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BRIEFING

# To govern is to choose

## The choices facing the Chancellor this autumn

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## Summary

The Chancellor has not had a quiet introduction to national policy making: overseeing 17 major fiscal announcements in as many months. This summer provided the first lull, driven by the success of vaccines and the understandable focus on Afghanistan. But the quiet phase is coming to an end, as an autumn involving some very big economic policy decisions gets underway. We don't yet know whether the Chancellor intends to deliver a Budget, but we are certain to see the first major spending review since 2015. And the Chancellor faces many calls, not least from the Prime Minister, to increase public spending.

Rishi Sunak's ability to answer them will be significantly boosted by the good news the Office for Budget Responsibility (OBR) will deliver within its updated forecasts on 27 October. Borrowing this year is likely to come in several tens of billions lower than expected, having already borrowed £26 billion less than previously forecasts in the first four months of 2021-22. More importantly, if the OBR moves its forecast for the long-term scarring effect of the pandemic on the British economy (currently 3 per cent of GDP) into line with the more optimistic consensus (the Bank of England now expects scarring of just 1 per cent) he will have a windfall that lasts, possibly to the tune of around £25 billion a year.

But even though this will ease the big picture fiscal arithmetic facing the Chancellor, the autumn will still require some major decisions to be made. Alongside dealing with whatever new paths the pandemic itself takes, the months ahead will also see Rishi Sunak have to decide what a post-Covid state should look like, answer a range of questions that the existence of the pandemic has meant have been put-off, and face up to new challenges – not least on the net zero transition. This paper therefore considers five big questions facing the Chancellor this Autumn, providing a briefing on the issues involved and the options on the table. They are:

1. Will he go ahead with the biggest ever overnight benefit cut in history?

- From 6 October, Universal Credit entitlements will fall by £20 a week. This will affect 4.4 million households, who will typically lose over 5 per cent of their disposable income. Around 1 million households will lose over 10 per cent. The income fall for the entire bottom half of the income distribution would be on a scale only normally seen during recessions. This £5 billion cut would be the biggest overnight benefit reduction ever, with only the decision to cut unemployment insurance benefits by 10 per cent in the 1930s coming close to matching it.
- The Chancellor should make the £20 a week uplift permanent in recognition of the fact that basic social security support is simply too low. Had it grown in line with

GDP per capita since 1990, it would be £40 a week higher. Even if the uplift is not to be kept in full for perpetuity, it should certainly not be removed as prices are rising swiftly (including for energy) and the economic recovery needs to be secured. The uplift could be made permanent but with the (boosted) entitlement then being frozen: doing so for four years would halve the cost by 2025-26, to around £3 billion a year.

## 2. How will he avoid the biggest state pension increase in decades?

Average earnings look set to rise by over 8 per cent in May-July, meaning that a strict application of the triple lock could see the largest nominal rise in the state pension for three decades, with an increase in the New State Pension from £180 to £194. But that average earnings increase reflects statistical anomalies, not the wage growth being experienced by workers. Unsurprisingly, Rishi Sunak has therefore given a clear steer that the pension triple lock won't operate in its usual way this year. But he has yet to decide what exactly will happen, which matters both for pensioners and the public finances. The Chancellor could uprate the state pension by:

- A double lock: The Chancellor could bypass the legislative requirement for earnings uprating and instead uprate by the higher of inflation or 2.5 per cent (likely to be inflation of around 3 per cent);
- Underlying earnings growth: alternative earnings growth figures include those from HMRC tax-data (3.4 per cent annual wage growth in July for the continuously employed) and ONS estimates for 'underlying' average earnings growth (between 3.5 and 4.9 per cent); or,
- Applying the Triple Lock over two years: a two-year earnings link would require a pension increase of around 4.4 per cent next year.

These options point to a State Pension rise in the region of 3 to 5 per cent. Relative to an 8 per cent uprating, these options could save a significant £3-4 billion a year

## 3. Which tax rise(s) will pay for better social care?

The Government is shortly to announce badly needed reform of our system for funding social care, possibly to the tune of £10 billion, alongside extra funding for the NHS. The Chancellor's role here is in deciding how to fund it. The favoured means to do so is via an increase in National Insurance (NI) rates. This would certainly raise significant sums (a 1p rise would raise £13 billion a year, with 26 million workers affected), and has the political advantage of being less visible (half the tax increase would fall on employers in the short term).

But this is a poor way to raise the revenue. It doesn't cover all people (those aged over 66 are exempt) and it doesn't cover all income (shareholders and landlords are unaffected). Alongside these horizontal inequities, it is less progressive than Income Tax and reinforces the under-taxation of the self-employed, which undermines both the public finances and employment protections.

If the Chancellor is set on increasing national insurance, there are a number of ways in which a rise could be made fairer and less distortionary. They include:

- To avoid increasing distortions, dividend and capital gains taxes could also be raised by up to 2p, with the former raising £1.5 billion and the latter £0.4 billion.
- To address the unjustified age cut-off working pensioners could start to pay personal NI at the rate of 1 per cent, raising around £0.1 billion.
- To protect the lowest earners, the personal NI threshold could be raised. A £250 threshold rise would cost the best part of £1 billion.

This package of measures would substantially improve upon a simple increase in NI rates, although it would not deal with the single biggest unfairness: that (non-working) pensioners would not contribute anything towards the cost of the improved social care system they would be the most immediate beneficiaries of.

## 4. How much departmental austerity will remain?

The Spending Review, likely to take place in late-October, will be the first time full multi-year spending settlements for departments have been set out since 2015. Current plans represent a rollercoaster for departmental spending: huge pandemic-related spending this year has been combined with plans for lower spending in 2022-23 and future years (reaching £16 billion by the middle of this decade) than was planned pre-pandemic. Against that backdrop the Chancellor has two distinct judgements to make.

The big short-term spending decision is how much Covid-19 related spending (set at £100 billion this year) to continue into next year. The current, unrealistic, answer is zero. In reality, the significant costs associated with managing an ongoing pandemic, as well as recovering from some of its lasting effects, will extend into future years. The OBR estimate that pandemic-related pressures on day-to-day departmental spending could require an additional £12 billion of spending in 2022-23 across the NHS, Education and Transport, falling to around £9 billion in 2024-25.

In the longer-term, the Chancellor has a choice over whether to reverse the cuts he has pencilled in to unprotected departmental budgets out to the middle of the decade. Proceeding with them would mean unprotected departments' real-terms per capita spending rising by just 3 per cent over the five years to 2024-25 and remaining almost one-quarter lower than in 2009-10. Reversing this cut would mean unprotected departments spending power rising in the coming years, although remaining 15 per cent smaller in real per capita terms than in 2009-10.

Revisions to economic and fiscal forecasts may well provide Rishi Sunak with the wriggle room to change course, and clear evidence of the deterioration in some public services should provide the motivation (there were 100 more deaths in prisons in 2019 than in 2010 and the number of assaults are up 130 per cent).

## 5. Will the Treasury get serious about net zero?

The Government has set out ambitious decarbonisation targets, but far less by way of policy detail on how they might be delivered. With the UK hosting the 2021 United Nations Climate Change Conference in Glasgow ('COP26'), a key task for this autumn is to put policy meat on the bones of our net zero strategy. All government departments have significant roles to play, but it remains to be seen whether the Chancellor will really make a substantive contribution to net zero policy progress this autumn.

For households, the key challenge is how they can be supported to decarbonise home heating. Existing homes will require investment of around £75 billion this decade on energy efficiency and low-carbon heating. The private sector will need to cover the majority of this, but to protect lower-income households and ensure sufficiently-swift progress the Treasury will need to start spending significant sums that might ramp up to over £5 billion a year by 2026. Other key decisions are on how to offer regulatory certainty on the phasing out of new gas boilers, and whether to move the burden of environmental levies away from the electricity needed to power heat pumps and on to gas.

Industrial decarbonisation will also need action, with more carrots and sticks to drive change. Targeted support for sectors facing the most significant transitions (such as steel and in carbon capture more generally) are inevitable if we want the UK's industry in these areas to survive. And clarity about the future path of carbon pricing for industry, including the phasing out of free allowances within the UK's ETS and extension to sectors such as shipping, is crucial if credibility is to be built, so that the prospect for medium- or long-term changes stimulate industry today.

This decade is also the crunch time for replacing our road taxes. Road tax revenues may start to decline from 2023-24, and by 2030-31 there will be a £13 billion hole in the public finances. The only plausible option to tackle the long-term problem is a new system of road pricing so that we have a replacement for Fuel Duty in an era of electric vehicles. The Treasury should begin to make progress on some of the very tricky questions that such a system raises. As a test bed for wider change, road pricing should first be introduced for home deliveries.

The Chancellor has had a relatively quiet summer and is set for good news on the public finances. But he still has big decisions to take this autumn. Those decisions are worth all of us paying attention to: they will do much to decide the size and shape of our post-pandemic state. We've had a relaxed summer, don't expect a quiet autumn.

## Introduction: After a quiet summer, there is some good (fiscal) news for the Chancellor

It has been a quiet summer for UK domestic policy making. Afghanistan has rightly dominated, and the (at least temporary) fall back from the July peak of Covid-19 cases has meant people and politicians focusing on taking holidays rather than debating pandemic policy making.  For the Chancellor, this lull is particularly stark given the contrast with the hyperactive last 18 months. In normal years we have two major fiscal events a year, but since the start of the pandemic in March 2020 we've had 17 fiscally significant announcements – almost one a month.[1]

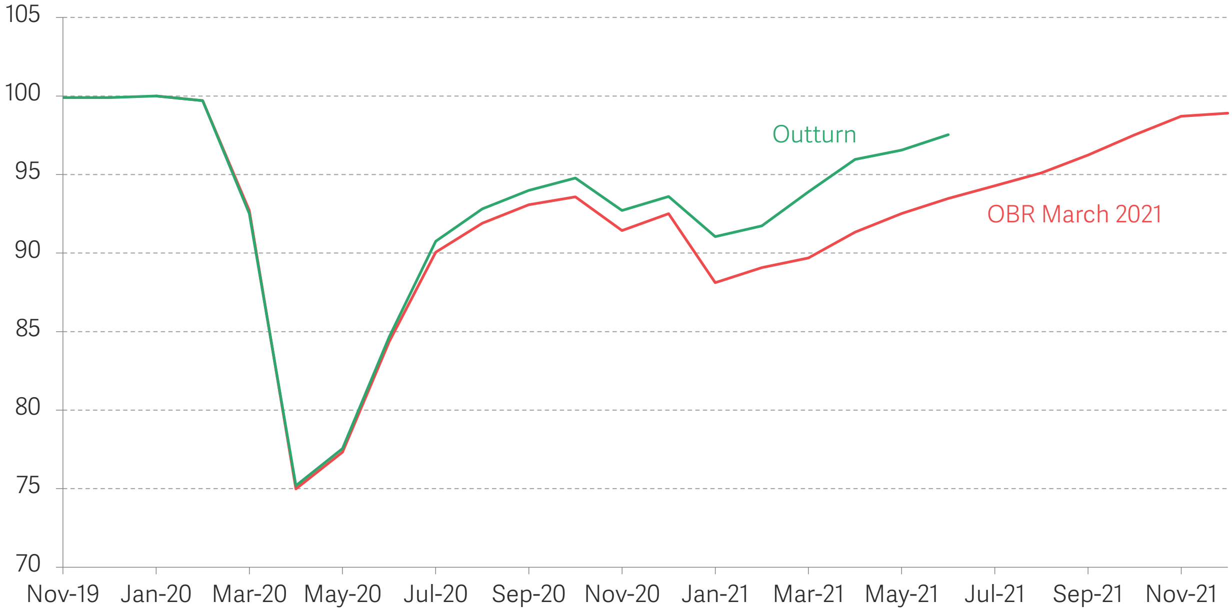
But with MPs returning to Westminster, this paper focuses on what questions the autumn has in store for the Chancellor, and what answers he may have in store for all of us. The next date in the fiscal calendar has been set for 27 October when the Office for Budget Responsibility (OBR) will publish its latest forecasts. It is unclear whether a Budget will accompany those forecasts. But with or without a Budget, big spending and taxation decisions will be taken, not least in a Spending Review that will set government spending plans through to the middle of this decade. As George Osborne showed in both 2010 and 2015, the first big spending decisions of a Parliament often shape the rest of it. Many of those decisions were delayed by the arrival of Covid-19, but the post-pandemic fiscal strategy of this Government through to the next general election will be determined this autumn.

Fortunately for the Chancellor, good news for the public finances will be the background to this autumn's decisions. The economy has recovered faster than the OBR expected in March, as Figure 1 shows. Unemployment has also fared better, falling to 4.7 per cent in Q2 2021, compared to an OBR forecast of 5.2 per cent.

1 See Figure 11 of: T Bell et al., Spending fast, taxing slow: Resolution Foundation analysis of Budget 2021, Resolution Foundation, March 2021.

FIGURE 1: **The economy has rebounded faster than the OBR expected in March**

Monthly index (January 2020 = 100) of Gross Value Added, outturn and OBR forecast: UK




NOTES: The OBR's March 2021 forecast is adjusted for the difference between the quarterly estimate of output and expenditure measures of GDP.
SOURCE: RF analysis of ONS; OBR.

Unsurprisingly, this has been matched with fiscal good news. In the short term, borrowing in 2021-22 is expected to be tens of billions less than previously forecast: in the first four months of this fiscal year the Government borrowed £78 billion – a large amount, but already £26 billion less than the OBR expected in that same period.

