TUNNEL VISION

Autumn Budget 2018 and ‘ending austerity’

Matt Whittaker

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@MattWhittakerRF @resfoundation
The Chancellor faces both a challenge and some potential good news ahead of his second Autumn Budget. The challenge stems from the fact that he must balance the seemingly conflicting goals – set very explicitly by the Prime Minister – of ‘ending austerity’ and lowering debt as a share of GDP. The former comes with a price tag, while the latter precludes the option of meeting that cost simply through extra borrowing. And both must be delivered against a backdrop of heightened economic uncertainty as Brexit approaches. The good news comes in the form of a significant upgrade in the public finances – potentially the largest in-year improvement the OBR has ever delivered – which is set to add to an already sizeable amount of headroom against his main fiscal targets.

Yet still the sums don’t add up. An ‘end-of-austerity’ package that ensures that no department need face any further cuts in real-terms per capita spending beyond 2019-20, alongside cancelling the final year of the four-year benefit freeze and re-investing in the work allowances that underpin the new Universal Credit (UC) system would cost around £31bn in 2022-23. The Chancellor could just about deliver that sum by making full use of his new higher borrowing headroom, but in doing so he would fall foul of his own debt rule. With so much uncertainty around, and an ongoing determination to lower debt relative to GDP, he will want to follow a more modest borrowing path. To square the circle, he will almost certainly need to raise some tax revenues – even if not at this Budget.
EXECUTIVE SUMMARY

‘Ending austerity’: the scale of the challenge on public services

Much of course depends on how we define the ‘end of austerity’. At a minimum, it should involve ensuring that real-terms spending on day-to-day public services ceases to fall in the next Spending Review period (starting in 2020-21). But with additional money having been pledged to NHS England for the five years between 2019-20 and 2023-24 and ongoing protections for spending on both defence and aid, even a flat profile for real-terms spending would leave many government departments losing out. Establishing a spending envelope that ensures no department need face any further cuts – even after accounting for budget increases in health, defence and aid – would require a nominal £23.6bn increase in resource departmental expenditure limits (RDEL) in 2022-23 relative to plans at the Spring Statement. Such a move would return real-terms RDEL spending to a level last recorded in 2011-12.

Yet even this level of spending increase is likely to be insufficient to truly ‘end austerity’. Presenting an RDEL envelope that ensures no department need face any drop in its real-terms spending per person after 2019-20 would require an additional £26.3bn in nominal terms in 2022-23. That would leave real-terms per capita RDEL at its highest level since 2014-15. Alternatively, presenting a package that ensures all departments can maintain their RDEL spending as a share of GDP at 2019-20 levels would cost £30.6bn in 2022-23. That would leave RDEL accounting for 15.7% of GDP, which would still mark a significant fall from the pre-crisis (2007-08) level of 17.7% of GDP.

Our contention is that the ambition should lie somewhere between these two options. Not all departments need grow in line with GDP, but clearly the importance of keeping pace with earnings-related costs and general economic developments mean that some should. And – after a near-decade of falling budgets – real-terms per capita spending protection feels like the minimum departments should expect from any package heralded as an ‘end to austerity’.

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EXECUTIVE SUMMARY
‘Ending austerity’: the scale of the challenge on social security

For millions of lower income families, ‘austerity’ is also wrapped up in the ongoing income squeeze associated with large-scale social security cuts. By 2022-23, the package of cuts to working-age welfare introduced at Summer Budget 2015 is set to save the government more than £14bn a year. Even after accounting for the introduction of the National Living Wage, an extension of free childcare and a variety of tax cuts, this package of benefit cuts is set to leave households in the bottom half of the income distribution some £610 a year worse off on average (in 2018-19 prices) than they otherwise would have been. Alongside a focus on public services expenditure then, the Chancellor should also revisit these benefit cuts. As a minimum, he should take action on both the benefit freeze and UC.

Cancelling the final year of the four-year benefit freeze (starting in April 2019) would cost £1.5bn in 2019-20 (rising to £1.7bn in 2022-23), and would be worth an average of £130 to households in the bottom half of the income distribution. That rises to an average of £200 among lower income couples with children, and £250 among lower income single parents. If the Chancellor doesn’t cancel year four of the freeze, lower income households will have lost out by £380 on average – rising to £580 among lower income couples with children and £710 among lower income single parents.

The government is also under pressure to deal with inflexibilities in the UC system that have created difficulties for some recipients during roll-out. But the Chancellor should also look again at the more than £3bn of UC work allowance cuts that have lowered incomes among working recipients. While all major welfare reform produces a mix of winners and losers, the work allowance cuts have tipped the balance such that we now expect the switch to UC to produce more losers (3.2 million families) than winners (2.2 million families).
EXECUTIVE SUMMARY
‘Ending austerity’: a £31bn price tag and the double Brexit “deal dividend”

For the purposes of illustration, we consider the feasibility of delivering a £31.4bn ‘end-of-austerity’ package that raises RDEL by £26.3bn (to ensure no department need face any further real-terms per capita spending cuts after 2019-20) and puts £5.1bn back into the benefits system to end the four-year freeze a year early and ensure UC better meets its intended goals. But how might such a package be funded?

The Chancellor himself has talked up the possibility of a double Brexit “deal dividend” that could create extra space for spending. The first part of this dividend relates to the fact that the OBR’s economic projections are currently based on an outcome that falls somewhere between a ‘no deal’ Brexit and a deal based on EEA membership. The Chancellor therefore expects the OBR to revise its projections up if and when a deal is finalised – thereby generating more growth and more tax revenues. The problem for the Chancellor is that, while he may be right in this conviction, he won’t see any such dividend in time for the Autumn Budget. The OBR has already stated that it will leave its Brexit assumptions unchanged in its Economic and Fiscal Outlook.

