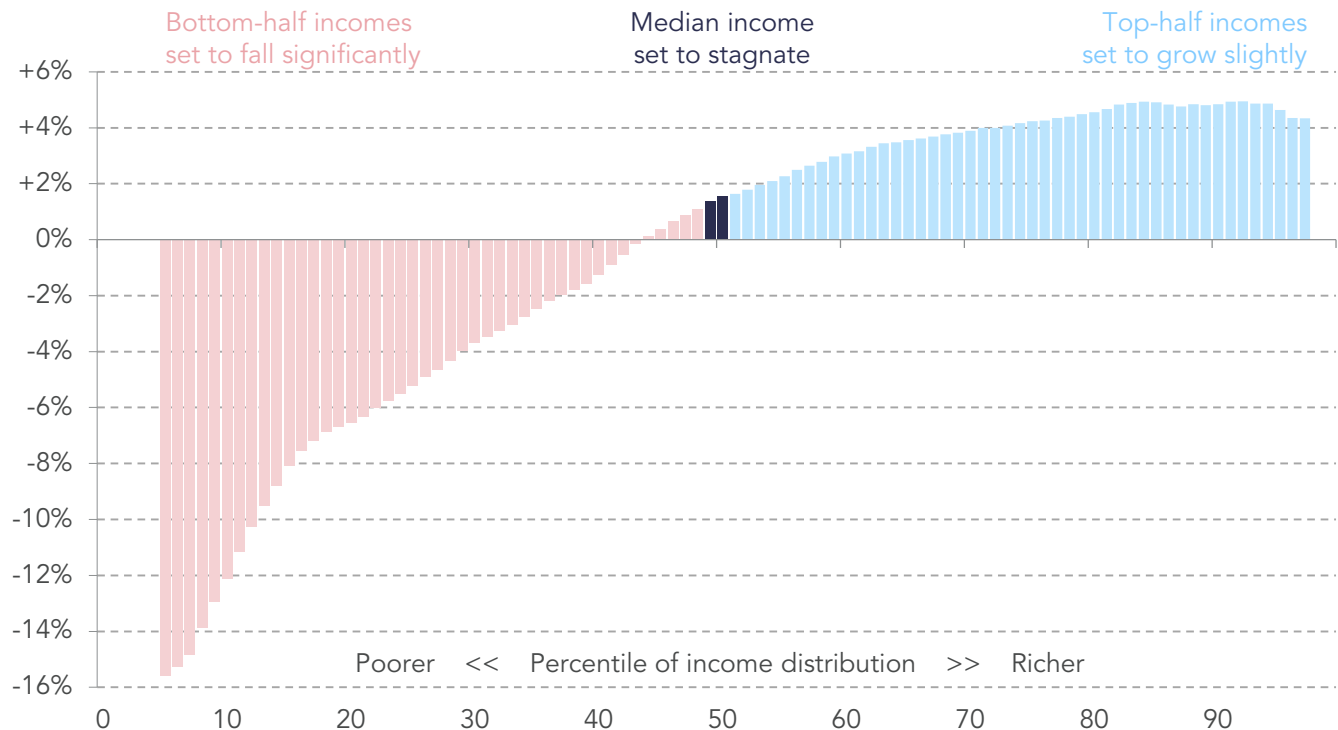
A combination of ultra-low inflation and rapid increases in employment have supported something of a ‘mini-boom’ in living standards over the last couple of years. As discussed above, growth has been far from spectacular but – relative to a decade characterised by pre-crisis slowdown and post-crisis contraction – it has been solid.

Recent income growth has also been quite progressive, with the strongest gains arising towards the bottom of the income distribution. Employment growth has been particularly helpful in this regard, concentrated as it has tended to be among those lower-income households that have traditionally been further away from the labour market. The introduction of the National Living Wage in April 2016 has also produced a welcome boost to pay among many of Britain’s lowest earners.

However, with inflation having picked up sharply since the EU referendum and employment growth plateauing, this ‘mini-boom’ is likely to have already run its course. More worryingly, our projection for living standards over the remainder of the parliament points to a period of extremely low and regressive growth in household incomes. Real wage growth is set to slow, and potentially turn negative for a period in 2017; further employment gains look difficult; and cuts to working-age benefits are set to start biting for many low- and middle-income households. As Figure 38 shows, we forecast income *falls* in the bottom half of the working-age income distribution.