The longer-term outlook for the public finances is not driven by these recent developments, but by what permanent damage the pandemic does to the size of the UK economy. Here too it is likely that the Chancellor will have some good news. In March, the OBR assumed that GDP would be permanently reduced by 3 per cent relative to a world without Covid-19. That expectation is now significantly more pessimistic than most forecasters, with the Bank of England now assuming a 1 per cent hit (although this in turn is optimistic compared to recent recessions).[2] The OBR are almost certain to move in the direction of the current consensus, but how far remains to be seen, with their judgement needing to balance good reasons for thinking that permanent damage to the labour market may be less than feared with less positive news on productivity and investment. For illustration, moving from a 3 per cent scarring assumption to 1 per cent could boost long-term tax receipts by (at least) £19 billion a year.[3] Higher than expected inflation will also change the fiscal outlook, raising more money from the Income Tax (and

2 Bank of England, Monetary Policy Report - August 2021.
3 This is a simple approximation based on National Account taxes being 35 per cent of GDP (March 2021 OBR forecast for 2025-26). Tax as a share of marginal GDP might be expected to be higher.

other) threshold freezes announced in March but also increasing debt interest payments. Alongside lower spending in some areas, this could see an overall fiscal improvement in the region of £25 billion.

## But the improved fiscal position hides many smaller pressures, and the Treasury now faces a series of tough choices

As ever, improved public finances give a Chancellor more room to manoeuvre. And that would be fortunate for this Chancellor, who faces significant pressures on spending that will come to a head this autumn. The pandemic saw a Conservative Government grow the state to wartime levels, but it is the decisions this autumn that will determine the size and role of the public sector post-pandemic. Resolving those pressures will also be complicated by an awareness in the Treasury that politicians may well want to reduce some taxes (or raise some less than currently planned) in the years ahead.

On the spending side, official forecasts have been flattered by delaying some big decisions. In March, the Chancellor pencilled in lower spending for future years than had been planned pre-pandemic even though Covid-19 has directly increased the need for spending in a number of areas – from subsidies for transport networks seeing far fewer passengers to ongoing costs of vaccinating us against, and testing us for, Covid-19. Beyond the direct costs of the pandemic, the big picture is that this autumn's Spending Review will bring to a head a range of decisions about this Government's approach to public spending – on everything from social care to the net zero transition. And the Treasury's desire for post-pandemic retrenchment will need to be reconciled with a Prime Minister who wears lightly the fiscal implications of promises made, and whose political project involves marking a clean break with the austerity of George Osborne.

The Chancellor also faces pressures on the tax revenue side of the ledger. While these have less need to be resolved swiftly, an awareness that they are coming down the track will shape the Treasury's approach to the autumn ahead. The existing fiscal outlook relies on a large (from 19 to 25 per cent) Corporation Tax rise in 2023-24. This is expected to raise £17 billion a year by 2025-26 but many Conservative ministers would prefer that rise did not go ahead in full with each 1p change costing around £3 billion a year.[4] Similarly, the 'super-deduction' investment allowance theoretically expires after 2022-23, but in practice the Government may well want to maintain a similar (but less generous) allowance permanently.[5] Other pressures on the tax side include the apparent desire to

4 Original costing is: HM Treasury, Budget 2021: policy costings, March 2021, and the cost of a 1p change is from: HM Revenue & Customs, Direct effects of illustrative tax changes, June 2021.

5 The super deduction provides relief at a rate of 130 per cent. This would likely reduce to 100 per cent in any extension given that the 'super' aspect of the current policy is only required to ensure that it does not pay to delay some investments until they can be offset against the future, higher Corporation Tax rate of 25 per cent. See: J Smith, Macroeconomic Policy Outlook Q1 2021, Resolution Foundation, April 2021.

freeze Fuel Duty (which is assumed to rise each year in the fiscal forecast) and Business Rates (which the Conservative manifesto proposed to "[reduce] … via a fundamental review of the system") and perhaps further raise the starting point for National Insurance (an "ambition" in the manifesto).

Sitting beneath this big picture fiscal context are some specific, tricky, multi-billion-pound policy questions. This note focuses on five big ones that the Chancellor may well have to answer in the next few months:

1. Will he go ahead with the biggest overnight benefit cut in history?
2. How will he avoid the biggest state pension increase in decades?
3. What tax rise(s) will pay for better social care?
4. How much departmental austerity will remain?
5. Will the Treasury get serious about net zero?

## Choice #1: Will he go ahead with the biggest overnight benefit cut in history?

As the Chancellor spends the autumn trying to manage the Prime Minister's wish to spend big in a range of areas, one thing both seem to agree on is that they should avoid making that task any harder by making the £20 a week uplift to Universal Credit permanent. As a result, from 13 October, basic Universal Credit (UC) entitlements are set to fall by £87 a month as the boost introduced in April 2020 comes to an end.[6] Notifications have already been sent to claimants, alerting them that the amount they receive each month is about to change significantly.[7] The scale of the impact of this decision is hard to overstate: if the Chancellor goes ahead with this cut, it would be the largest overnight benefit reduction that has ever happened. That should give policy makers reason to pause as to whether this is a good idea – politically, economically or morally.

### The end of the uplift would be the biggest overnight benefit reduction ever

On an annual basis, the reduction will – for now – take around £5 billion a year from the 4.4 million households that currently benefit from UC.[8] This figure does not include the change that has already taken place for those in work on tax credits, who had a cut

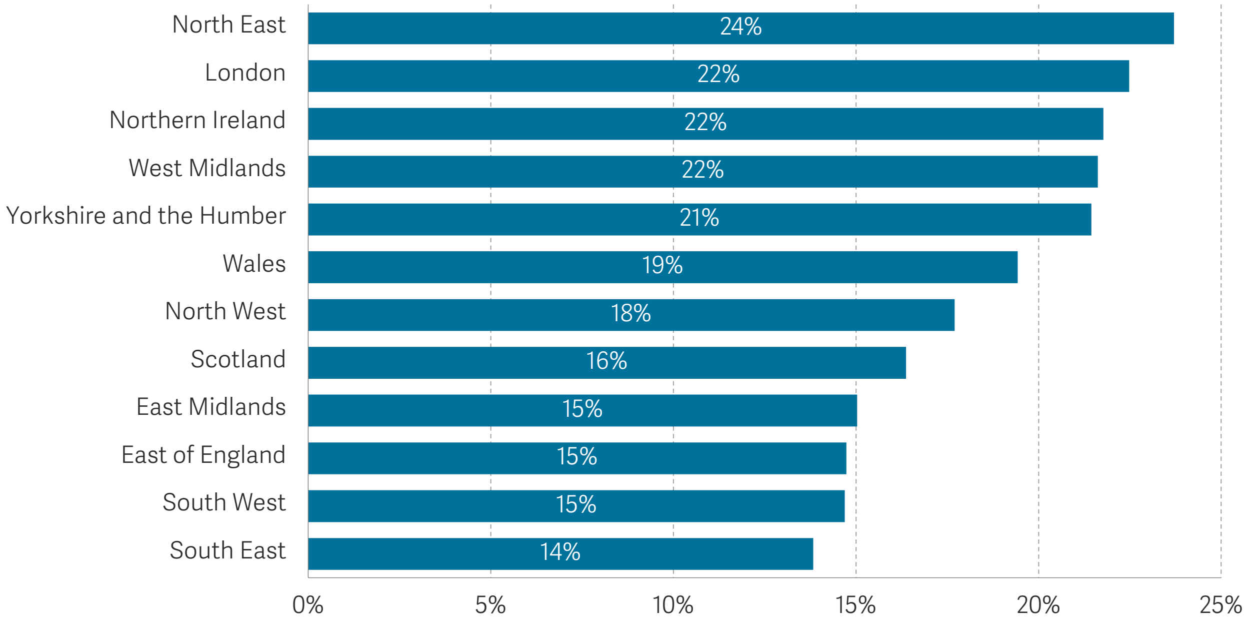
6 The £20 a week boost applies to UC assessment periods that end before 6 October. However, in most cases payments are received seven days after the end of assessment periods. The fall in payments will therefore happen on 13 October, with some people – those whose payment date is before the 13th – not feeling the impact until November.
7 Letter from Will Quince MP, July 2021.
8 Note that throughout this analysis we exclude households not in payment, and make an upwards adjustment to convert GB figures to a UK basis. GB figures are available at: Department for Work and Pensions, Universal Credit statistics, 29 April 2013 to 8 July 2021, August 2021.

in their regular tax credit income in April but who received a £500 bonus in April (the equivalent of £20 a week from April through September). In the longer term, as tax credits and other benefits are phased out and so more people move onto UC, the impact of the £20-a-week UC decision will grow to around £6 billion a year, with around 6.3 million households receiving UC at any one time.[9]

This would be a wide-ranging benefit cut. Within those 4.4 million households, there are 5.1 million adults (one-in-ten of the UK total) and 3.5 million children (one-in-four).[10] From the perspective of MPs, this averages at around 8,000 adults and 5,000 children per Westminster constituency. In large parts of the UK – the North East, Yorkshire and Humber, the West Midlands, Wales, and London – over one-in-five non-pensioner households will be worse off by £1,000 a year than if the boost were maintained. [11]

FIGURE 2: **Over a fifth of households in some regions will be £1,000 a year worse off if the boost is ended**

Proportion of non-pensioner households set to lose over £1,000 in Universal Credit: UK, 2021-22




NOTES: Losses are relative to a counterfactual of the benefit boost being maintained.
SOURCE: RF analysis of DWP, Family Resources Survey, using the IPPR tax-benefit model.

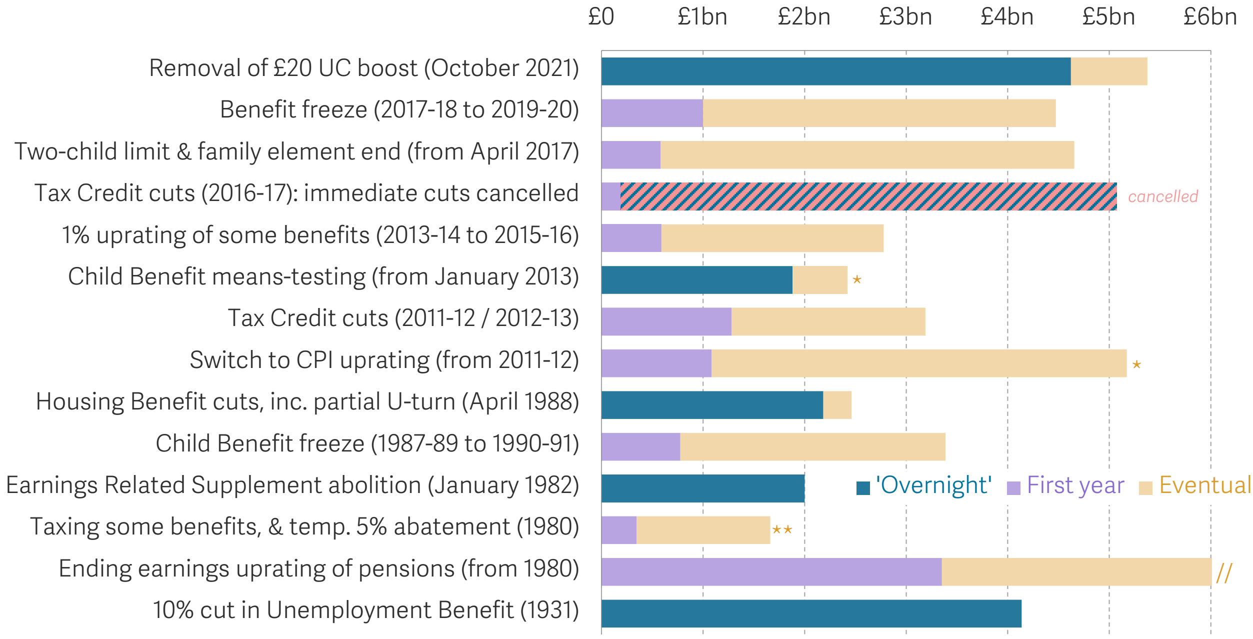
And what is so striking about this benefit cut is it that it will happen (in effect) overnight. Figure 3 compares the savings from this cut comparing to other major benefit reductions. In recent years the 'two-child limit' and the abolition of the 'family element'

9 In nominal, 2025-26, prices. The DWP forecasts 5.9 million UC cases in 2025-26, up from 4.3 million in 2021-22.
10 'Household' here more precisely refers to benefit units, and there will be more people who are indirectly affected as they share a house with a single person or couple on UC.
11 This updates the analysis in: T Bell, A Corlett & K Handscomb, Death by £1000 cuts? The history, economics and politics of cutting benefits for millions of households next April, Resolution Foundation, October 2020, which additionally looked at the losses from not continuing with the Working Tax Credit boost.

have also been major benefit cuts. But these changes only applied to new applicants: they began in April 2017, but their phase-out will continue into the 2030s. Freezes in benefit rates or switches to inflation rather than earnings uprating in the 1980s and 2010s have also saved substantial sums for the Treasury, but have taken place over several years and – by definition – do not involve reductions in nominal incomes.

FIGURE 3: **The £20 reduction would be one of the largest ever benefit reductions overall, but also perhaps the biggest to happen overnight rather than being phased in**

Annual scale of historic benefit reductions, in 2021-22 terms (adjusted using nominal GDP): UK




NOTES: 20th century costings (particularly those for 1931, the Child Benefit freeze and State Pension uprating) should be treated as approximate at best given the limited sources available. The effect of the UC reduction grows as the roll-out of UC continues. The £6 billion UC figure mentioned elsewhere is nominal. 2016-17 benefit freeze not included as this did not raise any money. * = The impact of these cuts will grow indefinitely, but the impacts shown are for 2021-22. ** = Technically a tax rise. // = axis cut off.
SOURCE: OBR, Policy measures database, April 2021; RF analysis of DWP, Family Resources Survey, using the IPPR tax-benefit model; Hansard; The May Report, 1931; Bank of England, A Millennium of Macroeconomic Data; OBR, Economic and Fiscal Outlook, March 2021.