The second “deal dividend” the Chancellor has pointed to comes from the fact that, once a Brexit deal has been secured, he says he will feel better able to make use of the “fiscal firepower” he has built up in recent years as an insurance against a no deal outcome. Again he won’t be able to definitively point to such a dividend at the Budget, but he could put in place conditional spending pledges that utilise his expected fiscal headroom. That is, he can hypothecate at least some of the headroom he has established against his fiscal ‘mandate’ (which requires him to ensure structural borrowing sits below 2% of GDP by 2020-21) for ‘ending austerity’ in the event of a calm Brexit.
EXECUTIVE SUMMARY
A fiscal windfall means extra borrowing can take some (but not all) of the strain

On this front, the good news for the Chancellor is that the headroom he was expected to have at the time of the Spring Statement – which stood at £15.4bn in 2020-21 – is likely to have grown. That’s thanks to a stronger than expected set of public finance figures over the first half of 2018-19, driven by an apparent increase in the tax-richness of the economy (or by an undercounting of economic growth). The expectation is that the OBR will provide him with a £13.1bn upgrade in 2018-19, representing the largest in-year improvement in the organisation’s history. That will take his headroom against his mandate to £28.5bn in 2020-21. By 2022-23, this headroom could stand at £39.5bn – enough to cover the entirety of the ‘end of austerity’ package we have set out.

The bad news for the Chancellor is that borrowing at this scale would almost certainly put him in breach of his debt rule (for public sector net debt to be falling as a share of GDP in 2020-21). The debt-to-GDP ratio would still be on course to fall between today and 2022-23, but much of this would be as a result of the unwinding of the Bank of England’s Term Funding Scheme. And the ratio would rise between 2021-22 and 2022-23 if he were to borrow precisely at the level of his fiscal mandate. Borrowing in this way would also leave the Chancellor vulnerable to any economic shock or change in forecasts – in the past the OBR has taken away as well as given. Given that the Prime Minister referred to the need to lower debt even as she delivered her ‘ending austerity’ speech, it seems likely that the Chancellor will instead make much more modest use of any fiscal headroom that comes his way.

Fiscal headroom may therefore provide some of the answer to the question of how to fund an ‘end of austerity’, and at the very least it allows the Chancellor to allocate the additional funds already pledged to the NHS in 2019-20 without having to raise taxes in the near-term. But over the longer-term it can’t be the only resource he leans on. Squaring the circle between ‘ending austerity’ and lowering debt will require some action on tax at some point in the near future.
EXECUTIVE SUMMARY

Balancing an ‘ending of austerity’ with falling debt means tax rises

Parliamentary arithmetic was always likely to constrain the Chancellor’s ability to make bold revenue-raising announcements at this Budget, increasing the imperative to seek out more creative solutions. He has already cancelled the planned abolition of Class 2 National Insurance for the self-employed, and changes to remote gaming duty for overseas gambling companies are also excepted – but these two measures raise just £0.6bn a year and are more than offset by plans for a ninth successive fuel duty freeze. Other moves will be needed.

He could, for example, choose to cancel the planned cut in corporation tax from 19% to 17% in April 2020. Following a series of cuts since 2009, the UK now has one of the lowest corporation tax rates across all advanced economies, making the upcoming cut hard to justify from the perspective of increasing competitiveness. The estimated cost of the policy has also increased significantly since it was first announced, providing a strong case for revisiting it. Cancelling the corporation tax cut would raise around £6bn a year.

Another expensive tax cut that the government could probably do without is the further raising of the personal tax allowance and higher rate thresholds in income tax. The cuts haven’t yet been scored, so will eat into the Chancellor’s fiscal headroom at some point but, given its presence in the 2017 Conservative manifesto, it is hard to see the government abandoning the pledge. However, one option that the Chancellor could deliver on would be to freeze the thresholds after the manifesto pledge has been met. This re-introduction of fiscal drag could raise £2bn by 2022-23. Fiscal drag could also be utilised in relation to inheritance tax, capital gains tax and VAT thresholds.

Taken together, a combination of cancelling the corporation tax cut (£6bn) and re-introducing fiscal drag to the income tax system (£2bn) could raise in the region of £8.5bn by the end of the parliament – most likely without widespread controversy or rebellion.
EXECUTIVE SUMMARY

The light at the end of the tunnel

Austerity is still very much a fact of life in the UK, felt both in terms of falling per capita spending on a number of public services and in terms of sizeable multi-year cuts in social security for millions of lower income working-age households. But with the annual deficit now back in the sort of territory it occupied before the financial crisis, the fiscal pressure that underpinned the start of our austerity decade now feels much less immediate. The Prime Minister’s pledge to ‘end austerity’ is therefore likely to feel like an overdue one to many families across the country. Yet the nation’s stock of debt remains elevated relative to pre-crisis levels, and our current economic backdrop is unusually uncertain. ‘Ending austerity’, then, is a difficult task.

But having talked up the moment, the government has raised expectations of a substantial change. The light at the end of the tunnel is likely to burn just a little bit brighter next Monday, as the OBR delivers good news for the Chancellor on the outlook for the public finances. But that good news – and the increased fiscal headroom it denotes – will not provide a complete route map out of austerity. The Chancellor must still pick his way through a number of obstacles.

He will likely need to acknowledge that ending austerity means abandoning his objective for structural balance. Much more challengingly, he will almost certainly need to deliver a tax-raising Budget if he is to ‘end austerity’ – even if such action is delayed for future Budgets. The public may be with him on that, but there’s no guarantee that his own party will be. The OBR windfall may mean the Chancellor can provide further resources for the NHS next year without tax rises, but the big picture looking to the future is that any government wanting to truly ‘end austerity’ will need to raise taxes in the years ahead.
A NEW DIRECTION

The Prime Minister has called for an ‘end to austerity’, suggesting a redrawing of the government’s fiscal priorities
Until now, Philip Hammond’s approach to the public finances has been driven by three key fiscal ‘rules’

Fiscal ‘mandate’
To have cyclically-adjusted net borrowing below 2% of GDP by 2020-21

‘Supplementary’ debt rule
To have public sector net debt falling as a share of GDP in 2020-21

Fiscal ‘objective’
To bring the public finances to balance as soon as possible in the next parliament (meaning by 2025-26 when the target was first established)
With the 2017 Conservative manifesto re-affirming a commitment to a balanced budget “by the middle of the next decade”

There is still work to do on deficit reduction, so we will continue to restore the public finances over the course of the next parliament. We will continue with the fiscal rules announced by the chancellor in the Autumn Statement last year, which will guide us to a balanced budget by the middle of the next decade.
At the Spring Statement, the Chancellor was on course to hit his mandate in 2020-21, with £15bn headroom

Back in March, the OBR’s Economic and Fiscal Outlook projected that the structural deficit (cyclically-adjusted net borrowing) would decline from 2.3% of GDP in 2017-18 to 1.3% in 2020-21, thanks largely to day-to-day departmental spending being cut as a share of GDP.