Figure 38: Projected real-terms income growth across working-age households: 2016-17 to 2020-21

Cumulative growth in household income after-housing costs (adjusted using CPI AHC deflator)

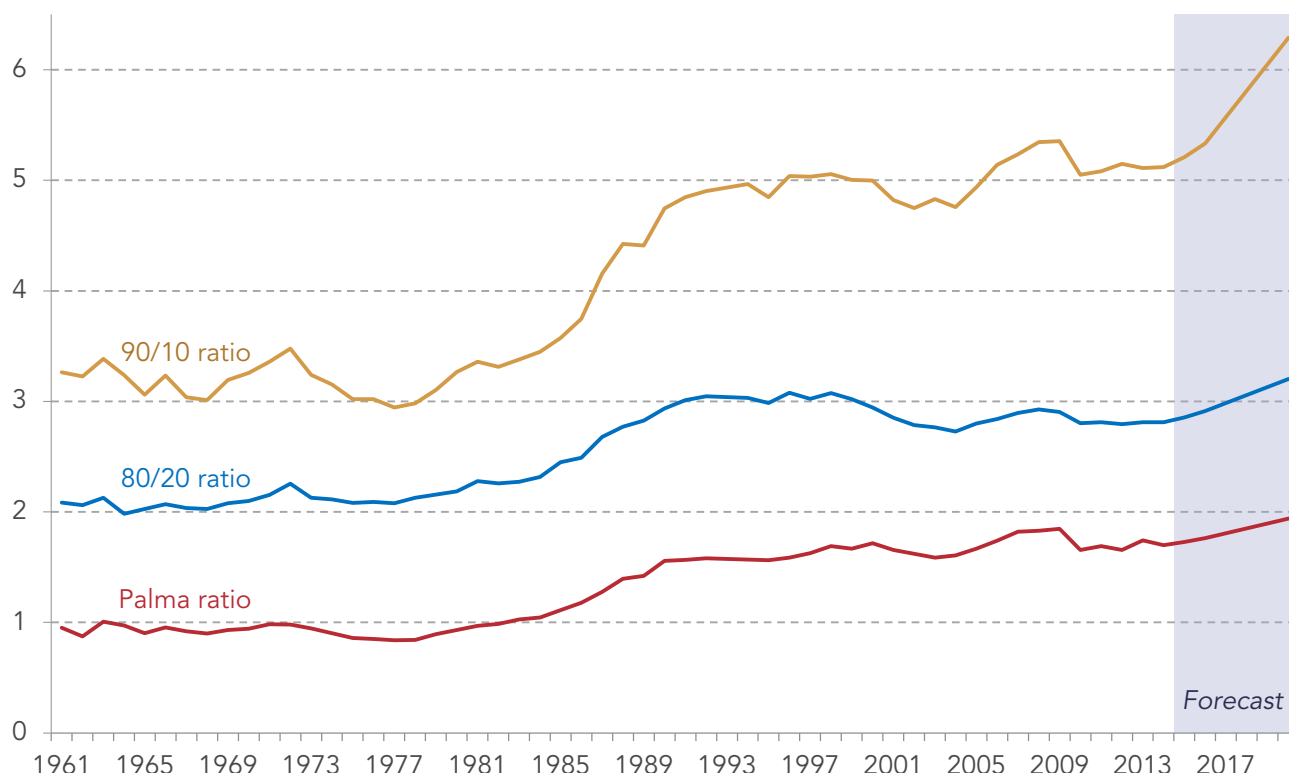


Source: RF modelling based on OBR projections

The upshot is that income inequality looks set to rise in the coming years, more than reversing recent modest improvements. Figure 39 details the recent evolution of a selection of measures of income inequality, along with our projection for the period to 2020. It suggests that the current parliament is on course to record the biggest rise in inequality since the 1980s. Combined with our forecast for the worst *level* of growth on record in the bottom half of the working-age income distribution, the living standards outlook appears somewhat bleak.

Figure 39: Selected income inequality ratios: outturn and projections

Inequality ratios after housing costs (all ages)



