Resolution Foundation BRIEFING

Blowing the budget

Assessing the implications of the September 2022 fiscal statement

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Summary

Yesterday, the Chancellor decided to blow the budget on a £45 billion package of tax cuts, the biggest for 50 years. In doing so, he rejected not just Treasury orthodoxy but also the legacy of Boris Johnson, unveiling a wholly new approach to economic policy. Today's Conservative Party is no longer fiscally conservative or courting the Red Wall, with debt on course to rise in every year of the forecast, and its focus shifting to the South of England, where the beneficiaries of these tax cuts are more likely to be living.

Large discretionary, deficit-financed, tax cuts are being loaded on top of an already large, but largely unavoidable, borrowing surge

Major tax cuts have been combined with an already large, and largely unavoidable, fiscal loosening, driven by a weaker economy and the need to subsidise families' and firms' surging energy bills. The Chancellor has – unwisely – not allowed the Office for Budget Responsibility (OBR) to update its forecasts, but we estimate that energy support and the weaker economic outlook will increase borrowing by £265 billion over the next five years compared to the OBR's March forecast. Tax cuts of £146 billion over the same period increase that to £411 billion.

The extra borrowing is greatest this year (£130 billion), driven by the energy bill support, but the permanence of the new tax cuts, combined with higher interest rates and weaker growth, mean that the £30 billion of headroom that the previous Chancellor maintained against his fiscal rule of having debt falling as a share of GDP will have been blown through twice over by the middle of this decade. This constitutes the largest permanent loosening of fiscal policy on record: the deficit will increase by 2.3 percentage points of GDP, or £67 billion, in 2026-27 compared to expectations in March.

The Chancellor set out that having debt falling as a share of GDP remains his key metric for fiscal sustainability, but he did not outline how that would be achieved. Doing so by the middle of this decade would require spending cuts of £36 billion in 2026-27, assuming tax rises have been ruled out. This would be broadly equivalent to the total cut to public spending announced by George Osborne in his 2010 Budget. Faster growth would reduce the spending reductions required, but pushing the other way are a range of fiscal pressures, including the Prime Minister's commitment to spend 3 per cent of GDP on defence (at a cost of £30 billion), and the general tendency not to proceed with inflation-linked rises in fuel duty (which could cost £4 billion by 2026-27).

New tax cuts will overwhelmingly benefit those on the highest incomes in the South of England, while personal taxes are still being increased for the vast majority of earners

The tax cuts confirmed yesterday are strongly focused on higher-income households, driven by the reversal of the rise in National Insurance and the scrapping of the additional 45p rate of Income Tax, along with associated cuts to Dividend Tax. Next year they will see someone earning £200,000 gain £5,220 a year, with the gain rising to £55,220 for a £1 million earner. Those on £20,000 will gain just £157. The result is that almost half (47 per cent) of the gains will go to the richest 5 per cent of households, compared to 12 per cent for the entire poorer half. Moreover, those living in the South East or London will see over three-times (on average, £1,600) the gains of those in the North East, Wales and Yorkshire (an average of £500). The South is also where the main impact of a welcome cut to Stamp Duty will be felt: the tax bill on the sale of the average first-time buyer home in London will fall by £6,300, compared to no gain for the average first-time buyer in the North East.

This package of tax cuts largely reverses rises announced by Rishi Sunak in recent years, but does not do so entirely: the four-year freeze to income tax thresholds remains in place. The scale of that freeze in an era of high inflation means that the vast majority of earners will still see their personal taxes increased when all tax changes announced during this Parliament are taken into account. Those earning under £155,000 will see their tax bill increase or be unaffected, with only those earning over £155,000 will receive a net tax cut thanks to the scrapping of the 45p tax rate. Workers earning between £63,000 and £125,000 lose the most (almost £1,500 in 2025-26). A similar pattern can be seen among households, even considering increases to benefit generosity as well: only the top 5 per cent will see significant income gains from policy changes (averaging £2,520 by 2025-26). Despite the rhetoric, tax as a share of the economy remains at its highest sustained level since the 1940s (at around 35 per cent of GDP).

The Chancellor's borrowing surge will boost growth in the short term, but raise interest rates

The Chancellor rightly identified raising the UK's growth rate as a core objective for economic policy makers. In the short run, the sheer scale of additional fiscal support to the economy will boost GDP: the £60 billion of energy bill support over the next six months could raise the level of GDP by roughly 1.5 per cent. But while the Government has its foot on the accelerator, the Bank of England has its foot firmly on the brake, given its view that demand in the UK economy currently outstrips supply. As a result, the Chancellor's short-term boost to growth will be offset by further interest rate rises, leaving the level of GDP largely unaffected in the medium term. Ten-year gilt yields rose by around 25-30 basis points on the day of the fiscal statement, with larger rises for shorter-term yields.

As a result, any lasting impact of the new tax cut package rests not on its ability to boost demand in the short run, but on whether it contributes to permanently growing the economy's supply potential. Gambling that it will do is the new central economic policy of the Government, and a key driver of the decision to scrap the rise in the rate of Corporation Tax (CT) from 19 per cent to 25 per cent planned for April 2023 (costing £18 billion a year). However, there are good reasons for being cautious that this will materially boost the economy. First, this change will leave the effective CT rate exactly where it has been during the past decade of low growth that the Chancellor is seeking to make a break from. Second, while in principle lower CT rates may boost growth by encouraging investment and innovation, in practice empirical studies find little evidence of a material impact on growth. Specific tax measures, including more ambitious Investment Zones, could contribute to growth, but crucial details about where they will be based and what regulatory changes they will involve remain unclear. More generally the level of growth, or depth of any recession, in the years ahead will be driven far more by the path of energy prices than the level of taxation, with countries that opted for both higher (Germany) and lower (US) tax levels outgrowing the UK economy over the past 15 years.

The outlook for household living standards has been boosted by energy bill support and tax cuts, but remains dire

As with growth, large tax cuts and support for energy bills will boost household incomes, but they are still on course for a dreadful few years. Non-pensioner incomes are projected to fall by 8 per cent over the course of this year and next, significantly more than during the financial crisis (5 per cent between 2009-10 and 2011-12). Even assuming that benefits are increased by 10 per cent in cash terms next April (as per the usual uprating rules, and as promised by a previous Chancellor and a previous Secretary of State for Work and Pensions), the proportion of people living in absolute poverty is projected to rise from 17 to 20 per cent (equivalent to an extra 2.3 million people) between 2021-22 and 2023-24, with the proportion of children jumping from 23 to 28 per cent (an extra 700,000 children).

While lower-income households have seen their incomes relatively protected this year, they are on course for a remarkably large income fall in 2023-24 (an 8 per cent decline) while only the top 5 per cent are projected to see income gains (2 per cent growth), thanks to the cuts to income taxes. These falls are driven by inflation continuing to outstrip wage growth, while a slow recovery of living standards through to the middle of this decade also reflects rising unemployment (the Bank of England project a rise to 6.3

per cent) and rapidly rising mortgage costs. Incomes are projected to be lower in 2024-25 than 2019-20, making this comfortably the worst parliament on record for living standards growth.

Orthodox this is not

Rising energy costs, surging interest rates and the aftermath of the pandemic mean that the early 2020s were already set to be a perilous time for households and a challenging one for economic policy makers. That is the backdrop to the Government's radical reshaping of economic policy yesterday, where it jettisoned fiscal conservatism to deliver the largest tax cuts in half a century. The Chancellor has set the UK economy on a new trajectory, one he hopes includes permanently higher growth but which will certainly involve far higher borrowing levels and costs. The degree of risk-taking is beyond that adopted by any Chancellor in generations. Orthodox it is not.

Liz Truss's Government has cancelled key planned tax rises which, along with other cuts, amounts to a £45 billion a year giveaway

It may not have been an official Budget, but the Chancellor's fiscal statement last Friday was nonetheless a very a big deal. The Government went beyond promises made by the Prime Minister in the leadership campaign, and cancelled key planned tax rises, cut various other taxes, and funded the energy package for households and firms. The new tax measures include:

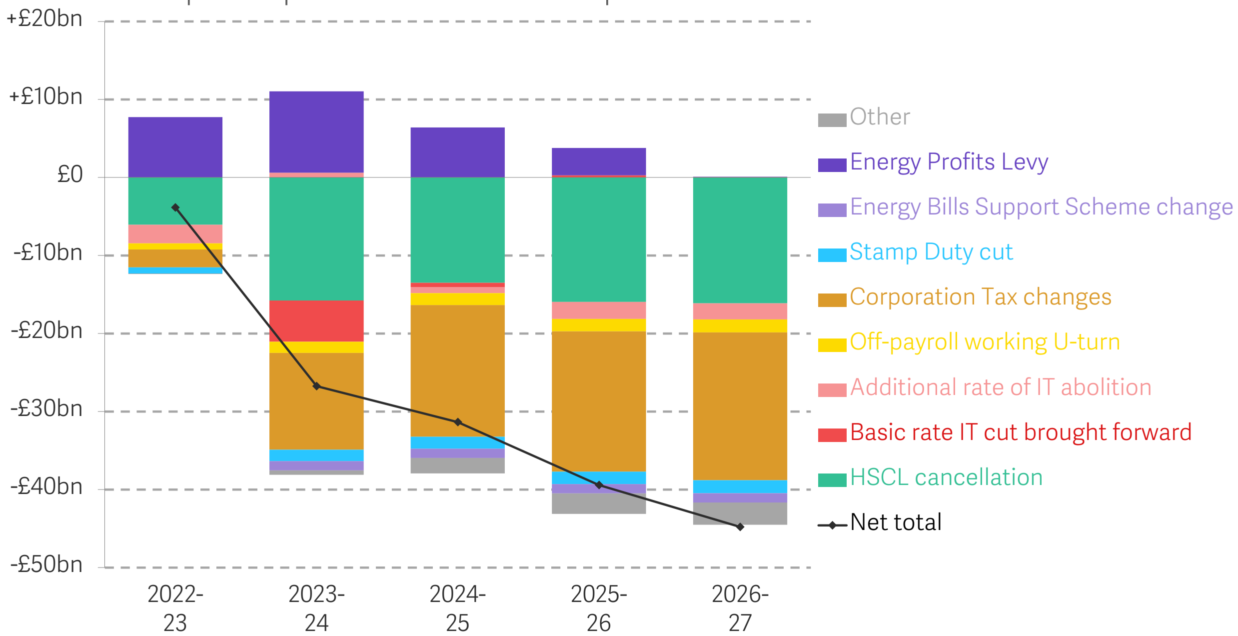
- Fully reversing the National Insurance Contributions (NICs) rate rise introduced this April, with NICs rates set to fall by 1.25 percentage points in November for both employees and employers, and the equivalent 'Health and Social Care Levy' (HSCL) for 2023-24 and beyond abolished. The combined cost of these measures is estimated to be over £15 billion in 2026-27.
- Cutting the basic rate of Income Tax by 1 percentage point to 19 per cent in 2023-24, one year earlier than had previously been announced by Rishi Sunak when he was Chancellor, equivalent to a giveaway of £5 billion in 2023-24.
- Removing the top rate of Income Tax for the highest earners, at a cost of £2 billion a year by 2026-27. This will apply to taxpayers in England, Wales and Northern Ireland; rates are devolved in Scotland.
- Reversing the 1.25 percentage point increase in Dividend Tax in April 2023 which, along with other, more minor, changes to the tax, will reduce revenues by £1 billion in 2026-27.

- Extending the Stamp Duty Land Tax (SDLT) zero band for both movers and first-time buyers in England and Northern Ireland – to £250,000 and £425,000 respectively. This measure will cost the Treasury £1.6 billion a year by 2026-27.
- Cancelling the planned rise in the main rate of Corporation Tax, which was scheduled to go up from 19 to 25 per cent next April, costing over £18 billion in 2026-27.
- Repealing reforms to off-payroll working (IR35) by April 2023, which will result in more workers being classed as self-employed, and tax revenues that are lower by £2 billion a year by 2026-27.

As Figure 1 shows, the impact of these and other smaller changes announced at the fiscal statement look set to reduce the Government's tax take by around £45 billion in 2026-27 – a permanent reduction of around 1.5 per cent of GDP.

FIGURE 1: **The Chancellor's fiscal statement amounts to a £45 billion tax giveaway**

Fiscal impact of polices announced in September 2022: UK

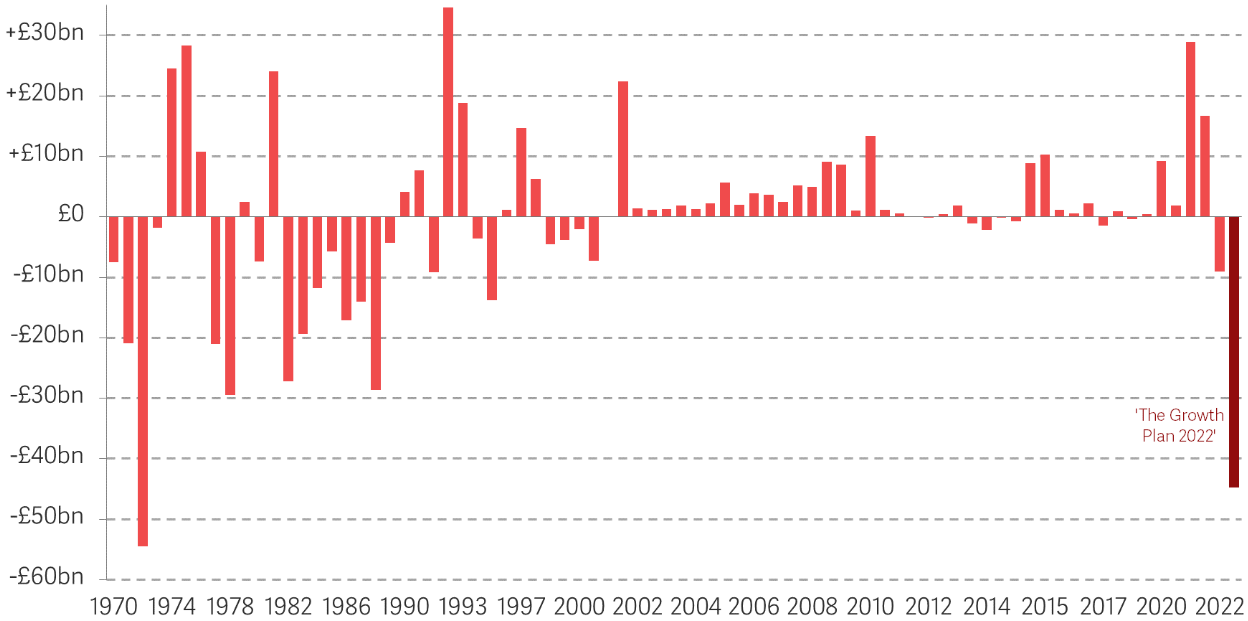


NOTES: IT = Income Tax. HSCL = Health & Social Care Levy (and National Insurance changes in 2022-23).
SOURCE: HM Treasury, The Growth Plan 2022.

