Catch 2022: Spring Statement 2022 preview

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Summary

The Chancellor has had good news since the Autumn:

- Strongest peacetime growth in a century means economy is around 0.5% larger with nearly 300k more people in employment.
- 2021-22 tax receipts set to come in around £40bn above expectations.

But high inflation and the invasion of Ukraine means the Spring Statement won't be as straightforward as the Chancellor had hoped.

The worse outlook and temporary nature of some of the increase in revenues means public-finances' improvement may well not last in full:

- All else equal, changes to the economic forecasts are likely to push up borrowing by around £20bn year.

Chancellor faces calls to be much more active on policy – from help to households to more spending on defence.

- Uprating benefits by 8 per cent in April would reduce relative poverty by around 500,000 and cost £9bn.

Good news (1): Economy

2021 saw fastest peacetime growth in nearly a century

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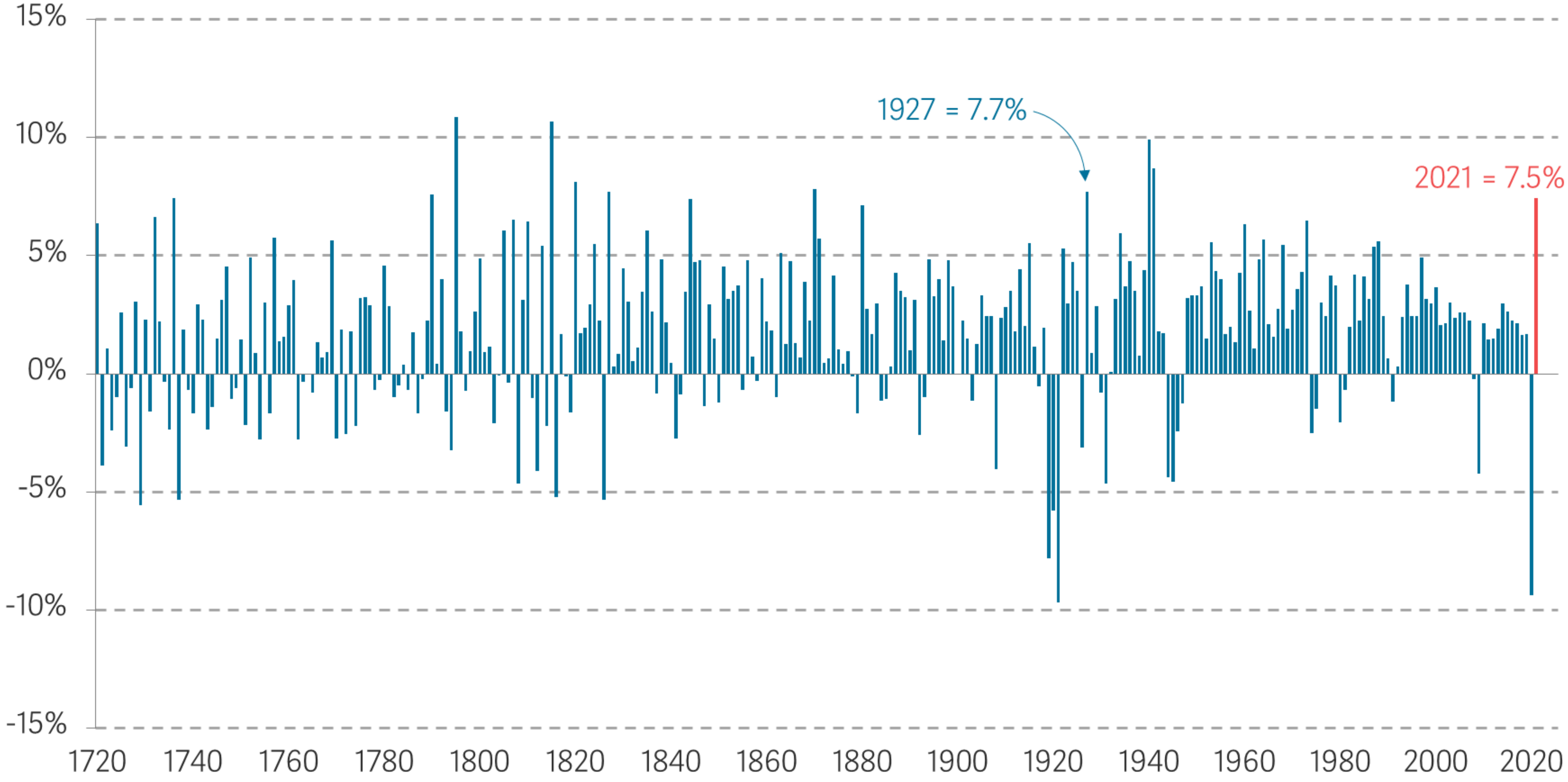
Real GDP growth, calendar years: UK



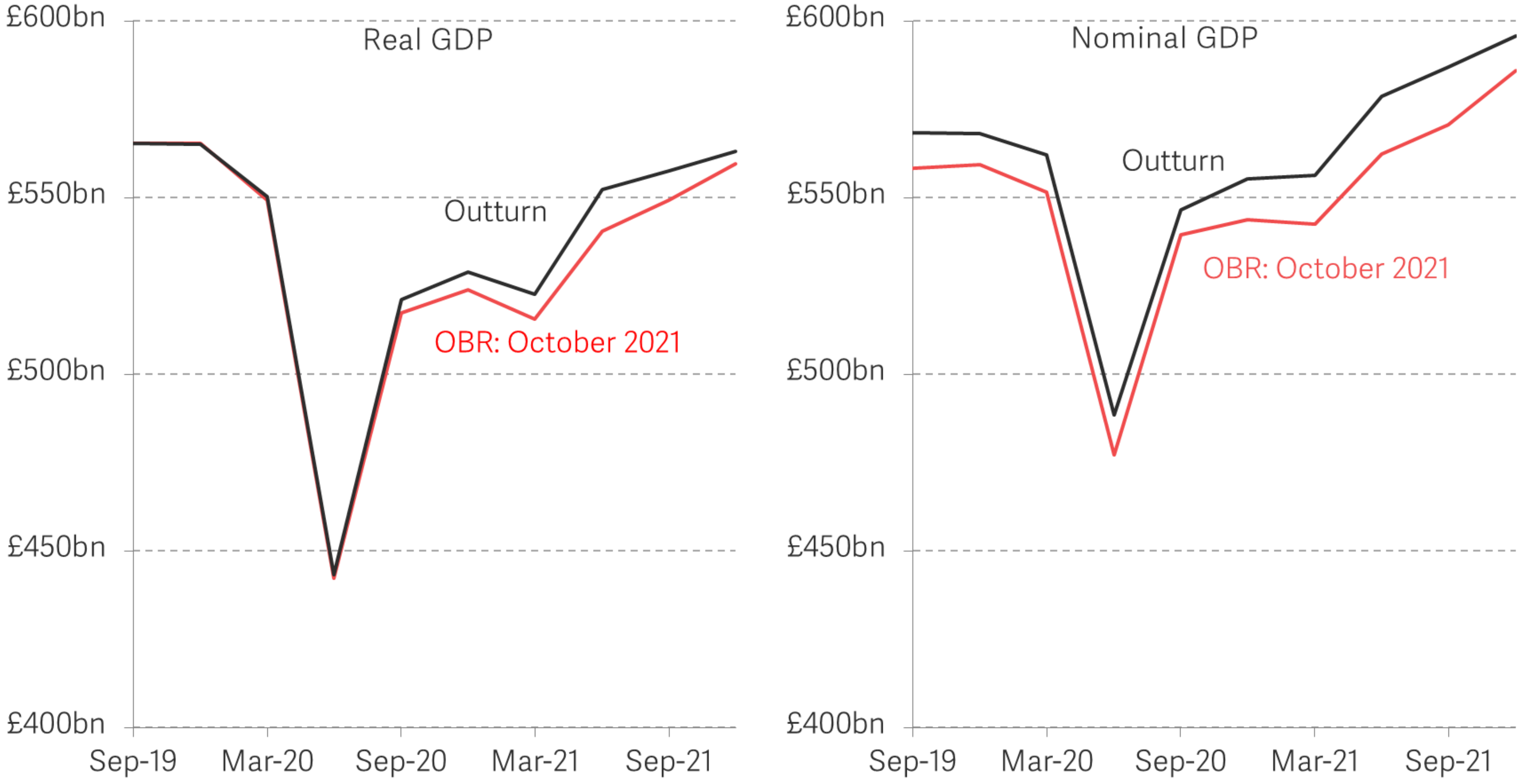
Following a huge fall in 2020, GDP has recovered sharply in 2021

And Omicron only proved a minor 'blip' to the recovery, with GDP rising by 0.8 per cent in January

Notes: From 1949 to 2020 the data are official ONS data, prior to that they are taken from Bank of England, A Millennium of UK Data.
Source: RF analysis of ONS; Bank of England, A Millennium of UK Data.

As a result, the economy is somewhat bigger than expected

Real and nominal GDP level, OBR forecasts and latest data: UK



Source: RF analysis of ONS, National Accounts.

Real GDP in Q4 2021 was around 0.5% higher than the OBR's October forecast

History of nominal GDP also revised up (effects past as well as present so doesn't help explain recent strength in tax receipts)

Employment (except among older workers) has continued to outperform expectations

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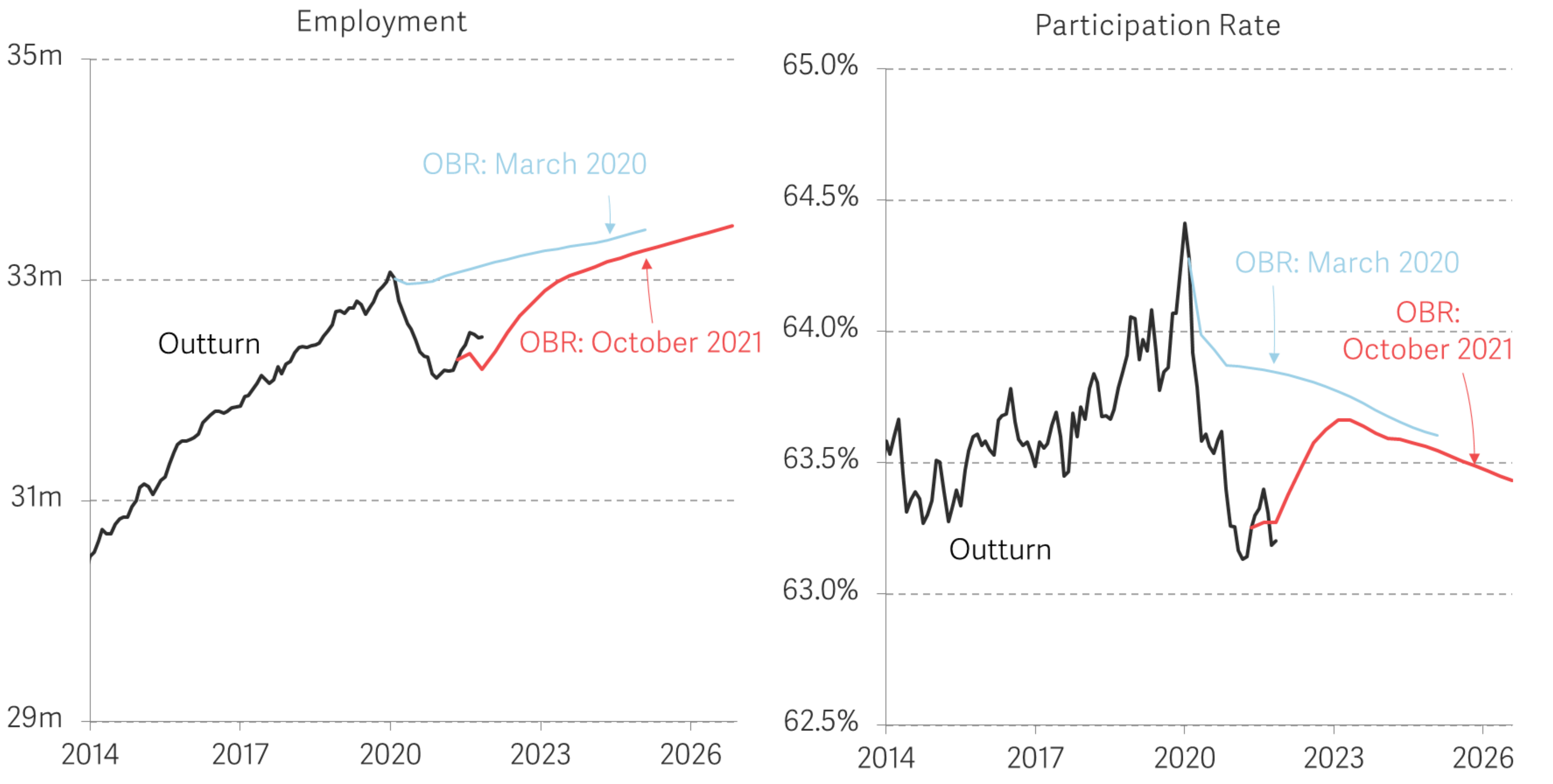
Labour market quantities, OBR forecasts and latest data: UK



Stronger economy has meant 290k higher employment

But older workers appear to be exiting the labour market, reducing participation

Source: ONS, Labour Market Statistics; OBR, Economic and Fiscal Outlook – various.

Extent to which tighter labour market has led to unusually high wage growth is uncertain

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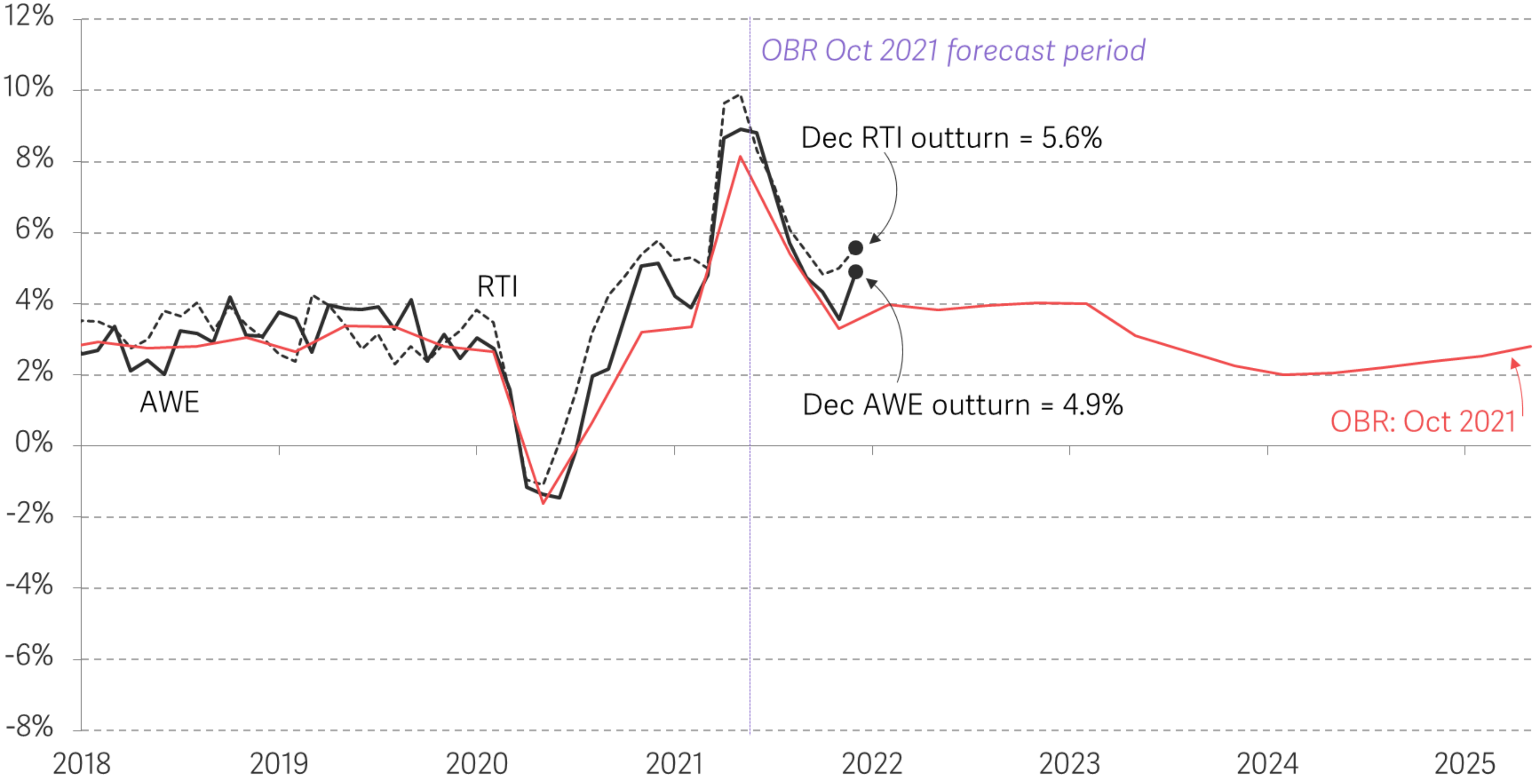
12-month growth rate of average weekly earnings, outturn and projections: UK