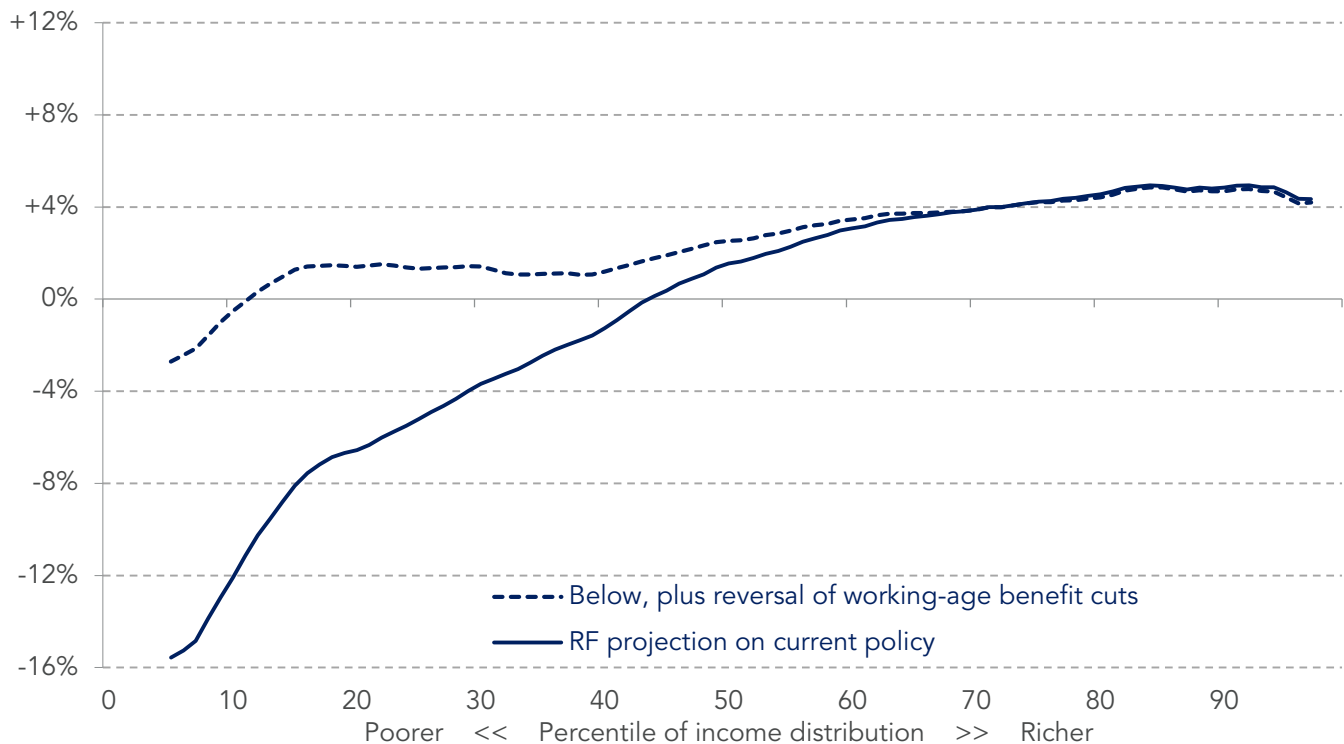
Source: RF analysis of DWP, Households Below Average Income, and RF forecast

Of course, given current circumstances these projections are even more uncertain than usual and much may change between now and the end of the decade. Importantly, there is also an opportunity to alter the projected trajectory by shifting policy choices. The Chancellor could significantly alter the shape of income growth in the coming years by revisiting the benefit cuts he inherited from his predecessor. The increase in the Universal Credit taper rate he announced at the Autumn Statement offset just 7 per cent of the more than £12 billion of working-age cuts due over the course of the parliament. Clearly there is scope to do much more – with the existence of two Budgets in 2017 giving ample opportunity.

Figure 40 provides an illustration of how much might be achieved. It replicates our projected income growth curve from Figure 38 and considers how the shape of the line would be altered if forthcoming working-age benefit cuts were reversed. It shows that the line would become considerably flatter, with positive (if very slight) income growth across most of the income distribution.

Figure 40: Alternative real-terms income growth projection: 2016-17 to 2020-21

Cumulative growth in household income for working-age households, after housing costs (adjusted using CPI AHC deflator)