Figure 2 puts the scale of that giveaway into a historical perspective: this is the biggest single package of tax cuts seen at any fiscal event in the past 50 years, since Antony Barber's ill-fated Budget in 1972.

FIGURE 2: **This was the largest set of tax cuts announced at a fiscal event since the Budget of 1972**

Net long-term annual impact of tax policy announcements at each fiscal event, 2026-27 nominal GDP terms: UK

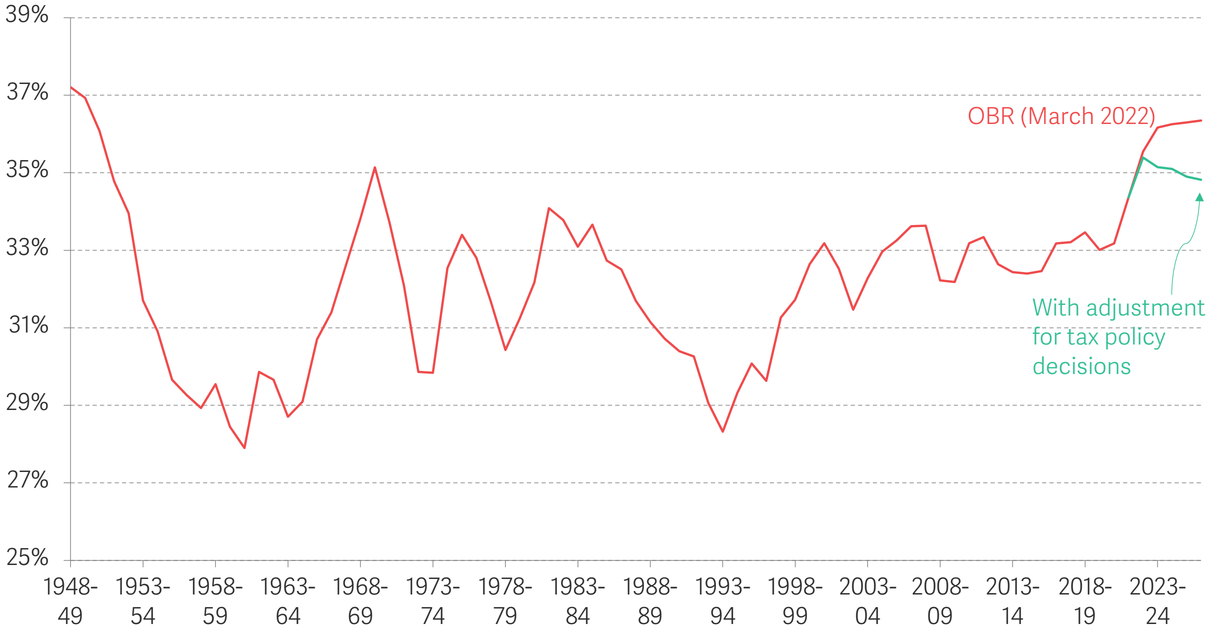


NOTES: Based on forecasts from the time of each fiscal event (actual impacts on tax revenue may have differed).
SOURCE: RF analysis of OBR, Policy measures database; HM Treasury, The Growth Plan 2022.

These huge tax cuts mean that revenues as a share of the economy are set to be much lower in the future than they were projected to be in the Office for Budget Responsibility's (OBR) last forecast in March. But they are on course to remain significantly higher than pre-pandemic, rising from 33 per cent of GDP in 2019-20 to around 35 per cent in 2022-23 and beyond. This would be the highest sustained rate since the 1940s (see Figure 3). Moreover, these figures are likely to be at the conservative end of the spectrum, as our forecast does not account for changes in the economic outlook, which may include a smaller economy in future but higher-than-expected tax receipts (before accounting for new policies), due to (for example) higher-than-expected employee earnings growth combined with the significant freeze in Income Tax thresholds.

FIGURE 3: **Despite the tax cuts in the fiscal statement, the tax share is still set to rise to its highest level since the 1940s**

National accounts taxes as a proportion of GDP: UK



NOTES: Green line does not account for economic forecast changes since March 2022.
SOURCE: RF analysis of OBR, Public finances databank; HM Treasury, The Growth Plan 2022.

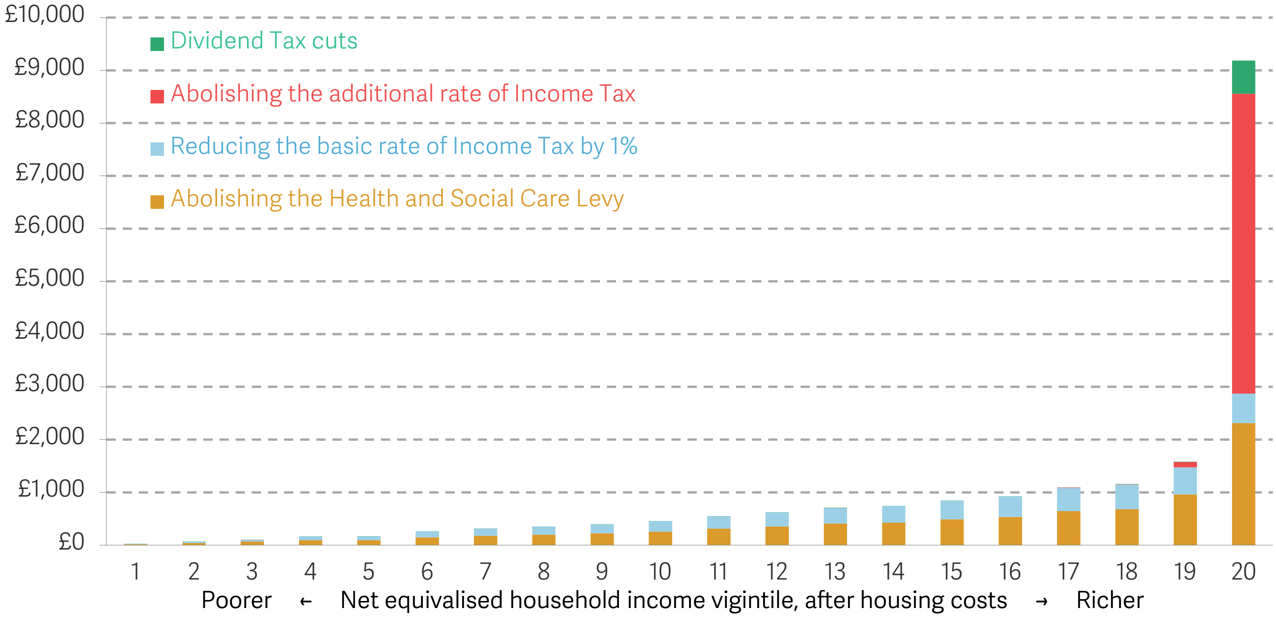
The highest-income households are the biggest winners from the Chancellor's changes to personal taxation

Personal taxation loomed large in the Chancellor's fiscal statement: £20 billion (or 45 per cent) of the £44 billion of tax cuts will be delivered to people via changes to Income Tax, NICs, Dividend Tax and Stamp Duty Land Tax (SDLT). But as Figure 4 makes plain, it is higher-income households that are set to gain the most from these newly announced tax measures. Two-thirds (66 per cent) of the gains from the personal tax cuts confirmed at the fiscal statement go to the richest one-fifth of households; in cash terms, this equates to being better off by £3,250 (an income increase of just 3.8 per cent) next year as a result. [1] In contrast, just 12 per cent of the gains will go to the poorest half of households, who will benefit on average by just £230 (a 0.6 per cent income increase) next year. But most striking are the gains that accrue to the top 5 per cent of households. They look set to receive almost half (47 per cent) of the value of the personal tax giveaways the Chancellor announced at the fiscal statement, equivalent, on average, to a £9,190 gain, on average, or a 5.5 per cent boost to their incomes.

1 In estimating the cost of the tax cuts announced at the fiscal statement, we do not model behavioural responses to changes in tax rates. In addition, under-coverage of top earners in the survey data used in our analysis (a known limitation) may affect our estimates of the cost of tax cuts affecting higher-income households.

FIGURE 4: **High-income households disproportionately gain from personal tax changes confirmed at the fiscal statement**

Impact of personal tax polices announced in September 2022, by equivalised household income vigintile, after housing costs, in 2022-23 prices: UK, 2023-24



NOTES: Dividend tax cuts modelled are both the reversal of the 1.25 percentage point increase in dividend taxes and the removal of the additional rate of dividend tax.
SOURCE: RF analysis of DWP, Family Resources Survey using the IPPR Tax-Benefit Model.

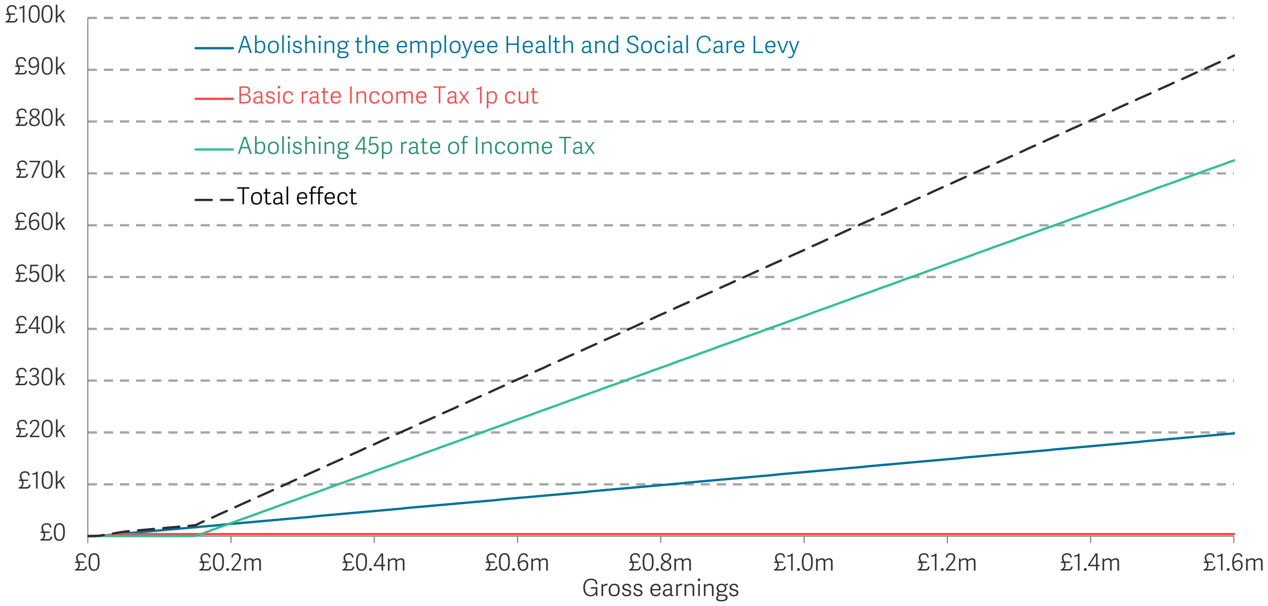
Looking at the impact of the personal taxation changes by an individual's gross earnings, as we do in Figure 5, drives home the point. In the round, the effect of the 1p cut in basic rate of income tax (worth £377 to all higher-rate taxpayers), the abolition of the 45p additional rate of Income Tax, and the abolition of the planned Health and Social Care Levy leaves someone earning £200,000 a year £5,220 better off in 2023-24 than they would have been absent the Chancellor's announcements, while those earning £20,000 a year will gain just £157. A person earning an exceptionally high £1 million a year will be £55,220 better-off, far more than the average household income.[2]

Moreover, the benefits will not be evenly spread across regions of the UK. As Figure 6 shows, the average gain for households in the South East in 2023-24 will be £1,670, with £690 of this increase coming from the scrapping of the additional rate of income tax. In contrast, households in the North East are least likely to benefit from the upcoming tax changes, with the average household gain being £470. This is largely due to the higher concentration of higher-rate tax payers in the South. Moreover, the regional impact of the stamp duty cuts follows a similar pattern, as discussed in more detail in Box 1.

2 In 2022-23, an estimated 27,000 individuals had a taxable income of £1 million or more. See: HMRC, Table 2.5 Income Tax liabilities by income range, June 2022.