The government was therefore set to meet its fiscal mandate with a margin of 0.7% of GDP, or £15.4bn.
While sizeable, the reported headroom of £15bn was no higher than the average enjoyed across all fiscal statements from June 2010.

The details of the fiscal mandate have differed over the period since 2010. It has switched from a focus on balancing the structural current budget (i.e. excluding capital spending) between 2010 and 2015, to an emphasis on securing an overall surplus between 2015 and 2017, and today’s target of getting structural borrowing below 2% of GDP.

Source: OBR
The Chancellor was also projected to be on course to meet his supplementary debt target at the Spring Statement, with headroom equivalent to £68bn.

The March 2018 Outlook projected that PSND would be broadly flat in the next few years, before falling by 3% of GDP in 2020-21 (equivalent to £68.4bn). This profile is driven in large part by the effect of loans made by the Bank of England to private sector banks under its Term Funding Scheme. Loans provided in 2016-17 and 2017-18 pushed up the headline PSND level, with this effect then unwinding when the loans are repaid in 2020-21. The effect was projected to contribute 2.4% of GDP to the 3% fall expected by the OBR.
But meeting his wider fiscal ‘objective’ of securing overall budget balance by 2024-25 looked much more challenging.

The presumed end of the “next parliament” when the objective was established in 2017 was 2024-25, a point two years beyond the OBR’s forecast horizon back in March. A straight line extrapolation of further deficit reduction beyond this point implies that the government would reach this date with a continued deficit of 0.4% of GDP, meaning some acceleration in consolidation would be required to meet the objective.

Source: OBR & ONS
Yet despite already looking unlikely to meet his stated objective, the Chancellor hinted back in March that he was prepared to make use of some of his fiscal mandate headroom to support an increase in spending.

*If, in the Autumn, the public finances continue to reflect the improvements that today’s report hints at then, in accordance with our balanced approach, and using the flexibility provided by the fiscal rules, I would have capacity to enable further increases in public spending and investment in the years ahead.*

*Philip Hammond, Spring Statement 2018 speech, 13 March 2018*
And the Prime Minister has more recently made it clear that she wishes to ‘end austerity’ (as long as the debt to GDP ratio continues to fall)

Sound finances are essential, but they are not the limit of our ambition… when we’ve secured a good Brexit deal for Britain, at the Spending Review next year we will set out our approach for the future. Debt as a share of the economy will continue to go down, support for public services will go up. Because, a decade after the financial crash, people need to know that the austerity it led to is over and that their hard work has paid off.

Theresa May, Conservative conference speech, 3 October 2018
With the Chancellor talking up the possibility of making use of a double Brexit “deal dividend” to support more spending

1. A boost to the economic forecasts

“The OBR’s forecast is based on a pretty much mid-way point between no deal at all and an EEA solution. The deal that we’re trying to negotiate with the European Union now represents an improvement from the point of view of the British economy over that mid-point and therefore should deliver us an upside in the form of higher economic growth and better outcomes than were otherwise anticipated”

2. The freedom to use existing fiscal “firepower”

“I will maintain fiscal firepower so that if we do find that things don’t turn out the way we want, we have got the ability to support the British economy and minimise any effect. But if we don’t need that fiscal firepower then of course it can be used for other things, either support for public services or further paying down of debt or indeed reducing taxes”

*Philip Hammond, interview with Kamal Ahmed, BBC, 12 October 2018*
The three fiscal rules therefore appear to have given way to two lodestars: ending austerity and lowering debt

Fiscal ‘mandate’

To have cyclically-adjusted net borrowing below 2% of GDP by 2020-21

Prepared to bump up against the mandate assuming a Brexit deal is brokered

‘Supplementary’ debt rule

To have public sector net debt falling as a share of GDP in 2020-21

Remains a stated priority, serving as the main fiscal constraint going forward

Fiscal ‘objective’

To bring the public finances to balance as soon as possible in the next parliament (meaning by 2025-26 when the target was first established)

Apparently de-prioritised in favour of ‘ending austerity’
first

THE LIGHT AT THE END OF THE TUNNEL

‘Ending austerity’ could take numerous forms, but as a minimum it is likely to mean an end to cuts in public service budgets

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The Prime Minister’s conference speech implies that ‘ending austerity’ – as a minimum – means avoiding any further public service spending cuts in the next Spending Review period

The 2015 Spending Review (SR15) set out day-to-day spending limits (DEL, or departmental expenditure limits) for all departments up to 2019-20 (2020-21 in the cases of the NHS, Ministry of Defence and Single Intelligence Account). Capital budgets for all departments were settled up to 2020-21.

Specific departmental spending limits for 2020-21 onwards will be detailed in the 2019 Spending Review (SR19), which is expected to take place next Autumn (though it is not yet clear how many years it will cover: Brexit uncertainty means it could be as brief as one year). Before then however, the Chancellor is set to announce the overall spending envelope that will inform SR19 at this month’s Budget.

Given the Prime Minister’s contention that “support for public services will go up” in the SR19, we might expect ‘ending austerity’ to mean – as a minimum – the establishment of a spending envelope that draws a line under the long period of falling public service spending from 2020-21 onwards.
But the price tag associated with ‘ending austerity’ after 2019-20 depends on how the government chooses to define a spending cut.

The extent to which the provisional Spring Statement trajectory for DEL after 2019-20 represents a continuation of austerity relative to the benchmark varies by which version of DEL we deem most relevant.

Focusing on the total, the path from 2019-20 to 2022-23 looks relatively flat. Taking account of population growth – to better reflect the level of service that DEL spending can pay for – results in a clearer downward trend.

Notes: The 2019-20 DEL figures are affected by the start of the five-year NHS plan. That is, because spending envelopes in other departments are already specified in this year under SR15, the new funds for NHS England must raise the total DEL.