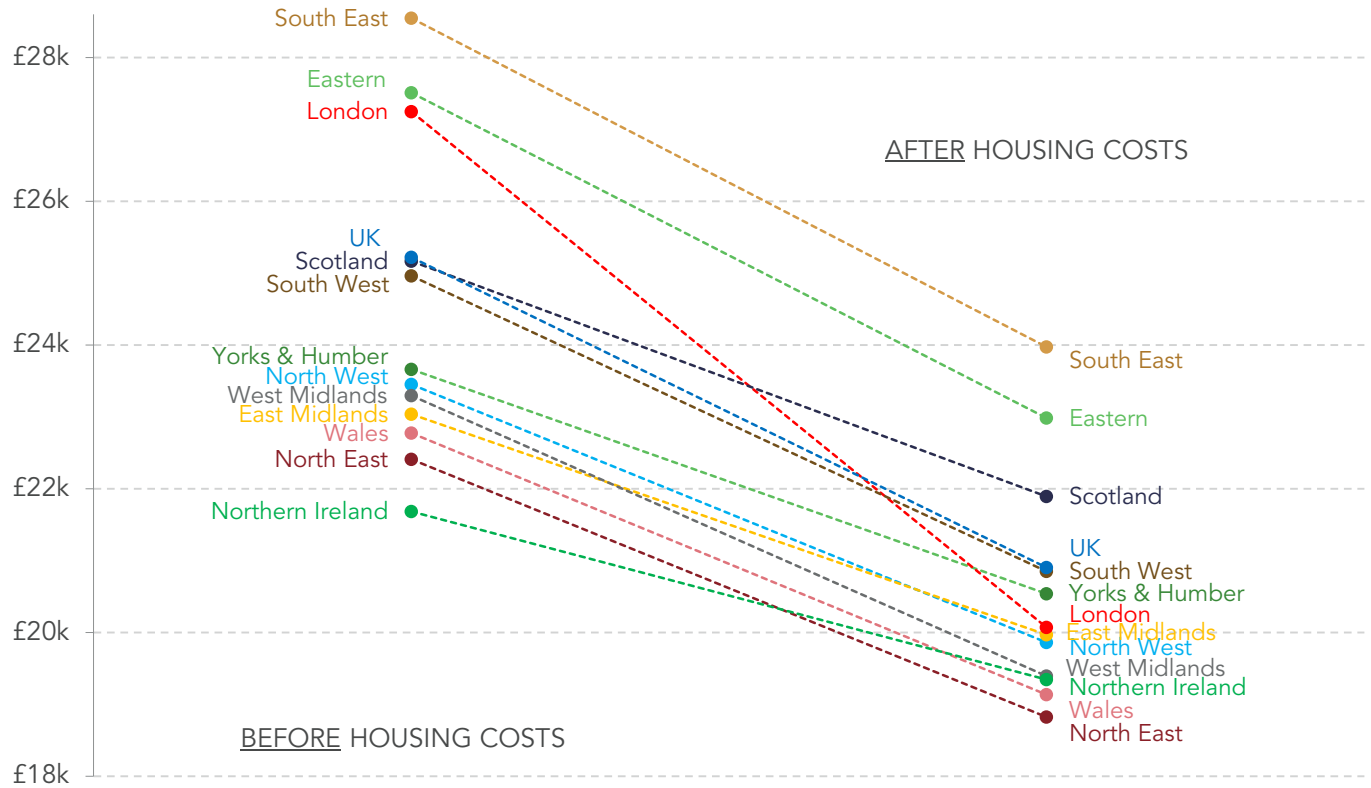


Notes: Benefit modelling includes: reversal of UC work allowance and family element cuts, removal of two-child cap; reversal of freeze in the value of working-age benefits in 2018-19 and 2019-20 (2016-17 has already occurred and we assume 2017-18 cannot be reversed at this late stage); and reversal of the benefit cap and age-limitation on Housing Benefit.

Source: RF modelling using IPPR tax benefit model

Such reversals would of course come with a price tag for the Exchequer. But, as discussed above, there is potential scope for reprioritising within the existing fiscal envelope by looking again at some of the undesirable tax cuts planned for the coming years. The prospect of overseeing the sharpest increase in inequality since Thatcher – and one that is the product of *falling*, rather than more slowly growing, incomes – is one that should focus the Chancellor's mind.

But it is not just income inequality that the Chancellor needs to tackle in the Spring Budget and beyond. Geographical disparities also persist, with incomes in the vast majority of the country more than 10 per cent lower than in the South East. As Figure 41 shows, housing costs can play a significant role in living standards outcomes. The inclusion of housing costs in our assessment of living standards results in a re-ordering of median income across different parts of the country – with London standing out.