FIGURE 5: **Newly confirmed tax changes are a huge giveaway to the very highest earners**

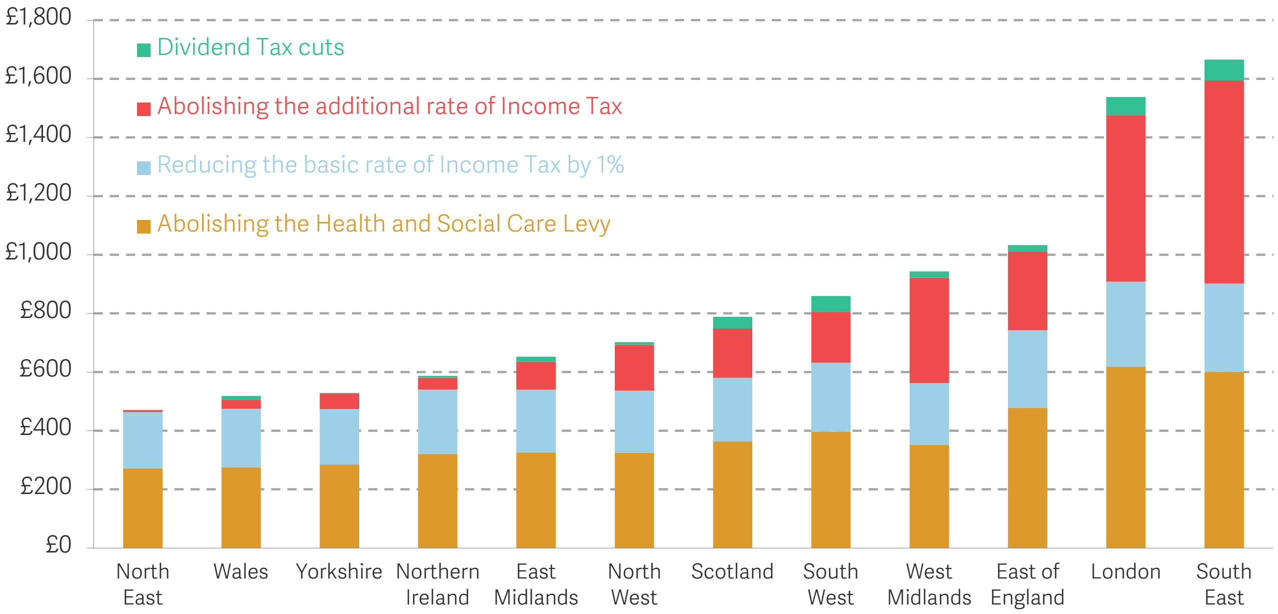
Annual individual income changes as a result of personal tax policies announced in September 2022, by gross earnings: 2023-24



NOTES: Assumes no pension contributions.
SOURCE: RF Case Study model.

FIGURE 6: **Households in London and the South East are set to gain the most from the tax policies taking effect in the winter and spring**

Impact of personal tax policies announced in September 2022 by region, in 2022-23 prices: UK, 2023-24



SOURCE: RF analysis of DWP, Family Resources Survey using the IPPR Tax-Benefit Model.
NOTES: Income Tax rates are devolved in Scotland. The Scottish Government has not announced whether it will follow the cuts announced by the Chancellor this week, but they will receive an increase to the block grant to reflect these changes. We have assumed that similar tax cuts will apply in Scotland in 2023-24.

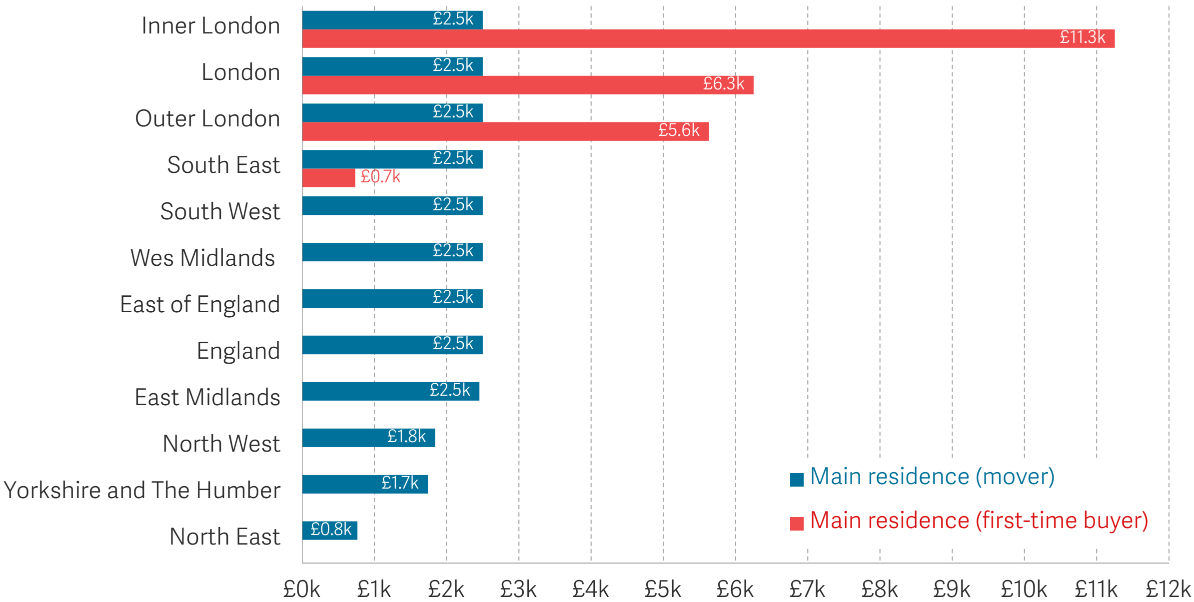
BOX 1: **Who benefits from the stamp duty cuts?**

The Chancellor announced another much-heralded tax cut in his fiscal statement on Friday: an extension of the Stamp Duty Land Tax (SDLT) zero band for both movers and first-time buyers – to £250,000 and £425,000 respectively – and an increase in the maximum value of a property a first-time buyer can purchase while being taxed more leniently than a mover to £625,000.[3]

Reducing the impact that Stamp Duty has in discouraging property transactions is very welcome, and should bring both economic and wellbeing benefits. Those come at a significant price tag, though, of £1.6 billion by 2025-26 and, as Figure 7 shows, the savings that a family buying the average-priced home in each region of England look set to make are not evenly spread. On average, a purchaser in London will save £2,500, over three-times more than the £800 savings made by a family buying the average-priced property in the North East. But the differences are most stark when considering first-time buyers: the typical first-time buyer in Inner London will see a reduction in stamp duty of over £6,300 compared to no benefit for the average first-time buyer purchasing outside of London and the South East.

FIGURE 7: **The stamp duty changes disproportionately benefit those buying homes in the most expensive parts of the country**

Average stamp duty savings resulting from changes announced in September 2022, by region of England



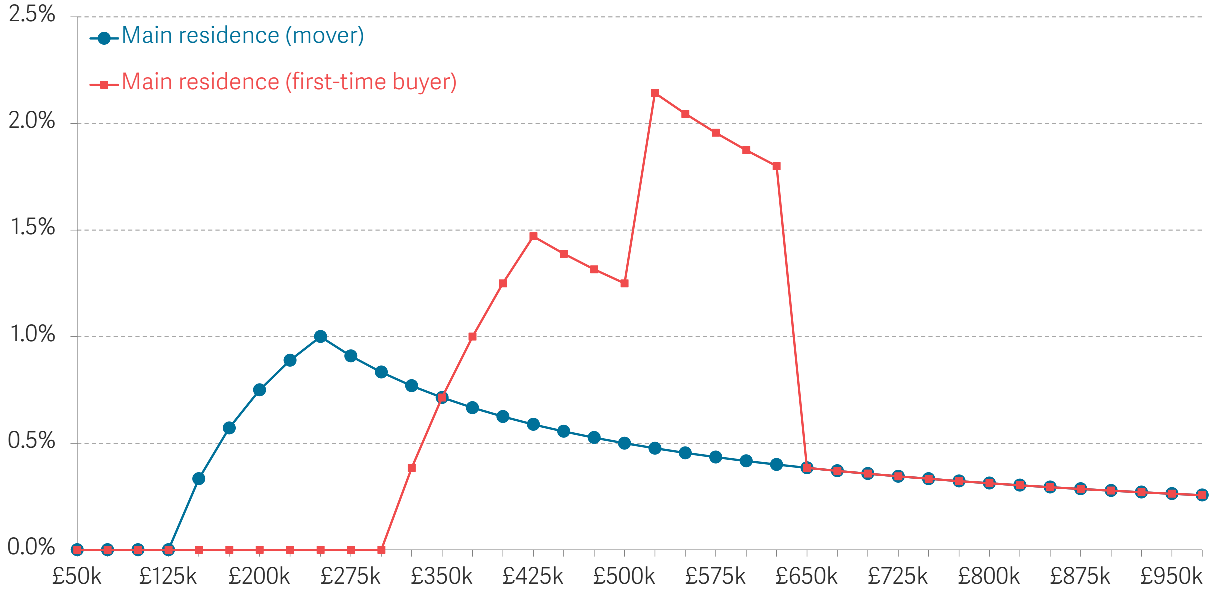
SOURCE: RF analysis of Stamp Duty Land Tax rates 22/9/22 and 23/9/22; ONS, House Price Index.

3 These changes apply to England and Northern Ireland only; Scotland and Wales have their own transaction taxes.

Figure 8 brings home the point that it is first-time buyers purchasing higher-value properties who are the biggest beneficiaries of the Chancellor's stamp duty changes. But the much-hoped-for effect on home ownership rates could be muted, but not eliminated, if these savings are substantially capitalised into the house price. There is some precedent for this: an HMRC evaluation of the stamp duty cut introduced for first-time buyers in the wake of the financial crisis estimated, for example, that between 50 and 70 per cent of the value fed through into higher house prices[4], and the SDLT holiday announced during the pandemic period clearly stoked demand (although other factors were also at play).[5]

FIGURE 8: **First-time buyers purchasing higher-value properties look set to enjoy the biggest savings as a result of the cut in stamp duty**

Stamp duty savings as a share of house price paid resulting from changes announced in September 2022: England



SOURCE: RF analysis of Stamp Duty Land Tax rates 22/9/22 and 23/9/22. See gov.uk for more details.

Although the fiscal statement undid most of Rishi Sunak's programme, the four-year freeze to income tax thresholds remains

As Table 1 shows, the package of tax cuts announced at the fiscal statement largely reverses rises announced by Rishi Sunak in recent years, but not entirely, given that the four-year freeze to income tax thresholds remains in place. Had the new Chancellor gone all the way in reversing his predecessor's tax rises, the Personal Tax Allowance and

4 A Bolster, Evaluating the Impact of Stamp Duty Land Tax First Time Buyer's Relief, HMRC, November 2011.
5 L Judge, F Odamtten & K Shah, Housing Outlook Q3 2021, Resolution Foundation, August 2021.

the higher-rate threshold would have increased by around 10 per cent (in line with this September's expected CPI figure) next April.

TABLE 1: **In the past 30 months, the Government has announced seven major personal tax and benefit changes**

Policy	Announced	Implemented
Four-year Income Tax thresholds freeze	March 2021	April 2022 to April 2025
Health and Social Care Levy introduced	September 2021	April 2022
Universal Credit taper cut	October 2021	December 2021
National Insurance threshold increase	March 2022	July 2022
Health and Social Care Levy abolished	September 2022	November 2022
Basic rate of Income Tax cut by 1p	September 2022	April 2023
Additional rate (45p) of Income Tax abolished	September 2022	April 2023

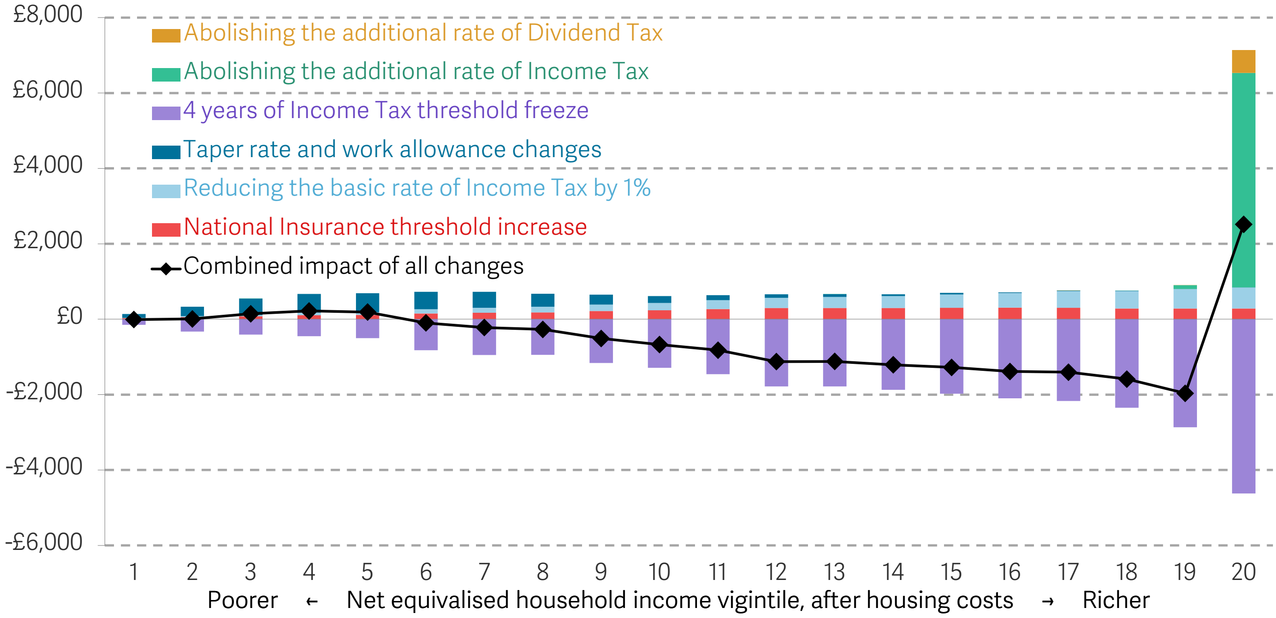
NOTES: As well as introducing (and abolishing) the Health and Social Care Levy, the Government also introduced (and abolished) a temporary 1.25 percentage point rise to National Insurance rates for the 2022/23 financial year. This will be reversed from November 2022. Similarly, when introducing the Health and Social Care Levy, the Government increased dividend tax rates by 1.25 percentage points. When scrapping the Health and Social Care Levy, this increase to dividend tax was reversed. When abolishing the additional rate of Income Tax, the additional rate of dividend tax was also abolished. The 1p cut to the basic rate of Income Tax was initially announced in March 2022 to come into effect in April 2024.

Retaining this one tax rise, however, means that the vast majority of earners still look set to see their tax bill rise as a result of all personal tax changes announced during this Parliament. Most materially, the freeze to the Income Tax thresholds in April next year will completely offset the gains from this week's announcement for all but the richest 20 per cent of households, leaving the households in the middle-fifth of the income distribution worse off by £123 on average in 2023-24 (-0.3 per cent) overall. It is only the richest 20 per cent of households who will see net tax cuts in 2023-24 – by £1,920 (2.3 per cent); for the top 5 per cent, this increase will be £7,500 (4.5 per cent).