Source: RF analysis of NHS Funding Settlement and OBR
With an extra £19bn needed in 2022-23 to keep DEL steady as a share of GDP relative to the 2019-20 baseline

Measured as a share of GDP – perhaps the fairest measure of the extent to which public service spending is keeping pace with developments in the economy – austerity appears very clearly on course to continue.

On current plans, DEL is set to fall to 17.3% of GDP in 2022-23, down from 18.1% of GDP in 2019-20. Maintaining the 2019-20 level would require an extra £19bn of spending in 2022-23 (in nominal terms) relative to current plans.
Focusing on the more appropriate measure of day-to-day spending (RDEL), ‘ending austerity’ looks even costlier

DEL comprises day-to-day (resource) spending (RDEL) and capital spending (CDEL), with the former accounting for roughly 85% of the total. In terms of hiring teachers, running prisons and keeping libraries open (i.e. those services most associated with austerity) it is RDEL that really matters.

Focusing on this measure implies that austerity is set to persist beyond 2019-20 whether we consider the overall RDEL budget, RDEL per person or RDEL as a share of GDP.

Notes: The 2019-20 DEL figures are affected by the start of the five-year NHS plan. That is, because spending envelopes in other departments are already specified in this year under SR15, the new funds for NHS England must raise the total DEL.

Source: RF analysis of NHS Funding Settlement and OBR
Relative to the Spring Statement projections, the government might need to raise its spending envelope by as much as £24bn in 2022-23 to ‘end austerity’ if taking the approach of maintaining day-to-day spending as a share of GDP.

<table>
<thead>
<tr>
<th>'Austerity' definition</th>
<th>2019-20 plans</th>
<th>Nominal increase relative to Spring Statement plans required to maintain 2019-20 levels</th>
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<tr>
<td></td>
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<td>2020-21</td>
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<tr>
<td>Real-terms DEL</td>
<td>£393bn</td>
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<td>Real-terms DEL per person</td>
<td>£5,781</td>
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<td>DEL as a share of GDP</td>
<td>18.1%</td>
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<td>Real-terms RDEL</td>
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<td>Real-terms RDEL per person</td>
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<td>RDEL as a share of GDP</td>
<td>15.3%</td>
<td>+£13.4bn</td>
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Source: RF analysis of NHS Funding Settlement and OBR
Failure to increase the SR19 envelope would imply further very sharp cuts to some departments – especially following the announcement of a new five-year NHS plan.

The five-year plan raises the NHS England budget by an average 3.4% a year in real-terms for the five years from 2019-20. By 2023-24, spending is due to rise by £20.5bn relative to 2018-19. The addition of a further £1.25bn each year to cover a specific pensions pressure will take the overall real-terms increase on 2018-19 to £21.7bn. Applying the Barnett consequentials produces real-terms budget increases in Scotland (£2bn), Wales (£1.2bn) and Northern Ireland (£0.7bn) too. Relative to the baseline, the policy is set to cost nearly £28bn by 2023-24.

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<td>NHS England budget under five-year plan</td>
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<tr>
<td>Nominal</td>
<td>114.6</td>
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<td>126.9</td>
<td>133.1</td>
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<td>2018-19 prices</td>
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<td>Cumulative change from 2018-19</td>
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<td>8.3</td>
<td>12.1</td>
<td>16.1</td>
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<td>NHS England budget incorporating additional pension payment</td>
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<td>Nominal</td>
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<td>128.2</td>
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<td>Nominal cost relative to pre-plan baseline</td>
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<td>21.4</td>
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Source: RF analysis of gov.uk, NHS Funding Settlement, 18 June 2018
The government is committed to spending (current and capital) at least 2% of GDP on defence each year (in line with its NATO pledge). It has met the target in each of the last eight years, though the proportion has fallen from 2.5% in 2010 to 2.1% in 2018. Following SR15, the 2020-21 RDEL Ministry of Defence budget has already been set at £28.9bn. Maintaining the RDEL share of GDP in subsequent years would require it the real-terms value to rise to £29.8bn by 2022-23. Likewise the Single Intelligence Account (SIA) 2020-21 RDEL is also already in place (£2.0bn). Following the same principle of fixing this spend relative to GDP would mean increasing RDEL to £2.1bn by 2022-23.

Since 2013 the government has been committed to allocating 0.7% of the UK’s gross national income (GNI) to overseas aid each year, with total spending amounting to £13.9bn in 2017. DFID accounted for just under three-quarters of that total (£10.1bn), with the rest spread across a number of other government departments and other organisations such as the EU and the BBC World Service. Sticking to the commitment in the coming years therefore affects DFID most directly. If we assume that it continues to account for roughly three-quarters of the overseas aid total, with the current split between day-to-day and capital spending within the department held constant, then the RDEL would rise by £0.4bn between 2019-20 and 2022-23 (in 2018-19 prices).
The current projection of a 4.2% reduction in real-terms RDEL per person between 2019-20 and 2022-23 implies a 15.5% cut for unprotected areas.

The five-year NHS plan provides for a £10.8bn real-terms increase in RDEL between 2019-20 and 2022-23. Maintaining defence and SIA spending as a share of GDP results in a combined £1.2bn real-terms RDEL increase over the same period. And continuing to meet the overseas aid pledge lifts the DFID RDEL by £0.4bn.

Given the provisional RDEL envelope set out at the Spring Statement, these protections imply a £22bn real-terms reduction in spending across all other departments.
Meaning already very large budget cuts in some departments would potentially strike deeper still

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<td>DFID</td>
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<td>Health &amp; social care</td>
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<td>Defence</td>
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<td>Wales</td>
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<td>Housing &amp; Communities</td>
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<td>Transport</td>
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</tbody>
</table>

On current plans, overall real-terms RDEL per person is set to fall by 18.2% between 2009-10 and 2019-20. But that cut is falling very unevenly across departments. RDEL per person is projected to grow by 30% in DFID and 10% in health, contrasting with cuts of more than 50% in BEIS, the FCO and housing & communities and a reduction of more than 75% in transport.
Meaning already very large budget cuts in some departments would potentially strike deeper still

If the Chancellor left the SR19 RDEL envelope unchanged from the provisional Spring Statement projection and delivered the five-year NHS plan and protections to defence and aid, the contrast between departments would become starker still by 2022-23.