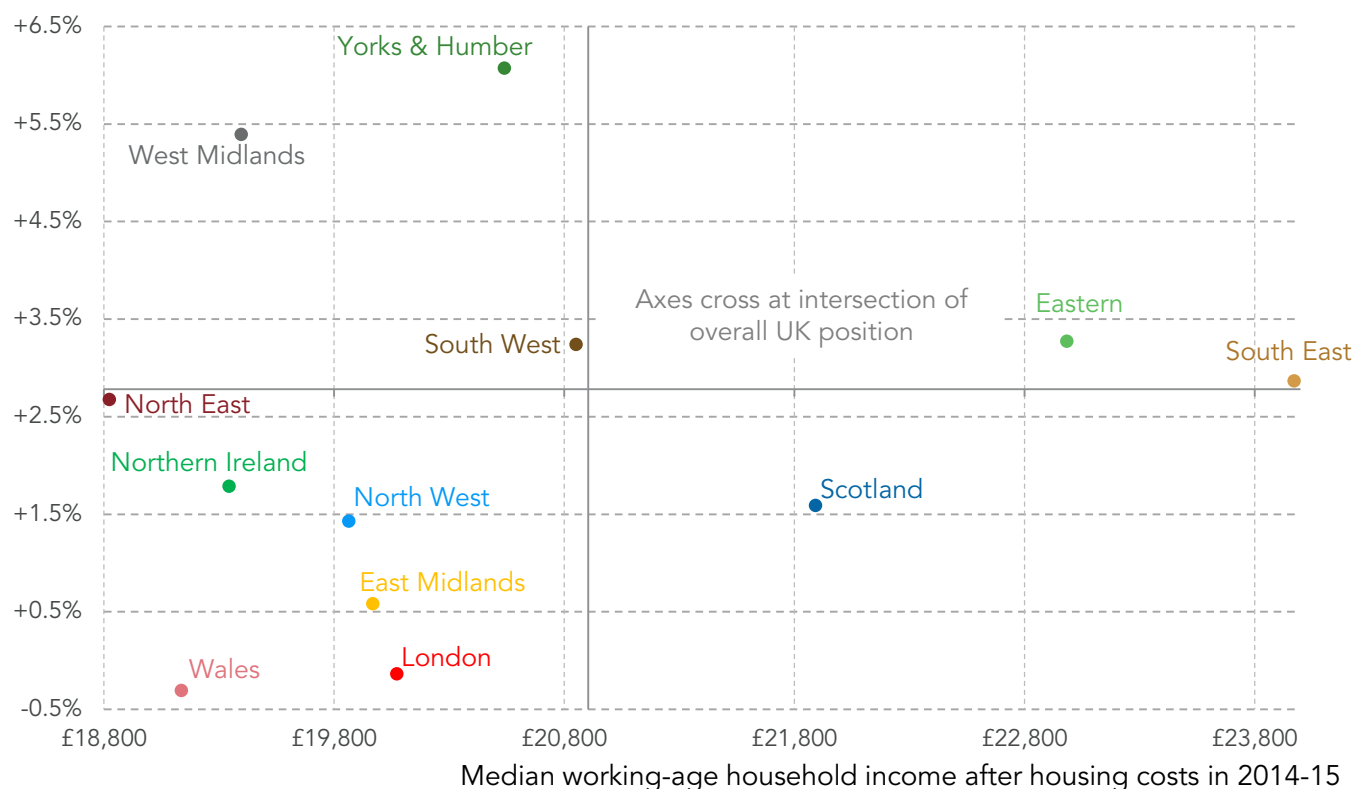
Figure 41: Working-age household income: 2014-15*Median working-age household income in 2014-15 before and after housing costs*

Source: RF analysis of DWP, Households Below Average Income

And there has been variation across the country in terms of the strength and pace of income recovery in the post-crisis period, as highlighted by Figure 42. It shows a division between those areas (London, the East Midlands, the North West, Wales, Northern Ireland and the North East) that have median incomes below the UK average and have grown less quickly over recent years and those parts of the country (the East of England and the South East) enjoying both higher-than-average incomes and higher-than-average growth.

Figure 42: Change in working-age household income after housing costs: 2014-15

Real-terms change in median working-age household income after housing costs between 2006-09 and 2014-15 (adjusted using CPI AHC deflator)