Of course, Income Tax thresholds were frozen over four years, from April 2022 to April 2025, and not just for this coming April. If we turn to the impact of all tax and benefit policy changes announced this Parliament, as shown in Figure 9, the ongoing effect of the freeze means that middle- to-high income households from the 6th to 19th vigintile will be worse off by 2025-26 when all changes have taken effect.

FIGURE 9: **Tax and benefit policy changes over the Parliament are dominated by the huge impact of freezing Income Tax thresholds for four years**

Impact of tax and benefit policies announced this Parliament by equivalised household income vigintile, after housing costs, in 2022-23 prices: UK, 2025-26



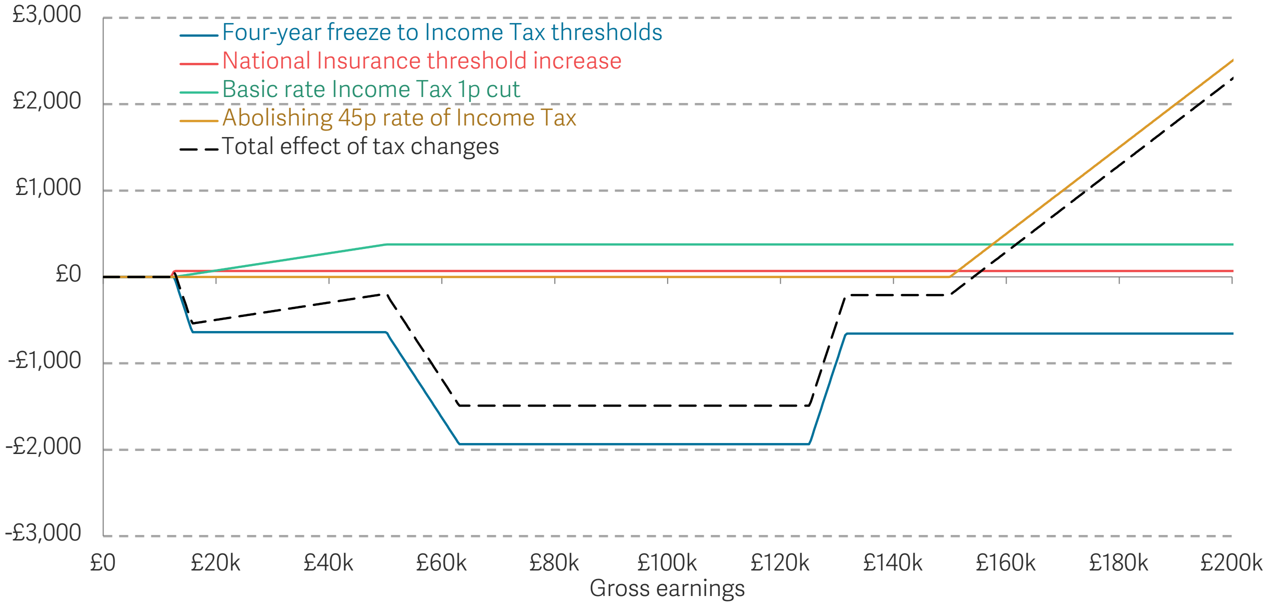
SOURCE: RF analysis of DWP, Family Resources Survey using the IPPR Tax-Benefit Model.

The poorest one-fifth of households are very slightly better off (by £90 in 2025-26 or 0.7 per cent) due to the cut to the Universal Credit (UC) withdrawal rate (the rate at which UC is withdrawn as post-tax family earnings rise). But, in contrast to the rest of the population, policy changes (the abolishment of the HSCL and the 45p additional rate) leave the richest 5 per cent of households significantly better off (on average by £2,520 or 1.5 per cent).

Finally, Figure 10 shows how each of the tax changes stack up at the individual level. To begin, the four-year freeze to Income Tax thresholds leaves all Income Tax payers worse off (the effect is smaller for those earning over £125,000 because such people do not benefit from the Personal Allowance anyway). Taken together, all workers earning less than £155,000 will be worse-off or unaffected by the package of tax changes announced over the Parliament, with workers earning between £63,000 and £125,000 losing the most – almost £1,500 – in 2025-26. In contrast, those earning over £155,000 will be better off, driven very much by the scrapping of the additional rate of Income Tax.

FIGURE 10: **From 2025-26, only those earning above £155,000 will be better off from this Parliament's changes to personal taxes**

Annual individual income changes as a result of permanent personal tax changes this Parliament: 2025-26



NOTES: Assumes no pension contributions.
SOURCE: RF Case Study model.

Huge deficit-financed tax cuts are especially surprising given largely unavoidable higher borrowing

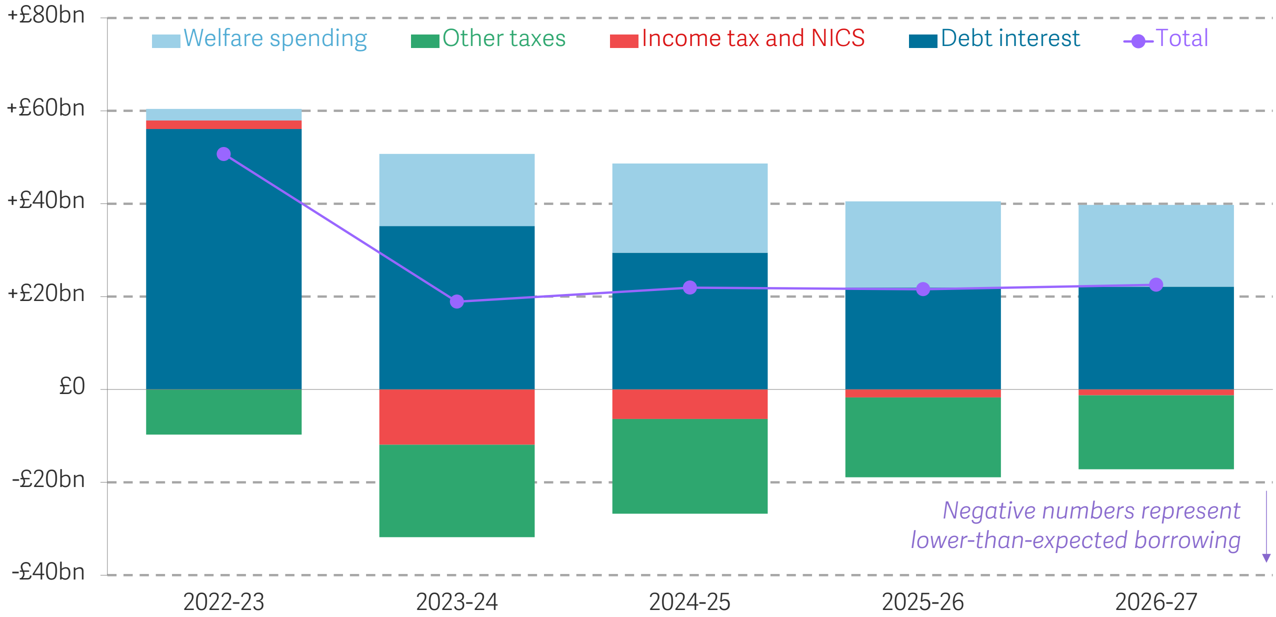
What makes the Government's decision to proceed with large, discretionary, permanent and deficit- financed tax cuts so unusual is the context: an already large, and largely unavoidable, fiscal loosening driven by a weaker economy and the need to subsidise surging energy bills of families and firms. The absence of an official forecast from the OBR unfortunately means that this has not been spelt out (although the Chancellor's commissioning of new forecasts for later this autumn is welcome). Below, we provide an assessment of the fiscal outlook.

Higher inflation and interest rates mean the outlook for the public finances has deteriorated

High inflation has led to a large rise in expected borrowing in the near term, but also a moderate increase in the medium term, driven by a worsened economic outlook (see Figure 11). Back in March, the OBR had expected annual CPI inflation to peak at 8.7 per cent, but it is now set to peak at around 11 per cent. In the short term, higher inflation raises government spending by increasing debt interest payments on index-linked gilts,[6] but, in the medium term, there are additional and partially offsetting effects from higher tax revenues on the one hand, and higher welfare and pension expenditure on the other.[7] To combat inflation, central banks around the world have been raising interest rates; this increases the cost of issuing new, or rolling over existing, government debt, thereby increasing public sector debt interest costs and contributing to a rise in borrowing in the medium term. Taken together, as shown in Figure 11, we estimate that the developments in the economy since March 2022 will increase borrowing this fiscal year by £51 billion and in the medium term (by 2-26-27) by around £23 billion per year.

FIGURE 11: **Rising inflation and interest rates have increased the forecast for net borrowing by £136 billion over the next five years**

Estimated change in public sector net borrowing forecast since March 2022 from changes in the economy, by fiscal driver: UK



NOTES: Forecasts are based on the Bank of England's August 2022 Monetary Policy Report. These forecasts are expanded and extended to provide an economic scenario which is used in the Resolution Foundation fiscal model. The inflation component input to these forecasts are based on the Resolution Foundation's inflation forecast model (see: J Leslie, In the Dread of Winter, Resolution Foundation, August 2022). Interest rates are based on market yield curves up to 16 September 2022.
SOURCE: RF analysis of Bank of England, Monetary Policy Report & Yield Curves; OBR, Economic and fiscal outlook, various; ONS, Consumer price inflation; BEIS, Weekly Fuel Prices.

6 Higher inflation leads to an increase in expected future interest and redemption payments on index linked gilts. These payments, while not requiring immediate cash out of HM Treasury, are recognised upfront in borrowing, and so affect this year's borrowing forecast.
7 The main two effects are that VAT revenues increase because the nominal value of sales in the economy rise (and do so more than the fall in the volume of sales created by a weakening economy) and that frozen tax thresholds will mean a greater proportion of income falls within the scope of tax or higher tax rates.

The cost of supporting the economy through the energy price shock requires a temporary increase in borrowing, but the Chancellor has also increased borrowing through permanent tax cuts

The changes to the fiscal outlook from the economy, while large, are dwarfed in the near term by the policy changes announced since Liz Truss became Prime Minister. These policy changes fall into two camps: immediate measures to cushion households and firms from rising energy prices, and tax cuts. The exact cost of energy support for families and firms is discussed further in Box 2.

BOX 2: **The Energy Price Guarantee and Energy Bill Relief Scheme**

The Energy Price Guarantee (EPG) provides much-needed support to households over this winter by capping typical household energy bills at £2,500 for two years, while the Energy Bill Relief Scheme (EBRS) provides broadly similar levels of support for non-domestic customers (such as businesses, charities and public sector organisations) for six months. The Government has now confirmed that both schemes will be funded by the state rather than through bill clawbacks, at an estimated cost over the next six months of £31 billion for households, and £29 billion for businesses.[8]

However, the eventual price tag, particularly of the EPG, will depend on wholesale gas and electricity prices over the coming months. Based on gas and electricity futures prices from 21 September 2022 (combined with removing the environmental levy of approximately £150 per annum), we estimate the cost of the scheme for households will be upwards of £100 billion over two years, as Figure 12 shows.[9]

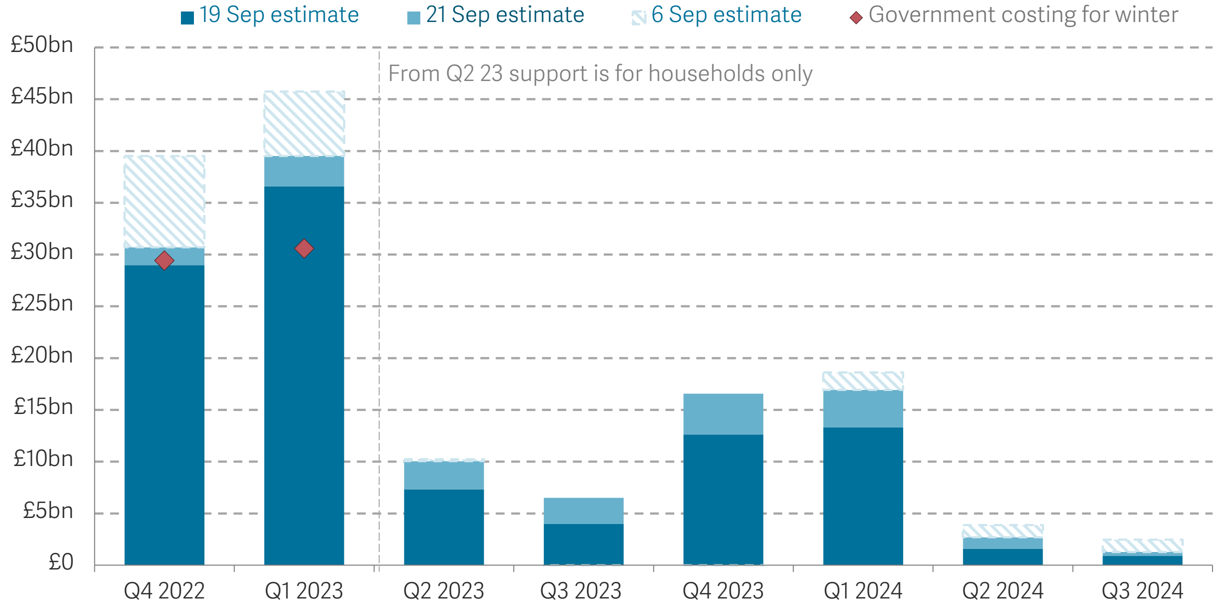
But wholesale energy prices are highly volatile. For example, wholesale gas futures prices for this winter peaked above £8/therm on average in August, but have now fallen back to £4.59/therm. Figure 12 also highlights what this means for the uncertainty of the EPG (where there is no ceiling on the Government's liability).

8 Costings taken as an average of market prices during 10 working days between 29 August and 12 September, after also taking green levies off bills.