In this scenario the real-terms DFID RDEL per person would have risen by 33% relative to 2009-10, whereas the housing & communities budget would be 63% lower and the transport RDEL would be down 80%.

Source: RF analysis of NHS Funding Settlement and OBR
That outcome appears unlikely, but avoiding cuts in any departments after 2019-20 could require an uplift in RDEL in 2022-23 of £24bn...

Delivering the NHS plan and protections for defence and aid while additionally holding all other RDEL spending constant at its 2019-20 level in real-terms would require an overall nominal increase in the RDEL envelope of £23.6bn in 2022-23.

That would take real-terms RDEL back to a level last recorded in 2011-12.

Source: RF analysis of NHS Funding Settlement and OBR
Rising to £26bn once we account for population growth...

Choosing instead to fix currently unprotected elements of RDEL in line with their 2019-20 real-terms RDEL per capita level would require a nominal spending envelope increase of £26.3bn in 2022-23.

That would result in the highest real-terms RDEL per person spending since 2014-15.
And £31bn if RDEL is instead protected as a share of GDP

Looking across the protected departments, RDEL is set to rise between 2019-20 and 2022-23 as a share of GDP. Fixing spending relative to national income across all other departments after 2019-20 requires a £30.6bn increase in the nominal envelope in 2022-23 relative to current plans.

Even with this sizeable increase however, total RDEL would be returned to just its 2016-17 level relative to GDP.
The increase in RDEL envelope required of the Chancellor will vary depending on his approach to defining ‘austerity’ and on the number of years he specifies as part of SR19 – but it is set to be very significant in any instance.

<table>
<thead>
<tr>
<th>'Austerity' definition</th>
<th>2019-20 plans</th>
<th>Nominal increase relative to Spring Statement plans required to maintain 2019-20 levels in all departments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>2020-21</td>
</tr>
<tr>
<td>Real-terms RDEL</td>
<td>£334bn</td>
<td>+£13.6bn</td>
</tr>
<tr>
<td>Real-terms RDEL per person</td>
<td>£4,904</td>
<td>+£14.6bn</td>
</tr>
<tr>
<td>RDEL as a share of GDP</td>
<td>15.3%</td>
<td>+£15.7bn</td>
</tr>
</tbody>
</table>

Source: RF analysis of NHS Funding Settlement and OBR
To truly ‘end austerity’ the Chancellor must also look again at ending working-age benefit cuts.
While not referred to by the Prime Minister in her ‘ending austerity’ speech, ongoing social security cuts are likely to feel to many like a second obvious area of spending that needs revisiting at the Budget.

George Osborne set out a catalogue of cuts to working-age social security in the 2015 Summer Budget. The package covered both a tightening of eligibility for different benefits and a reduction in the generosity of a number of elements. The cuts delivered on the pre-2015 election pledge to make £12bn of savings, with that figure set to be achieved in 2019-20 and growing thereafter. Some of the cuts have been dropped or tweaked since the original announcement, but the majority remain in place. Government savings are likely to top £14bn by 2022-23.

Among the largest of the cuts is the **four-year cash freeze** in the value of a number of working-age benefits that started in April 2016. By default, the value of benefits such as Child Benefit, Tax Credits, Universal Credit (UC), Housing Benefit limits, Job Seekers Allowance (JSA), Income Support and Employment and Support Allowance (ESA), are uprated each April in line with the CPI rate of inflation that prevailed in the previous September. The four-year freeze overrode this default, keeping the value of the various payments flat in cash terms.

The policy was originally projected to save £3.9bn a year by its final year (2019-20). However, higher than expected inflation in both years three and four (with CPI inflation standing at 3% in Sep-17 and 2.4% in Sep-18) mean that we now know the cumulative saving will total £4.4bn. The policy therefore accounts for around one-third of the total package of cuts introduced in 2015.

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While not referred to by the Prime Minister in her ‘ending austerity’ speech, ongoing social security cuts are likely to feel to many like a second obvious area of spending that needs revisiting at the Budget.

Cuts to UC ‘work allowances’, form another sizeable part of the overall package. They lower the amount that UC recipients can earn before their benefit entitlement starts to be withdrawn; a move that both reduces the incomes of recipients and lowers their incentive to work. A subsequent reduction in the rate at which the UC award is tapered away (from 65% to 63%) at Autumn Statement 2016 provided some offset to the work allowance cuts, but even after this move the UC cuts account for around one-quarter of the total cuts package.

The introduction of a two-child limit for benefits with a ‘child element’ (such as Tax Credits and UC) from April 2017 was also a significant move, limiting eligibility to just two children in a family at any one time. The removal of the ‘family element’ from Tax Credits and UC similarly ends entitlement to a premium for the first child in a claimant family. Together, these two sets of cuts account for around 15% of the total.

Other cuts delivered as part of the 2015 Summer Budget package include: the introduction of the benefit cap that limits the maximum amount a family can receive in total across a range of benefits (with the State Pension being the main exception); a four-year policy of consecutive 1% reductions in social sector rents (with the burden falling on landlords rather than households); and cuts to the support provided to new recipients of ESA who are considered healthy enough to carry out ‘work related activities’ (like CV preparation), aligning their awards with those made to JSA recipients.
As things stand, the cuts are set to deliver significant losses to lower income households (even after accounting for various tax cuts) by 2022-23

The distributional analysis shown here includes the impact of the National Living Wage, income tax cuts associated with the raising of the personal allowance and higher rate threshold, additional hours of free childcare, numerous alcohol and fuel duty freezes, removal of the family element, the two-child limit, UC work allowance cuts, pension tax relief cut, the four-year benefit freeze, the reduction of the UC taper to 63%, abolition of the six-week wait in UC and the introduction of a Housing Benefit run-on for those moving onto UC.

Note: Assumes full entitlement, full UC roll-out and that the two-child limit is three quarters of the way to being fully in place.

Source: RF analysis using the IPPR tax benefit model
With roughly half of the package of benefit cuts still to land, the Chancellor still has the option of cancelling or reversing some of the future hit to incomes, thereby ‘ending austerity’ for lower income households.