Source: RF analysis of DWP, *Households Below Average Income*

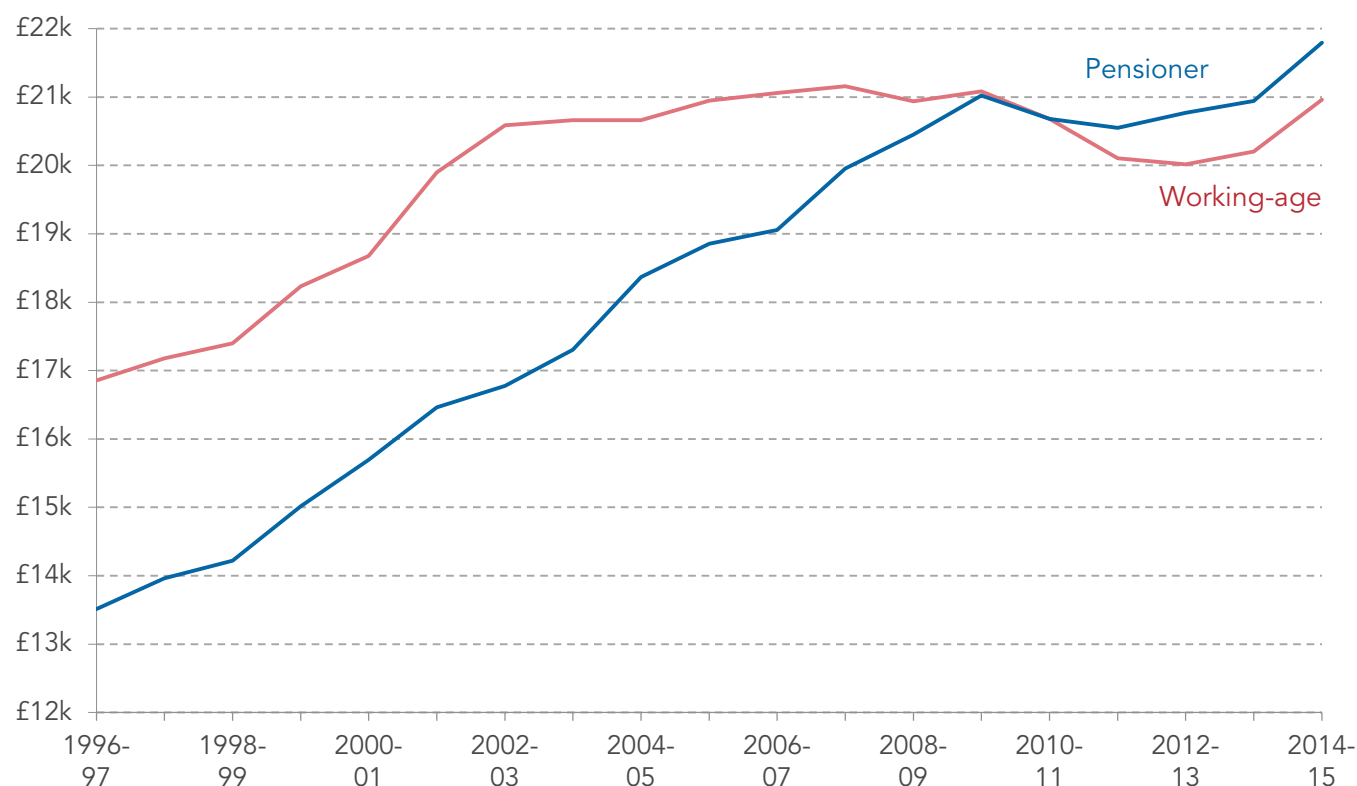
The Industrial Strategy Green Paper acknowledges the need to spread growth across the UK, and the imminent arrival of new ‘Metro Mayors’ in some of Britain’s major city regions offers an opportunity to bring local knowledge to bear on differing living standards challenges up and down the country.^[14] But, as the vote for Brexit made clear, some geographical divisions run deep. For example, our analysis showed that long-term economic differences across local authorities had a much greater bearing on referendum voting patterns than experiences in recent years.^[15] Dealing with regional disparities – within areas and across the country – will require concerted action.

One further potential division for the Chancellor to consider as the Budget approaches relates to age. A combination of demographic forces and active government decisions about the distribution of deficit-reducing cuts over the past decade has shifted the composition of government spending quite profoundly. Spending on older people and healthcare has come to comprise a growing share of total government spending, while the proportion allocated to education and economic development has shrunk – with these trends expected to continue towards the end of the decade.

As Figure 43 shows, there has been a considerable divergence of experience across working-age and pensioner households over recent years. Measured after housing costs, median pensioner incomes are now around £830 a year higher than working-age ones – reversing a deficit of £3,810 back in 2002.

[14] See S Clarke, [City living: devolution and the living standards challenge](#), Resolution Foundation, October 2016

[15] S Clarke & M Whitaker, [The importance of place: explaining the characteristics underpinning the Brexit vote across different parts of the UK](#), Resolution Foundation, July 2016

Figure 43: Median household income after housing costs in working-age and pensioner households*Median real disposable household income after housing costs (adjusted using CPI AHC deflator)*

Source: RF analysis of DWP, Households Below Average Income

The welcome strong growth recorded by pensioners in recent years is the result of a number of policy successes – from occupational pensions, to housing, to trends in older working – which have had particularly strong effects on more recent cohorts of pensioners. But the cross-over detailed in Figure 43 is also a product of economic failure dragging on working-age household incomes.