9 This updates a forecast first shown in: A Corlett et al, A blank check: An analysis of the new cap on energy prices, The Resolution Foundation, September 2022

FIGURE 12: **The total price tag of the Energy Price Guarantee could vary significantly depending on future wholesale gas and electricity prices**

Estimated total cost of EPG by quarter, by wholesale futures curves: UK



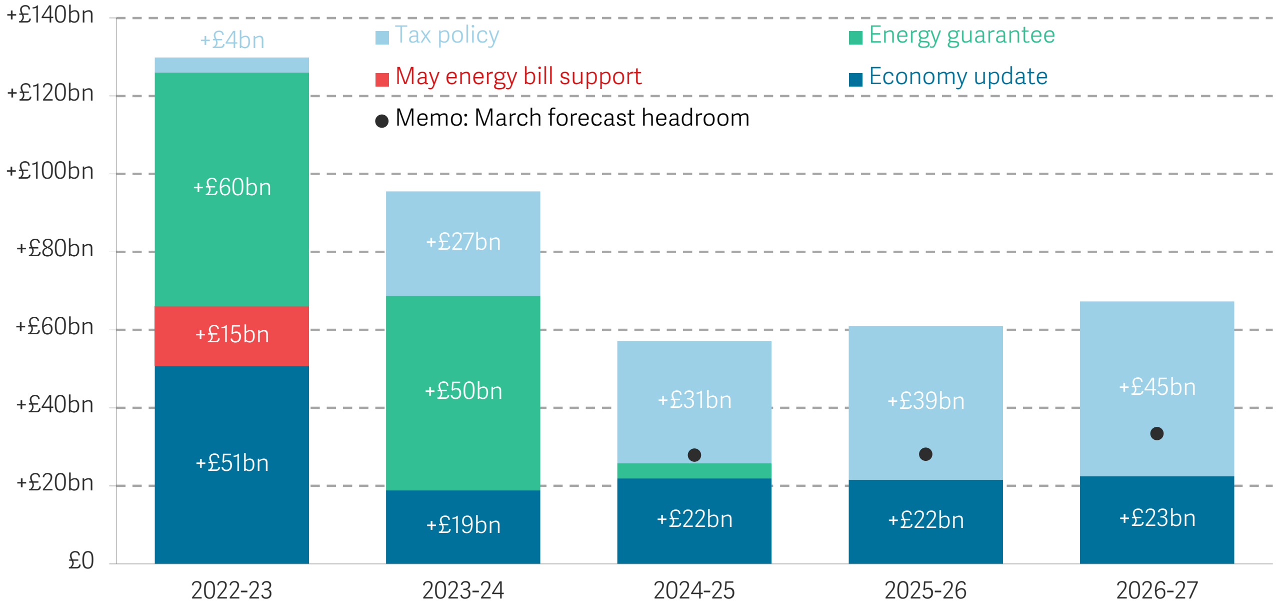
NOTES: Assumes that the wholesale supported rates are in line with business support of £211 £/MWh for electricity and £75 £/therm for gas. Environmental levy assumed to apply to all UK households and weighted based on energy consumption throughout the year. We have based our estimates for the cost of the scheme on wholesale gas and electricity prices for the periods covered by the EPG (rather than wholesale costs, in line with Ofgem's price cap methodology, which assumed a particular hedging strategy over the price cap assessment period). Government figures for domestic gas and electricity consumption are taken from 2019 to avoid pandemic effects, and are weighted by quarter to reflect higher energy use in the winter months. This estimate comes with inherent uncertainty, not only in terms of volatility in energy markets, but also how households and businesses will response to price signals by reducing demand. Government costing weighted by energy consumption.
SOURCE: RF analysis of BEIS gas and electricity consumption data, Ofgem Default Tariff Cap methodology, ICE exchange data, ONS Families and households in the UK: 2021.

Shifts in wholesale futures prices over just two days, Monday 19 September to Wednesday 21 September, would have changed the estimated cost of the household scheme over the next two years by £20 billion. The EBRS has largely built in an upper limit on the amount that the Government will pay, so the uncertainty about its cost relate more to what will be surely be intense lobbying about which sectors will have access to support beyond March 2023.

Figure 13 draws together the impact of the weaker economy and the policy decisions on the forecast for government borrowing. In total, the impact of inflation, energy support packages, and tax changes are expected to add £130 billion to borrowing this year, and £411 billion cumulatively over the next five years.

FIGURE 13: **Total borrowing over the next five years is set to be over £400 billion higher than previously projected**

Estimated change in public sector net borrowing forecast since March 2022: UK

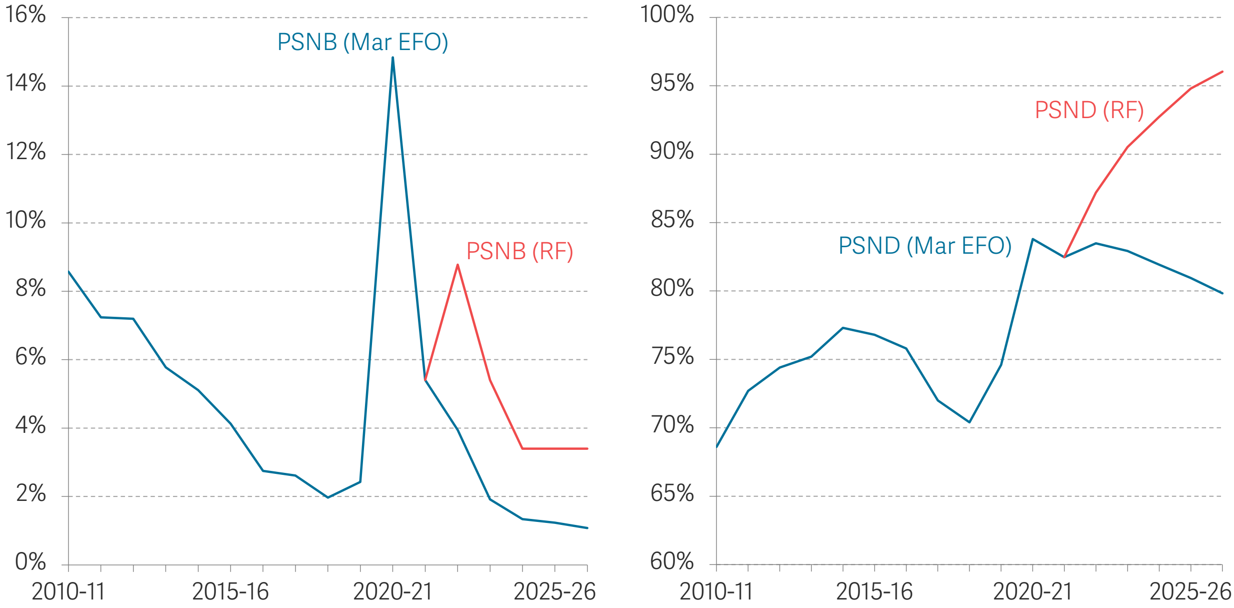


NOTES: Forecasts are based on the Bank of England's August 2022 Monetary Policy Report economic forecasts. These forecasts are expanded and extended to provide an economic scenario which is used in the Resolution Foundation fiscal model. The inflation component input to these forecasts are based on the Resolution Foundation's inflation forecast model (see: J Leslie, In the Dread of Winter, Resolution Foundation, August 2022). Interest rates are based on market yield curves up to 16 September 2022. Energy guarantee costings are from the Government in 2022-23 and based on gas futures curves from 21 September 2022 for subsequent years. Costings do not include money for business support for energy bills after 2022-23.
SOURCE: RF analysis of Bank of England, Monetary Policy Report & Yield Curves; OBR, Economic and fiscal outlook, various; ONS, Consumer price inflation; BEIS, Weekly Fuel Prices; Cornwall Insight; ICE; HMT.

As a result, as shown in Figure 14, the peak in borrowing this year is now expected to be a little over half the peak during the pandemic (8.8 per cent of GDP compared to 14.8 per cent) before settling at 3.4 per cent of GDP in the medium term. That is 2.3 percentage points higher than had been expected by 2026-27, and is 0.7 percentage points higher than the average level under the last Labour government (1997 to 2010).

FIGURE 14: **Borrowing and debt forecasts are far higher than before**

Outturn and forecast of public sector net borrowing and debt, as a share of GDP: UK



NOTES: Forecasts are based on the Bank of England's August 2022 Monetary Policy Report economic forecasts. These forecasts are expanded and extended to provide an economic scenario which is used in the Resolution Foundation fiscal model. The inflation component input to these forecasts are based on the Resolution Foundation's inflation forecast model (see: J Leslie, In the Dread of Winter, Resolution Foundation, August 2022). Interest rates are based on market yield curves up to 16 September 2022. Energy guarantee costings are from the Government in 2022-23 and based on gas futures curves from 21 September 2022 for subsequent years. Costings do not include money for business support for energy bills after 2022-23.
SOURCE: RF analysis of Bank of England, Monetary Policy Report & Yield Curves; OBR, Economic and fiscal outlook, various; ONS, Consumer price inflation; BEIS, Weekly Fuel Prices; Cornwall Insight; ICE; HMT.

That 2.3 per cent of GDP equates to £67 billion higher borrowing in 2026-27 than previously forecast. That means not just blowing through the pre-existing headroom against the key fiscal rule to have debt falling, but doing so twice over.[10] Although the economy explains part of this deterioration, tax cuts explain around two-thirds of the total medium-term increase in borrowing. Indeed, as shown as shown in Figure 15, this is the largest permanent increase in borrowing on record.

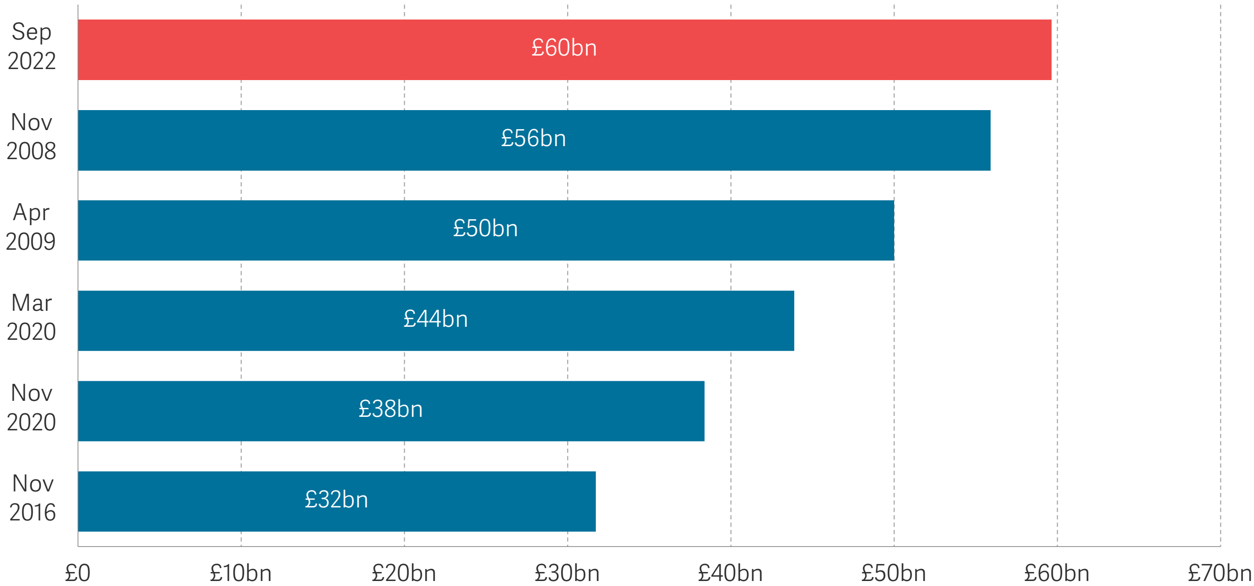
There has been a similar deterioration in the forecast for debt, which is now expected to reach around 95 per cent of GDP by 2026-27, far higher than the 80 per cent projected in March (Figure 14). The new Chancellor stated that "the government is committed to fiscal sustainability and reducing debt as a proportion of Gross Domestic Product (GDP) over the medium-term". Were he to want to meet that in actuality by 2026-27, and assuming that tax rises have been ruled out, government spending would need to be cut by £36 billion (1.2 per cent of GDP) in that year. To put that in context, it is a little over £1 billion less than the total cut to public sector current expenditure in day-to-day spending under George Osborne's austerity period from 2010-11 to 2017-18 (£37.7 billion in 2026-27

10 Headroom is measured against the rule for debt to be falling as a share of GDP.

terms), and nearly the same in real per capita terms as the spending cuts he announced in the June 2010 Budget.[11] These exact figures are sensitive to the rate of growth in the economy; if nominal GDP grows at a faster or slower rate than is currently expected, then fewer or more spending cuts respectively would be needed to meet that ambition.

FIGURE 15: **This is the largest permanent fiscal loosening on record**

Change in public sector borrowing in the final year of the forecast, adjusted for GDP-deflator inflation, selected fiscal events since 1977, 2021-22 prices: UK



NOTES: chart shows the final year of the forecast available for comparison in the OBR's Historical forecasts database for public sector net borrowing adjusted for changes in the GDP deflator (taken from the OBR's Public finances databank).
SOURCE: RF analysis of OBR, Historical official forecast database & Public finances databank – August 2022; and HMT, The growth plan 2022.