The one benefit cut that comes close would have been the cuts to tax credits planned for April 2016 and announced by George Osborne, but that change was cancelled as the scale of losses loomed (aided by an improved fiscal outlook).[12] In the New Labour years, the lone-parent (premium) benefit cut in 1997 was significant for many families, but not of the same scale as the reductions in Figure 3. The package of Housing Benefit cuts in April 1988 did amount to a big overnight benefit cut, but some U-turns and the downfall of John Moore (then the Secretary of State responsible) followed, and this was only half the size of the planned UC reduction. Relative to GDP – which Figure 3 adjusts for – the

12 The equivalent cuts to UC did mostly go ahead, eventually, though there was a partial reversal under Philip Hammond.

only similarly-sized overnight benefit cut came amid the Great Depression in 1931 as the UK left the Gold Standard and implemented a deficit reduction package included cutting unemployment insurance benefits by 10 per cent. Relative to today's GDP, this cut may have reduced spending by £4 billion, although this figure is highly uncertain. Notably, though, the cut contributed to the collapse of the then Labour Government and was reversed a few years later.

While others have noted that this is the biggest cut to the basic rate of social security since World War Two,[13] this analysis points to it being even more unprecedented. We believe the UC reduction is quite possibly the largest overnight reduction in benefit support ever in GDP terms, and certainly the largest in real terms.[14]

## For the bottom half of the income distribution, the October UC reduction will be an income hit on a scale only normally seen in recessions

As well as considering the scale of the benefit cut relative to previous cuts, we can also consider it against other changes in household incomes. Even excluding the expiry of the £1,000 a year boost to Working Tax Credit that has already taken place, the total disposable income of the poorer half of the non-pensioner population will be reduced by around 2 per cent. Annual income falls on that scale are generally confined to recessions, as shown in Figure 3. And this fall will stand in stark contrast to the experience of poorer households in the depths of this crisis in 2020, when incomes may – remarkably – have grown for the poorer half of non-pensioners, in substantial part thanks to benefit boosts.[15]

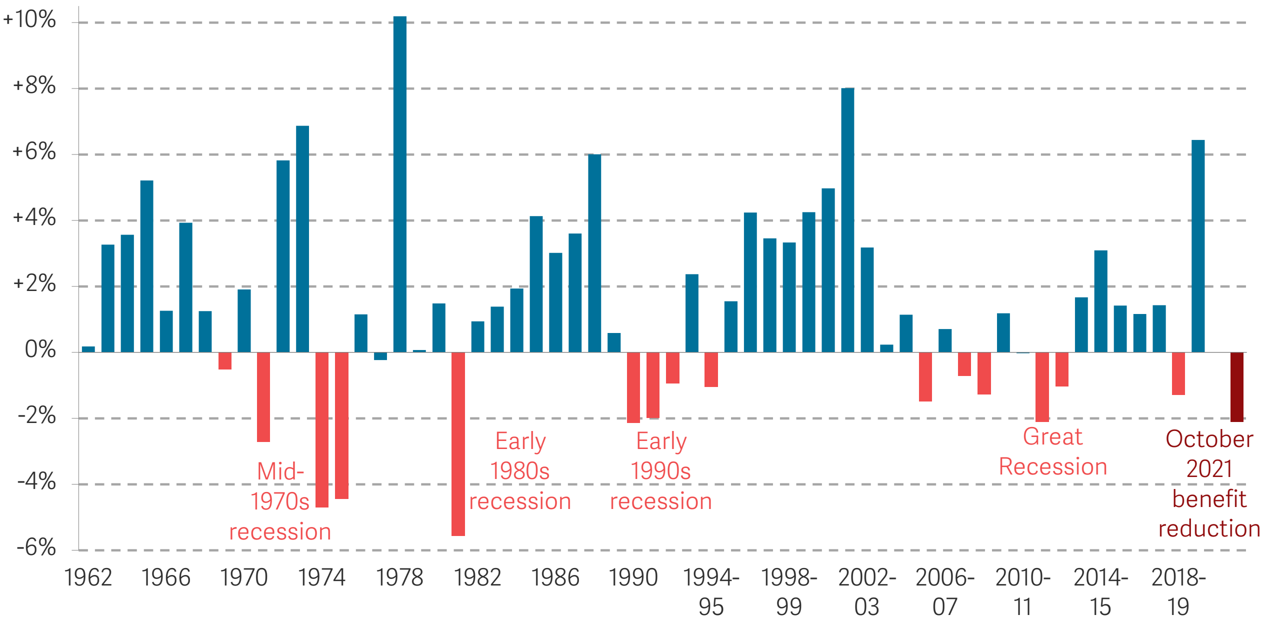
13 Joseph Rowntree Foundation, UK heading for the biggest overnight cut to the basic rate of social security since World War II, July 2021.

14 The Treasury might say that the £20 increase was always described as a temporary boost, and so letting it expire is not a 'cut' in the same way as previous policies. But that is not much comfort to those families receiving UC, many of whom are doing so only because of the pandemic, and who will have no experience of a lower level of support. (As of July 2021, 31 per cent had been on UC less than a year, and 73 per cent less than two years, with over a million households joining UC in April 2020.)

15 K Handscomb, K Hathleen & L Try, The Living Standards Audit 2021, Resolution Foundation, July 2021.

FIGURE 4: **Removing £5 billion from lower-income households will be a loss comparable to annual income falls during recessions**

Real (CPI-adjusted) growth in average equivalised household disposable income, after housing costs, for the poorer half of non-pensioners: UK/GB




NOTES: Some historic income falls may simply be noise. October 2021 figure shows the impact of the UC reduction only. Based on GB data for 1994-95 to 2001-02. Uses a version of CPI that excludes all housing costs.
SOURCE: RF analysis of DWP and IFS, Households Below Average Income; RF analysis of DWP, Family Resources Survey, using the IPPR tax-benefit model.

The timing of this income shock is also problematic, coming as the Job Retention Scheme comes to an end, and in an autumn that will see an increase in the energy price cap, which may increase typical bills by £139 a year, and rising inflation (consumer price inflation may reach as high as 4 per cent).[16] The economy might be recovering now, but this autumn will not feel like one at all for millions of families.

## The majority of affected households will lose over 5 per cent of their disposable income, and 1 million will lose over 10 per cent

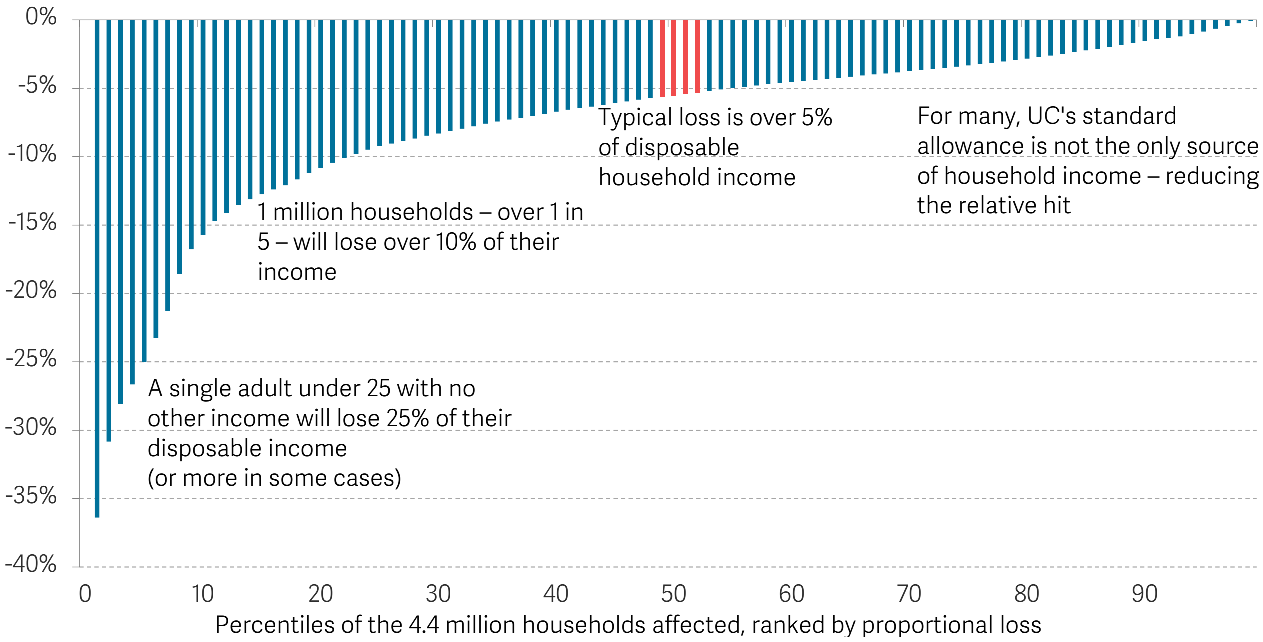
We showed above that the UC reduction will have a big impact on the overall (non-pensioner) income distribution, but those averages hide the direct effect on household affected. For the 4.4 million households affected, the typical loss will be over 5 per cent of disposable (after housing costs) income, and for 1 million households (one-in-five of those affected) losses will be over 10 per cent of their income (see Figure 5). For some,

16 See: S Read, Energy bills to rise by at least £139 for millions of households, BBC News, August 2021; J Smith, Macroeconomic Policy Outlook Q2 2021, Resolution Foundation, June 2021.

the losses are even larger: a single adult aged 25+ with no other income will lose a fifth of their income, while one aged under 25 will lose a full quarter.[17]

FIGURE 5: **Among those currently receiving UC, the typical loss in October will be over 5 per cent of disposable income, but 1 million households are set to lose over 10 per cent of their income**

Distribution of losses (after housing costs) from the £20/week reduction in October 2021, among those receiving UC: UK




SOURCE: RF analysis of DWP, Family Resources Survey, using the IPPR tax-benefit model.

This decision will help determine this Parliament's living standards record for lower income households. We showed at the start of this year that keeping the uplift would double the projected disposable income growth for the poorer half of the non-pensioner population, from 3 per cent to 6 per cent over the whole Parliament (assuming that market incomes grow in line with the OBR's 'upside' scenario from November 2020).[18]

## There are options to reduce the cost, but the crisis has shown that basic support simply isn't high enough

The Government could – and should – choose instead to make the uplift permanent, at an eventual cost of around £6 billion a year. The fairest approach would be for this to apply not just to UC, but also to tax credits, and to the legacy benefits that have so far been excluded.

17 Some in-work households will no longer receive UC at all as a result of the change. This will mean a small number of households in Scotland will lose entitlement to the £10 per week (per child) Scottish Child Payment (due to the way this payment is passported). It is theoretically possible that a family with two children might therefore lose £40 a week from October (£20 from the UC uplift and £10 per child from the Scottish Child Payment).

18 M Brewer et al., The Living Standards Outlook 2021, Resolution Foundation, January 2021.

And the choice is not simply between keeping the uplift or not. For those who recognise that the previous level of benefits was too low but think a £20 increase is too much, an alternative would be to keep the boost but to then freeze the (boosted) basic entitlements. Aided by a higher inflation forecast, the (real) size of the uplift would gradually halve by 2025-26 (see Figure 6). The cost would also halve to £3 billion a year. This would avoid anyone experiencing falls in their cash income; fiscal policy would become more supportive of the recovery; and some long-term progress would be made in raising the safety net. Yet this middle way would still leave basic out-of-work support at low levels historically, and would sit alongside the new Housing Benefit freeze[19] and ongoing two-child limit and family element abolition: this Parliament would hardly be considered a benefits bonanza.

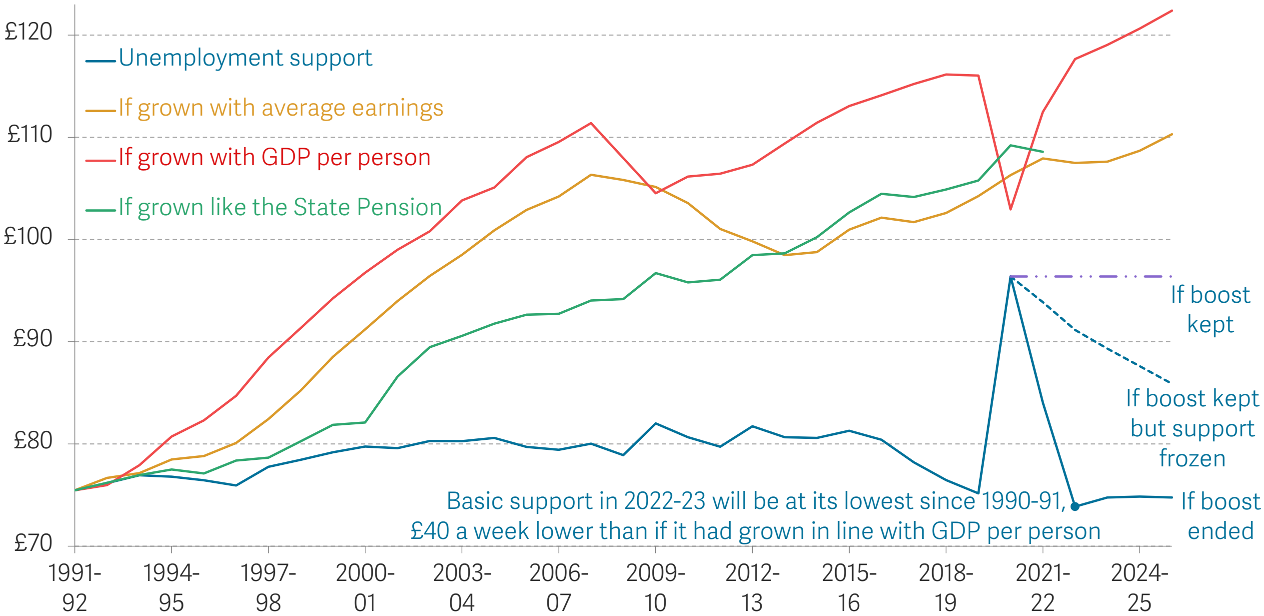
Stepping back, the underlying logic for the £20 uplift remains as strong as ever: basic out-of-work support is simply not generous enough. Even with the boost, basic support is far from sufficient to take people out of absolute poverty.[20] With it, a single adult without children might have an income equal to only 42 per cent of the Minimum Income Standard: this would fall to 33 per cent without it.[21] Before the boost was introduced, over 40 per cent of those on UC were 'food insecure'.[22]

Back in March 2020, the Chancellor declared that the emergency welfare measures delivered "a significantly strengthened safety net", particularly benefiting "our most vulnerable households".[23] Ultimately the case for that same Chancellor thinking again on the biggest overnight benefit cut in history is the same: if the reduction goes ahead, basic out-of-work support will be its lowest level in real terms since 1990-91, as Figure 6 shows, and its lowest ever relative to earnings.