This significant change obviously matters for the context in which public policy is made. While it must be remembered that not all pensioners have achieved the scale of income growth highlighted in the chart, it is clear that the age-based stereotypes of the 20th Century are increasingly out of kilter with reality. For example, it is odd given this reversal that recent policy has focused spending cuts almost exclusively on working-age households (and indeed lower income working-age families in particular).

In order to build on the successes that have produced recent increases in pensioner incomes, the Chancellor – and the government more generally – must recognise what are often new challenges facing younger cohorts. Dealing with many of the issues raised above – in relation to growth, investment, productivity and the appropriate tax-benefit mix – will go a long way to supporting further living standards improvements.

Going on an economy drive

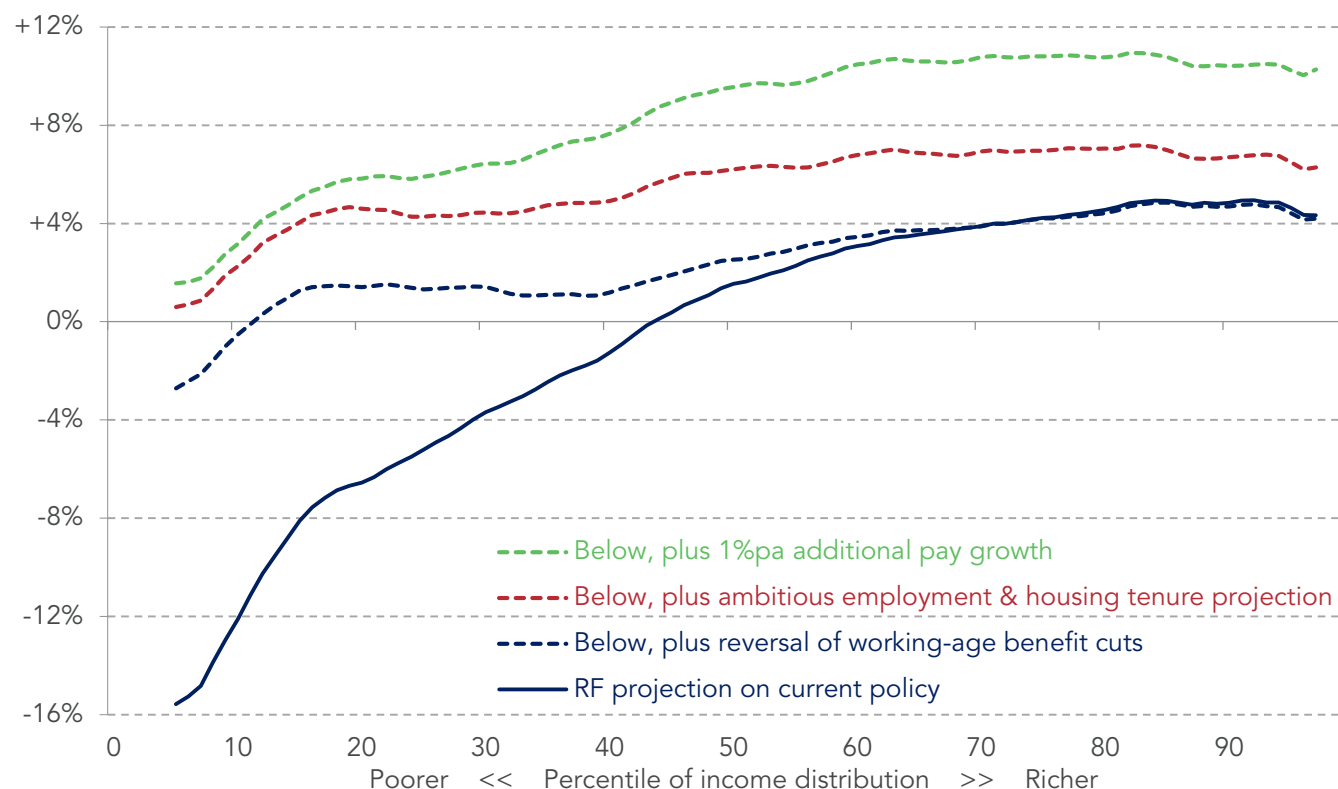
The expectation is that the final Spring Budget will be a relatively quiet affair. With little having changed since the Autumn Statement, the Chancellor is unlikely to find himself presented with any significant change in fiscal outlook – though there is likely to be some modest good news.