Pay growth somewhat stronger than OBR forecast

Pay settlements were growing at around 3% in Jan suggesting high rates of pay growth are not becoming ingrained

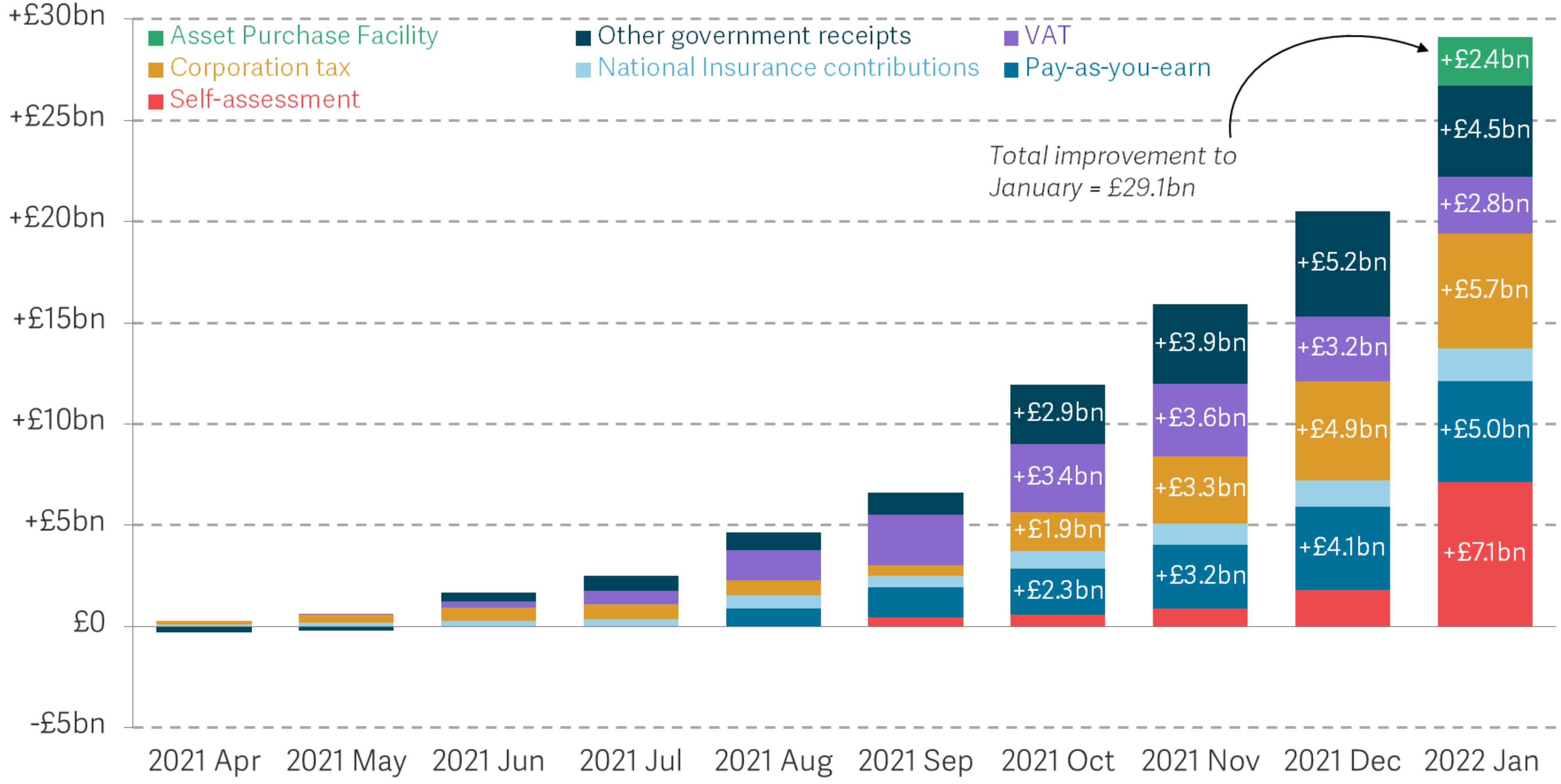
Likely that wage growth forecast will be stronger at least in the near term, but significant uncertainty here

Notes: Average weekly earnings series is whole economy total pay (i.e. includes bonuses) and the RTI data is mean pay growth of paid employees (defined as the number of people receiving paid renumeration included in PAYE RTI). The OBR's forecast is for 'average earnings growth' defined as wages and salaries divided by number of employees.
Source: ONS, Labour Market Statistics; and OBR, Economic and Fiscal Outlook – October 2021.

Good news (2): Fiscal

Receipts are already almost £30bn higher than expected

Cumulative central government current receipts, 2021-22 outturn relative to forecast: UK



Tax revenues are higher than expected across the board

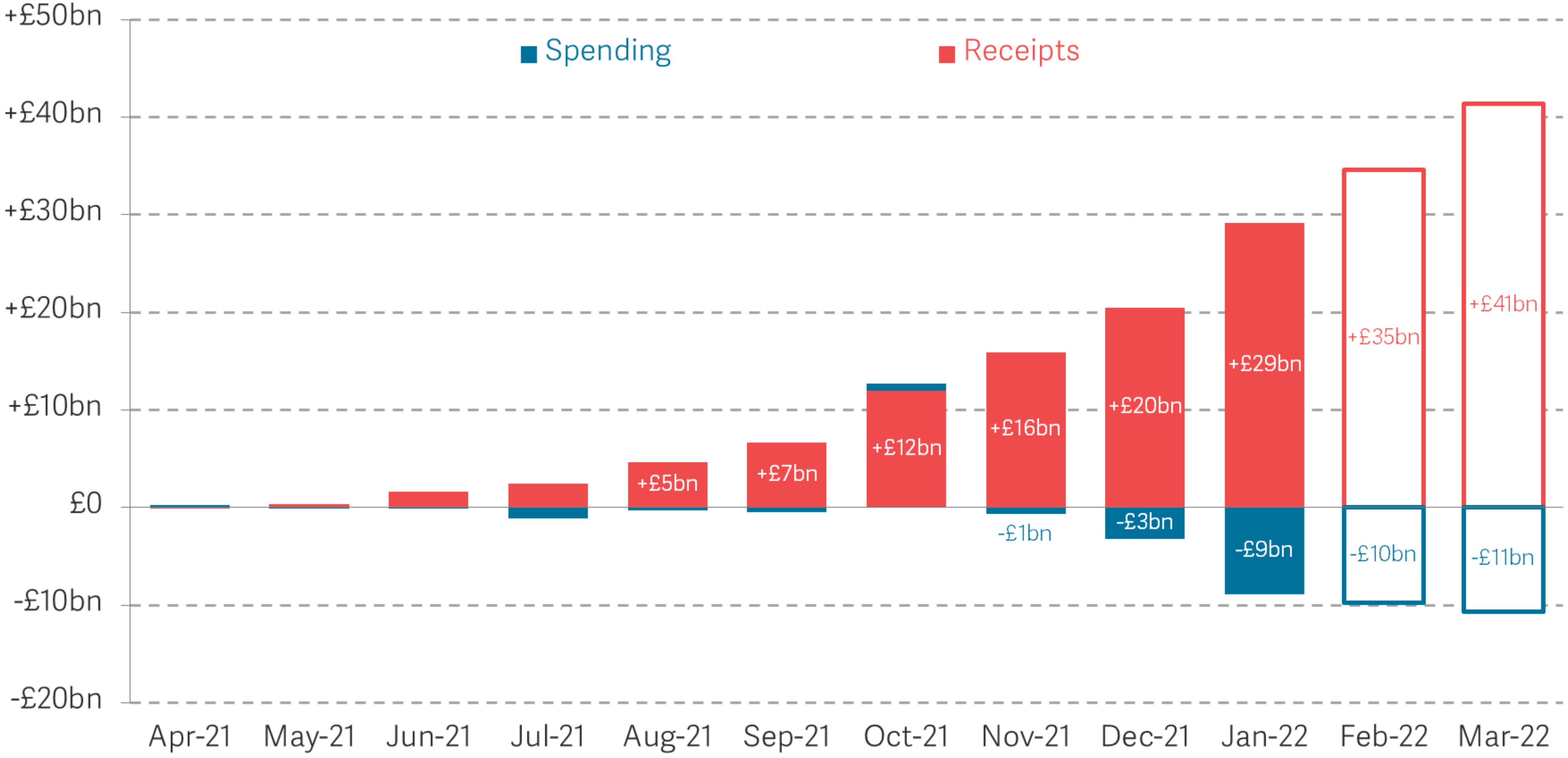
This increase is much larger than would be expected given economy news

Key question: is this a one-off, or will it last?

Source: RF analysis of ONS, Public Sector Finances; OBR, Economic and Fiscal Outlook, various.

Borrowing set to come in £30bn lower than expected this year

Changes in central government current receipts and expenditure, outturn relative to forecast : UK



Receipts surge offset somewhat by more spending

Reflects higher inflation impact on gilts, which will build in the final 2 months of the year

If this is the case, and receipts continue to improve, borrowing will come in around £30bn better than the expected £183bn

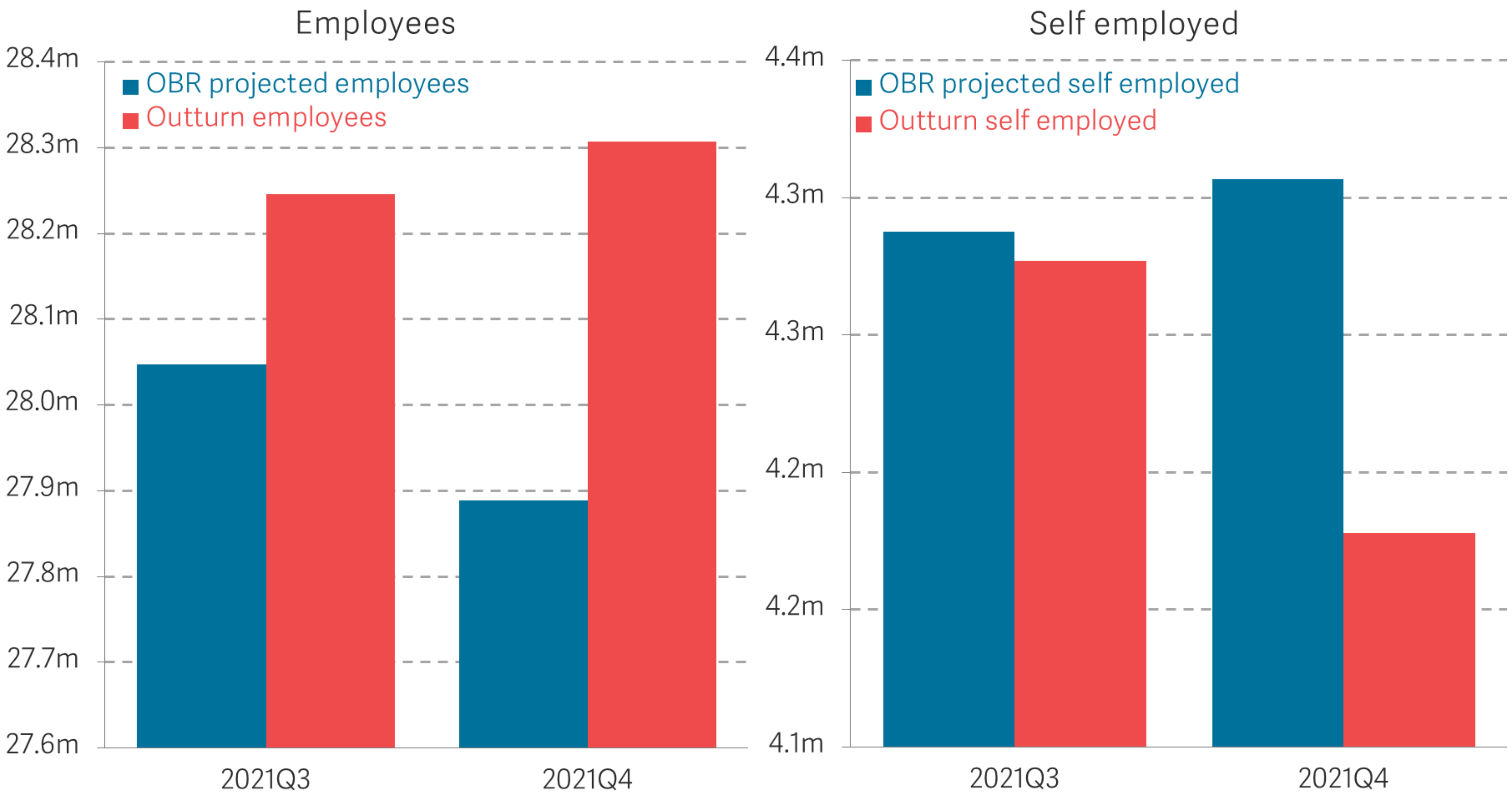
Note: Figures exclude PSNB-neutral intra-public sector transfers: (1) the Asset Purchase Facility (affecting central government receipts and public corporations net borrowing); and (2) grants to local authorities (affecting central government expenditure and local authorities net borrowing). Negative spending numbers in the chart represent increased spending compared to previous OBR forecast. The final two bars represent projections based on extrapolating growth in revenues (excluding self-assessment tax returns) from November to January forward and using the estimated increase in debt interest spending on indexed-link gilts based on the RF economic scenario (see later slides) and the OBR's ready reckoner between RPI inflation and interest payments (other spending items were kept fixed at the January level).
Source: RF analysis of ONS, Public Sector Finances; OBR, Economic and Fiscal Outlook, various.

What explains the strength of receipts?