The Government's strategy is to hope the economy grows fast, but there are significant risks which could further worsen the fiscal outlook

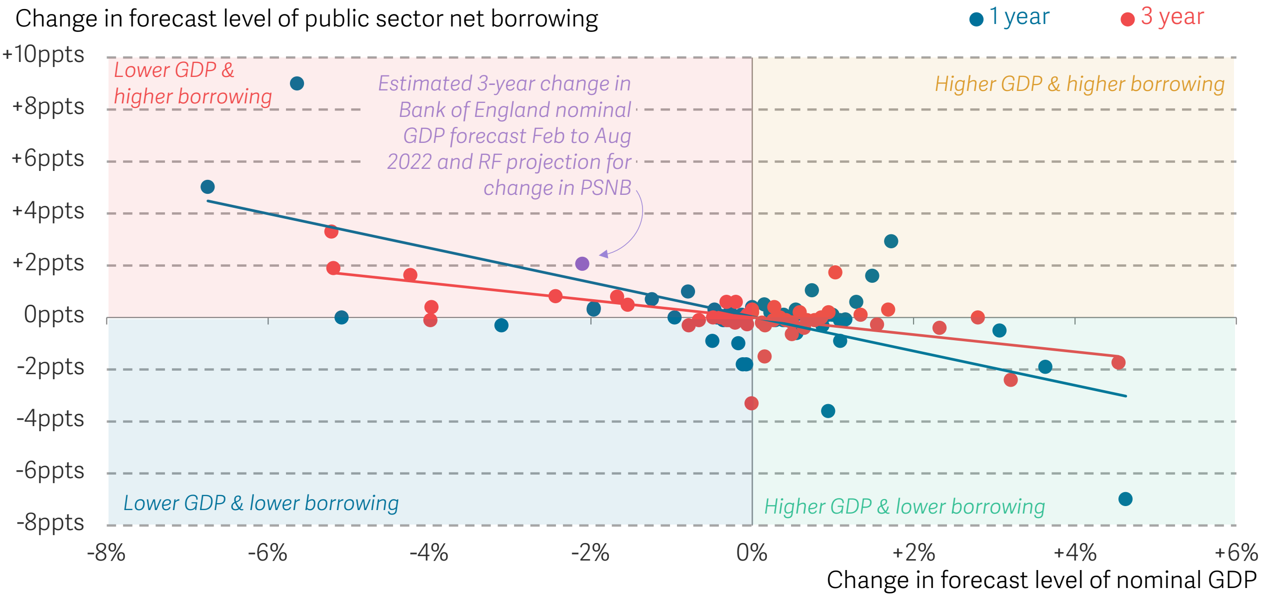
Chancellors always face significant unknowns when setting fiscal policy but Kwasi Kwarteng has loosened policy in the context of unusually high levels of uncertainty. Figure 16 puts the analysis above of changes in borrowing into a historical context. There has, rightly, been a tendency for the Government to borrow more when the economic outlook worsens, particularly at short-term horizons (i.e. one-year horizon). But this relationship weakens looking further ahead into the forecast because traditionally governments will use policy changes to offset changes in the economy and keep the public finances sustainable. At the third year of the forecast, we project that the

11 Figures in real terms using the OBR's March 2022 GDP deflator forecast.

borrowing forecast has risen by 2.1 percentage points, which would be the second largest change between official forecasts since 1999. At the same time the change in the outlook for nominal GDP is negative but not particularly extreme. In other words, the fiscal loosening is unusually high given the change in the economy despite the huge uncertainty about the outlook.

FIGURE 16: **Relative to history, the fiscal loosening looks large**

Change in forecast level of nominal GDP and public sector net borrowing (as a share of GDP) between successive Government/OBR forecasts: UK, 1999-2022



NOTES: The change in the PSNB forecast is defined as the percentage point change in PSNB as a share of GDP between successive Government/OBR forecasts based on the year of the forecast. The change in GDP is defined as the percentage change in nominal GDP between successive forecasts where these forecasts have been adjusted by the gap between latest ONS outturns and the forecast made in the contemporaneous fiscal year (or the previous year if available). This is intended to remove the impact of reclassification decisions made by the ONS. The change in the nominal GDP forecast is roughly backed out from the Bank of England's February and August forecast (accounting for revisions) and should be treated as approximate.
SOURCE: RF analysis of OBR, Historical Forecast Database; Bank of England, various.

The Government is explicitly pinning its hopes for fiscal sustainability on a material increase in the growth rate in the economy. The likelihood of this is discussed below, but there are also various risks which could or are likely to worsen the fiscal outlook beyond what is projected. These fall into three broad categories.

First, there will be significant pressures for the Government to change stated policy in ways which will require additional borrowing. Fuel duty is a classic example where current policy is for it to rise in line with RPI inflation, but, in practice, it has been frozen for over a decade and there is no prospect of it rising anytime soon.[12] Scrapping fuel duty increases is projected to cost around £4 billion by 2026-27, a likely and material further

12 OBR, Economic and Fiscal Outlook, March 2022.

increase in borrowing.[13] There could also be continued pressure on business rates. Under current plans from 2023-24, the business rates multiplier will rise in line with inflation. The increase in the inflation forecast means as much as an additional £10 billion in costs for businesses per year by 2026-27 (relative to the forecast in March 2022), which may be hard to sustain politically. And, of course, there continues to be significant pressure on public services. The Government said very little about its spending plans as part of the fiscal statement but one area where higher spending has been promised is on defence. The Spending Review 2021 outlined defence spending would rise to 1.8 per cent of GDP by 2024-25.[14] Liz Truss has since committed to raising defence spending to 3 per cent of GDP which would equate to around £30 billion extra spending a year.

Second, the cost of the Government's energy price guarantee is dependent on the market price of gas and electricity. The market is extremely volatile (as highlighted in further in Box 4) and the Government's finances are now directly exposed to that volatility. In addition, the Government plans to extend the business support after the initial six-month period but there is currently no announced policy and so the costs of this have not been included in our projections.

Third, the economic outlook itself is highly uncertain. The current plans make clear that the Government is hoping for growth to rise, with the Chancellor setting out a new 2.5 per cent growth target. That is far from certain and indeed the economy could slow more, or inflation rise faster, than expected. There is also the additional risk that markets lose confidence in the UK's economic management. Market moves on the day of the fiscal statement make this risk plain: 10-year gilt yields rose by around 25-30 basis points after the Chancellor's statement, with even larger rises for shorter-term yields. Currency markets also showed a negative reaction with sterling falling by more than 2 per cent against the dollar by the afternoon. These moves have real costs to the Government finances: a sustained rise in gilt yields of 30 basis points equates to around £5 billion in additional interest costs per year by 2026-27, and a currency devaluation will raise import prices and thus further increase inflation.

As it stands it is clear that the Government is not on track to meet the previous Government's fiscal rules, nor are the plans consistent with medium-term fiscal sustainability without significant spending cuts (given the likely ruling out of tax rises).

13 This assumes the 5p cut as part of the measures to deal with the rise in fuel costs is reversed. If not, that represents an even larger fiscal risk.
14 Based on the OBR's March forecast of GDP.

The sharp rise in spending will boost demand this winter, but will likely be offset by higher interest rates in the medium term

The Chancellor's fiscal statement was framed in terms of stimulating growth. This is clearly the right priority: UK GDP per capita growth over the past 15 years has been weaker than any similar period since the 1930s.[15] This weakness has left the UK in a period of relative decline compared with its peers – indeed the average productivity gap with France, Germany and the US nearly doubled between 2008 and 2019.[16] So, how likely is it that the Government's new approach will bring about faster growth?

Fiscal giveaways will support growth in the very near term, giving the economy a 'sugar-rush' boost to demand. By protecting households from very sharp increases in energy prices, the EPG means that consumer spending should be much stronger than otherwise expected this winter. To provide a rough guide to the scale of this effect, the Government's estimate of £60 billion for energy bill support this winter, could boost the level of GDP by roughly 1.5 per cent based on standard OBR multipliers.[17] This effect on the economy could be relatively rapid given the direct boost to household's incomes and firms' cashflow.

But the likely interest-rate response from the Bank of England means that the level of GDP will not be higher in the medium term. Indeed, while the Government has its foot on the accelerator, with measures that will boost demand, the Bank of England has its foot firmly on the brake. Following seven successive interest rates hikes, it is clear that the Bank views demand in the economy as increasing above its supply capacity. So the measures announced in the fiscal statement, which are set to increase demand further, are likely to prompt a sharp interest rate response from the Bank of England.[18] For example, more than 2 percentage points of higher Bank Rate would be needed to offset the inflationary impact of the energy support this winter (again based on standard multipliers).[19] That said, the Bank has so far been reluctant to raise interest by more than 0.5 percentage points at any one meeting – and then it takes around 18 months for

15 See, for example: Bank of England, A Millennium of Macroeconomic Data; and ONS, National Accounts.
16 Source: OECD, Level of GDP per capita and productivity dataset. For more on the UK's relative decline, see: Resolution Foundation & Centre for Economic Performance, LSE, Stagnation nation: Navigating a route to a fairer and more prosperous Britain, Resolution Foundation, July 2022.
17 We use the multiplier for 'Other Annual Managed Expenditure'. See Box 2.1 in: The impact of fiscal policy on GDP growth and unemployment, Economic and Fiscal Outlook, , OBR, November 2020.
18 The September MPC Minutes noted that: "While the [Energy Price] Guarantee reduces inflation in the near term, it also means that household spending is likely to be less weak than projected in the August [Monetary Policy] Report over the first two years of the forecast period. All else equal, and relative to that forecast, this would add to inflationary pressures in the medium term", Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 21 September 2022, Bank of England, 22 September 2022.
19 S Burgess et al., The Bank of England's forecasting platform: COMPASS, MAPS, EASE and the suite of models, Bank of England Working Paper No. 471, 2013.

interest rates to have their maximum impact on the economy.[20] All this means that it is plausible that a winter recession could be avoided, before tighter monetary policy offsets the growth boost in the medium term.[21]

In the longer run, policy makers should be cautious in assuming tax cuts will reverse the UK's sluggish growth

Of course, the Chancellor's fiscal statement was not all about stimulating growth via increased demand, but also about stimulating supply. Critically, the Government has cancelled the planned rise in the headline rate of Corporation Tax (CT), a serious giveaway of around £18 billion by 2026-27. However, it would be unwise to expect a large boost to long-term growth from this measure, for two reasons. First, the change is just cancelling a planned rise that was itself not expected to harm growth a great deal. Figure 17 shows that the effective corporate tax rate – the share of profits paid in tax once all the reliefs are taken into account – has been and is expected to remain relatively stable. Maintaining corporate tax rates at the same level they have been at during the UK's period of slow growth is unlikely to fundamentally transform that slow growth.

Second, the evidence suggests that, on balance and within broad limits, corporate taxes are not a major determinant of investment and GDP. In principle, CT cuts may boost GDP by raising after-tax profits and thereby encouraging business start-ups, innovation and investment – something the UK certainly needs more of. A simple back of the envelope calculation based on a standard model suggests that the impact of cancelling the CT increase could be to increase the level of GDP by around 0.5 per cent per cent over the medium term.[22]

20 For a discussion of the time taken for monetary policy to have its maximum effect on the economy, see: See: J Cloyne & P Hürtgen, 'The Macroeconomic Effects of Monetary Policy: A New Measure for the United Kingdom', American Economic Journal: Macroeconomics, American Economic Association, vol. 8, pages 75-102, October 2016; and C Ellis, H Mumtaz & Pawel Zabczyk, 'What Lies Beneath? A Time-Varying FAVAR Model for the UK Transmission Mechanism', The Economic Journal, vol. 124, pages 668 – 699, 2014.

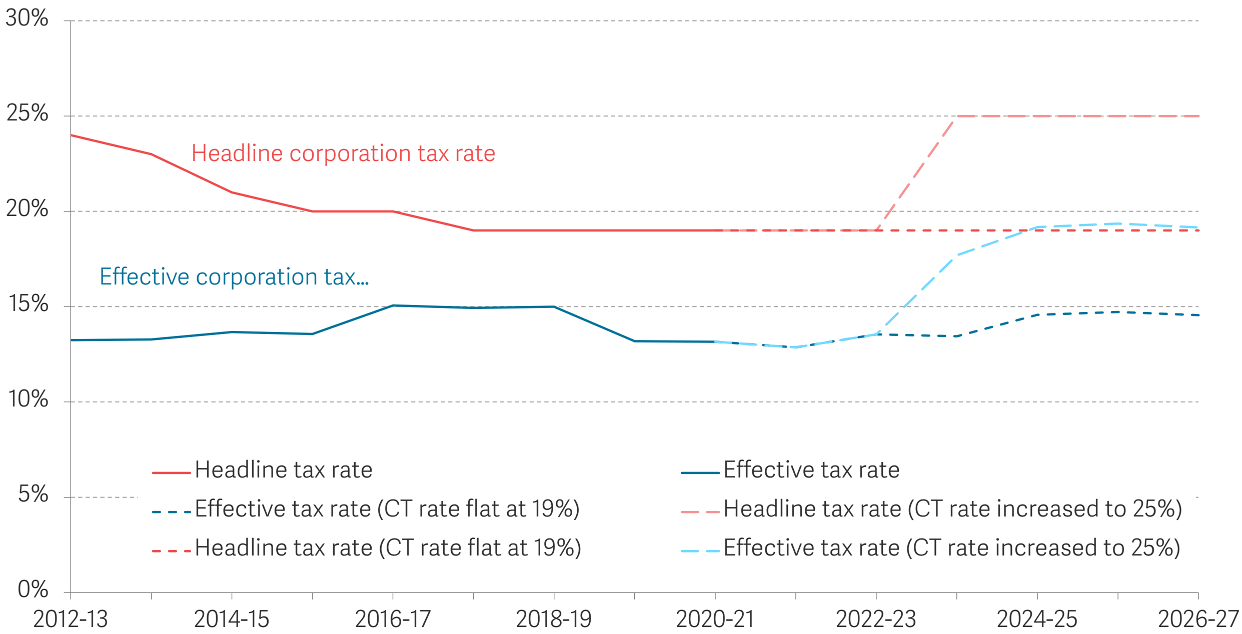
21 The September MPC Minutes indicated that the UK is set to contract by 0.1 per cent in Q3 2022 having already contracted by 0.1 per cent in Q2 2022, Monetary Policy Summary and minutes of the Monetary Policy Committee meeting ending on 21 September 2022, Bank of England, 22 September 2022.

22 This is based on a simple neoclassical production function with a capital share of one-third, an elasticity of substitution of 0.7 and 70 per cent of the present value of investment already being tax deductible due to depreciation allowances.

Over five years, this would be 0.1 percentage point extra growth per year, enough to help meet around one-tenth of the gap between recent trend growth and the Government's 2.5 per cent growth target.[23] In practice, the evidence is mixed and does not point to a major impact on growth.[24] This in part reflects that the effects of cuts will be attenuated because a lot of these expenditures are already tax-deductible and any net impact will also depend on how the cut is financed over the long run - i.e. whether other taxes are increased that might harm growth, or whether growth-enhancing expenditure is cut at the margin.

FIGURE 17: **Despite falls in the headline corporation tax rate, the effective tax rate has remained stable over time**

Outturn and forecasted headline and effective corporation tax rate: UK



NOTES: Forecasts for the effective corporation tax rate have been calculated using OBR's business profits forecasts published in March 2022. The effective tax rate is for financial years while headline CT rates are for calendar years (e.g., 2012-13 aligns to 2012).
SOURCE: OBR, Economic and fiscal outlook - March 2022, OBR, Economic and fiscal outlook – October 2021.