19 This freeze is similar, in that it follows an April 2020 boost to housing support, but the freeze is not time-limited so will eventually more than cancel out the initial boost.
20 D Tomlinson et al., The Living Standards Audit 2020, Resolution Foundation, July 2020.
21 A Davis et al., A Minimum Income Standard for the United Kingdom in 2021, Joseph Rowntree Foundation, July 2021.
22 Department for Work and Pensions, Family Resources Survey: financial year 2019 to 2020: Household Food Security in the United Kingdom, March 2021.
23 HM Treasury, The Chancellor Rishi Sunak provides an updated statement on coronavirus, March 2020.

FIGURE 6: **If basic benefit support had risen in line with GDP per capita since 1991-92, rather than falling, it would be £40 higher than planned in 2022-23**

Real unemployment support (CPI-adjusted), outturn, projected and counterfactual: UK




SOURCE: RF analysis of ONS; IFS, Fiscal Facts; OBR, Economic and Fiscal Outlook; Bank of England, Monetary Policy Report - August 2021.

## Choice #2: How will he avoid the biggest state pension increase in decades?

At the same time as the UK faces the biggest benefit cut ever, the combination of the triple lock system of pension uprating with the vagaries of statistical measures of average earnings mean there is the potential for a historically-large state pension increase in April 2022. Given the potential costs and inequities involved, Rishi Sunak has given a clear steer that the pension triple lock won't operate in its usual way this year.[24] But exactly what happens remains to be seen – with significant implications for pensioners and the public finances.

### Average earnings growth may exceed 8 per cent but this does not reflect the reality of what is happening to people's earnings

The 'triple lock' involves the basic state pension being increased by whichever of three components is higher:

1. Inflation, based on annual growth in the CPI series in the previous September;
2. 2.5 per cent; or
3. Earnings growth, normally based on 'total pay' (including bonuses), in the Office

24 The Guardian, Rishi Sunak hints at suspension to pension triple lock, July 2021.

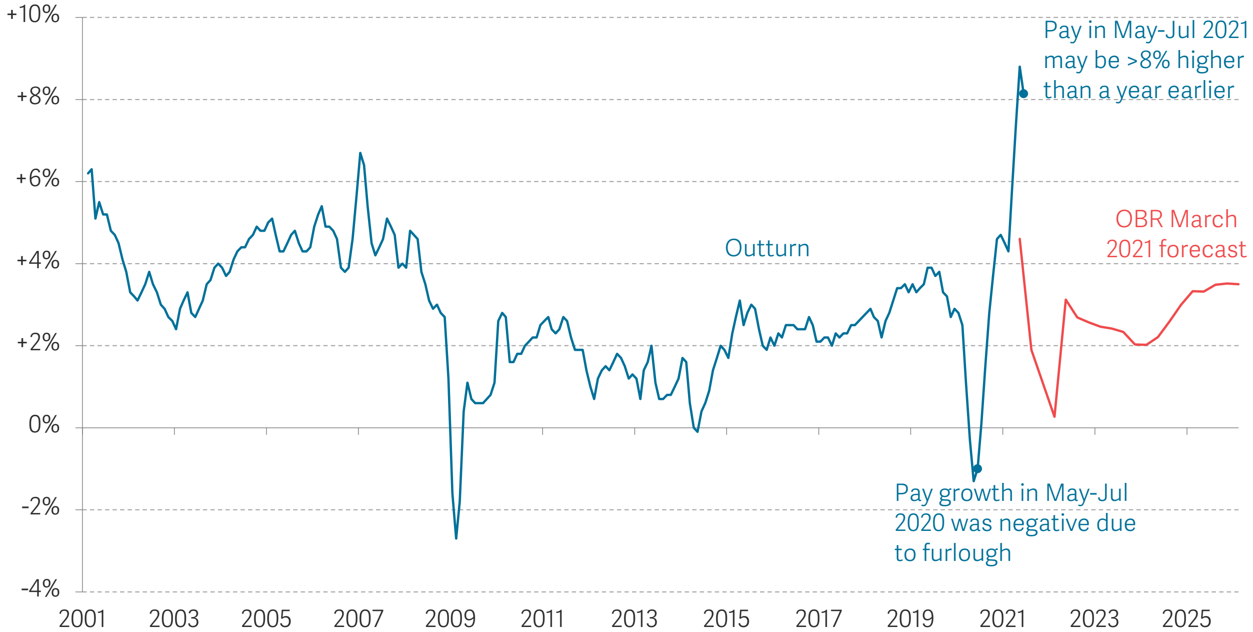
for National Statistics' (ONS's) Average Weekly Earnings (AWE) data, measured for May-July in the previous year.

The case for this approach is that the basic level of the state pension is too low, so that a ratchet whereby pensions grow faster than earnings over the long-term is desirable. But whatever your view about that long-term objective, the operation of the triple lock this year leaves a lot to be desired, as we warned would be the case as long ago as June 2020.[25]

This is because average pay statistics are being exceptionally distorted by the pandemic's impact on the labour market. The ONS's figures for annual pay growth recorded in May-July 2021 are distorted by what was happening in May-July 2020 – when average pay levels were temporarily very low thanks to nearly 10 million workers being furloughed with up to a 20 per cent pay cut. On top of this, the fact that those jobs that have been lost through the pandemic have been concentrated amongst lower earners has mechanically boosted the average earnings of those who remain in employment. It is as a result of these two effects, rather than because those in work are seeing significant earnings growth, that annual pay growth reached 8.8 per cent in April-June, and is expected to remain above 8 per cent in the May-July figures.[26]

FIGURE 7: **8 per cent annual pay growth is likely to be very transient, partly reflecting circumstances in mid-2020**

Nominal annual growth in average total pay: UK/GB



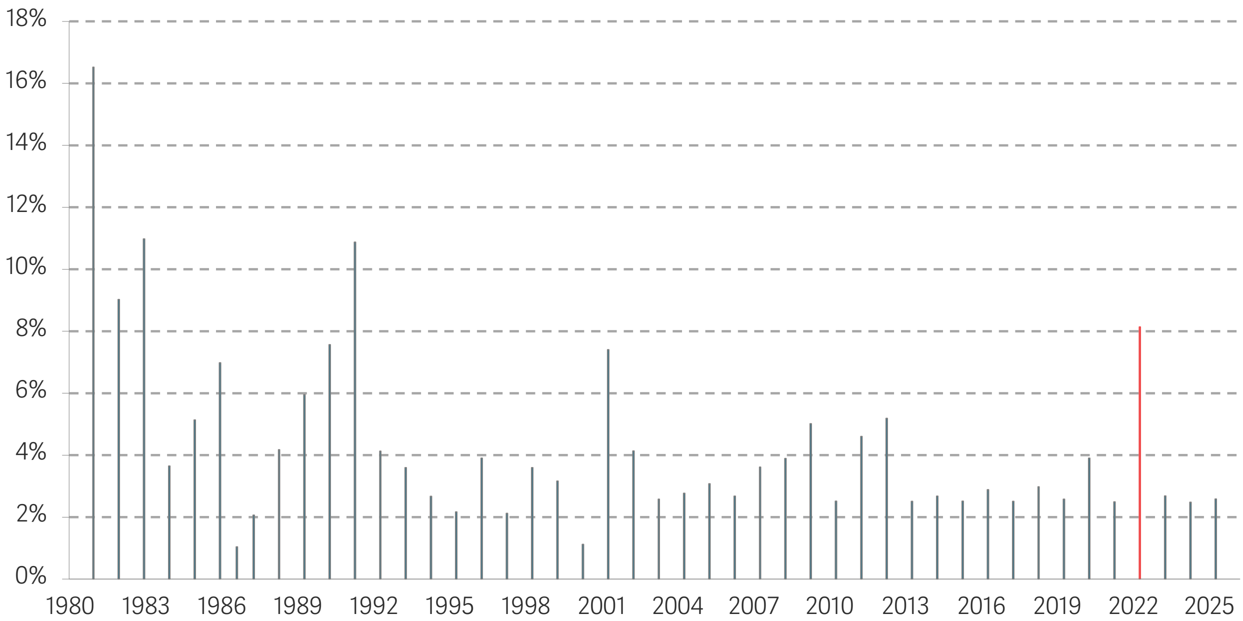

NOTES: GB outturn; UK forecast. Rough projection of 8.1 per cent shown for May-July 2021.
SOURCE: ONS and OBR.

25 T Bell & L Gardiner, Locked in? The triple lock on the State Pension in light of the coronavirus crisis, Resolution Foundation, June 2020.
26 If average total pay were the same in July as June, and there are no revisions, pay growth would be 8.1 per cent.

Following the usual operation of the triple lock would therefore see a nominal state pension increase of over 8 per cent, the largest since April 1991 (when inflation went above 8 per cent), and narrowly topping the 7 per cent increase that occurred in April 2001 (when pensions rose by £5 a week, following the '75p' scandal). This would take the Basic State Pension (for men born prior to April 1951 and women born prior to April 1953) from £138 to £149 a week in April 2022, and the New State Pension (for later cohorts) from £180 to £194. In real terms the 2022 increase would also be the largest for decades.

FIGURE 8: **An 8 per cent pension rise would be the fastest nominal growth in over thirty years**

Monthly nominal percentage change in the State Pension: UK



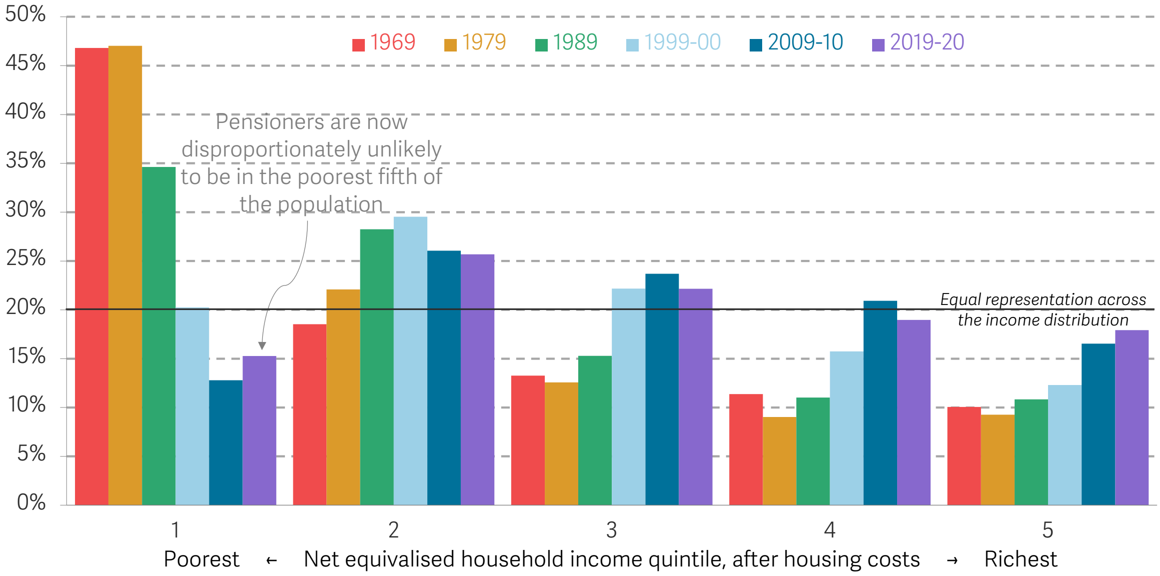

NOTES: Rough projection of 8.1 per cent shown for 2022.
SOURCE: RF analysis using IFS and OBR.

## BOX 1: **The position of pensioners in the UK's income distribution**

Like any benefit increase, state pension increases are inequality-reducing overall. But, whereas pensioners were once concentrated at the bottom of the income distribution, they are now less likely than the rest of the population to be relatively poor: the poverty rate for pensioners in 2019-20 was 18 per cent, compared to 22 per cent overall and 31 per cent for children (Figure 9). There are now fewer pensioners in the bottom 20 per cent of society than there are in the top 20 per cent.

FIGURE 9: **Pensioners are no longer concentrated at the bottom of the household income distribution**

Proportion of pensioners in each quintile of the overall household income distribution, after housing costs: UK/GB




NOTES: GB in 1999-00.
SOURCE: RF analysis of DWP and IFS, Households Below Average Income.