Of the roughly £14bn of cuts expected to be delivered by 2022-23, around £7.7bn is still to be delivered. Taking a broader approach to ‘ending austerity’ than the Prime Minister hinted at in her speech, the Chancellor could use the Budget to put a halt to some or all of these remaining cuts.

Perhaps the most obvious move the Chancellor could make would be to cancel the final year of the benefit freeze. Year four, which starts in April 2019, is set to account for £1.5bn of the £4.4bn total saving by the end of 2019-20. Cancelling it would bring some relief to millions of already hard-pressed lower income families.
Cancelling the final year of the benefit freeze would be worth an average of £130 a year to households in the bottom half of the income distribution.

Even if the final year of the freeze were cancelled, roughly 10 million households would still be worse off as a result of the first three years of the policy. But it would at least stop things moving in the wrong direction.

Failure to cancel the final year of the freeze would leave households in the bottom half of the incomes distribution £380 worse off in total as a result of the policy.

Source: RF analysis using the IPPR tax benefit model
And that average benefit would rise to £200 for couples with children in the bottom half of the distribution.

Source: RF analysis using the IPPR tax benefit model

Families with children have been especially hard hit by the benefit freeze. Cancelling the final year would save couples with children in the bottom half of the income distribution from facing a £200 a year cut on average.

Failure to cancel it would leave these families £580 worse off in total once the full four years of the freeze is in place.
And higher still (£250) among lower income single parents, leaving them £710 worse off a year in total.

Cancelling the final year of the freeze would be worth £250 a year to lower income single parents; but failing to do so would take their average cumulative loss to £710 a year.

Source: RF analysis using the IPPR tax benefit model
Alongside necessary adjustments to the workings of Universal Credit, the Chancellor should also restore the work allowances that support incomes and boost incentives – with a particular focus on single parents and second earners

Until now, claimants have only moved onto UC when making a new claim for support. This ‘natural migration’ has progressed at different speeds across the country, but is now nearing completion. From 2019, a period of ‘managed migration’ had been due to begin, in which those already in receipt of legacy benefits would be told that they needed to switch over to the new system. However, with a fifth of new claims not being paid on time and many claimants experiencing financial hardship as a result of practical difficulties and inflexibility in the UC system, the government has decided to slow the pace of the managed migration and is considering options for refining the system before moving significantly more people across.

Such reform is necessary and welcome – reflecting many of the recommendations we have made in recent months. But it does nothing to mitigate the impact of sharp cuts in UC work allowances which, once UC is fully rolled-out, are set to save the government more than £3bn a year. These cuts have tipped the balance to mean that the move to UC is now set to deliver more losers (3.2 million families) than winners (2.2 million families).

As part of his attempt to ‘end austerity’ at the Budget, the Chancellor should approach UC in two ways. First, he should provide sufficient funds to facilitate a re-design of the system that ensures it is fit for purpose. Second, he should re-invest in UC’s work allowances so that it provides at least the same level of support for working families as the existing tax credit system, placing particular emphasis on single parents and second earners.
Cancelling the final year of the benefit freeze and re-investing in UC work allowances would cost a combined £5.1bn by 2022-23, representing the minimum the Chancellor should do on benefits.

<table>
<thead>
<tr>
<th>'Austerity' definition</th>
<th>Nominal reduction in government savings associated with cancelling or reversing each social security cut</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2019-20</td>
</tr>
<tr>
<td>Cancelling the final year of the benefit freeze</td>
<td>+£1.5bn</td>
</tr>
<tr>
<td>Re-investing in UC work allowances</td>
<td>+£1.5bn</td>
</tr>
<tr>
<td>Scrapping the two-child limit</td>
<td>+£1.1bn</td>
</tr>
<tr>
<td>Restoring the family element</td>
<td>+£0.6bn</td>
</tr>
</tbody>
</table>

Notes: The UC savings are calculated by weighting original OBR projections at the time of the 2015 Summer Budget to account for slower than expected roll-out of UC. We assume that full roll-out is completed in 2022-23, bringing the savings back into line with the original estimate for that year.

Source: OBR and RF calculations
Delivering an ‘end to austerity’ package that provides protection in per capita spending in all departments alongside action on the benefit freeze and UC would cost £31bn in 2022-23, with fuller packages costing more still.

A full ‘end to austerity’ might be considered to involve ensuring that all departments have their day-to-day spending levels maintained as a share of GDP (with NHS England doing better still), alongside reversing many of the largest 2015 benefit cuts that are still to bite in full. Such an approach would cost £30.6bn on the RDEL side and £7.3bn on benefits, creating a combined cost of £37.9bn in 2022-23.

Our contention is that minimum that might be accepted as marking an ‘end to austerity’ falls a little way below this. For the purposes of illustration we consider the feasibility of delivering a package in which every department at least has it’s 2019-20 RDEL spending maintained on a real-terms per capita basis (at a cost of £26.3bn), alongside a cancellation of the final year of the four-year benefit freeze (£1.7bn) and a restoration of funds to UC designed to re-invest in work allowances and so ensure the new system is fit for purpose (£3.4bn). Taken together, this package would cost £31.4bn in nominal terms in 2022-23.
FINDING THE WAY OUT

Funding a genuine ‘end to austerity’ requires some combination of higher borrowing and higher taxes
As noted above, the Chancellor has indicated a willingness to make use of a potential double Brexit “deal dividend” to support more spending

1. A boost to the economic forecasts

“The OBR’s forecast is based on a pretty much mid-way point between no deal at all and an EEA solution. The deal that we’re trying to negotiate with the European Union now represents an improvement from the point of view of the British economy over that mid-point and therefore should deliver us an upside in the form of higher economic growth and better outcomes than were otherwise anticipated”

2. The freedom to use existing fiscal “firepower”

“I will maintain fiscal firepower so that if we do find that things don’t turn out the way we want, we have got the ability to support the British economy and minimise any effect. But if we don’t need that fiscal firepower then of course it can be used for other things, either support for public services or further paying down of debt or indeed reducing taxes”

Philip Hammond, interview with Kamal Ahmed, BBC, 12 October 2018
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But that “dividend” is of course hugely uncertain, and won’t be available in time for the Autumn Budget in any case.