Consistent with this, there is a very weak relationship in practice between effective corporate tax rates and investment rates across OECD countries (see Figure 18). So while this tax cut may boost growth at the margin, counting on it to achieve the transformation the Government is aiming for is risky.

23 Growth needs to increase by about 1 percentage point per year if the Government's 2.5% growth target is to be achieved.
24 Some studies find a large effect: see for example, J Cloyne, J Martinez, H Mumtaz & P Surico, Short-Term Tax Cuts, Long-Term Stimulus, Working Paper 30246, July 2022. However, a recent literature review finds limited evidence of positive effects of corporation taxes on growth, with big differences between studies. See: S Gechert & P Heimberger, Do corporate tax cuts boost economic growth?, Working Paper 201, May 2021.

FIGURE 18: **The relationship between business investment and the effective rate of corporation tax is very weak**

Corporate investment as a share of GDP and modelled effective corporation tax rate for OECD countries, 2017-19

NOTES: Ireland and Costa Rica are dropped as outliers. Iceland and Israel are dropped due to missing investment data. A three-year average (2017 to 2019) for corporate investment as a share of GDP and modelled effective tax rate has been used. A two-year average of the effective tax rate (2018 to 2019) is used for Latvia due to missing data.
SOURCE: OECD, Corporate Tax Statistics: Third Edition.

However, there were other tax cuts beyond the flagship cancellation of the CT rise which could plausibly have some growth effect. For example, cuts in the top rate of income tax could in principle similarly boost GDP by encouraging enterprise, innovation and technology adoption, although many of these activities already attract reliefs.[25] Overall, however, there is no strong evidence of a link between top income tax rates and economic growth, across countries or over time.

Likewise, the evidence is weak that changes to marginal tax rates for typical workers (such as the NICs cut) increases overall labour supply.[26] The liberalisation of IR35 self-employment tax rules is likely to cost the Government substantial revenues without materially affecting the level of genuine self-employment (see Box 3).

25 See C Jones, Taxing Top Incomes in a World of Ideas, Journal of Political Economy 130 (9), September 2022 and U Akcigit, J Grigsby, T Nicholas & S Stantcheva, Taxation and Innovation in the 20th Century, The Quarterly Journal of Economics 137(1), June 2021 respectively for theory and evidence in support of this idea.

26 The 2010 Mirrlees Review concluded that 'hours of work do not respond particularly strongly to the financial incentives created by tax changes for men, but they are a little more responsive for married women and lone mothers', and the latter are mainly found to respond through changes in participation rather than changes in hours. See: Mirrlees Review of Taxation, Dimensions of Tax Design: Labour supply and taxes, September 2010.

BOX 3: **Complex contracting**

The IR35 tax rules were reformed in 2016 Budget when businesses were given more responsibility for determining the tax status of their contractors. The aim of the policy was to ensure that contractors who are not genuinely self-employed pay the same Income Tax and National Insurance contributions as employees, and that businesses could not avoid taxes by hiring self-employed workers in the place of regular employees.[27]

Repealing this provision, as the Chancellor has indicated the Government will do by April 2023, will bring about a fall in tax revenue of £1.1 billion next fiscal year, and £2.0 billion a year by 2026-27, presumably because of abuse as contractors choose to self-declare their self-employed status (which comes with a significant tax advantage over employees).[28] When the IR35 reforms were implemented for the public sector, an estimated 50,000 workers switched from self-employment to employee status, increasing tax revenue by up to £275 million a year.[29] The impact of the more recent private sector reforms is uncertain but almost certainly far larger, given how many more self-employed people there are in the private sector.[30] And although it is not a given that all workers who switched to employee status will return to self-employment (some may be put off by the administrative burden of reclassifying, for example), the high estimated cost of this measure suggests that the Treasury expect significant numbers to do so.[31]

As we have argued in the past, there is a strong case for equalising self-employed and employee taxes across the board – and so reinstating billions of pounds of tax avoidance for workers who can switch their employment status is hard to justify. [32] But repealing IR35 may also end up reducing the tax burden of higher earners more than those on lower pay: previous Resolution Foundation analysis suggests that it was primarily workers in higher-paying

27 HMRC, Understanding off-payroll working (IR35), May 2021; National Audit Office, Investigation into the implementation of IR35 tax reforms, February 2022.
28 T Bell & H Slaughter, Crystal balls vs rear-view mirrors: The UK labour market after coronavirus, Resolution Foundation, April 2020.
29 National Audit Office, Investigation into the implementation of IR35 tax reforms, February 2022.
30 In 2015, before the initial IR35 policy was announced, there were nearly 6 times as many self-employed workers in the private sector as in the public sector. Source: ONS, JOBS02: Workforce jobs by industry, September 2022.
31 Two years after the implementation of IR35 in the public sector, 50,000 public sector contractors had become employees and the net increase in tax revenue was £275 million, implying a net gain of £5,500 per worker. See: National Audit Office, Investigation into the implementation of IR35 tax reforms, February 2022. If we assume this is also the net loss per worker (across both public and private sectors) once the policy has been repealed, the Treasury's costing of £2.0 billion in 2026-27 would imply around 370,000 workers switching status. Although this is a somewhat simplified calculation, it is fair to assume that the Treasury expects the numbers of workers affected to be in the hundreds of thousands.
32 T Bell & H Slaughter, Crystal balls vs rear-view mirrors: The UK labour market after coronavirus, Resolution Foundation, April 2020.

occupations who switched their status in 2021, and who now have a clear incentive to revert to their former self-employed status.[33] So, as well as making the IR35 repeal a regressive policy, higher earners moving into self-employment could increase the scale of the resulting tax avoidance.

Finally, the Government has outlined plans to introduce Investment Zones (IZs): area-specific tax incentives and planning liberalisation aimed at encouraging business investment and boosting economic activity. Location will be important – while poorer areas may be tempting targets for this policy it is important to learn from the lessons of the past and focus IZs in areas which have links to urban areas, have high potential for growth, or where constraints around costs and planning are truly binding. Two previous versions of this policy have underperformed expectations.[34]

Overall, the tax cuts and structural measures announced may provide some limited support to growth in the medium term but will be nowhere near enough to get us to a new 2.5 per cent trend GDP growth rate, nor to pay for themselves. The £45 billion of tax cuts announced yesterday would need to increase GDP by 4 per cent over the long term in order to be self-funding – an implausibly large boost for measures that are more likely to have a marginal long-run effect on GDP. A prudent Chancellor should therefore assume they will require higher borrowing or public spending cuts in the years ahead.

The outlook for household finances has improved slightly as a result of higher borrowing, but is still very poor

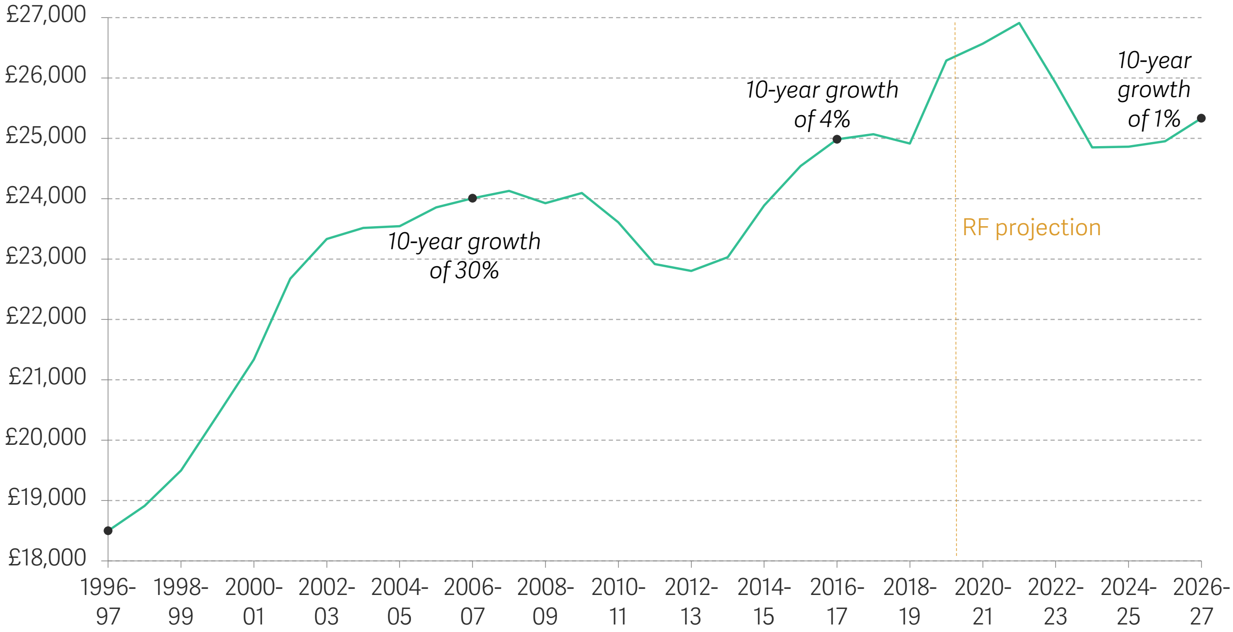
Despite the significance of both the EPG and the newly announced tax cuts, as well as the earlier support packages for 2022-23, the outlook for real household incomes remains extremely poor, as we show in our updated, detailed projections.[35] Putting together policy choices and economic forecasts (primarily from the Bank of England given the lack of new OBR figures), we project real household disposable incomes up to 2026-27. For non-pensioners, the typical equivalised income after housing costs falls by 4 per cent (£1,000) in 2022-23 and another 4 per cent (£1,100) in 2023-24, leaving real incomes 8 per cent (£2,100) lower in real terms than in 2021-22 (see Figure 19). Thanks to the EPG in particular, this is actually an improvement on the previous vintage of our projections

33 See Figure 7 of: N Cominetti et al., Labour Market Outlook Q1 2022: How should we interpret strong nominal earnings growth?, Resolution Foundation, April 2022.
34 See Evidence Review: Area Based Initiatives, What Works Centre for Local Economic Growth, January 2016 and P Swinney, In the zone: Have enterprise zones delivered the jobs they promised?, Centre for Cities, 2019.
35 Our method is described further in A Corlett & L Try, In at the deep end: the living standards crisis facing the new Prime Minister, Resolution Foundation, September 2022. Our latest projections are based in part on the Bank's August economic forecasts, but we use an adjusted inflation forecast that accounts for the EPG. We assume that the employer NICs cut boosts wages and cuts prices (in line with OBR estimates) but do not include an adjustment for lower Corporation Tax or any other assumptions of higher economic growth. However, nor do we make any adjustment for any counteracting change in monetary policy.

(which forecast a 10 per cent fall).[36] But this two-year fall is nonetheless only paralleled in the historic record by the mid-1970s: by comparison, incomes fell by 5 per cent between 2009-10 and 2011-12 during the Financial Crisis.

FIGURE 19: **Despite significant Government support, the typical household income of non-pensioners is set to drop by 8 per cent between 2021-22 and 2023-24**

Real median non-pensioner equivalised household disposable income, after housing costs, 2021-22 terms: GB/UK



NOTES: All figures beyond 2019-20 are projected.
SOURCE: RF analysis of DWP Stat-Xplore and Households Below Average Income; and RF projection including use of the IPPR Tax Benefit Model, ONS data, and Bank of England and OBR forecasts.

Inflation is at the heart of this picture, with prices in 2022-23 projected to be 10 per cent higher than in 2021-22, and to rise by another 7 per cent in 2023-24.[37] As a result, despite a projection of continued high nominal earnings growth of over 5 per cent through 2023-24 – supported slightly by the cut to employer NICs – real pay is continuing to fall. We assume that most benefits will rise in line with inflation, as usual, and therefore receive a significant boost of around 10 per cent next April and 8 per cent in April 2024 (though these increases will merely maintain the real value of benefits, and only with a significant lag). In addition, much of the substantial support provided to households in 2022-23 was temporary (meaning that energy costs will effectively rise in April when the £400 rebate expires); the outlook for households is further worsened by the Bank of England's

36 A Corlett & L Try, In at the deep end: the living standards crisis facing the new Prime Minister, Resolution Foundation, September 2022.
37 Projected inflation is based on RF analysis building on the Bank's August 2022 Monetary Policy Report but incorporating the impact of the EPG.

projections that unemployment will rise – going from 3.6 per cent in the most recent data (May to July) to 6.3 per cent by Q3 2025; and by rapidly rising mortgage interest costs.[38]

As a result, based on current forecasts, there is no rapid recovery to be expected beyond 2023-24. Instead, the fall in incomes between 2019-20 and 2024-25 is still projected to make this comfortably the worst parliament on record for changes in living standards, with a 5 per cent drop in the typical income. The ten years from 2016-17 to 2026-27 are currently projected to be a lost decade for non-pensioner household income growth (with just a 1 per cent – or £300 – rise), on top of poor performance over the previous decade (just 4 per cent growth, or £1,000).

Despite extensive state support, the incomes of the poorest households are set to fall sharply next year

Beyond the median, projected living standards changes vary greatly across the income distribution. In 2022-23, the poorest have been relatively well-protected due to both targeted and universal support (although this does not account for the fact that lower-income households have faced higher inflation than richer ones).