## There are a few options to get around the default triple lock

Given the disconnect between average earnings growth figures and what is happening to actual workers' earnings, the Chancellor has made it fairly clear that he will not go ahead with such large pension increases. In July, he told the BBC: "The triple lock is government policy but I recognise people's concerns about what that might mean", promising to take a decision based on "fairness for both pensioners but also for taxpayers."[27]

He is right to avoid these distorted figures feeding through to state pension uprating. But he has a range of options in how he does so, some of which may even be seen to follow the spirit of the triple lock (and the legislative requirement for earnings uprating). These include:

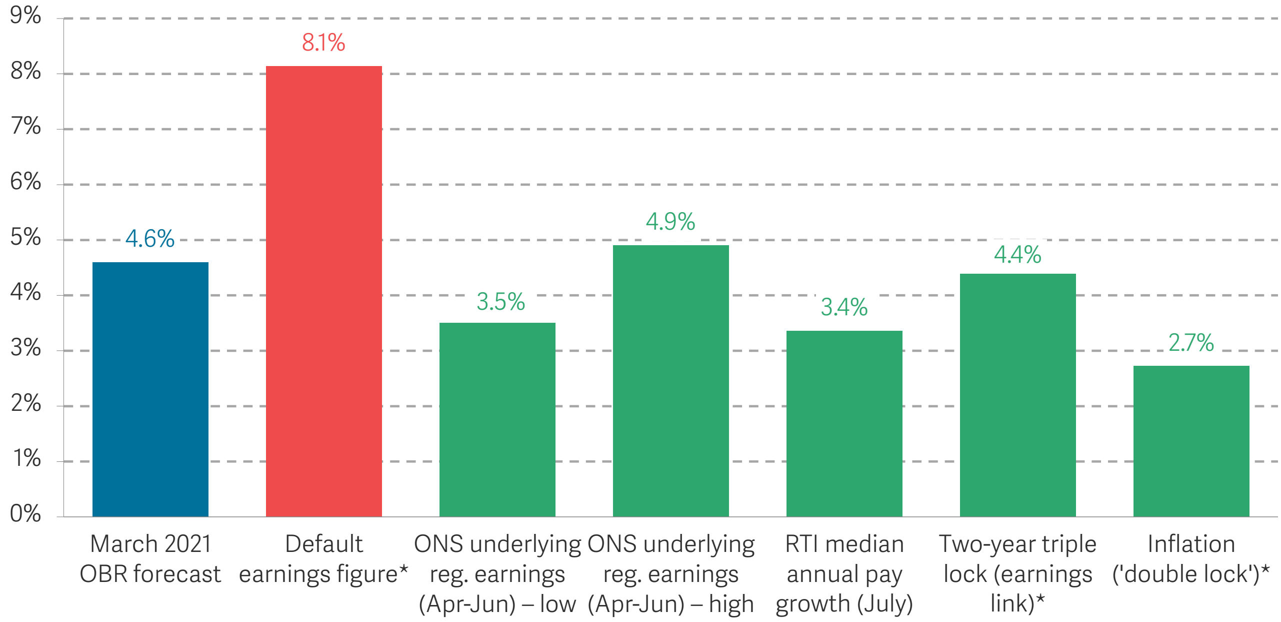
1. For this year, an alternative measure of earnings could be chosen that isn't affected by the same problems as the usual measure;
2. The triple lock could apply over two years rather than one, which in practice would mean ensuring that the pension has risen enough over the past two years to keep pace with earnings; or
3. A 'double lock' could apply this year, excluding earnings. This would mean the state pension increasing in line with inflation.

27 BBC News, Chancellor Rishi Sunak hints at ruling out 8% pension rise, July 2021.

We show these and other uprating options in Figure 10. Inflation in September is expected to be around 3 per cent. Based on average earnings figures so far, a two-year earnings link would require a pension increase of around 4.4 per cent next year. And there are a range of alternative earnings growth figures that could be used, including tax-system data showing how actual pay has typically grown for the continuously-employed (3.4 per cent in the year to July)[28] and ONS estimates for 'underlying' average earnings growth (between 3.5 and 4.9 per cent).[29]

FIGURE 10: **The default measure of earnings growth is likely to be over 8 per cent, but sensible alternative measures for uprating State Pensions are likely to be around 3-5 per cent**

Estimated growth in possible State Pension uprating metrics




NOTES: * = Rough projections, if average total pay were the same in July as June and there are no revisions, and September inflation matches the Bank of England's Q3 forecast.
SOURCE: RF analysis of OBR; ONS; Bank of England.

## The pension uprating choice will have important fiscal consequences

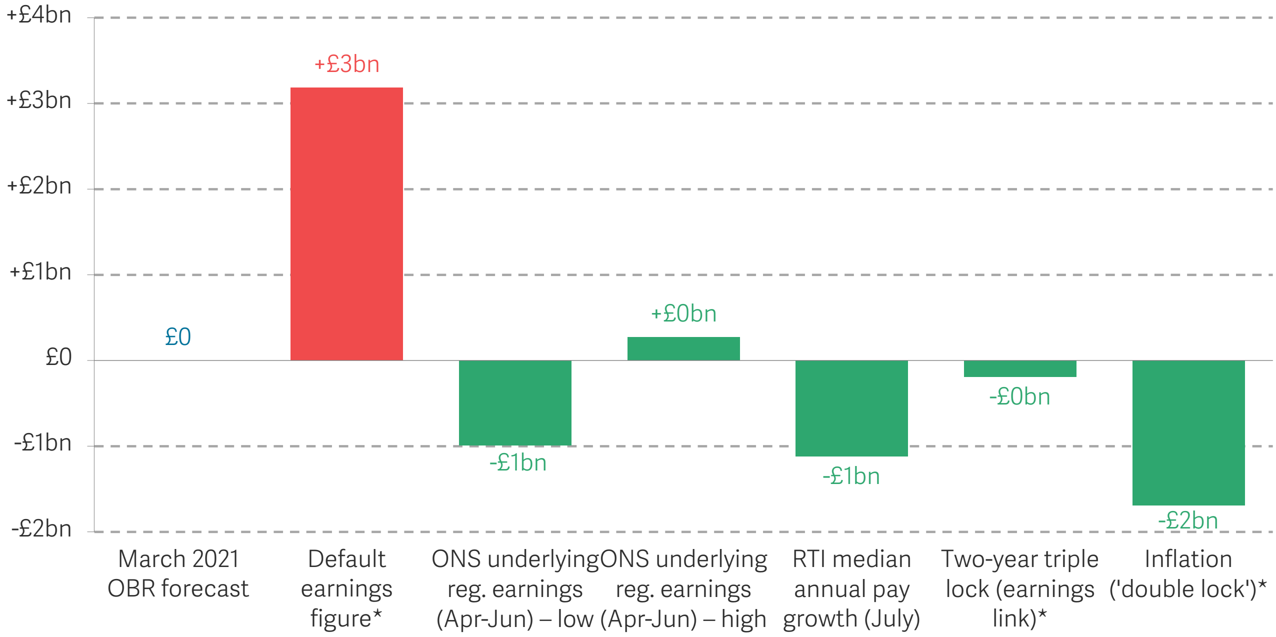
Estimates of what each of these uprating options would mean for the public finances are shown in Figure 11. Given that the OBR's March fiscal forecast assumed a pension rise of 4.6 per cent (because they forecast weaker average earnings growth than we have seen), the options here would not save huge sums relative to that forecast. But relative to 8 per cent uprating, the choices could save a significant £3-4 billion a year. When set alongside the other challenging choices in this report, it's clear that the real decision facing the Chancellor is less whether he ditches a literal interpretation of the triple lock, but how he

28 ONS, Earnings and employment from Pay As You Earn Real Time Information, UK: August 2021.
29 ONS, Average weekly earnings in Great Britain: August 2021.

does so. With plenty of options on the table, a pension rise of 3 to 4 per cent next April is more likely than the biggest rise in decades.

FIGURE 11: **An extra £3 billion a year may need to be spent if the 8 per cent earnings growth figure is used, relative to the March Outlook, but alternative measures could provide a small saving for the Government**

Fiscal impacts of uprating options, relative to the March 2021 OBR Outlook: UK




NOTES: * = Rough projections, if average total pay were the same in July as June and there are no revisions, and September inflation matches the Bank of England's Q3 forecast.
SOURCE: Costings based on OBR, Fiscal risks report, July 2021.

## Choice #3: Which tax rise(s) will pay for better social care?

In June 2019 the Prime Minister said "My job is to protect you or your parents or grandparents from the fear of having to sell your home to pay for the costs of care and so I am announcing now – on the steps of Downing Street – that we will fix the crisis in social care once and for all with a clear plan we have prepared to give every older person the dignity and security they deserve."[30]

Two years on that plan is, reportedly, about to be announced, along, perhaps, with additional spending for the NHS to allow it to recover from Covid-19 (with the NHS Confederation saying that £10 billion is needed to cope with the ongoing challenge of Covid-19, and to start to reduce waiting lists). And the challenge is not just about how much extra to spend on social care, but how to raise it.

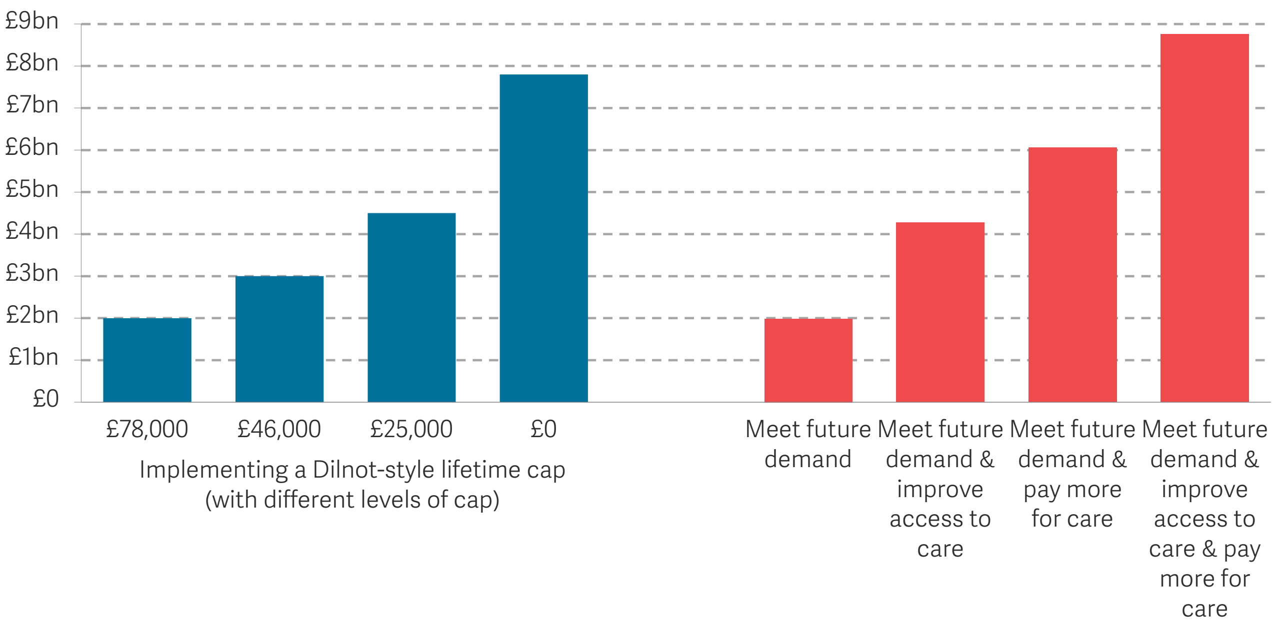
30 gov.uk, Boris Johnson's first speech as Prime Minister: 24 July 2019

## Substantial spending increases will be needed to 'fix the crisis in social care'

'Fixing' social care is likely to require new spending in multiple areas: none of them cheap. Implementing a cap on total costs, as recommended in the Dilnot review, and which is the Prime Minister's priority, could cost £2 billion in England with a £78,000 cap, according to the Health Foundation.[31] A lower cap would obviously cost more. A cap is highly desirable, but other calls on resources within the social care system are an even higher priority. In particular, more spending is needed to reduce the disgraceful level of unmet care needs. Simply meeting demand increases will cost several billion, as would improving access to care, such as by raising the means-tested savings threshold. And actually improving the quality of care – and the pay of workers – would cost still more. [32] It is not hard to imagine care absorbing an additional £10 billion in England by 2023-24 (the total cost to the UK Government may be higher reflecting Barnett consequentials for the devolved administrations and some suggestions that action on social care may be part of a wider health package also aiming to help clear NHS backlogs in the shorter-term.[33])

FIGURE 12: **Adequate funding as well as a cost cap could require between £4 billion and £16 billion a year (in England alone)**

Estimated additional social care funding requirements, 2023-24: England




NOTES: the cap's costs would be low until a significant number of people reach the cap; this is not reflected here.
SOURCE: O Idriss et al, Social care funding gap: our estimates of what it would cost to stabilise and improve adult social care in England, The Health Foundation, February 2021.

31 O Idriss et al, Social care funding gap: our estimates of what it would cost to stabilise and improve adult social care in England, The Health Foundation, February 2021.
32 N Cominetti, L Gardiner & G Kelly, What happens after the clapping finishes?, Resolution Foundation, April 2020.
33 Financial Times, Rishi Sunak draws up tax-raising options to fund English social care, July 2021.

## Increasing National Insurance is popular and broadly progressive, but means older cohorts and those with wealth pay nothing

The scale of additional spending required means that the Treasury is keen that it is funded by increases in taxation. The relative ease with which such an increase can be presented as specifically hypothecated for social care reform also means that this is the one area where this autumn is likely to be about tax as much as spending.

The Government's preferred revenue raiser is an increase in National Insurance (NI) rates. It's not hard to see why. It could readily raise significant sums (a 1p rise in NI for employees, employers and the self-employed would raise £13 billion a year in 2024-25). The fact that half of the tax rise comes via employers makes the scale of the increase less visible than a broadly equivalent 2p rise in income tax, even though ultimately workers are likely to bear a good amount of the incidence of the employer NI rise via lower pay. And the move has public support (at least in theory) – with polls suggesting that 64 per cent support, and 18 per cent oppose, a one percentage point NI rise "to help pay for social care reform".[34] There are reasons why we have a long history of NI increases (with 1p rises in all NI rates in both 2011-12 and 2003-04) while the basic rate of Income Tax has not increased since 1975.