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Though the Chancellor could make ‘conditional’ spending pledges that utilise his expected fiscal headroom

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So how much headroom does he have?
On the economy, nothing much appears to have changed since March

<table>
<thead>
<tr>
<th>Metric</th>
<th>Measure</th>
<th>OBR Mar-18 projection</th>
<th>ONS Oct-18 outturn/estimate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Nominal GDP</td>
<td>Year-on-year growth in annualised GDP (Q2-18)</td>
<td>3.3%</td>
<td>3.3%</td>
</tr>
<tr>
<td>Real GDP</td>
<td>Year-on-year growth in annualised GDP (Q2-18)</td>
<td>1.5%</td>
<td>1.4%</td>
</tr>
<tr>
<td>16+ employment rate</td>
<td>Four-quarter average (Q2-18)</td>
<td>60.8%</td>
<td>60.9%</td>
</tr>
<tr>
<td>Non-oil output per hour</td>
<td>Four-quarterly average of year-on-year growth (Q2-18)</td>
<td>1.1%</td>
<td>1.1%</td>
</tr>
<tr>
<td>Nominal average earnings</td>
<td>Four-quarterly average of year-on-year growth (Q2-18)</td>
<td>2.6%</td>
<td>2.7%</td>
</tr>
<tr>
<td>CPI</td>
<td>Q1-18 to Q3-18 average rate</td>
<td>2.5%</td>
<td>2.6%</td>
</tr>
</tbody>
</table>

Source: OBR & ONS
But public finance data revisions have lowered the borrowing total in 2017-18

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

At the Spring Statement, the OBR only had ONS data on borrowing up to Jan-18. For the final two months of the financial year it avoided applying a straight extrapolation of the year-to-date data on the basis that it expected local authorities to underspend their budgets by less than the ONS was assuming at the time.

As a result, the OBR projected that the full year borrowing figure for 2017-18 would total £45.2bn, only slightly down on the 2016-17 level.

Source: OBR & ONS
But public finance data revisions have lowered the borrowing total in 2017-18

Since March, the ONS has revised its back data and added figures for the last two months of 2017-18. The new estimate puts borrowing in 2017-18 at £39.8bn, some £5.4bn (11.8%) lower than the OBR’s projection in March.

This lower figure reflects a combination of factors, including lower spending than the OBR had assumed by both central government and local authorities, along with larger corporation tax receipts and some measurement differences.

Source: OBR & ONS
And provisional figures for the first half of 2018-19 suggest borrowing is on course to come in well below the Spring Statement projection this year too.

To date, we have provisional ONS data for borrowing in the first six months of 2018-19. This shows a marked (£10.7bn, or 35%) reduction relative to the revised 2017-18 figures, and one that is larger than the OBR projected back in March.

The difference stems from stronger-than-expected tax receipt growth (stronger than provisional GDP figures would imply too) and lower central government spending.

Source: OBR & ONS
As recent reports have suggested, rolling the figures forward implies a £13bn reduction in borrowing in 2018-19 relative to the OBR’s March projection. The OBR pointed out that a straight extrapolation of the first six months of 2018-19 data would lower full-year borrowing by £11bn relative to its Spring Statement projection. But it also noted that the figures appear to be understating the strength of onshore corporation tax receipts so far this year, hinting that the full-year figures would therefore come in even lower. As the Financial Times has reported, correcting for this implies that borrowing might end the year at £24bn, some £13.1bn (or 39.8%) lower than the OBR’s previous projection.
If the 2018-19 improvement carries over into subsequent years, the Chancellor will enjoy a sizeable headroom increase against his fiscal mandate.

As noted above, the March 2018 Outlook implied that the Chancellor would have headroom of £15.4 billion in 2020-21 relative to his fiscal mandate.
Lifting the space he is projected to have in 2020-21 from £15bn to £28bn

Applying the £13.1bn borrowing upgrade in 2018-19 and assuming that this improvement persists into subsequent years (with no change in either GDP or the OBR’s output gap assumption), raises the 2020-21 headroom to £28.5bn (or 1.3% of GDP)

This also means that the Chancellor could meet the £7.4bn increase in NHS funding scheduled for 2019-20 while still borrowing less than he was projected to back in March.

Note: The uptick in the revised structural borrowing line in 2019-20 is caused by the fact that the first year of the five-year NHS plan directly increases RDEL, with no offsetting revenue increase as yet announced. Source: OBR, ONS and RF calculations.
That would represent the most significant scale of headroom enjoyed by Philip Hammond, and the largest since Autumn Statement 2014.

Forecast headroom against fiscal mandate in successive OBR Economic and Fiscal Outlook publications.

Source: OBR and RF calculations
If the Chancellor were to use the entirety of this potential headroom relative to his fiscal mandate, he could spend an extra £39bn in 2022-23.

The fiscal mandate specifies getting the structural deficit below 2% of GDP “by 2020-21”, implying that it must remain below this level in all subsequent years. Relative to our latest projection for structural borrowing, this mandate therefore provides the Chancellor with headroom of 1.7% of GDP by 2022-23 – equivalent to £39.5bn.

Source: OBR, ONS and RF calculations
However, following such a borrowing trajectory would result in a potential breaking of the supplementary debt rule.

The debt target specifies that debt must be falling as a share of GDP “in 2020-21”. It continues to do so even in this max ‘mandate’ scenario of significantly higher borrowing, but this is again due primarily to the unwinding of the Bank of England’s Term Funding Scheme in that year.

The language used by the Prime Minister and Chancellor suggests that they want debt to continue falling as a share of GDP beyond 2020-21—something which does not occur in 2022-23 in our scenario.

Source: OBR, ONS and RF calculations
With lowering debt still a priority for the government, the Chancellor is likely to make much more modest use of his mandate headroom.

For illustration, we consider the outcome associated with an approach in which the Chancellor aims to keep structural borrowing in line with its newly projected 2019-20 level of 1.4% of GDP. In this instance, he still frees up £24.7bn by 2022-23, while remaining well under his fiscal mandate limit.

Source: OBR, ONS and RF calculations
With lowering debt still a priority for the government, the Chancellor is likely to make much more modest use of his mandate headroom.