- Upside news on: income taxes, VAT and Corporation Tax
- That news is larger than explained by economic improvement
- Could reflect 'tax richness' of the economy:
  - Income taxes: self employment has fallen and wages rises top heavy
  - VAT: switch to higher-rated spending
  - Corporation tax: investment weaker
- We find some evidence for these factors but not enough to explain receipts' strength

Fall in share of self-employed explains a small part of the unexpected rise in income taxes

Employee and self-employment outturns and previous OBR forecast: UK



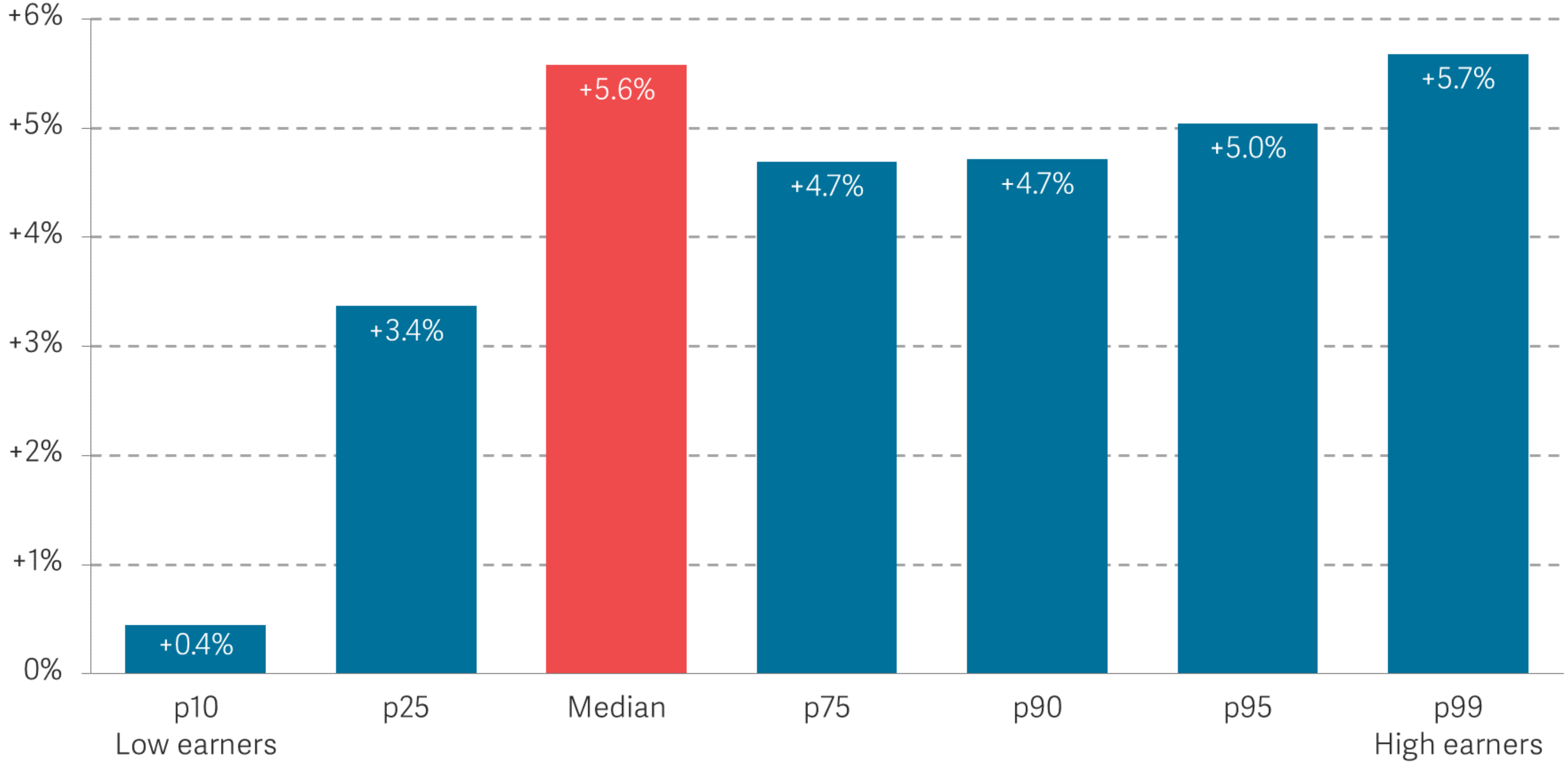
The number of self-employed is around 130k lower than expected

The Treasury receives more tax for an employee than for a self-employed individual earning the same amount – £3,100 for an employee with a salary around £27,000

Notes: [1] This example assumes the payrolled employee is on the standard 1250L tax code and has no other deductions such student loans. [2] This figure was estimated using HMRC's Self-employed ready reckoner.
Source: ONS, Labour Market Statistics; OBR, Economic and Fiscal Outlook - October 2021.

Stronger pay growth among higher earners also helps receipts

Nominal pay growth by percentile of wage distribution: December 2021

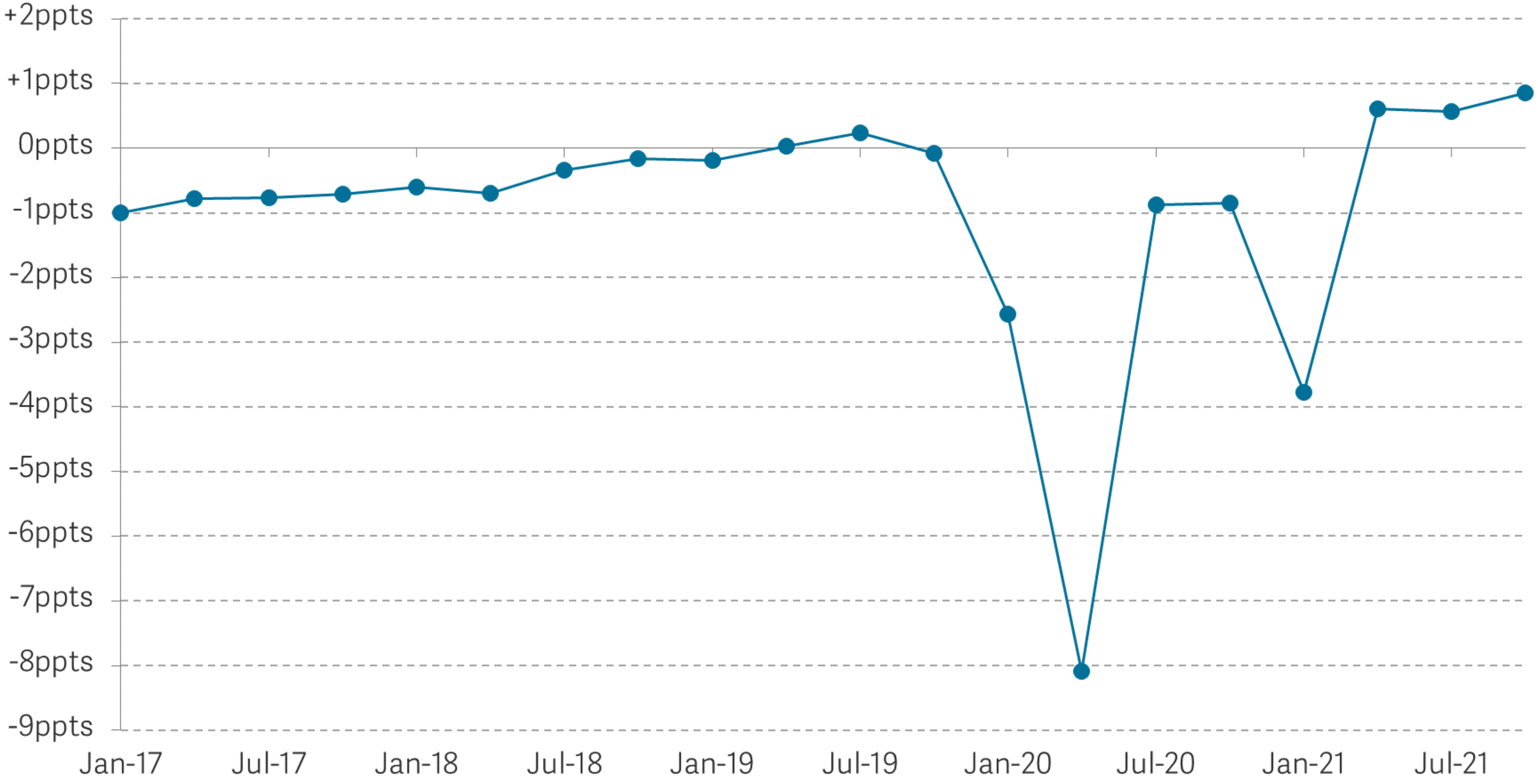


Stronger wage growth among higher earners translates into higher tax receipts for a given average wage rise given their higher marginal tax rates

Source: RF analysis of ONS, Real-time PAYE pay data

On VAT, spending shifts help explain some of the strength

Change in approximate share of retail sales spent on standard rate VAT items, relative to average share in 2019: UK



The pandemic saw consumption shift towards goods and away from services

More recently retail sales have shifted towards non-food goods

Most food products attract no VAT vs 20% for most goods

This could mean £1.5-2bn in additional revenue per year

Notes: Low- or no-VAT rated spending is defined as spending in food stores (specialised and non-specialised), chemists, medical goods stores, books and newsagents, and second-hand goods stores. These will not map perfectly to VAT rates: for example, spending on food items which attract standard rate cannot be split out from zero-rated food, and zero-rated children's clothing cannot be separated from standard-rated clothing.
Source: RF analysis of ONS, Retail Sales.

Investment weakness may help a little in explaining strength of corporation tax receipts

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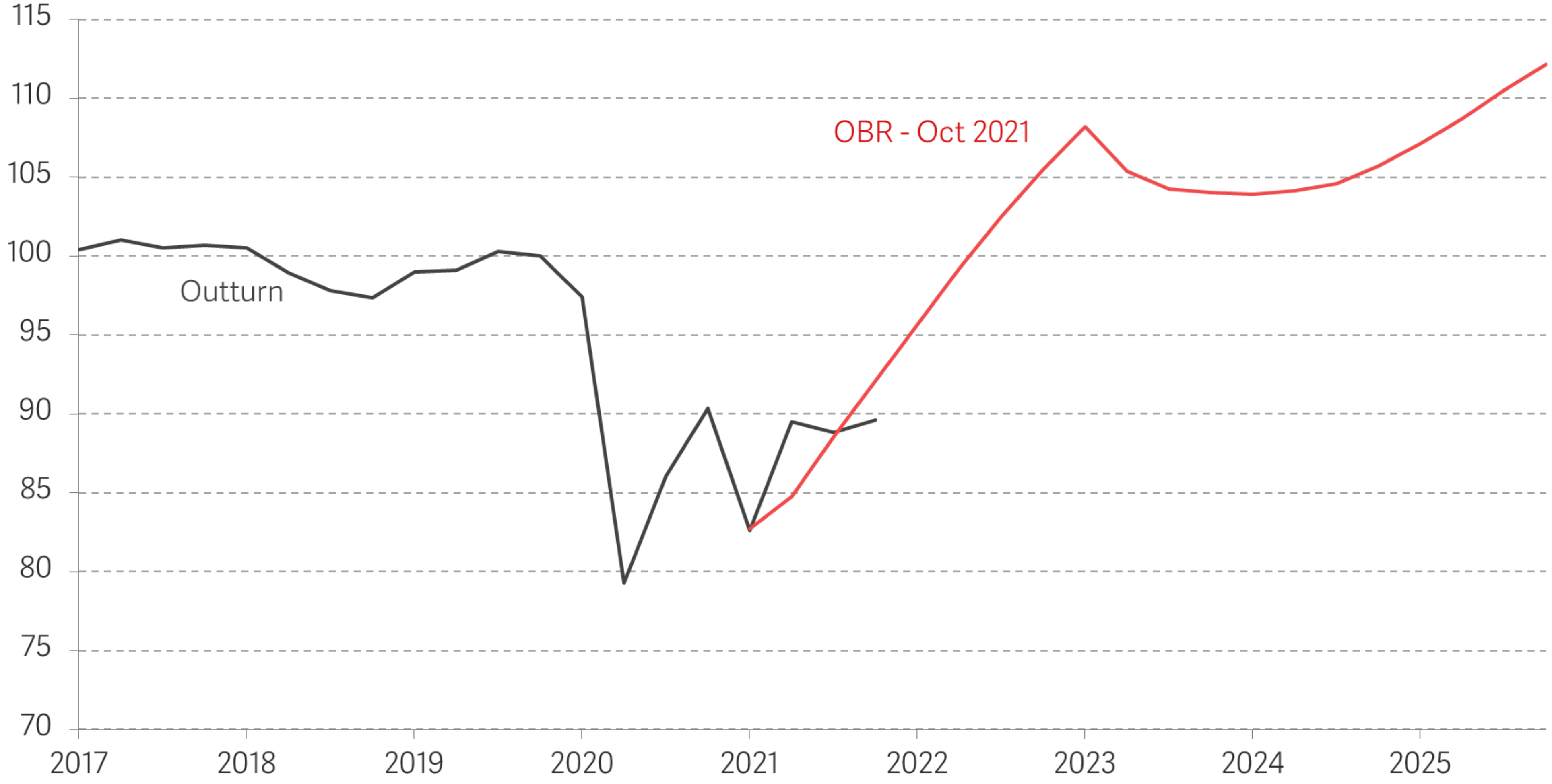
Index of business investment, OBR forecasts and latest data (2019 Q4 = 100): UK



Corporation tax receipts £5.7bn higher

Investment is tax deductible (and some is eligible for the super deduction)

Assuming all of the shortfall in investment in the most recent quarter was eligible for the tax deduction suggests an upper bound of £1.6bn in extra tax

Source: RF analysis of ONS, National Accounts; OBR, Economic and Fiscal Outlook – October 2021.

Individual tax factors not enough to explain strength of receipts

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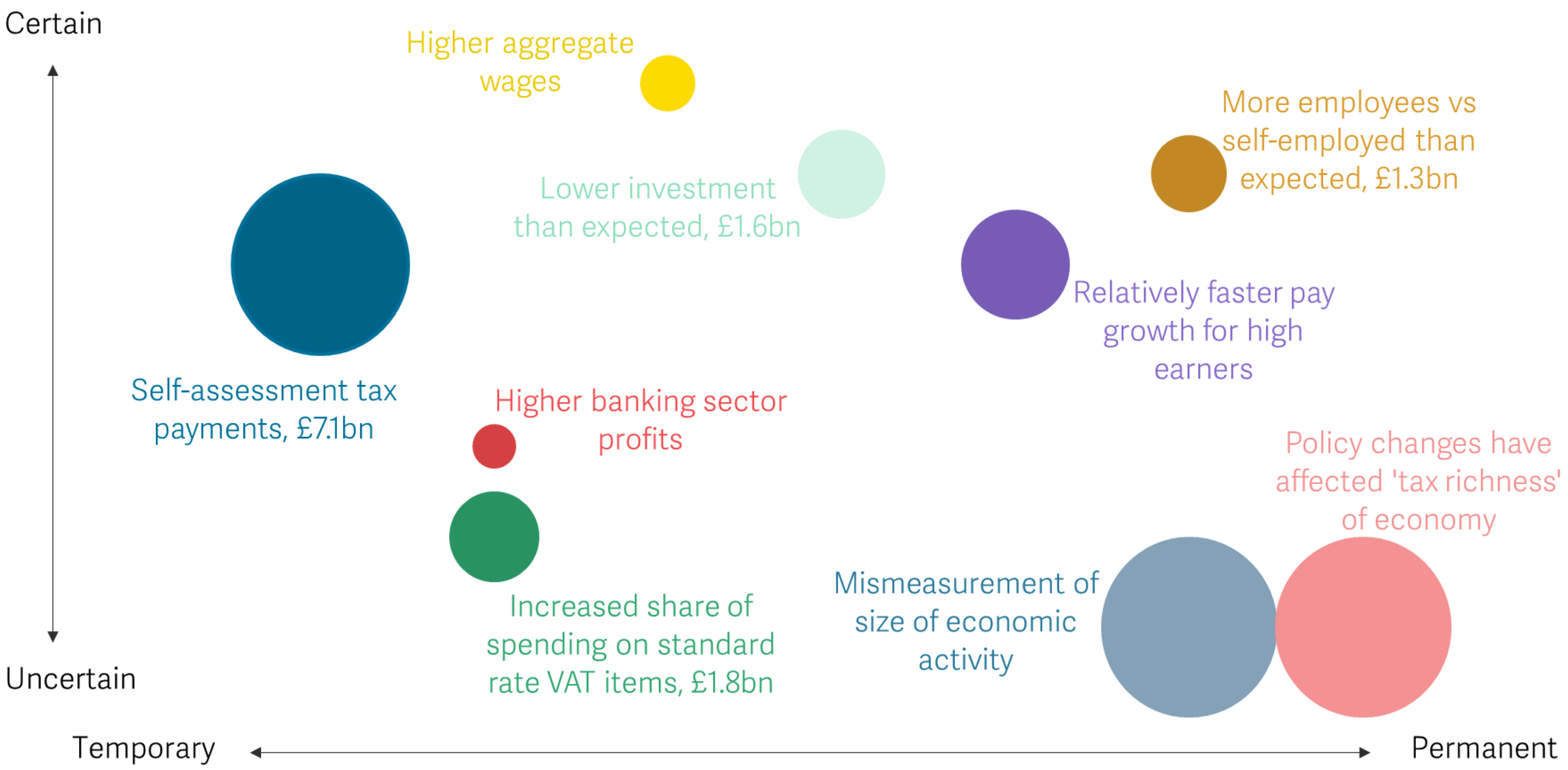
Subjective assessment of the certainty and permanence of different tax factors: UK



Individual tax factors explain relatively little of higher revenues

The £7.1bn increase in self-assessment taxes, relative to expectations, may be due to specific pandemic-related effects and therefore temporary – tax holidays timings make this more uncertain

OBR is left having to make a major judgement call about how much revenue improvement to assume lasts into future years

Notes: Each bubble represents a hypothesis of why tax revenue has increased relative to expectations. Bubble sizes are back of the envelope calculations for the maximum impact each hypothesis could have (where no £ value is given, that indicates particular uncertainty but none of these estimates will be accurate, given data availability). Position of bubbles on axes of permanence and level of certainty on whether the impact exists is entirely subjective.
Source: RF analysis of OBR, Economic and Fiscal Outlook – October 2021; Bank of England, Bankstats; ONS, Public Sector Finances; ONS, Real-time PAYE pay data; ONS, Quarterly GDP; ONS, Retail Sales.