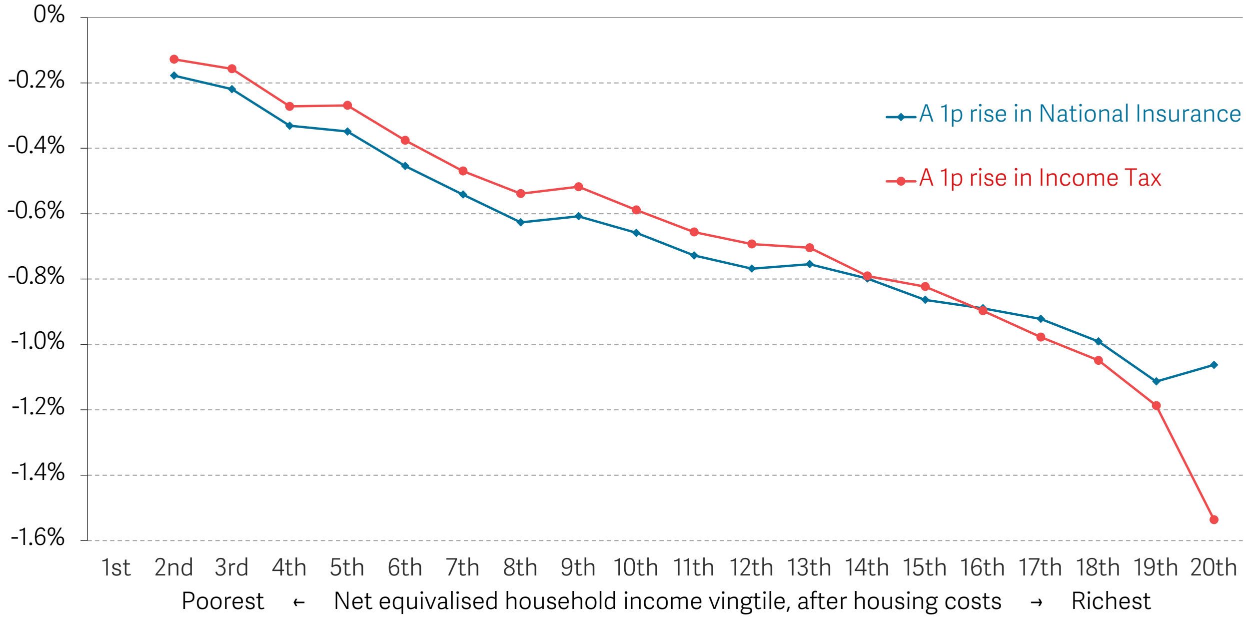
However, it is a deeply sub-optimal way to raise the revenue.[35] Most importantly, it doesn't cover all people (with those over 66 exempt), it doesn't cover all income (all income sources except earnings are exempt) and it can reinforce the under-taxation of the self-employed relative to employees that is causing real problems in our labour market (because there is no equivalent to employer NI for self-employed earnings).

An increase in NI would be progressive, but it would be less so than a rise in Income Tax, as Figure 13 shows.[36] This partly reflects the exemptions of types of income that higher income households are more likely to rely on (such as dividends or rental income). NI (starting at around £9,600 this year) also affects more low earners than Income Tax (starting at £12,570). Similarly, for a worker on £20,000 a year, a 1p NI increase would currently mean a tax rise of £104 a year, whereas a 1p Income Tax rise would cost them £74. The progressivity also obscures the aforementioned horizontal inequalities of age and income form that are impossible to justify.

34 Ipsos MORI, Two in three support increasing national insurance for social care reform or to reduce NHS backlog, August 2021.
35 T Bell & A Corlett, A caring tax rise?: the impacts of a potential increase in National Insurance, Resolution Foundation, July 2021.
36 While for simplicity the modelling above is presented on a UK wide basis it is important to note that there are big differences in how the two different ways of raising revenue would interact with the UK's devolution settlement because NI is a reserved UK government tax, but Income Tax is substantively devolved. For more detail see D Eiser, Funding a rise in social care spending England: implications for taxpayers in Scotland and rUK, September 2021.

FIGURE 13: **A rise in National Insurance would be progressive overall, but less so than an equivalent Income Tax increase**

Impact on average household disposable income of raising all personal National Insurance or Income Tax rates by 1p, 2024-25, by vingtile: UK




NOTES: Impacts are relative to disposable incomes after housing costs. Income Tax rise includes an increase in dividend tax rates. National Insurance rise does not include any changes in employer National Insurance. We exclude the bottom 5 per cent, due to concerns about the reliability and volatility of data for this group.
SOURCE: RF analysis of DWP, Family Resources Survey, using the IPPR tax-benefit model.

## If NI is to rise, there are a number of steps that could make it fairer

Through its inequities, increasing NI could both be unfair and increase one of the big problems for the UK's tax system: distortions caused by different treatment of different forms of income. But if the Chancellor is set on increasing NI, there are a number of ways in which an NI increase could be fairer and less distortionary (with the common theme being that they aim to make an NI more like an Income Tax increase):

1. If employees are to be affected both directly by a 1p employee contribution rise and indirectly by a 1p employer contribution rise, self-employed rates should rise by 2p rather than 1p.[37] This would raise around £0.5 billion more.
2. To avoid increasing distortions between sources of income, dividend tax and CGT rates could also be raised by up to 2p, with the former raising £1.5 billion and the latter £0.4 billion.
3. The inequity by age could be addressed by working pensioners starting to pay

37 As a share of labour costs, employee and employer NI rate rises would not be purely additive and so the combined rate rise may be slightly less than 2 percentage points. However, this is a relatively minor distinction, and in the case of the self-employed much larger rate rises would be theoretically justified.

personal NI at the rate of 1 per cent, which could raise around £0.1 billion.[38]

4. The personal NI threshold could be raised to offset the small loss for the lowest earners. For illustration, a £250 threshold rise (potentially taking the total to around £10,000) would more than cancel out a 1 per cent rate rise for those earning below around £13,000. This would cost the best part of £1 billion.

5. NI could be made annual and aggregated across jobs – like Income Tax – removing some related unfairness, such as those with temporarily low income being overtaxed overall and those with large bonuses undertaxed.[39] This would likely raise revenue overall.

The Chancellor is lucky that there is public support for some tax rises to pay for social care, but he should still strive to ensure tax rises are fair between different generations and different sources of income. Our suggested package of measures would substantially improve upon an approach narrowly-focused on raising NI rates, although it would not deal with the single biggest unfairness: that (non-working) pensioners would not contribute anything towards the cost of the improved social care system they would be the most immediate beneficiaries of.

## Choice #4: What changes will he make to departmental spending plans in both the short-term and long-term?

The Spending Review, likely to take place in late October, will be a big moment for the Chancellor and for the country. It is the first time since 2015 that full, multi-year, spending settlements for departments will be set out, and is the first time that this Government will be able to demonstrate in full its post-pandemic and post-Brexit strategy for the size and role of the state.

In March, an indicative path for total departmental spending to the middle of the decade was outlined by the Chancellor, but in the October Spending Review final plans for the overall level of spending will need to be confirmed, and detailed department-by-department budgets set for 2022-23 to 2024-25. This will take place for both capital and resource (day-to-day) budgets: we focus here on resource spending as the big decision around the overall size of the capital envelope has been made, even if individual departmental capital budgets are yet to be allocated in full.[40]

It is convenient to think about the decisions facing the Chancellor as two distinct

38 Employers of pensioners already pay full employer NI.

39 A Corlett & D Finch, Double take: workers with multiple jobs and reforms to National Insurance, Resolution Foundation, November 2016.

40 At Budget 2020, Spending Round 2020 and Budget 2021 the Government committed to delivering "£600 billion of gross public investment over the next five years" (see, for example, HM Treasury, Budget 2021, March 2021). Some of this overall envelope has already been allocated to provide for school and hospital rebuilding and other high-priority programmes, and the Spending Review 2021 will provide multi-year detailed department-by-department capital settlements.

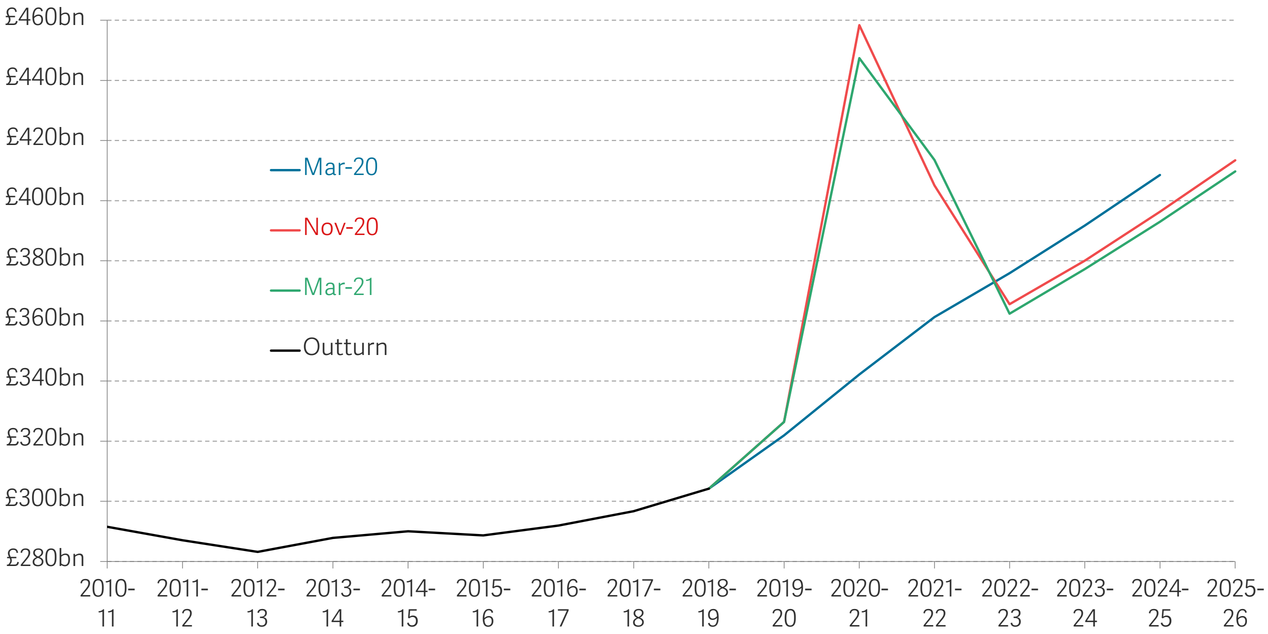
judgements: one short and one longer-term. The big short-term spending decision is how much Covid-19 related spending to provide for beyond this year; the current answer is zero. The longer-term decision is about what the lasting size of the UK state should be after its enormous pandemic expansion. It is this that will determine whether the Chancellor will continue with his plans to cut spending for unprotected departments. These have been pencilled in since the onset of Covid-19, and would mean extending the decade of austerity that unprotected departments have faced since 2010-11.

## Covid-19 spending and additional cuts to public spending from 2022-23 mean that departments are in the middle of a spending rollercoaster

The Government's response to Covid-19 is projected to have boosted day-to-day spending (Resource Departmental Expenditure Limits, RDEL) by over £100 billion in 2020-21 relative to plans in March 2020, as Figure 14 shows. This increase tapers away sharply, with spending in 2022-23 and future years lower than was planned pre-pandemic, as a result of the Chancellor's decisions to reduce planned departmental spending.[41] These cuts were first announced in November 2020, increased slightly in March 2021, and reach £16 billion by the middle of the decade, explaining why the latest forecast for RDEL shown in Figure 14 is lower in the years 2022-23 to 2025-26 than was planned in November 2020.

FIGURE 14: **Day-to-day departmental spending has increased a lot in the short-term and is planned to be cut in the medium-term**

Nominal Resource Departmental Expenditure Limits, as forecast in March 2020, November 2020 and March 2021: UK




SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various.

41 Central government expenditure is £9.4 billion lower so far in the 2021-22 financial year than forecast by the OBR in March 2021, this is not a result of differences in RDEL spending relative to forecast but is instead "mostly due" to lower than forecast spending on the Coronavirus Job Retention Scheme and the Self-Employed Income Support Scheme. See: OBR, Commentary on the public sector finances, July 2021.

These cuts, coupled with existing commitments on spending increases for health and education in particular, mean that the Chancellor's plans imply a real-terms reduction in unprotected departmental spending in 2022-23.[42] For those departments, including the likes of local government and prisons, this is unlikely to feel like the end to austerity that the Chancellor's predecessor, Sajid Javid, said the Government was "turning the page on" in 2019.[43]

## In the short-term, the Chancellor will have to decide how much Covid-19 spending to allocate to departments in 2022-23 and beyond

To date, the Chancellor has set out Covid-19 spending plans for 2021-22, including a £55 billion "Covid-19 reserve". The Government confirmed in March 2021 that £36 billion of this has been allocated predominantly to "key priorities including Test and Trace, support for local authorities and funding to help tackle backlogs in the NHS and courts".[44] Since the March 2021 Budget, a further £6.6 billion has been allocated to the NHS for spending pressures in 2021-22.[45] But other than this there has been little new spending announced since March 2020, meaning that the Chancellor will still have headroom (of £10 billion or more) within the reserve to increase in-year budgets for Covid-19 related spending.

However, there is no Covid-19 reserve at all for 2022-23 or future years. In reality, significant costs associated with managing an ongoing pandemic, and recovering from some of its lasting effects, will extend into future years (these will be beyond the limited amounts announced to date including an extra £1.4 billion in "catch-up" funding for schools over three years).[46] The OBR, for example, has estimated that pandemic-related pressures on day-to-day departmental spending could require an additional £12 billion of spending in 2022-23 across the NHS, Education and Transport, falling to around £9 billion in 2024-25.[47]

These pressures mean that it is almost certain that day-to-day departmental spending levels will not fall as low as currently planned. If they were to do so overall, and an additional £12 billion was to be spent on Covid-19 related priorities in 2022-23, it would require a commensurate cut in unprotected departments' budgets (assuming existing departmental protections for core spending remain intact).