This approach delivers a profile for debt-to-GDP that is almost precisely the same as the March projection, and one in which the ratio is broadly flat in 2022-23. This is therefore likely to represent the maximum level of borrowing the Chancellor could consider without jeopardising his debt rule.

In practice, given significant economic uncertainty and a likely ongoing preference for lowering debt ahead of any future economic shocks, we can expect the Chancellor to borrow less than this.

Source: OBR, ONS and RF calculations
The government’s dual goal of ‘ending austerity’ and lowering debt appears unachievable without at least some tax rises – raising a political challenge

The arrival of a £13bn fiscal windfall is likely to take some of the immediate pressure for tax rises off a Chancellor who was tasked with explaining how he was funding increased NHS spending while knowing that he doesn’t have the parliamentary numbers to take any bold action on revenues. But the broader goal of ‘ending austerity’ will need action on tax – even if this might now be delayed beyond this particular Budget.

The Chancellor has ear-marked some revenue-raising changes ahead of the Budget, but they are modest in scale. For example, he has cancelled the planned abolition of Class 2 National Insurance for the self-employed, saving around £0.4bn a year from 2019-20. And changes to remote gaming duty for overseas gambling companies are expected – raising an average of £0.2bn a year. But these moves are dwarfed by a number of expensive forthcoming tax cuts.

Fuel duty, is about to be frozen for a ninth successive year in April 2019, at a cost of around £0.9bn (and a cumulative cost of £10bn). The Chancellor had hinted that this would be the year in which the ad-hoc cancelling of the default uprating would come to an end, but the fact that this hasn’t proved to be the case suggests that the policy may rumble on indefinitely. In addition, the 2017 Conservative manifesto promised a personal income tax allowance of £12,500 “by 2020” and a higher rate threshold of £50,000. Hitting these goals would cost around £2 billion in 2020-21. Future corporation tax cuts will be expensive too, with the reduction from 19% to 17% in April 2020 set to cost £5bn in 2020-21, rising to £6bn in 2022-23. These challenges could however provide the Chancellor with some opportunities.
Income tax is due to be cut again over the next two years, but the Chancellor could raise £2bn by re-introducing fiscal drag after that point.

Hitting the 2017 manifesto pledge of raising the PTA to £12,500 and the HRT to £50,000 “by 2020” requires the Chancellor to announced above-inflation uprating – with an associated cost. But having got to these targets, he could then keep the thresholds fixed in cash terms. Doing so delivers on the manifesto pledge but brings in new revenues through fiscal drag. Overall, such a move would raise £2bn in 2022-23 (with the figure roughly doubling in 2023-24 as the impact on the higher rate threshold becomes more marked).

Source: OBR and RF calculations
Such a move would be broadly progressive

Of course any tax rise must be paid for, and this move would cost basic rate taxpayers £70 each by 2023-24. But the tax rise would be broadly progressive, with the biggest burden being borne by households in the upper middle part of the income distribution (those at the very top of the income distribution would be less affected because they are above the point at which the PTA is withdrawn)

Source: OBR, ONS and RF calculations
Cancelling the 2020 corporation tax cut would generate £6bn, with little likely effect on UK competitiveness

The headline corporation tax rate has now fallen from 30% to 19% in recent years and will drop to 17% in 2020-21. Yet the UK rate is already low by international standards and it is hard to imagine the forthcoming cut making much difference to business attitudes. The fact that the estimated cost of the policy has increased significantly since it was first announced provides a strong argument for revisiting it. However, a U-turn is probably on ice until (some) Brexit uncertainty has been resolved.

Source: OBR, ONS and RF calculations
Beyond some of these usual suspects, the Chancellor has a surprisingly large number of alternative options for raising funds

It’s not just in relation to income tax thresholds where the Chancellor could make use of fiscal drag. Freezing the combined inheritance tax threshold at £1 million (it’s due to reach this point in 2020-21) would raise funds, as would freezing the capital gains tax threshold. The Chancellor could look again at the VAT threshold – which is thought to distort business decisions – too.

Environmental taxes provide a further opportunity. Concern about plastic waste is high and the introduction of the plastic bag charge has proved popular, so the Chancellor make want to consider other options. Any new plastic charges are likely to impact consumption more than public finances, but policies on the £2.4 billion ‘red diesel’ discount, the Climate Change Levy or Carbon Price Floor could raise significant sums while driving cleaner technology.

Many other parts of Britain’s tax system are in need of reform or replacement. HM Treasury could, for instance, begin consultation on: Pension tax relief; Entrepreneurs’ relief (costing £2.7 billion a year); the National Insurance exemption for working pensioners (costing around £0.9 billion a year); elements of Inheritance Tax, including Agricultural and Business property reliefs (costing £1.2 billion) and ‘normal gifts out of income’; and the excessively generous treatment of inherited pensions and the distortionary writing-off of capital gains tax at death (estimated to cost £1.2 billion a year).
There is light at the end of the tunnel, but actively heading towards it will inevitably mean jumping over some obstacles in the years ahead.

The task the Chancellor has been given at next week’s Budget – of simultaneously ‘ending austerity’ while still lowering debt – is undoubtedly a difficult one. But it is likely to be made significantly easier by a very large upgrade in the OBR’s public finance forecasts. That upgrade will mean that the light at the end of the tunnel will be more clearly visible than it has been for some time, and it should offer the Chancellor the opportunity to deliver a Budget that raises spending in key areas without having to raise taxes. But if he truly wants to declare that austerity is over, then he must at some point tackle the more difficult decisions around tax.

The Chancellor obviously has to deal with political realities, but he has options for raising significant sums from relatively incremental changes. A combination of cancelling the corporation tax cut (£6bn), re-introducing fiscal drag to the income tax system (£2bn), focusing on environmental taxes (£0.5bn), and introducing targeted wealth tax reforms (£1bn) could raise in the region of £10bn by the end of the parliament.

Of course, tax reform should be about more than raising funds in ways designed to go under the radar. Longer-term, the UK’s tax system would benefit from a more strategic review that deals with an apparently shrinking tax base and the need to reform dysfunctional approaches to property and inheritance taxes. But faced with the difficult task of delivering an ‘end to austerity’ while continuing to lower the UK’s debt-to-GDP ratio, it’s clear that the Chancellor will need to be creative in his approach to tax.