The bad news: inflation

The inflation surge to date is driven by energy bills and petrol

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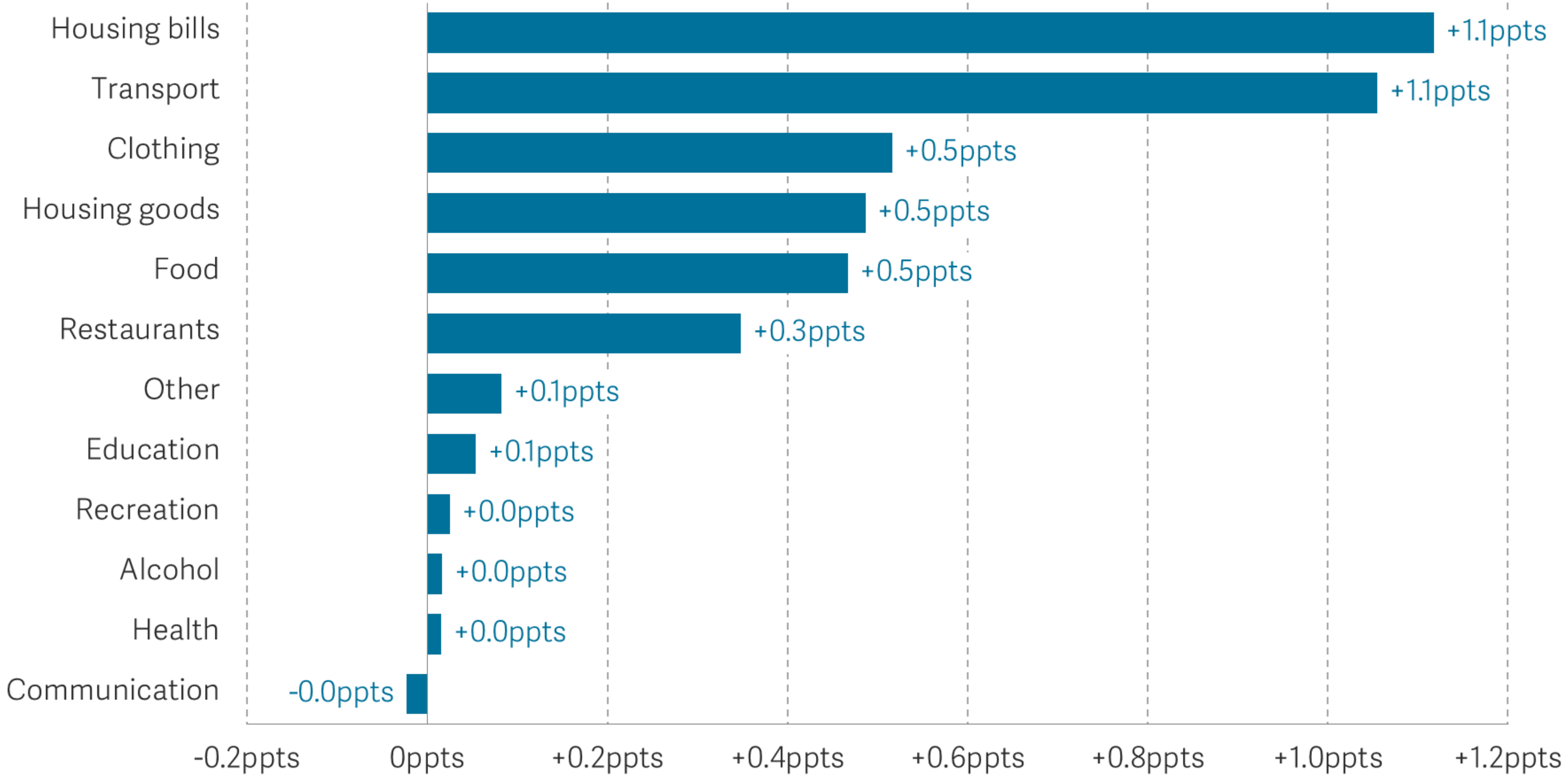
Change in contribution to annual CPIH inflation, January 2021 to January 2022: UK



The global recovery has led to demand rising above supply, particularly for goods

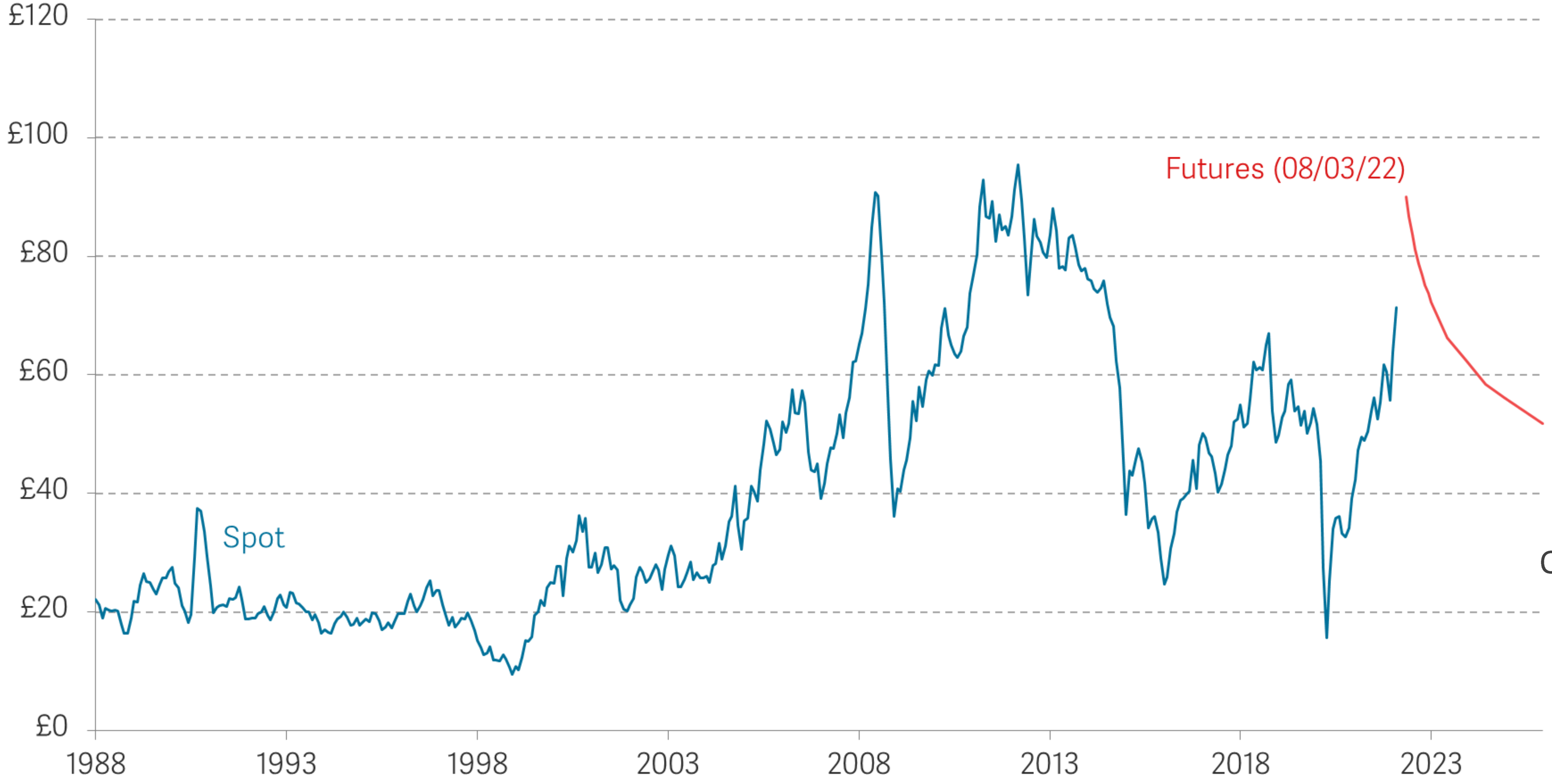
This has been felt most keenly in oil and gas prices, as well as generalised rises in goods prices

Services inflation has risen more slowly

Notes: Data do not sum to the total change in CPIH inflation between these periods due to rounding.
Source: RF analysis of ONS, Consumer Prices.

Invasion of Ukraine has pushed energy prices up further

Real brent crude spot and futures prices



The invasion of Ukraine is first and foremost a human tragedy, but it will have major economic effects

Oil, gas and other commodity prices are currently elevated and extremely volatile

Notes: Data are put into 2022 prices using CPI outturns and forecast.
Source: RF analysis of ONS, Consumer Prices; Intercontinental Exchange (ICE); US Energy Information Association; Bank of England.

OBR could double its forecast for the coming inflation peak…

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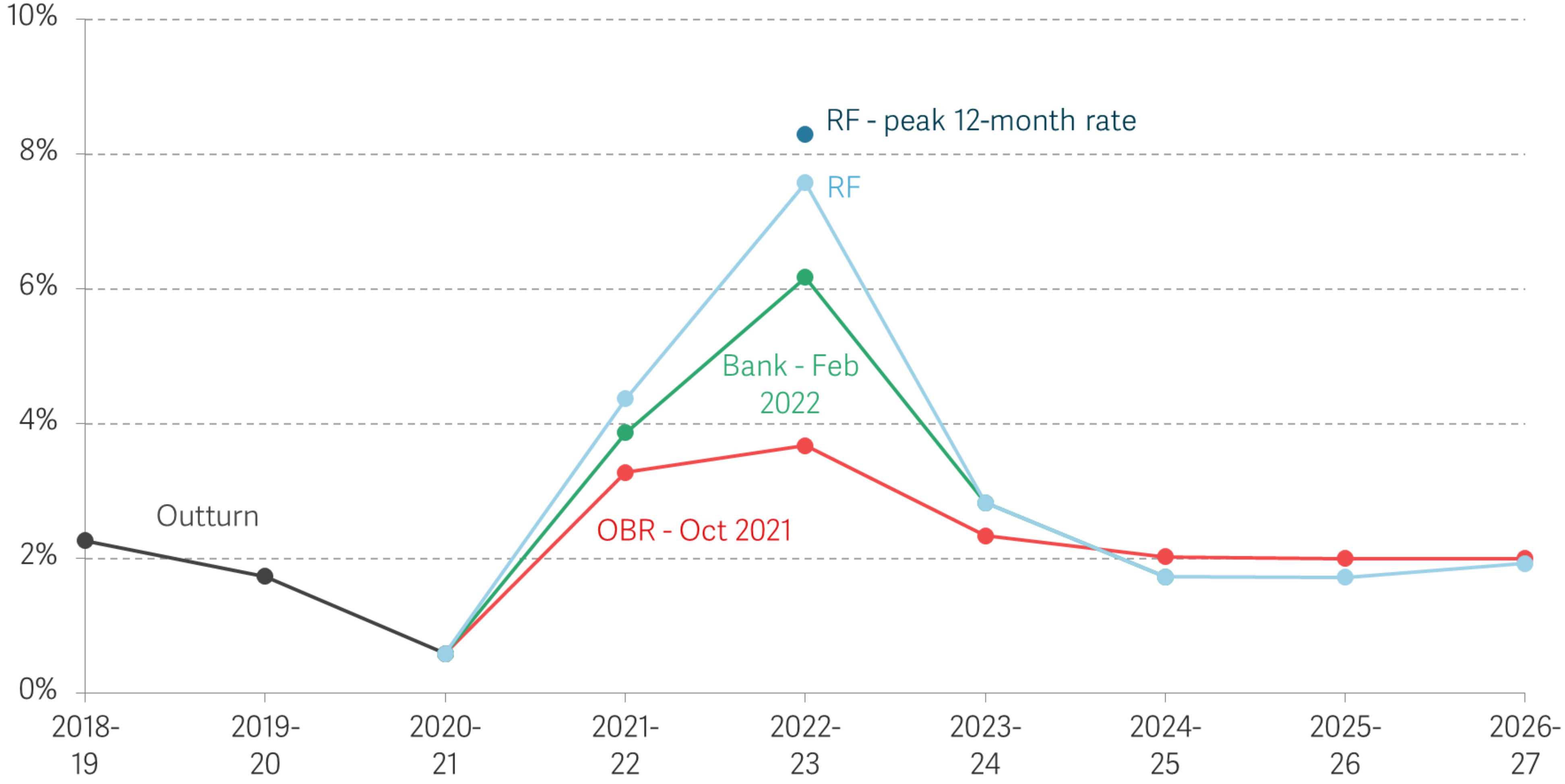
Annual CPI inflation outturns, and select forecasts: UK



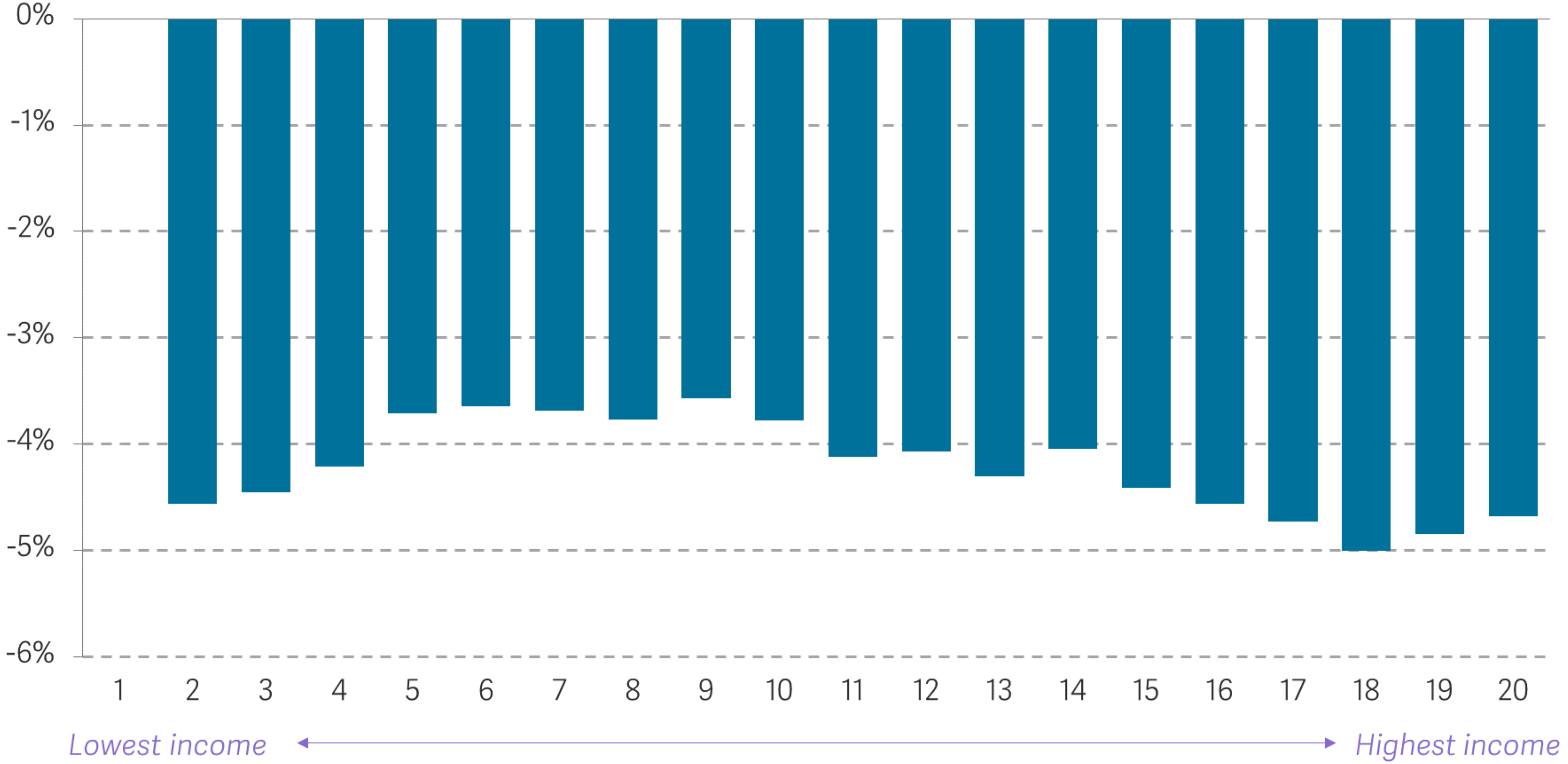
The RF scenario maps energy price rises up to OBR data cut off of 2 March into the direct effect on inflation – through petrol prices and gas/electricity bills

Energy prices remain elevated and have been very volatile; if they stay high, inflation will be more persistent

Notes: Peak annual rate refers to the estimated peak in the monthly rate of annual CPI inflation.
Source: RF analysis of ONS, Consumer Prices; Bank of England, Monetary Policy Report – February 2022; OBR, Economic and Fiscal Outlook – October 2021; Intercontinental Exchange (ICE).