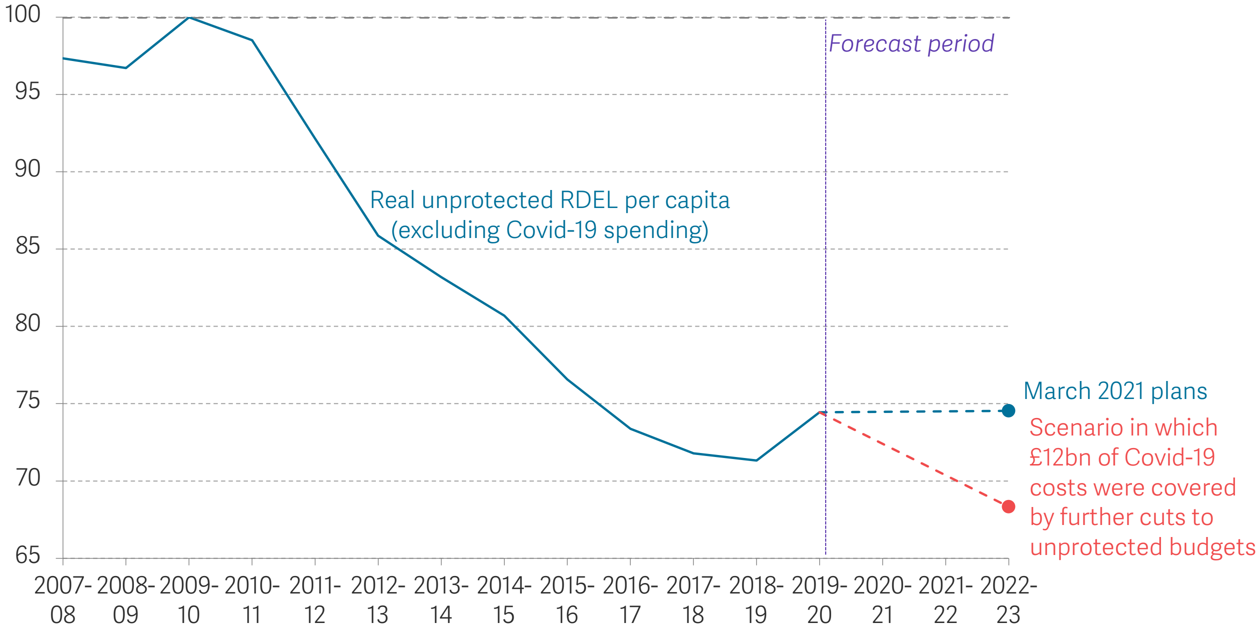
As shown in Figure 15, a further cut of this magnitude would push unprotected departmental spending down to 68 per cent of 2010-11 levels (in real, per capita, terms). This is lower than the level reached in 2018-19 before the end of austerity was declared,

42 T Bell et al., Spending Fast, Taxing Slow: Resolution Foundation analysis of Budget 2021, Resolution Foundation, March 2021.
43 S Javid, Spending Round 2019: Chancellor Sajid Javid's speech, September 2019.
44 HM Treasury, Budget 2021, March 2021.
45 Department of Health and Social Care, £7 billion for NHS and social care for COVID-19 response and recovery, 18 March 2021.
46 Department for Education, Huge expansion of tutoring in next step of education recovery, 2 June 2021.
47 OBR, Fiscal risks report, July 2021.

and would mean an 8 per cent fall in real unprotected departmental spending per capita relative to 2019-20. A cut of this scale is almost certainly impossible to politically or practically implement, so we expect short-term spending plans to rise in the spending review, possibly to the tune of over £10 billion pounds over a couple of years.

FIGURE 15: **Unprotected departmental spending would fall to new lows if it takes all the strain from increased Covid-19 spending in 2022-23 and beyond**

Indices of real-terms (GDP-deflator adjusted) per-capita resource 'unprotected' departmental expenditure limits (2009-10=100): UK




SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2021.

## In the longer-term, the Chancellor has a choice over whether to reverse the cuts he has pencilled in to unprotected departmental budgets out to the middle of the decade

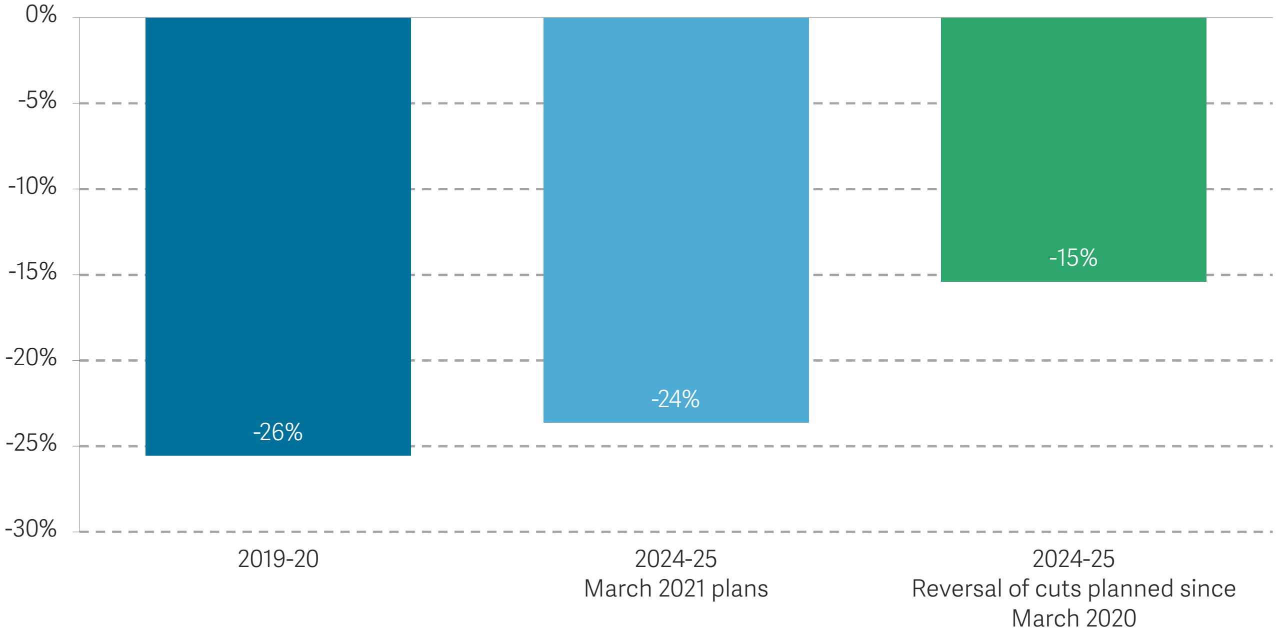
As well as short-term Covid-19 related spending pressures, the Chancellor will also have to decide at the Spending Review whether he wishes to proceed with the pencilled-in reductions in departmental spending plans that reach £16 billion by 2024-25. The Government's case for these reductions is that the UK economy is set to be lastingly smaller than hoped pre-pandemic, but if revisions to economic and fiscal forecasts show less scarring of the economy and lower borrowing, then he could well have room to reconsider these cuts. The evidence on the pre-pandemic deterioration in some public services may also provide the motivation to spend more: for example, there were 100 more deaths in prisons in 2019 than in 2010, with the number of assaults and self-harm incidents up 130 per cent over the same time period.[48]

48 RF analysis of Ministry of Justice, Safety in Custody Statistics.

Current spending plans would see unprotected departments' real-terms per capita spending rise by just 3 per cent over the five years to 2024-25 – leaving it almost one-quarter lower than in 2009-10 (and with less than one fifth of the reduction in spending between 2009-10 and 2018-19 reversed). If however, the Chancellor abandoned all of the pencilled-in £16 billion of cuts, it would allow for moderate progress in non-Covid RDEL spending in unprotected departments: instead of leaving spending in many departments close to the levels when George Osborne was in office (with only three-quarters of the spending power they had in 2010), the reversal of these planned cuts would leave their spending power just 15 per cent smaller in real per capita terms than in 2009-10, as shown in Figure 16.

FIGURE 16: **Reversing the cuts the Chancellor has pencilled in over the past year would return unprotected departmental spending to its 2014-15 level**

Change since 2009-10 in real-terms (GDP-deflator adjusted) per-capita resource 'unprotected' departmental expenditure limits: UK




SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, March 2021.

Although these decisions sound like small beer compared to the hundreds of billions of spending routinely talked about during the pandemic, they are very material. Indeed they may shape the policy, and politics, of the run in to the next general election in 2023 or 2024.

## Choice #5: Will the Treasury get serious about net zero?

As well as broader spending plans, the Chancellor will need to decide whether this is the autumn when the Treasury steps up to address big policy questions posed by our ambitious targets to reduce greenhouse gas emissions. This is particularly pressing in the run up to the 2021 United Nations Climate Change Conference in Glasgow ('COP26').

The Government will (hopefully) be answering some of those questions this autumn, not least in the Heat and Buildings Strategy, the Treasury's Net Zero Review and the overall Net Zero Strategy. These (already delayed) documents will be very welcome, given the work needed to get the UK onto a pathway to net zero and to meet its international commitments (e.g. to reduce emissions by 68 per cent by 2030, relative to 1990 and compared to 44 per cent in 2019). Forthcoming Resolution Foundation work will look at the UK's net zero plans in more detail, as part of the Economy 2030 inquiry.[49]

But it remains to be seen whether the Chancellor will really make a substantive contribution to net zero policy progress this autumn. Three of the big questions the Treasury will need to address are:

- How to help households decarbonise home heating;
- How to encourage industrial decarbonisation through carbon pricing and support; and
- How to protect the public finances by replacing road taxes.

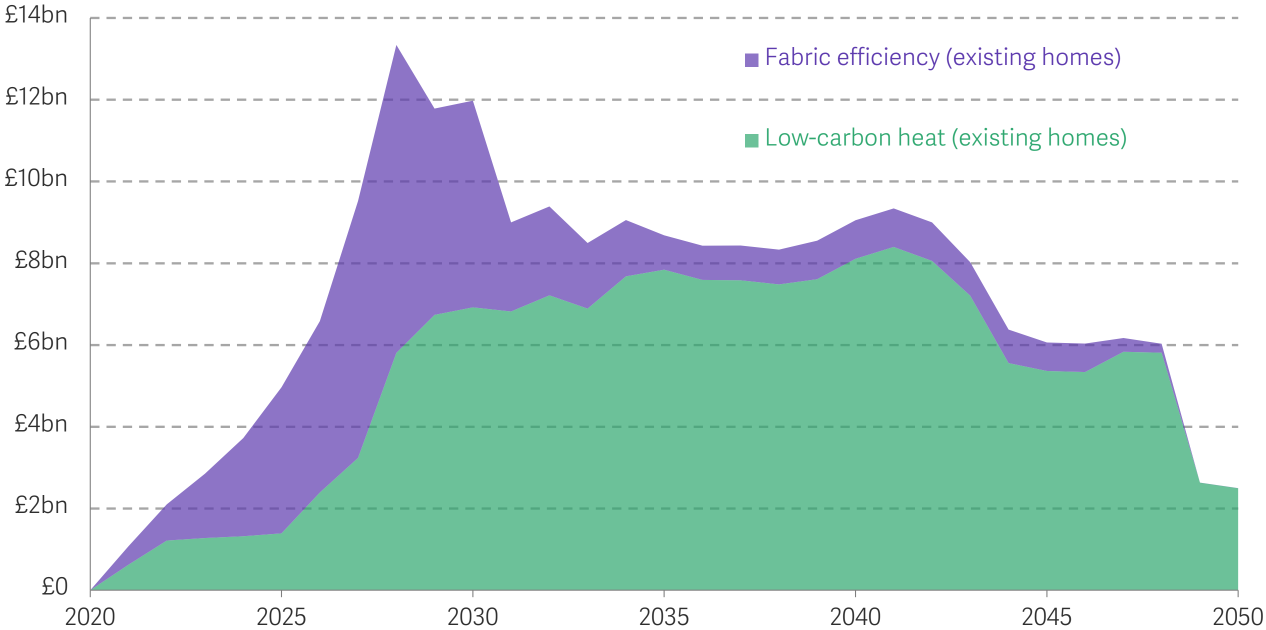
### Heating is a key challenge, and will require significant government spending

A key net zero challenge for the 2020s is to increase funding, certainty and incentives regarding the heating of buildings, and particularly homes. Over the decade 2022-2031, the Climate Change Committee's 'balanced pathway' assumes that £39 billion of additional capital spending is provided on fabric efficiency for existing homes (e.g. insulation), and £37 billion for low-carbon heat (mostly heat pumps), with additional investment also needed for new homes, non-residential private sector buildings and the public sector.[50]

49 T Bell et al., The UK's decisive decade: The launch report of The Economy 2030 Inquiry, Resolution Foundation and the Centre for Economic Performance, May 2021.
50 Note there is significant uncertainty about how much a heat pump installation will cost in future decades.

FIGURE 17: **The balanced pathway to net zero will require significant capital spending on home insulation and low-carbon heat**

Selected forecast annual capital costs required relative to a hypothetical fossil fuel counterfactual: UK




SOURCE: The Climate Change Committee, Sixth Carbon Budget, December 2020.