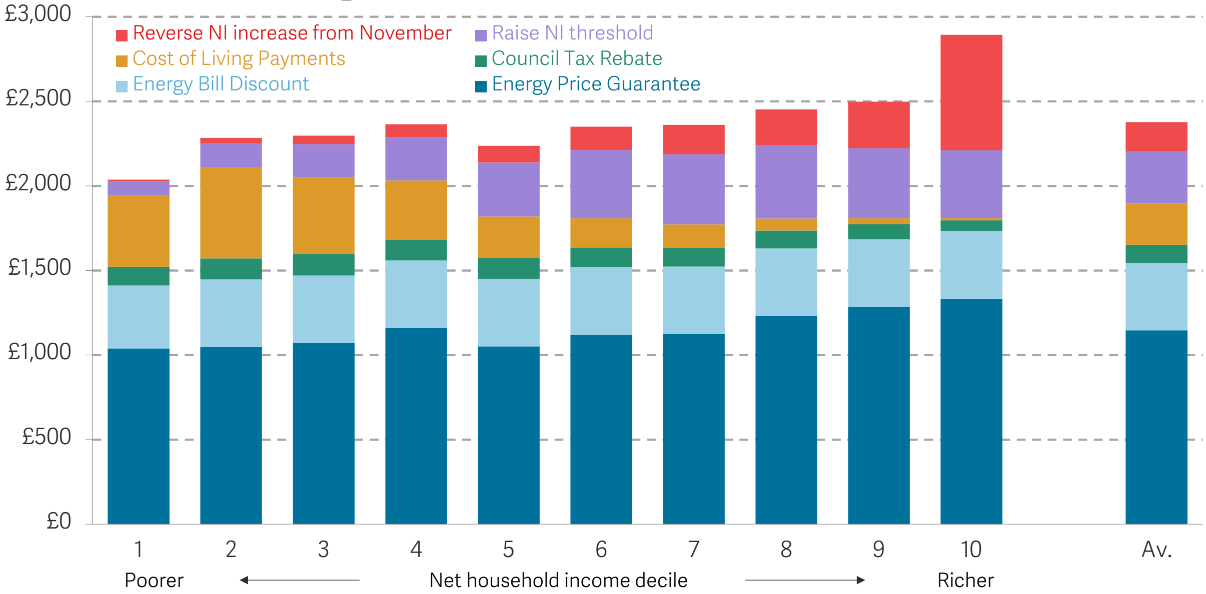
As Figure 20 shows, the total impact of living standards support this year are shared fairly evenly, with households benefiting by £2,070 on average. The highest income decile is the outlier, with households benefiting by £2,500. Of this support in 2022-23, the Energy Price Guarantee comprises the highest share of support with the highest-income households receiving £1,300 compared with £1,000 for the lowest-income households.[39]

38 Our projections use OBR forecasts from March 2022 for average mortgage interest payments. This may be an underestimate in the medium term given that the forecast then was for Bank Rate to peak at 1.9 per cent (they have already risen to 2.25 per cent), but actual payment increases (as measured within the RPI basket) have so far been slower than expected.

39 While higher-income homes use slightly more energy than lower-income households, the most important predictors of how much energy a household uses is a combination of who lives in the household and the size and energy efficiency of the home, making the EPG relatively flat across the income distribution.

FIGURE 20: **The Energy Price Guarantee comprises the largest support for households this year, but the National Insurance rise reversal provides benefits for higher income households**

Average policy impacts of cost of living interventions by decile of equivalised household income, after housing costs: GB/UK, 2022-23



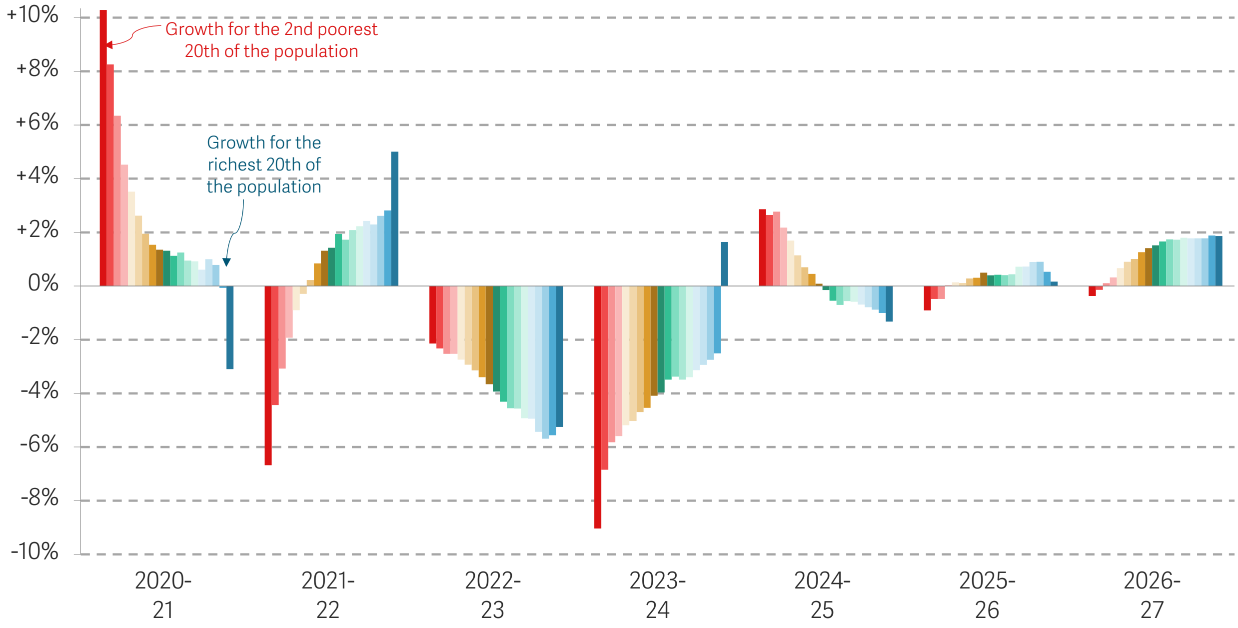
NOTES: As per the fiscal statement, NI rise is reversed in November 2022 (in line with abolishing the Health and Social Care Levy from April), and it does not model any changes to employer NI. EPG savings using per unit prices and standing charges for 34p/KWh unit and 46p per day standing charge for electricity and 10.3p/KWh and 28p per day standing charge for gas announced by BEIS. The gain is relative to pre-announced Ofgem Q4 2022 price cap, Cornwall Insight forecast for Q1 and Q2 2023 released 8 September, and RF assumptions up to Q1 2024 based on earlier Cornwall Insight forecasts. EPG benefits compared to Ofgem price cap and therefore modelled for GB only. Other benefits modelled for UK.
SOURCE: RF analysis of DWP, Family Resources Survey, using the IPPR Tax Benefit Model; the Living Costs and Food Survey, 2019-20; BEIS energy bills support factsheet; counterfactual Cornwall Insights price forecasts.

The relative protection of lower income households (given their lower income levels) this year is shown in Figure 21, which is exactly as it should be given the impact of the living standards shock is far greater for poorer households. In 2023-24, however, this is reversed – despite the assumption of 10 per cent benefit uprating. The typical low-income non-pensioner in the bottom fifth of the income distribution ('p10'), could be 8 per cent worse off in 2023-24 than 2022-23 in real terms, which would be the worst drop on record. In contrast to the rest of the population, the top 5 per cent may have higher real disposable incomes in 2023-24 than in 2022-23, aided by Income Tax and National Insurance cuts.

This outlook is also reflected in our projections for absolute poverty – shown in Figure 22. Between 2021-22 and 2023-24, the proportion of people living in absolute poverty is projected to rise from 17 to 20 per cent (again despite the EPG and an assumption of 10 per cent benefit uprating next April), with the proportion of children jumping from 23 to 28 per cent. These changes are equivalent to an extra 2.3 million people, including an extra 700,000 children, living in poverty. Some of these increases are projected to reverse in 2024-25 due to another (assumed) high benefit uprating, but poverty rates are nonetheless projected to be higher in 2026-27 than 2019-20.

FIGURE 21: **Even with 10 per cent benefit uprating, the incomes of the poorest are set to fall again next year**

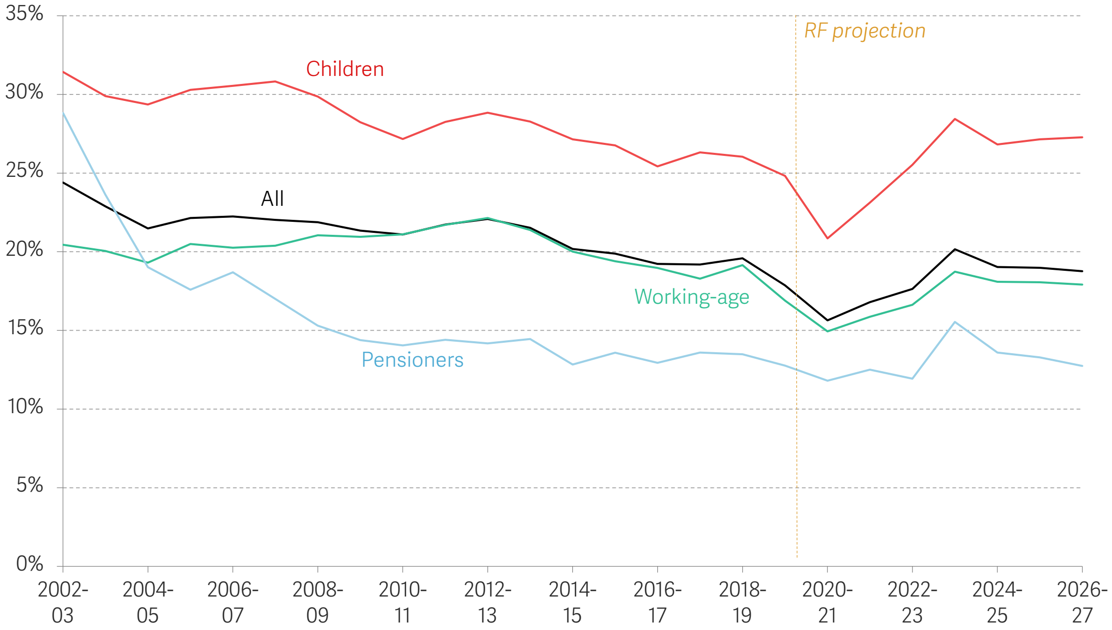
Annual real growth in average equivalised household disposable income for non-pensioners, after housing costs, by income vigintile: UK



NOTES: 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.

FIGURE 22: **Absolute poverty is projected to rise in 2022-23 and 2023-24**

Proportion of people living in absolute poverty, after housing costs: UK



NOTES: Outturn data is available for 2020-21 but the values shown here are our nowcasts, as we use 2019-20 rather than 2020-21 data as the starting point for our projections.
SOURCE: RF analysis of DWP & IFS, Households Below Average Income; and RF projection including use of the IPPR Tax Benefit Model, ONS data, and Bank of England and OBR forecasts.

The new direction is clear, but huge, top-heavy tax cuts and unsustainable debt may be the wrong policies for the wrong time

Rising energy costs, surging interest rates and the aftermath of the pandemic mean that the early 2020s were already set to be a perilous time for households and a challenging one for economic policy makers. But this was a fiscal statement that choose to introduce huge permanent tax cuts in the name of growth. These measures mean two-thirds of the gains from the tax cuts will go to the richest fifth of households, who disproportionally live in the South. But despite £45 billion in unfunded tax cuts by 2026-27, the policy appears destined to fail on its own terms – with taxes as a share of the economy still set to be sustained at levels not seen since the 1940s.

That said, the Government's focus on trying to fix the UK's lamentable growth performance is clearly the right one. However, while demand-led growth will be surely stronger in the near term, higher interest rates from the Bank of England mean that even the short-term 'sugar rush' provided by the fiscal giveaways are unlikely to mean the economic pie is bigger in the medium term. Looking ahead further ahead, what really matters is the extent to which the measures announced contribute towards achieving the Government's aim of raising trend growth to 2.5 per cent. Putting all our eggs in that basket is high risk given limited evidence that tax changes like those announced yesterday make a significant difference to growth rates.

Although the decision not to publish the forecasts offered by the OBR means that the outlook is even more uncertain than usual, our analysis lays bare the consequences of the Government's new approach. Borrowing is set to rise by £400 billion in the coming years and the permanence of the tax cuts – combined with higher interest rates and weaker growth – mean that the £30 billion of headroom the Government had back in March has been blown through twice over. All this leaves debt on an unsustainable path rising every year in the forecast. To achieve the new Government's stated aim of debt falling, swingeing spending cuts of around £35 billion in 2026-27 would be needed. Little wonder that financial markets have responded by selling UK assets, increasing the cost of borrowing at the 10-year point by nearly a percentage point.

All in all, the Government appears to have jettisoned fiscal conservatism to deliver the largest tax cuts in half a century. The Chancellor has set the UK economy on a new trajectory, one he hopes includes permanently higher growth but which will certainly involve far higher borrowing levels and costs. By blowing the budget, he is taking a risk beyond that adopted by economic policy makers for many a generation.

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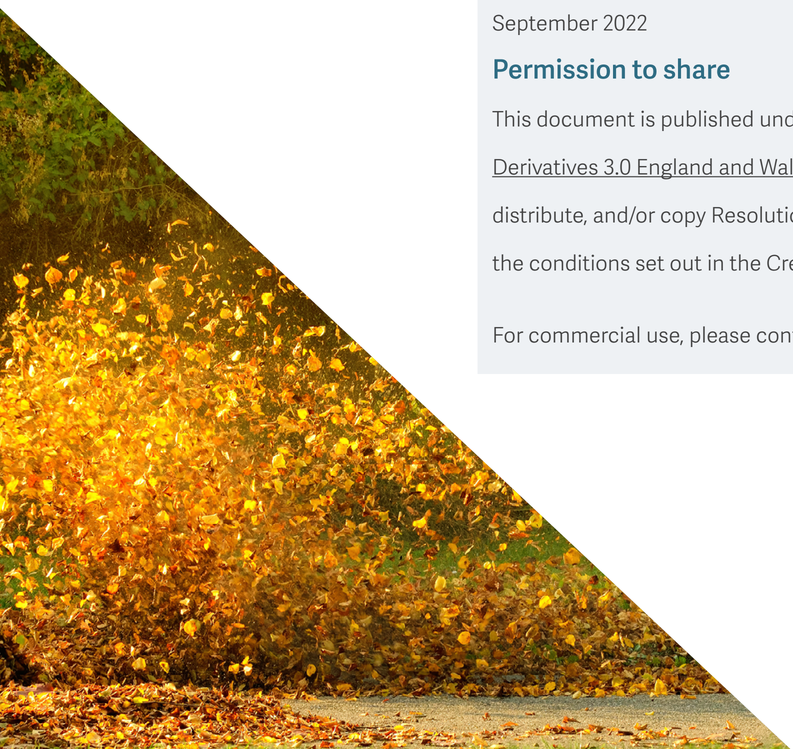

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