…driving the biggest income falls since the 1970s

Annual real growth in average equivalised household disposable income for non-pensioners, after housing costs, by income vingtile: UK, 2022-23

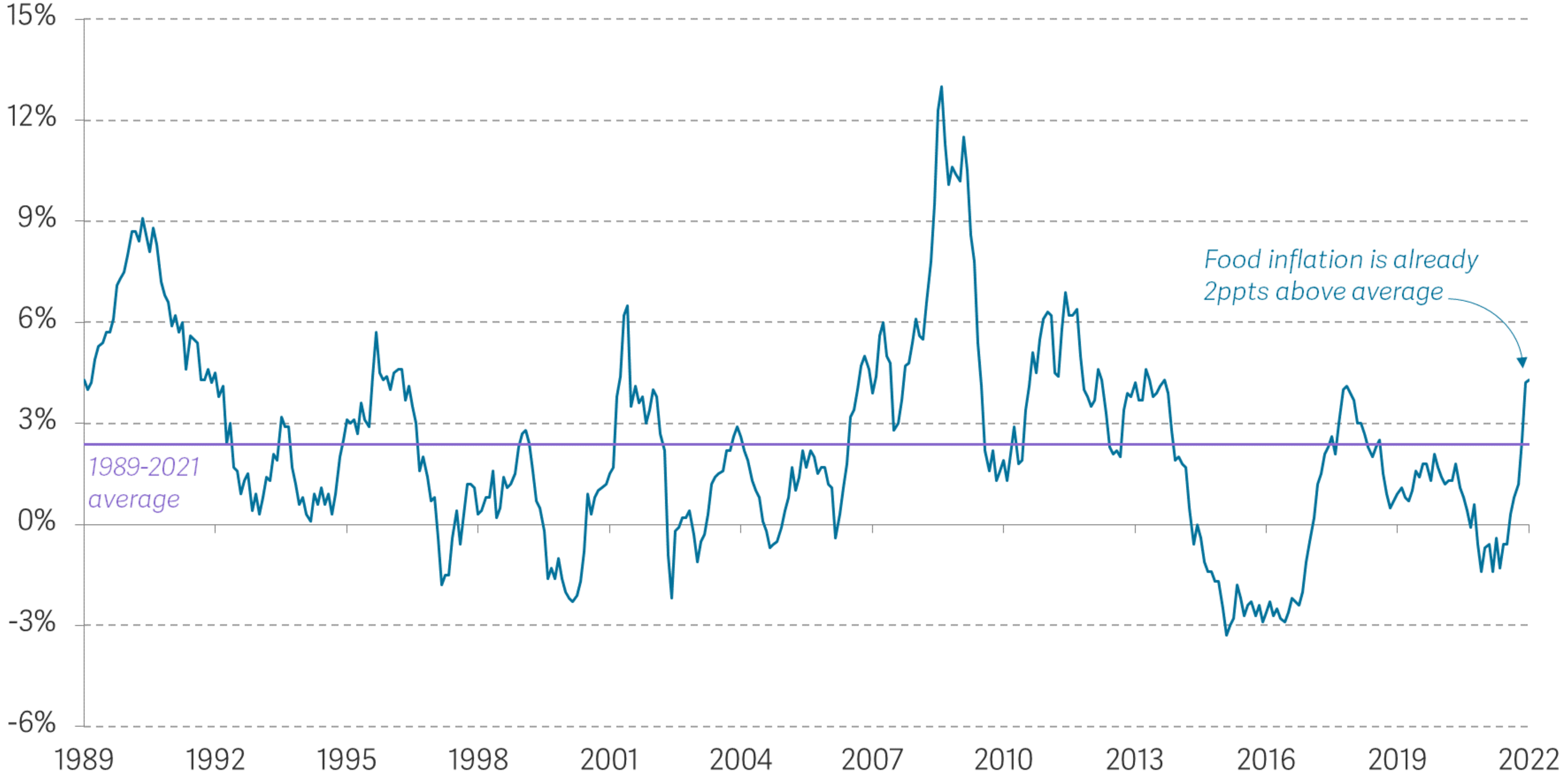


2022-23 is set to be tough for all households as high inflation lead to largest annual fall in disposable incomes since the 1970s

Notes: These forecasts use the RF scenario used in this paper to estimate income growth in 2022-23. These do not account for differential inflation rates across the income distribution (discussed in subsequent slides); were this to be included, lower income households would fair relatively worse than higher income households. We exclude the bottom 5 per cent, due to concerns about the reliability of data for this group.
Source: RF analysis of DWP, Households Below Average Income; and RF projection including use of the IPPR Tax Benefit Model, ONS data, and Bank of England and OBR forecasts.

Rising food prices look likely to further add to inflation later in 2022

Annual food and non-alcoholic beverages price inflation: UK



Source: RF analysis of ONS, Consumer Prices.

Some agricultural prices have risen significantly – wheat is up about a ⅓ since January

Oil price rise will feed through into broader food-price inflation

Lowest income fifth of families spent 13% of total expenditure on food, while the richest tenth spent 7%.

If we see high food inflation the danger is we repeat the unequal impact of inflation seen in 2009

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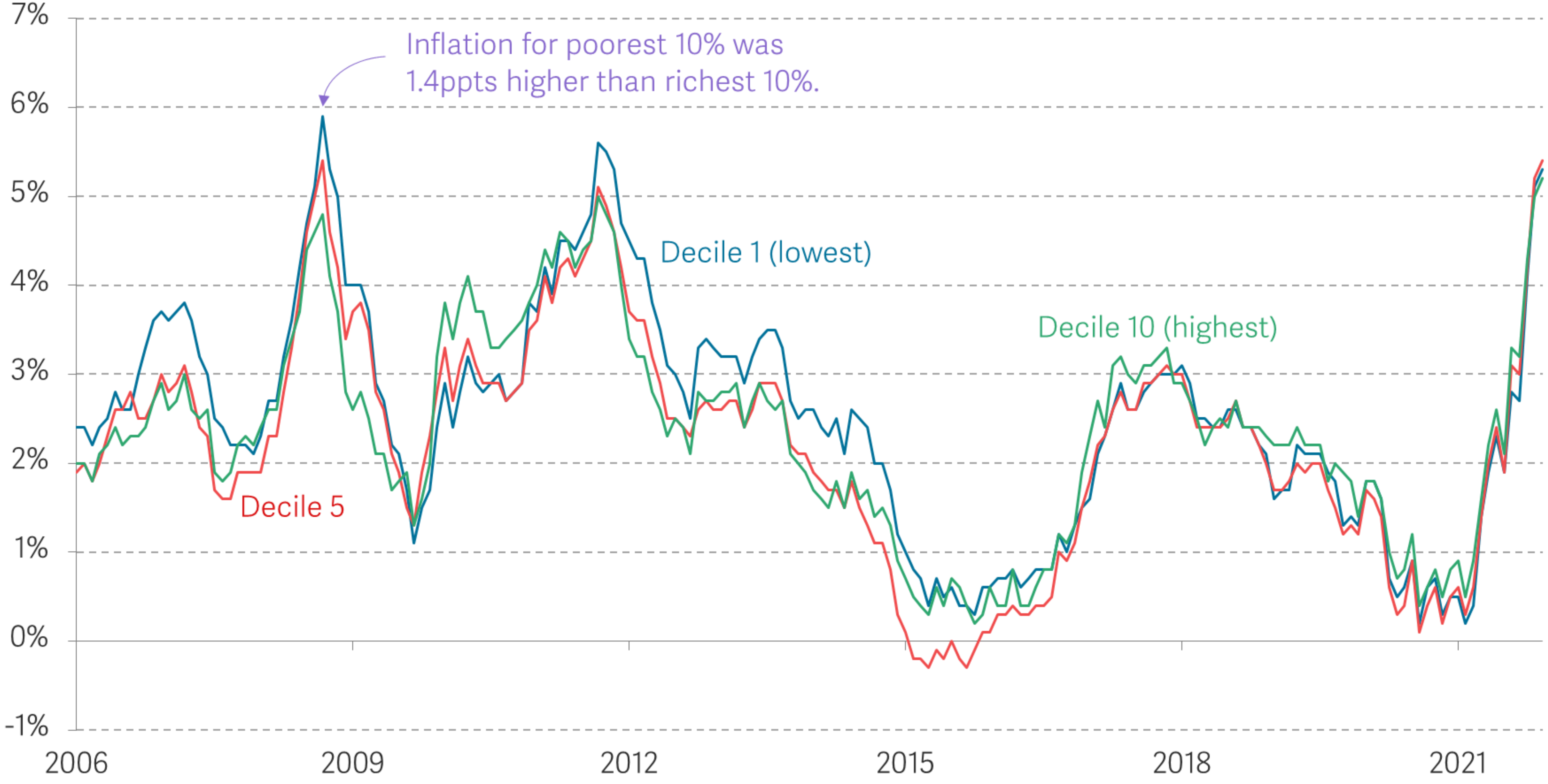
Average annual CPI inflation by equivalised disposable income decile: UK



Together, food and housing bills make up over twice as much of expenditure for the lowest income tenth of households compared with richest tenth

We expect similar, if not larger, gaps between inflation rates across the income distribution as in 2008/09. This implies inflation rates for the poorest will likely hit over 10 per cent this year

Source: RF analysis of ONS, CPI-consistent inflation rate estimates for UK household groups (plutocratic weighting).

Higher inflation combines with policy changes to drive income falls for many households – for example single parent on NLW

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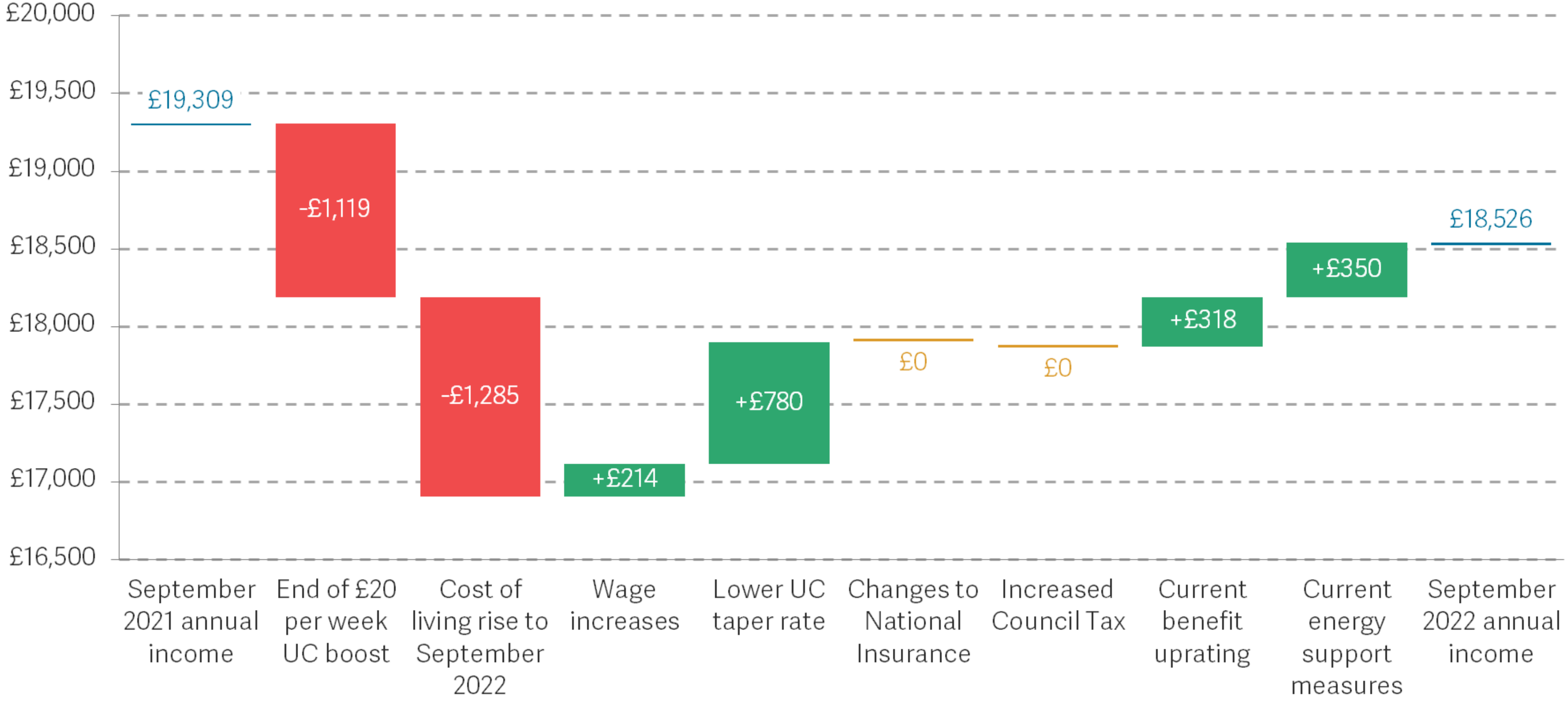
Annual household income (BHC) for a single parent with one child working 20 hours at the National Living wage, living in social rented sector, 2022-23 prices