There is no need for all of these costs to be borne by taxpayers, given that these investments will provide significant savings and other benefits over time for the occupants. But it is not realistic to expect that none of these costs will fall upon the state: the Government will want to protect lower-income households from the costs of this transition, as well provide certainty that the change will happen. Because of this, the OBR has provided indicative figures in which the public sector contribution ramps up to over £5 billion a year by 2026.[51]

The Conservative manifesto committed to spending over £9 billion during the 2020s on improving the energy efficiency of properties owned by those on lower incomes and on public buildings, and it is reported that 'Clean Heat Grants' worth £7,000 may begin in April 2022. But actual plans for most of this spending are still missing,[52] and serious commitments are needed to be in a position to deliver the scale of home improvements shown in Figure 17, and to deliver the target of installing 600,000 heat pumps a year by 2028. Attempts to develop policy in this area (most recently, the Green Homes Grants scheme) have ended in failure, so the mechanisms to support home improvements are also in need of significant policy development.

It is not only a matter of spending on the existing stock of homes. Regulation needs to provide a clear path to stopping new home gas connections (by 2025) and phasing

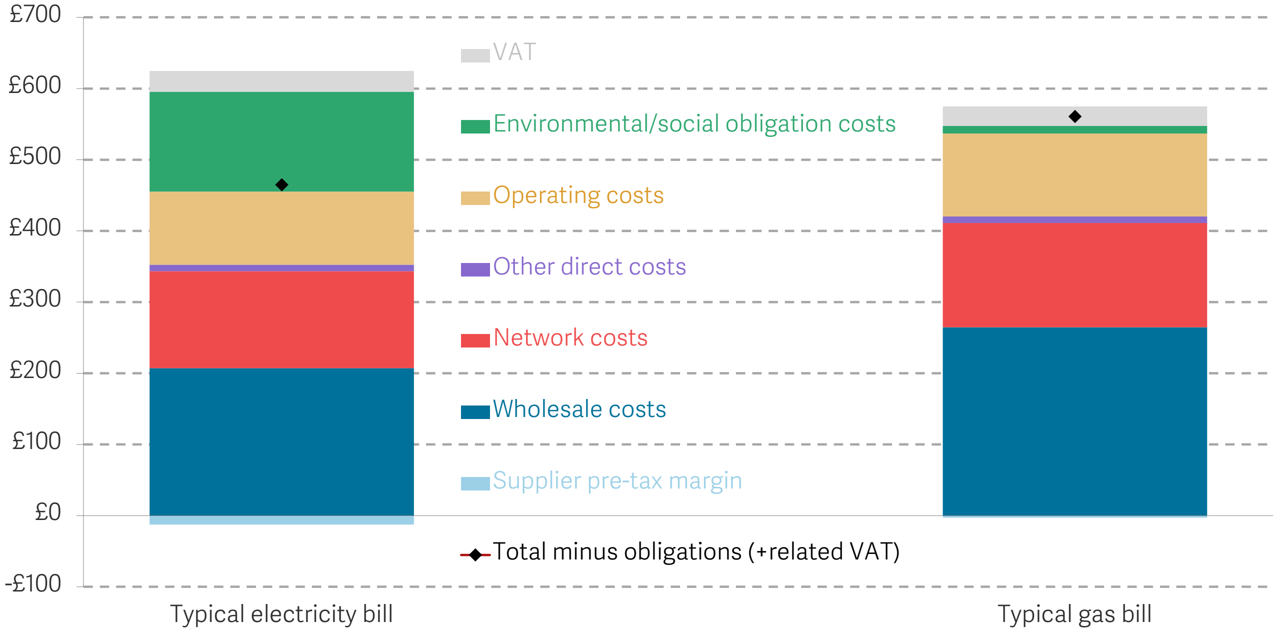
51 See chart 3.19 in OBR, Fiscal risks report, July 2021.
52 The Energy Efficiency Infrastructure Group, Placing Homes at the Heart of a Green Recovery in 2021, February 2021.

out new boilers entirely (reportedly by 2025).[53] There is also a strong case for moving environmental and social levies away from the electricity that will power heat pumps (and electric vehicles) so as to not to disincentivise electrification.[54] These levies could either be moved from electricity to gas (Figure 18 shows how these are currently all borne by electricity users), or be met through general taxation, although this would have obvious implications for the public finances (levies have been popular with successive governments for meeting some of the investment costs in energy infrastructure without requiring tax rises).

Crucially, all of this needs to happen in a way that helps, rather than hurts, lower-income households – with differing strategies for homeowners, private renters and social renters.

FIGURE 18: **A significant proportion of electricity – but not gas – bills is from environmental and social levies**

Breakdown of typical electricity and gas bills, 2019: UK




NOTES: Carbon pricing (applying to electricity but not gas) not broken out.
SOURCE: Ofgem, Bills, prices and profits, March 2021.

## Industrial decarbonisation will need to be pushed along by both support and a credible path for carbon pricing reform

In the case of industry, there is a need both for targeted support for sectors facing the most significant transitions ('carrots') and broad incentives for decarbonisation via

53 The Times, Households with gas boilers face green levy, August 2021.
54 See, for example: R Wolf, J Dupont & R Newton, Options for energy bill reform, April 2021; and The Times, Households with gas boilers face green levy, August 2021. For non-domestic properties, it is also problematic that the Climate Change Levy still has a higher rate for electricity than for gas (per KWh) – when ideally there should be no charge on electricity use beyond the carbon pricing that already applies (see G Bangham et al, Unhealthy finances: How to support the economy today and repair the public finances tomorrow, Resolution Foundation, November 2020.).

carbon pricing ('sticks'). On the former, piloting clean steel production will need Treasury support, as will carbon capture and storage (and going slow is likely to yield the same result as not going at all).

As for the 'stick', it's too often over-looked that the UK already has a carbon pricing system, through the new UK Emissions Trading Scheme (ETS) (and formerly the EU ETS). The cost of carbon for those covered by the scheme is already around £50 per tonne, following a dramatic rise in the EU ETS price over the last year. But there is general agreement that carbon pricing can do more to help the UK reduce emissions – including on road transport (discussed below) and home heating (discussed above). When it comes to carbon pricing directly affecting industry, the main task this autumn is to set out a clear direction for future reform.

Such reforms could include a Carbon Border Adjustment Mechanism. This would allow the awards of free allowances to be phased out, ensuring that industrial emissions always face the full carbon price, but without being undercut by imports.[55] Additionally, emissions trading may also be extended to new sectors such as shipping.[56]

The pace and nature of change will inevitably depend on what happens elsewhere (particularly in the EU), but the Treasury's theoretical support for a wider use of carbon pricing to guide industry through the net zero transition now needs to translate into greater clarity about the path of reform. That clarity is crucial if credibility is to be built, so that the prospect of medium- or long-term changes stimulate industry to make changes today.

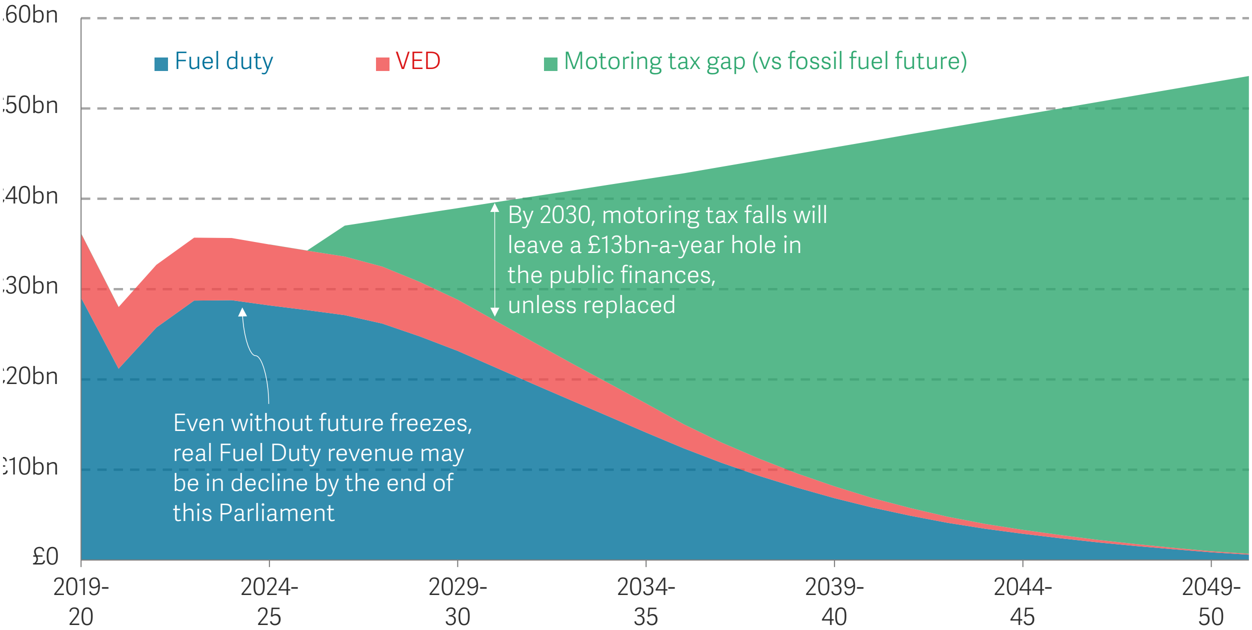
## As the net zero plan firms up, the Treasury needs to think how to replace road taxes

The UK has done well to establish a broad plan for road transport decarbonisation, with a ban on new petrol and diesel car sales from 2030 (except plug-in hybrids until 2035), and potentially a Zero Emissions Vehicle mandate to further shift the UK towards electric vehicles before then. Given this progress, it is time to confront seriously the problems caused by Fuel Duty and VED revenues disappearing in an electric vehicle future. As Figure 19 shows, this is not a question for future decades: even on current policy, road tax revenues may start to decline from 2023-24, and by 2030-31 there will be a £13 billion a year hole in the public finances. Fixing this problem is not directly important for reaching net zero: indeed, the need to incentivise electrification might point to keeping taxes on electric vehicle use as low as possible for as long as possible. But the scale of the fiscal risk is such that doing nothing is not an option.

55 BEIS, UK Emissions Trading Scheme free allocation review: call for evidence, March 2021.
56 G Bangham et al, Unhealthy finances: How to support the economy today and repair the public finances tomorrow, Resolution Foundation, November 2020.

FIGURE 19: **Road taxation will need major reform within this decade**

Projected Fuel Duty and Vehicle Excise Duty revenue, and gap relative to maintaining revenue, real-terms (GDP-deflator adjusted): UK




NOTES: This forecast assumes that Fuel Duty rises each year from 2022, rather than being frozen.
SOURCE: RF analysis of OBR, Fiscal risks report, July 2021.

In the shorter-term, uprating Fuel Duty – which Figure 19 assumes happens, and which would preserve £3 billion a year by 2025-26 – would help both the public finances and decarbonisation;[57] as could reforming Vehicle Excise Duty (on which the Government consulted in March 2020, but has since said nothing).[58]

But perhaps the only plausible long-term solution is a new system of road pricing to replace both Fuel Duty and Vehicle Excise Duty. This is theoretically both justifiable and desirable given the externalities of car use, most importantly through congestion (congestion that would be increased by phasing out of the existing road taxes).[59] The Treasury (and others) must therefore begin to make progress on some of the very tricky questions this raises, including:

- How exactly would a new charge work? The theoretical ideal would be a charge based on the precise location, time, congestion and type of vehicle – but that has barriers related to technology and privacy.[60]
- When does a new system need to be fully operational? A £13 billion fiscal hole opening up by 2030-31 and the fact that purchasing new petrol or diesel cars will by

57 S Evans, Analysis: Fuel-duty freeze has increased UK CO2 emissions by up to 5%, CarbonBrief, March 2020.
58 HM Treasury, Vehicle Excise Duty: call for evidence, March 2020.
59 IFS, Tax by design, September 2011.
60 Options to raise more from VED are discussed in: G Bangham et al, Unhealthy finances: How to support the economy today and repair the public finances tomorrow, Resolution Foundation, November 2020.

then no longer be possible, means it needs to be in place during this decade.

- For the many internal-combustion-powered vehicles that will still be on the roads, would they pay the new charge as well as Fuel Duty and Vehicle Excise Duty? It does not seem attractive for a new charge to apply only to electric vehicles, nor does it seem likely that drivers would be asked to pay both full Fuel Duty and a similarly-large new road charge. One potential outcome is that Fuel Duty is replaced by a combination of road pricing and an extension of carbon pricing to cover petrol and diesel: the current carbon price would imply a charge of around 12-13p per litre of fuel, considerably lower than Fuel Duty of 58p (though the carbon price may be expected to rise in future).[61]
- What phasing-in is required? We have previously suggested that road pricing should be first introduced for home deliveries, both to tackle the congestion that these cause, and as a relatively simple test-bed for the necessary technologies.[62]

There are obvious reasons why politicians have delayed progress on this difficult area, always telling themselves it can wait until after the next election. But the can-kicking has got us to the point at which we now have to be at least piloting options within the next few years.

More broadly, although the Treasury and Rishi Sunak are very far from solely responsible for converting the UK's ambitious decarbonisation targets into concrete policies to meet them, the Chancellor will soon determine, in the decisions he does, or doesn't, take in the months ahead, whether the Treasury is a driving force of our net zero transition or a block on it.

## Conclusion

The Chancellor has had a relatively quiet summer. And good news in the short and medium term on the public finances means that he has room for manoeuvre in satisfying the Prime Minister's wish to spend more.

But he still has big decisions to take, even if this autumn does not see a significant increase in Covid-19 cases requiring the return of some restrictions and targeted economic support. This note has provided the background to five of them, illustrating the breadth and depth of the issues he will need to confront.

Taken together, this autumn's decisions will amount to the Chancellor setting the Government's direction right up until the next election. A Conservative Government that

61 RF calculation based on a carbon price of £50 per tonne.
62 G Bangham et al, Unhealthy finances: How to support the economy today and repair the public finances tomorrow, Resolution Foundation, November 2020.

has overseen a Covid-19-induced explosion in the role of the state must now decide what it believes the state's size and role should be as we emerge from the pandemic. That is not a recipe for a quiet autumn on the economic policy making front.

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