Given that the uncertainty that existed back in November remains in place, the sensible approach he took at the Autumn Statement to steer a steady ship and establish sizeable fiscal headroom without rushing to restore balance appears to remain the best course of action.

However, as we have argued above, there is certainly scope for reprioritising in order to provide better support for low and middle income households in particular – who otherwise face the prospect of falling incomes over the coming years. Yet as Figure 44 shows, he can go further still.

Figure 44: Alternative real-terms income growth projection: 2016-17 to 2020-21

Cumulative growth in household income for working-age households, after housing costs



Notes: Benefit modelling includes: reversal of UC work allowance and family element cuts, removal of two-child cap; reversal of freeze in the value of working-age benefits in 2018-19 and 2019-20 (2016-17 has already occurred and we assume 2017-18 cannot be reversed at this late stage); and reversal of the benefit cap and age-limitation on Housing Benefit.

Source: RF modelling using IPPR tax benefit model

Reversing some or all of the working-age benefit cuts planned for the rest of the parliament would provide a welcome flattening of the growth incidence curve, but living standards improvements would remain very low by historic standards across the entirety of the income distribution. In order to lift the curve, the Chancellor will need to focus on other drivers of income growth.

The scenarios we set out in Figure 44 are no more than thought experiments, illustrating the scale of improvement that would be associated with different outcomes. For example, the red line considers how incomes would be affected if employment growth was to surprise on the upside in the same way that it did in the last parliament. If the 16+ employment rate were to continue to rise at the same rate as it did from 2010-11 to 2015-16, it would reach 62.2 per cent in 2020-21 (rather than falling to 59.9 per cent as the OBR currently expects). This equates to 1.2 million more people in employment than in our central forecast (all in the private sector we assume). This is extremely high, though as our previous work has shown not outside the realms of possibility if policy can do

more for particularly excluded groups.

The optimistic scenario depicted by the red line also assumes that housing tenure changes in a way that reduces overall increases in costs relative to our baseline forecast, with the proportion of renters falling back to its 2015-16 level. Taken in combination, these employment and housing assumptions increase typical income growth by around 4 percentage points over the four years of the forecast. The gains are largest in the low-and middle-income part of the distribution, reflecting the progressive nature of any further employment gains.

The scenario set out by the green line goes further still, adding an extra 1 per cent to the annual earnings growth projections underpinning our central forecast, for example because of a tight labour market responding more than currently expected to rising inflation. This approach produces only modest gains at the lower end of the income distribution – reflecting lower rates of employment – but boosts growth significantly in other parts of the income distribution. Securing growth in line with this most optimistic of scenarios would leave average annual growth over the course of the parliament broadly in line with the rates recorded during the late-1990s period of strong, shared growth.

We do not offer these scenarios as indications of what might be possible in the short-term if the Chancellor were to introduce any particular set of policies, but instead to highlight what making serious progress on living standards requires.

With two Budgets in 2017, the Chancellor can set a clear direction of travel designed to raise investment, boost productivity, respond to changes in the world of work, reform the tax system and tackle new and old inequalities.

There is of course no silver bullet, and many changes will take time to bear fruit, but we offer a range of options for consideration:

- » Revisit the benefit cuts inherited from the last government, recognising how economic circumstances have shifted over the past 12 months in a way which leaves low and middle income households much more exposed;
- » Move away from further expensive – and regressive – plans to raise the personal allowance to £12,500 and the higher rate threshold to £50,000 by 2020;
- » Drop plans for further cuts to corporation tax that are not necessary for the UK to maintain a highly competitive tax regime;
- » Make strides on changing the corporate tax incentives that underpin short-termism and mitigate against long-term investment in UK business;
- » Use the Taylor Review as a jumping off point for reforming the tax landscape to better reflect the changing world of work and broaden the base in order to protect against the volatility of the economic cycle;
- » Provide more clarity on what Brexit means, with a particular focus on future migrant worker and trade policy; and
- » Set out an assessment of the current balance of government spending across different groups in society and different parts of the country, establishing a clear, principles-based justification for the government's priorities.

A Budget that covers such ground will likely provide few big headlines and will be notable for its lack of rabbits; but it would nevertheless have the potential to be truly radical and game-changing for the UK.

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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