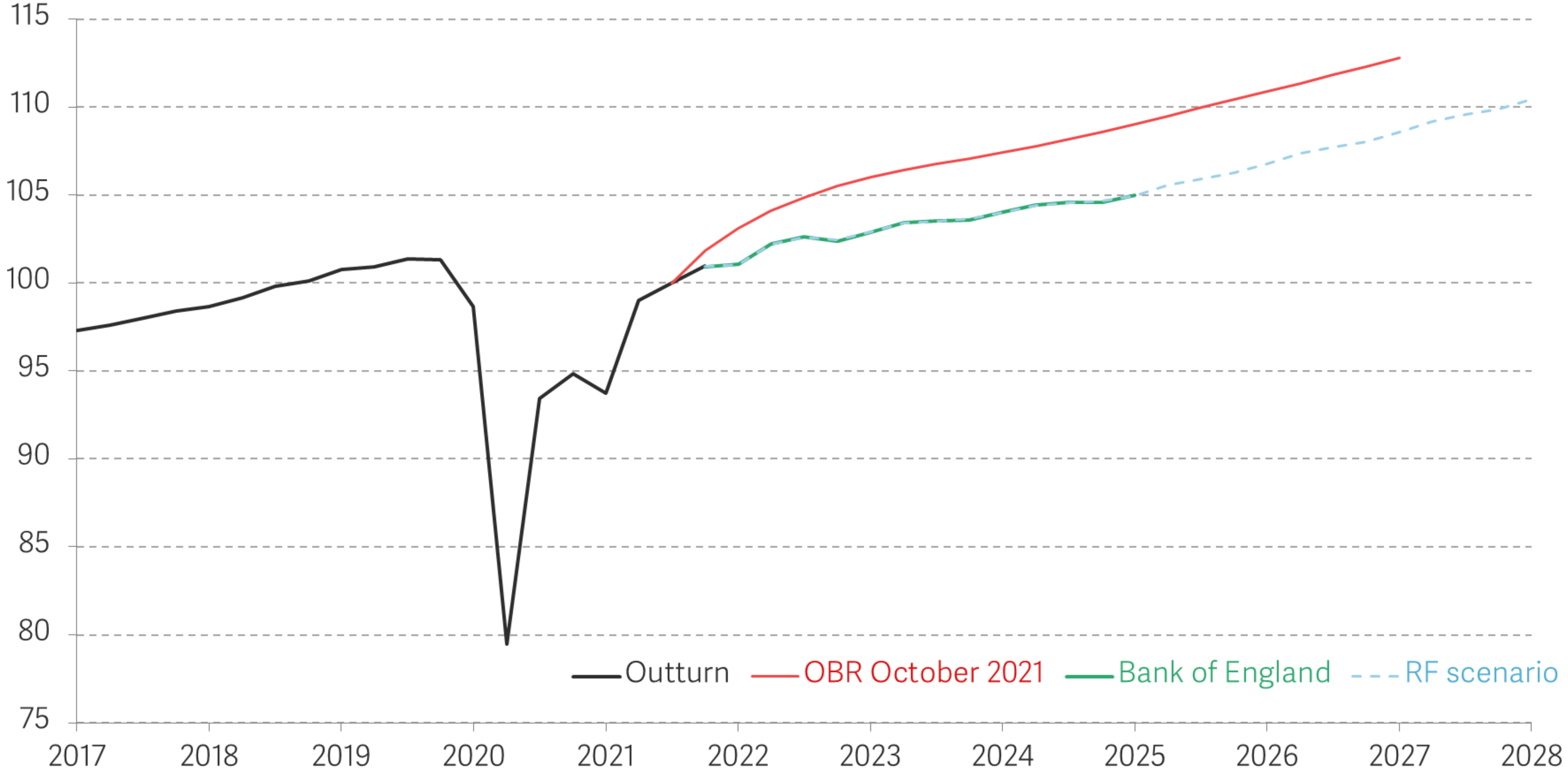


Notes: National Insurance changes include additional 1.25% employee contributions, as well as higher payment threshold. Increased Council Tax is partly offset by assumed higher Council Tax Support. Energy support measures include £200 energy bill rebate, and £150 Council Tax grant. Inflation rate from 2021-22 to 2022-23 assumed to be 7.6% in line with our Ukraine scenario in the Living Standards Outlook. Source: RF microsimulation model.

Impact on economy and public finances

Higher inflation means weaker real GDP

Index of quarterly GDP level (2021 Q4 = 100): UK



Bank of England forecast was for weaker growth than OBR's even ahead of the invasion of Ukraine (3.7% v 6.0% this year)

OBR forecast could be weaker still

Source: RF analysis of Bank of England, Monetary Policy Report – February 2022; OBR, Economic and Fiscal Outlook – October 2021; ONS, GDP.

Sharp increases in energy prices suggest a risk of recession

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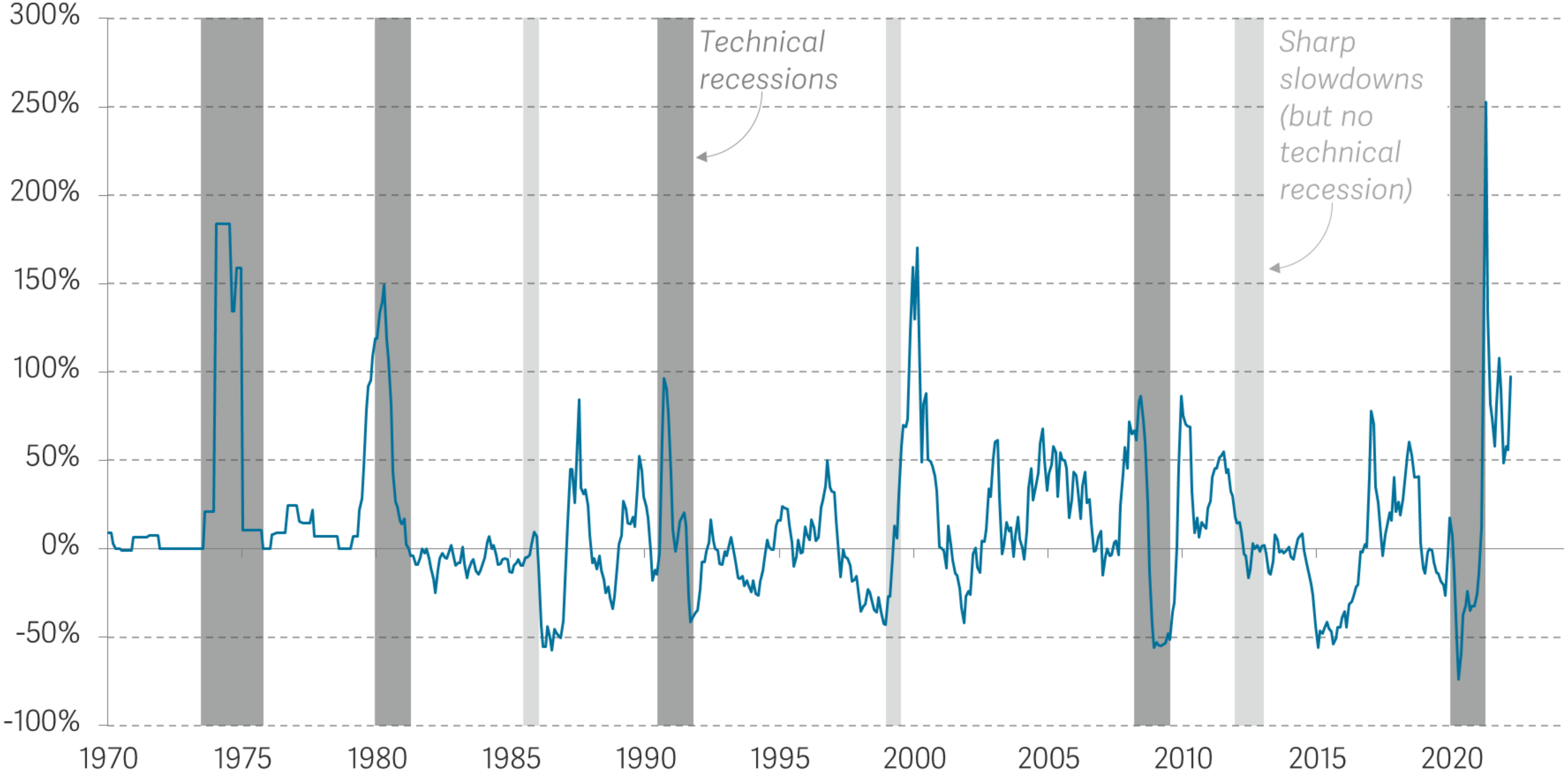
Annual percentage change in the dollar price of oil and recession and sharp slowdowns: UK



Rapid rises in oil prices have been associated with recessions – particularly in the 1970s and 1980s.

Notes: Technical recessions are defined as at least two successive quarters of negative growth; slowdowns are defined as a sharp slowdown in quarterly growth to below 0.1 per cent outside of a recession (more than a year and a half away from the start or end of a recession). Oil price is Brent from 1988 and West Texas Intermediate prior to that.
Source: RF analysis of ONS, National Accounts; and US Energy Information Administration, Crude Oil Prices.

Financial markets are concerned about recession risk

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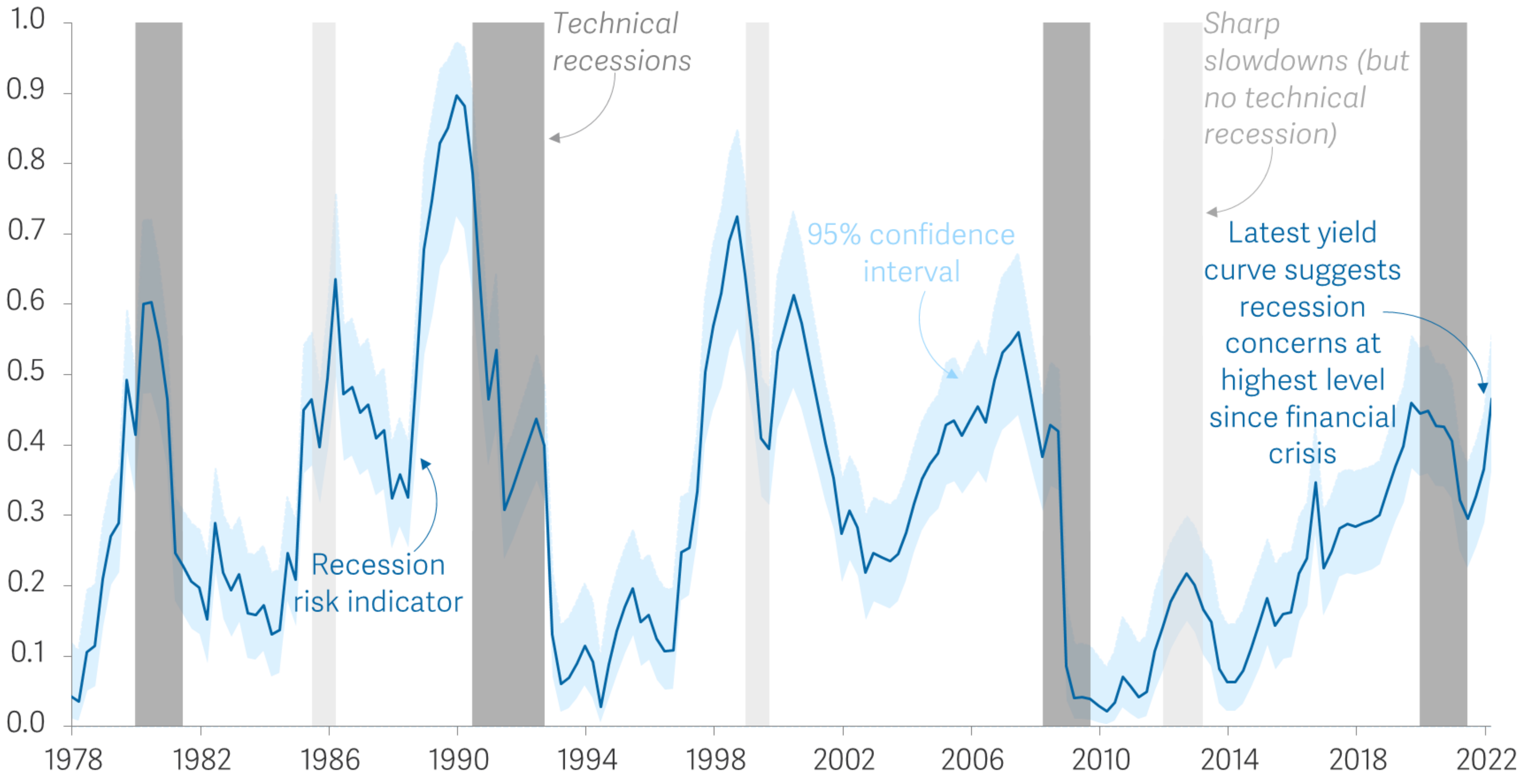
Recession risk indicator based on the slope of government yield curve: UK

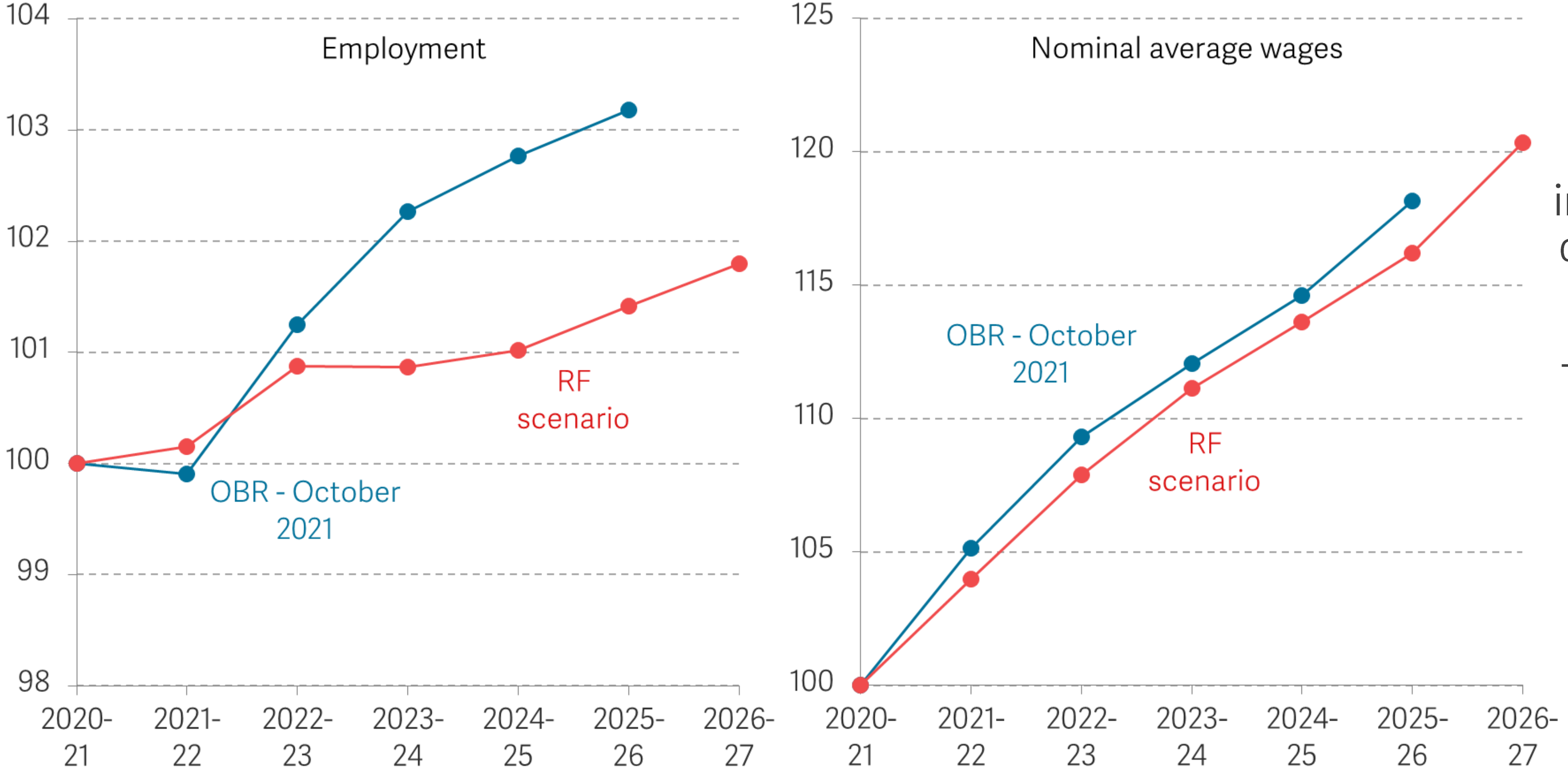


Notes: Technical recessions are defined as at least two successive quarters of negative growth; slowdowns are defined as a sharp slowdown in quarterly growth to below 0.1 per cent outside of a recession (more than a year and a half away from the start or end of a recession). Predicted recession probability taken from a simple univariate Probit model of the probability of a recession in the following three years driven by the slope of the yield curve.
Source: RF analysis of ONS, National Accounts; Bank of England, Yield Curve Data.

Financial market prices suggest concerns about the risk of a recession are at their highest level since prior to the financial crisis.

Even without a recession a weaker labour market is likely

Index of employment and nominal average wages (2020-21 = 100): UK



Higher inflation reduces real incomes, output and demand for workers.

This leads to a lower forecast for employment and earnings, relative to the OBR's expectations.

Source: RF analysis of OBR, Economic and Fiscal Outlook, October 2021; ONS, Labour Market Statistics.

Higher inflation also means higher interest rates – and debt servicing costs

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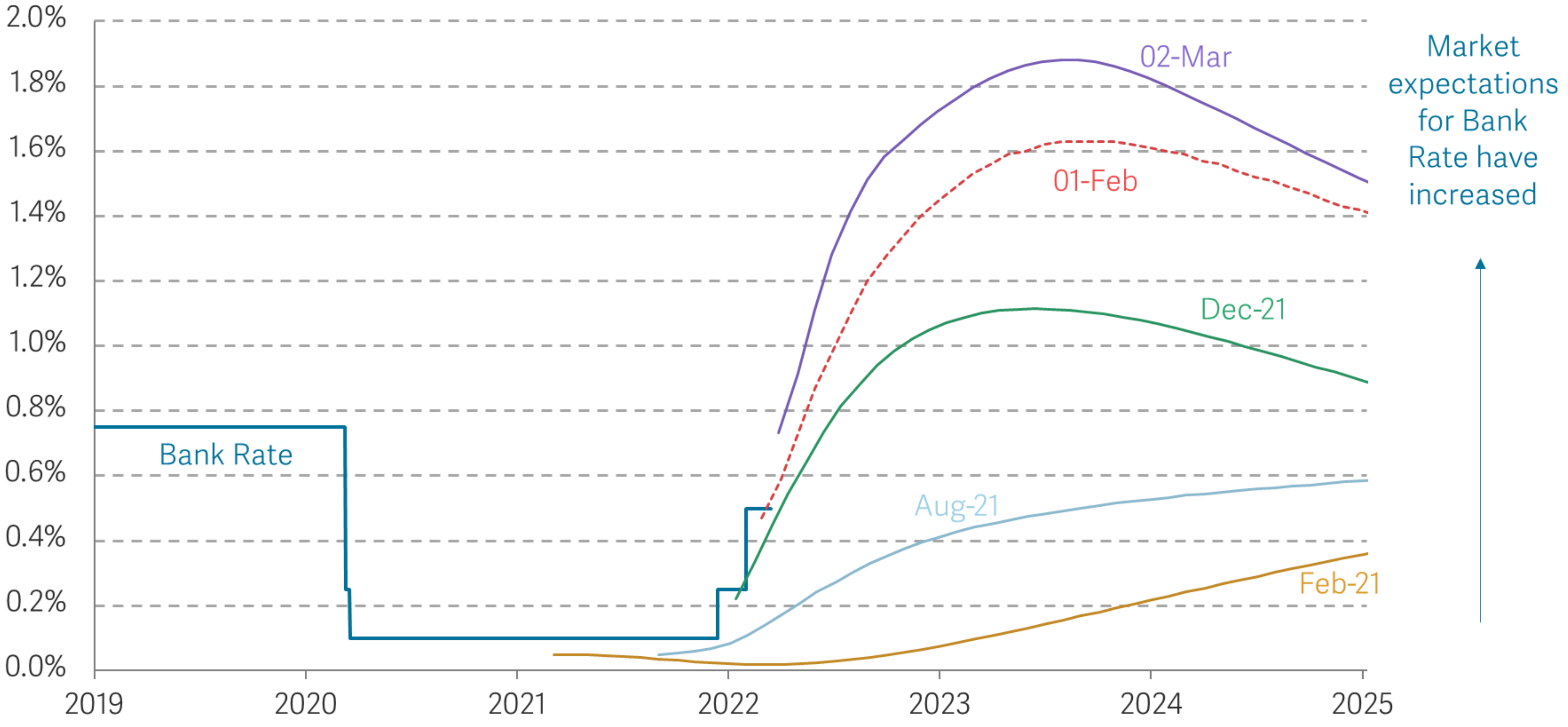
Bank Rate and overnight index swap forward curves: UK



Markets are pricing in around five rate rises by the end of this year taking rates to highest level since 2009.

This will feed through to longer-term gilt yields increasing debt service costs.

Source: Bank of England, Yield Curve Data.

Inflation + weaker labour market will worsen fiscal position. Key OBR judgement: how this nets out with higher receipts

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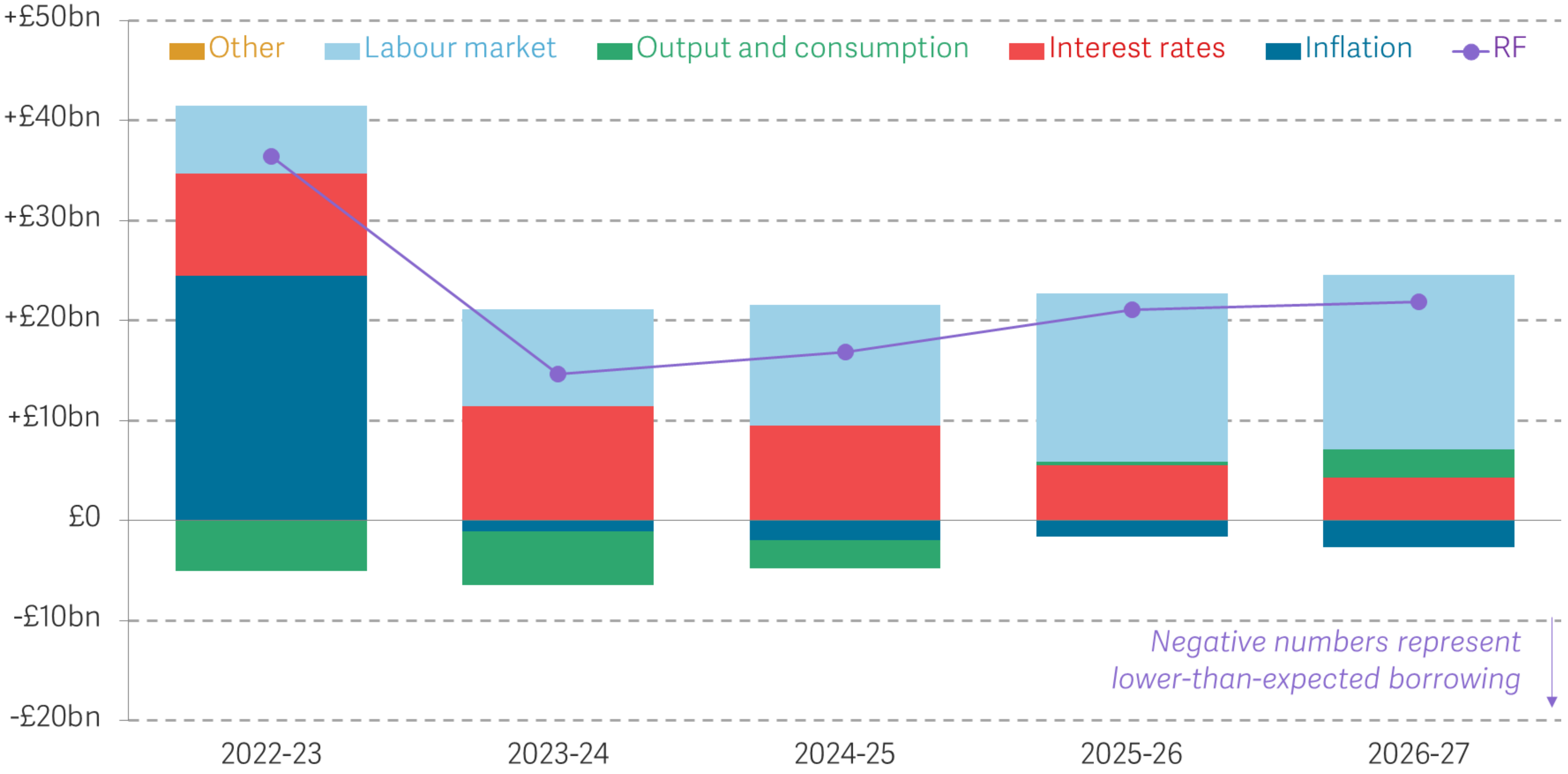
Change in public sector net borrowing forecast since the OBR's October 2021 forecast, by economic driver: UK



All else equal, changes to the economic forecasts are likely to push up borrowing by around £20bn a year

But all else is not equal: tax receipts have come in much stronger than expected this year

So OBR's key fiscal judgement is the relative weight to place on a worse economic outlook in future vs the persistence of the positive news on tax receipts this year.

Notes: The Resolution Foundation fiscal model is used to translate this economic scenario to a revised fiscal forecast. We utilise the OBR's 'ready reckoners' for how changes in the economy feed into government borrowing. Here, the OBR provides summary estimates for how individual economic variables affect specific elements of government spending and revenue. For example, higher employment leads more people to pay income tax and thus higher income tax revenue.
Source: RF analysis of ONS, Consumer Prices; Bank of England, Monetary Policy Report – February 2022; Bank of England, Yield Curves; OBR, Economic and Fiscal Outlook – October 2021; OBR, Ready Reckoners; Intercontinental Exchange (ICE).

Medium-term fiscal outlook is uncertain

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- There are two major effects on the medium-term fiscal outlook: the **deterioration in the economic outlook** from higher inflation; and the potential news that **tax revenues have increased** for a given level of measured economic activity.

- These **two effects are both uncertain** – what is going to happen to the economy? And how persistent will the tax revenue increases be?

- Our best judgement is that at least some of the improvement in tax revenues will prove lasting.

- If half of the increase in tax receipts lasts, it could be offset by the approximate £20bn deterioration in borrowing forecast for 2026-27 driven by the deteriorating economic outlook, leaving **medium run public finances relatively unchanged**.

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Higher inflation plus the war in Ukraine also mean plans for a policy-light Spring Statement have been ripped up

There is pressure for policy to respond to the cost of living crisis and war in Ukraine

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Formally this is a Spring Statement, not a Budget. But the Chancellor’s hope that it could be a policy light (and cheap) statement have faded.

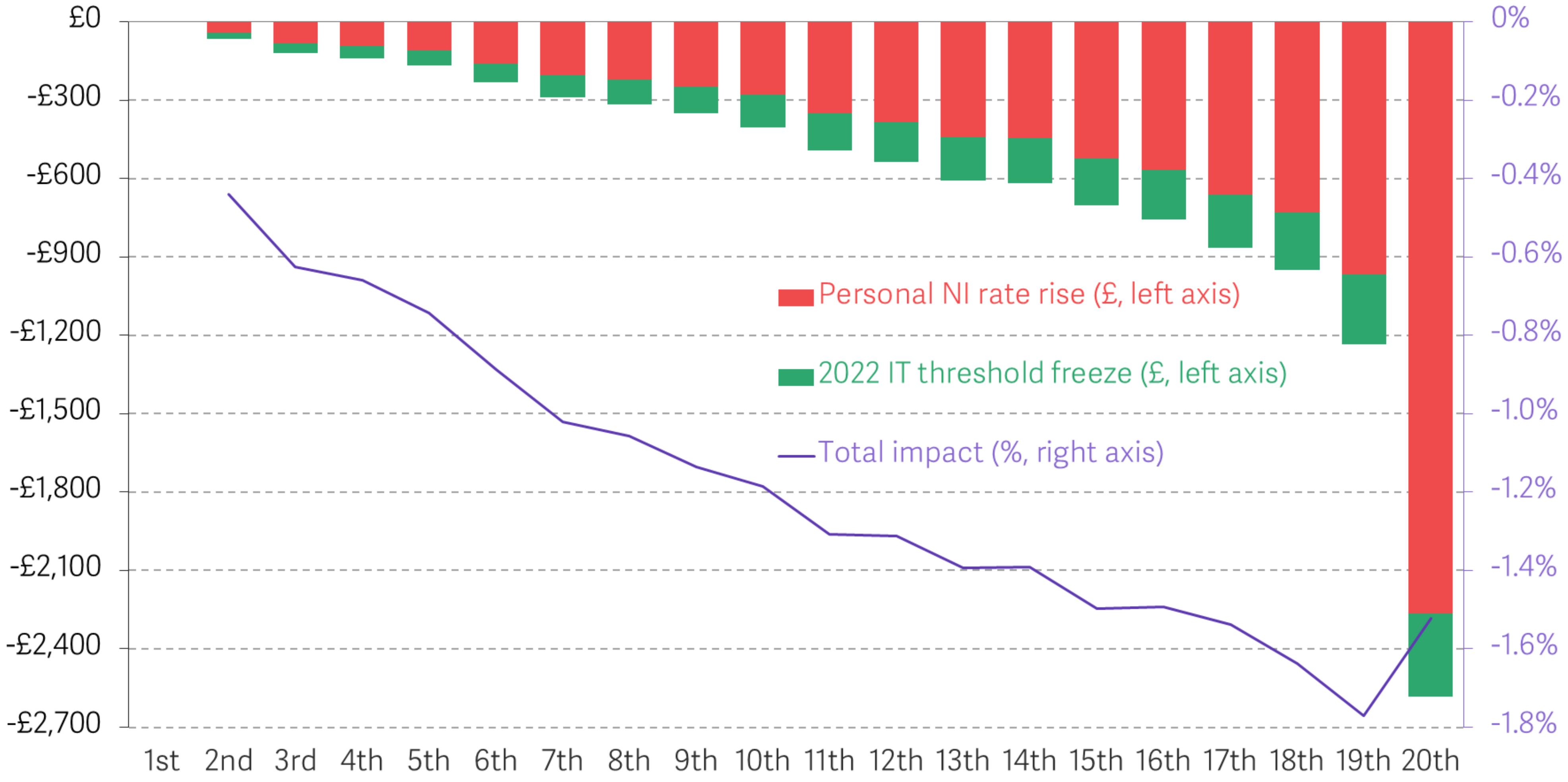
Calls for help with the cost of living include proposals for:

- tax cuts;
- energy production or efficiency measures; and,
- benefit increases.

Conservative backbenchers demands for increase in defence spending have also grown.

Scrapping NICs rise would do little to help those hit hardest

Annual impact on average disposable household incomes in 2022-23, by equivalised income vingtile after housing costs: UK

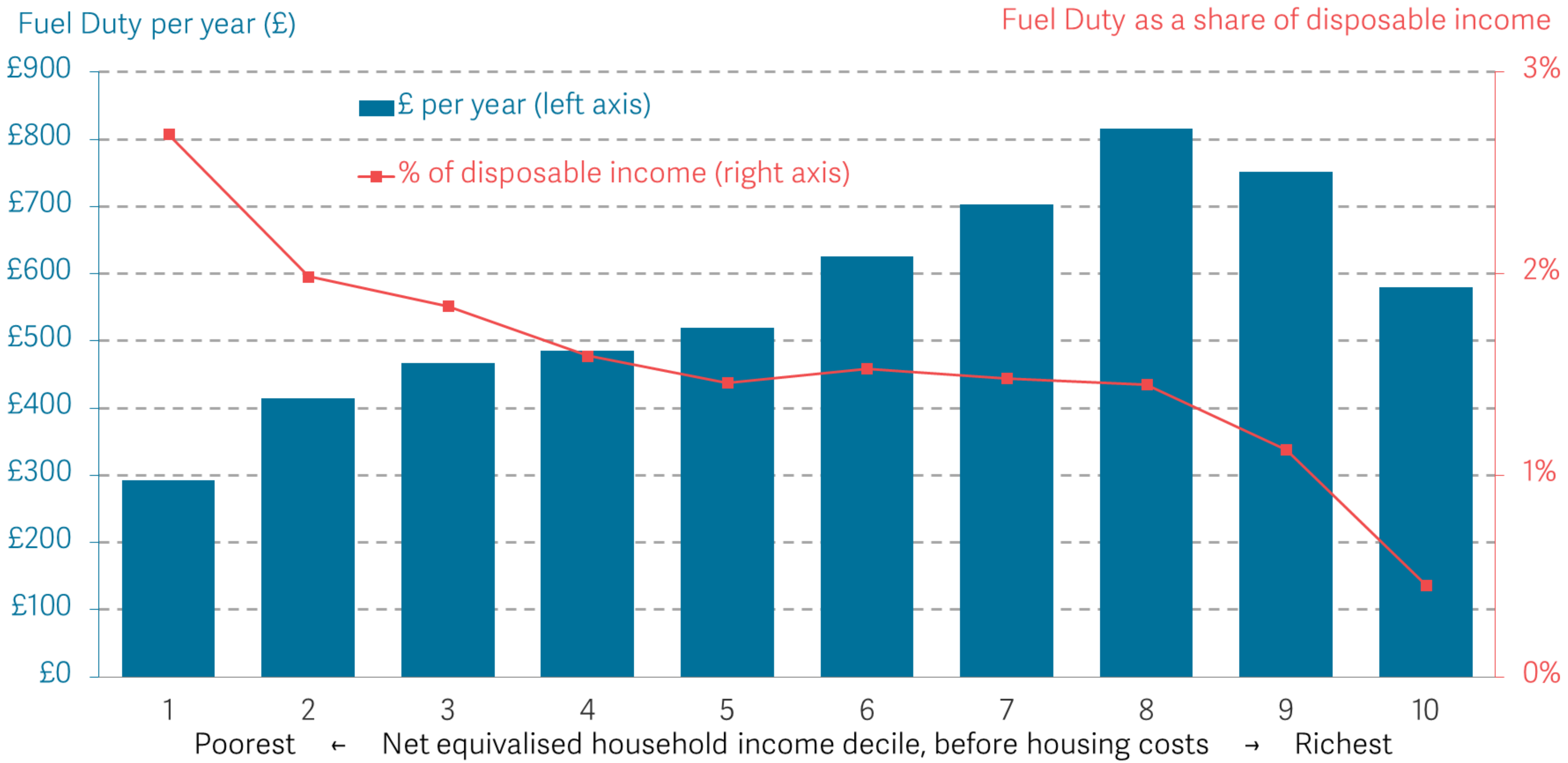


Scrapping the employee NICs rise would cost around £9bn, but do little to help those hardest hit by energy bill rises: the poorest fifth would only gain £60 on average

Notes: Figures are relative to a scenario without either tax rise. We exclude the bottom 5 per cent, due to concerns about the reliability of data for this group.
Source: RF analysis of DWP, Family Resources Survey, using the IPPR Tax Benefit Model.

Fuel Duty is already frozen but there are calls for it to be cut

Average Fuel Duty spending by income decile, 2019-20: UK



Fuel Duty is not rising this April

A further 5 per cent cut would cost around £1.4bn

The Chancellor should assume that the cost of this rising would be become permanent given history shows we shouldn't expect a rise to go ahead in 2023

Source: ONS, The Effects of Taxes and Benefits on Household Income, UK, 2019/20.

Calls for action on energy supply and efficiency overstate potential impacts

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Calls for fracking or expanded North Sea production will make no difference to energy production or prices this year.

Households and firms will reduce consumption in face of higher prices, which can be supported by already desirable measures to:

- Accelerate existing schemes to insulate homes and roll out heat pumps; and,
- Promote voluntary in-home measures to reduce consumption, including boiler optimisation.

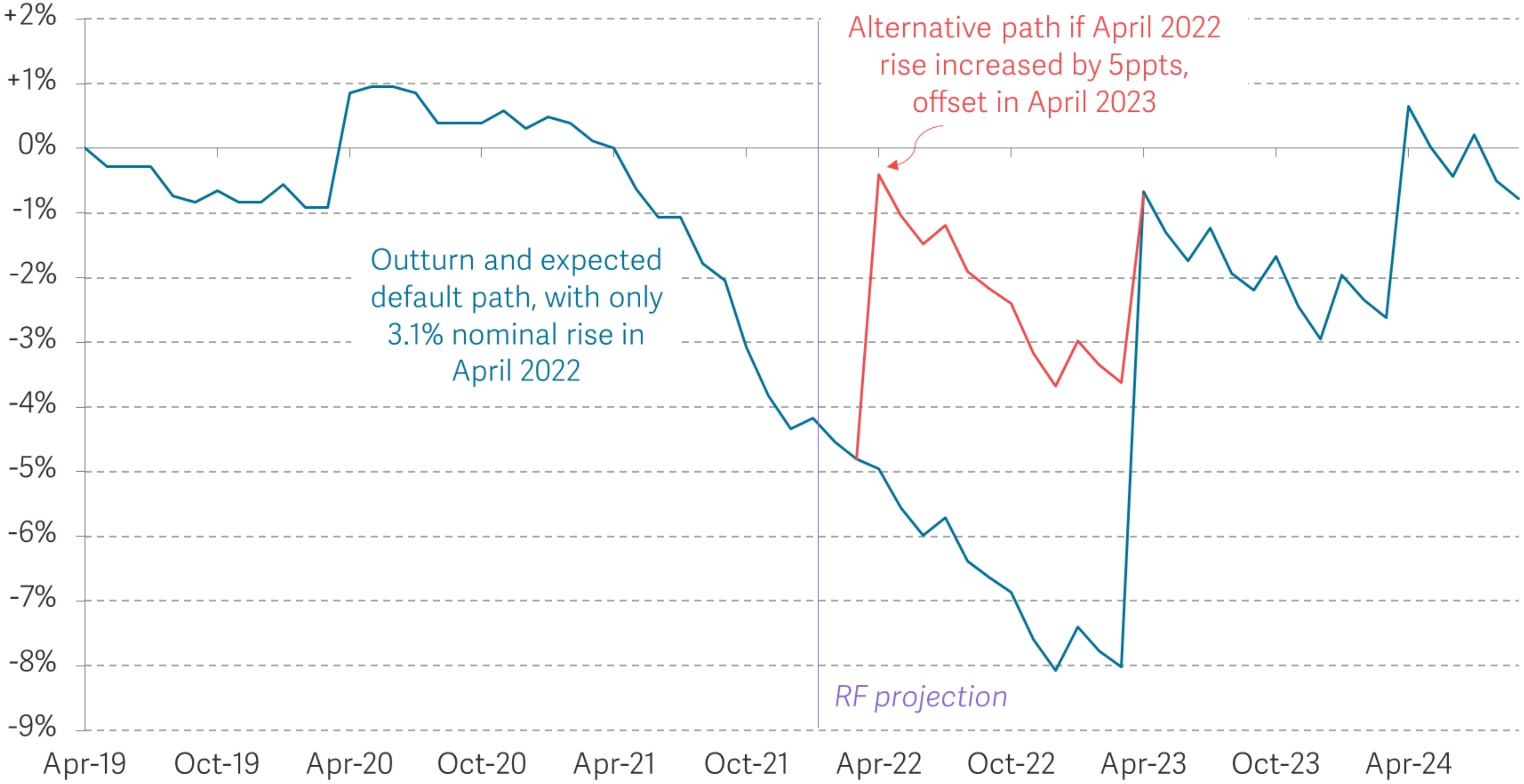
More immediately, Government should reduce energy bills by moving Renewable Obligation costs into general taxation, reducing the average bill by around £70.

<u>But</u> these measures will have a limited impact when compared to the scale of the energy price shock.

⇒ Targeted support through the benefits system is needed.

The Chancellor should increase this April's benefit uprating

Illustrative cumulative real change in the value of Universal Credit's child element since April 2019: UK



Increasing benefits by a further 5ppts this year is by far the most effective way to support those on lower incomes

Benefits that can't be re-uprated at short notice should increase in October at the latest

The Chancellor can choose how permanent any increase is by adjusting April 2023 uprating

Notes: We exclude the bottom 5 per cent, due to concerns about the reliability of data for this group.
Source: RF analysis of DWP, Family Resources Survey, using the IPPR Tax Benefit Model.

Bringing forward some of 2023's benefit rise is the best way to help those on lower incomes

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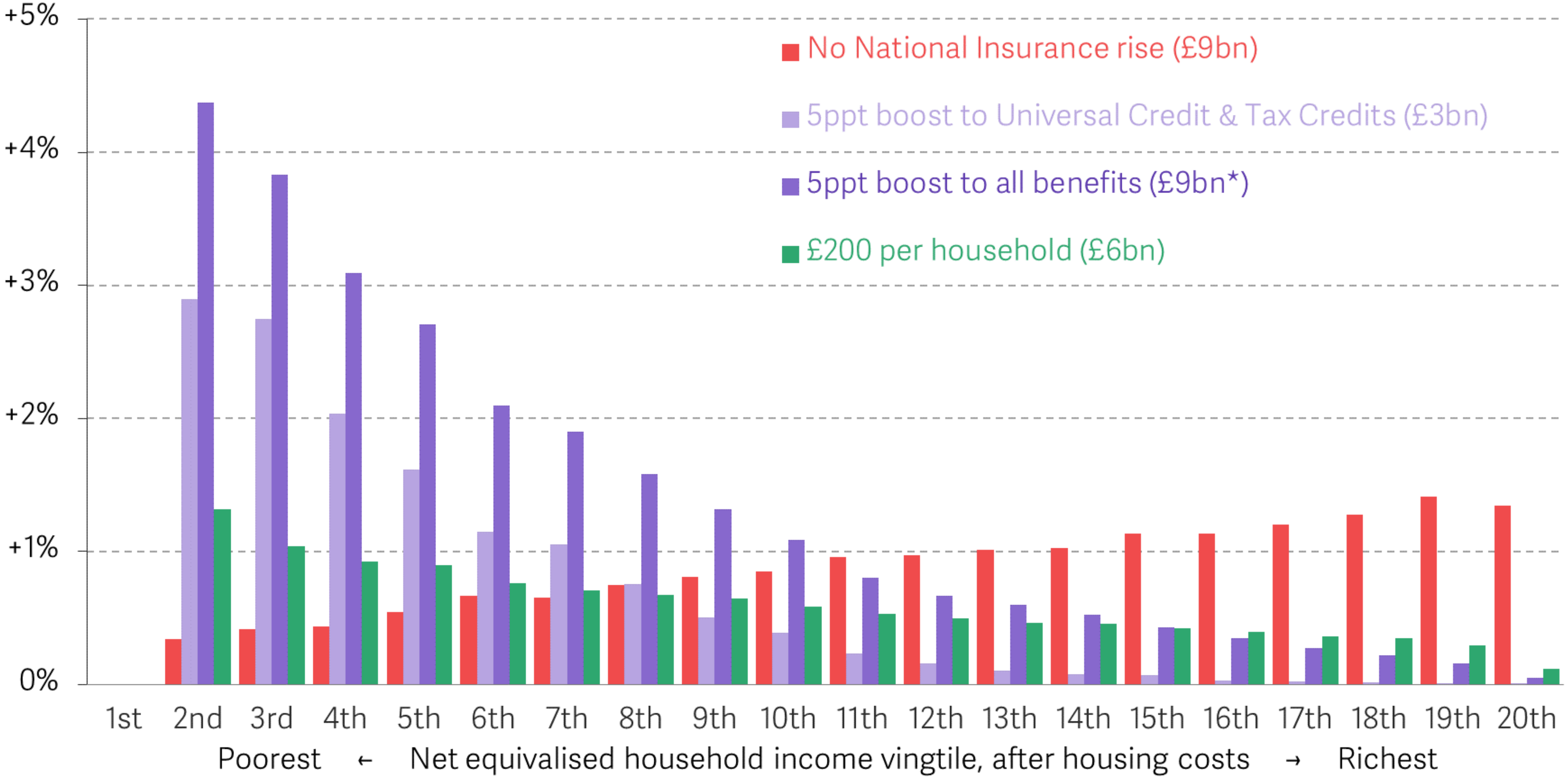
Impact of measures to support households in the face of a rise in energy prices (% of disposable income, 2022-23): UK



Protecting the real value of benefits in 2022-23 would be well-targeted (and temporary if required)

Increasing only means-tested benefits would lower the cost to a maximum of £5 billion

Notes: * It is unlikely that all benefits can be increased as early as April 2022, therefore this cost for 2022-23 would in reality be lower than £9 billion. We exclude the bottom 5 per cent, due to concerns about the reliability of data for this group. National Insurance impact and costing excludes the employer rate.
Source: RF analysis of DWP, Family Resources Survey, using the IPPR Tax Benefit Model.

Permanent increases in defence spending mean real trade-offs vs health spending and tax rises

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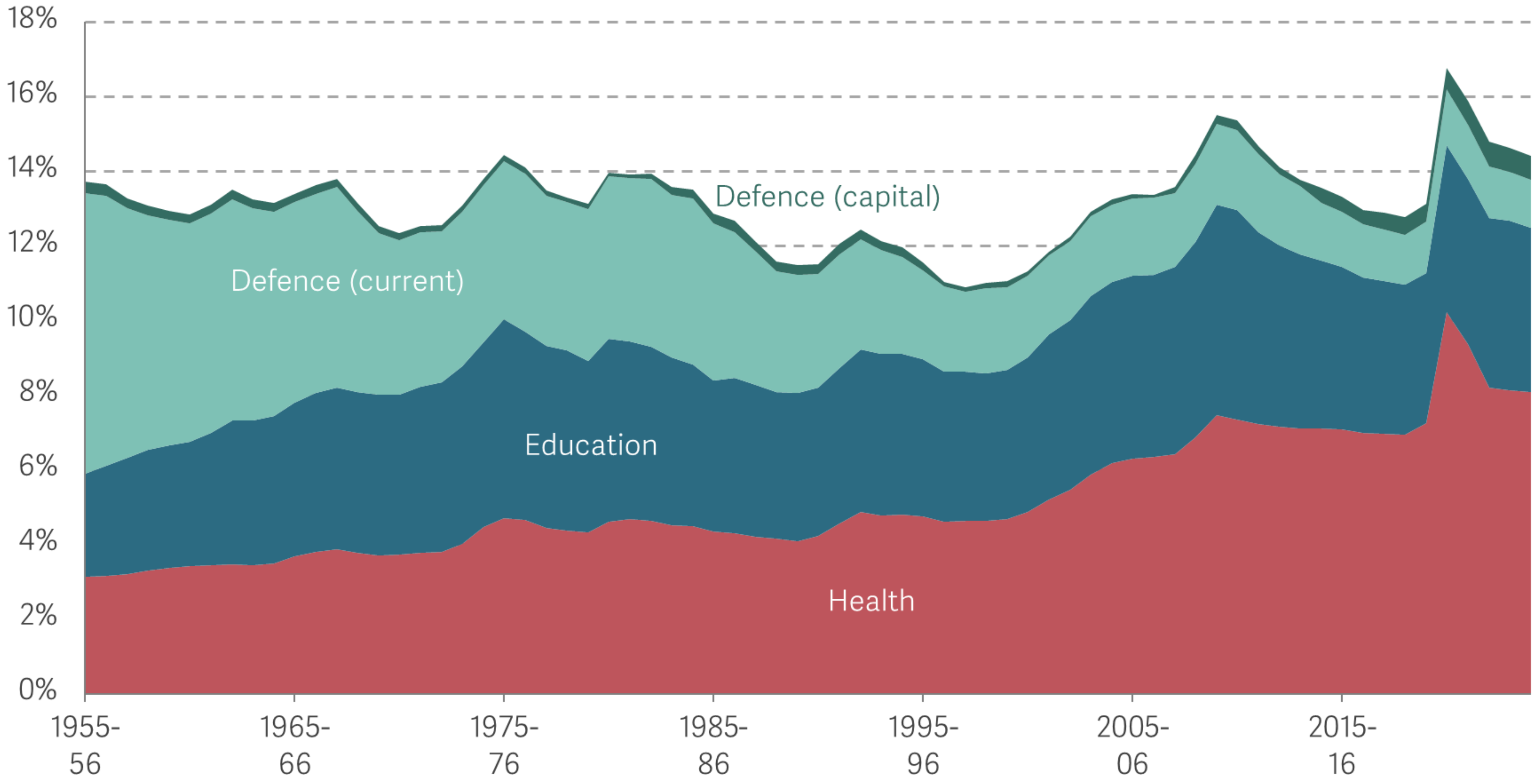
Government spending on select government department areas: UK



Defence budget has fallen from 7% to 2% of GDP post-WW2, enabling the growth of the welfare state

Temporary costs of supporting Ukraine will be financed by higher borrowing

Recent spend increases are very capital intensive

Permanently higher current spending (ie for soldiers) means lower spending elsewhere or higher taxes

Notes: The presented numbers do not adjust for the impact of student loans.
Source: Analysis of HMT, PESA Tables various, and Spending Review 2021; OBR, Economic and Fiscal Outlook Oct 2021; Bank of England, A millennium of macroeconomic data for the UK, 2020.

Resolution Foundation

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