Mind the (credibility) gap: Autumn Statement preview

Torsten Bell, Adam Corlett, Jack Leslie, Jonathan Marshall, Felicia Odamtten, Krishan Shah, James Smith & Lalitha Try

1 November 2022
Sunak faces a gloomier economic outlook as the new PM than he left as Chancellor:
- GDP set to be 2-4% weaker by end-2024 with OBR likely to forecast a recession
- Unemployment expected to rise by 500k, peaking above pandemic levels
- The weaker outlook increases borrowing by over £20bn

Despite U-turns, the mini-budget’s legacy is higher borrowing:
- £17bn of tax cuts remain and the costs of energy support remain large and uncertain
- Interest rates are rising around the world (increase since mini-budget costs HMT around £10bn)
- Relative rise in UK borrowing costs since mini-budget has unwound but the increase over the summer has not and costs around a further £10bn
- Government will need to reduce borrowing by at least £40bn to hit likely fiscal rules with minimal headroom

The menu of spending cuts and tax rises is long, if unappetising:
- Around £10bn in easy-to-announce but bad-for-growth investment cuts likely
- More than £20bn in day-to-day spending cuts beyond the current spending review would usher in a new period of austerity given around £20bn in real-terms cuts in the coming years
- Cuts to working-age benefits and pensions would save around £9bn but would be disastrous in the context of the cost of living crisis
- So further tax rises, not just spending cuts, should be expected
The economic outlook is grim
The OBR will slash its growth forecasts, with a recession likely

Calendar-year forecasts for real GDP growth in 2023 and 2024, by date of forecast: UK

A lot has changed since the Office for Budget Responsibility’s last forecast in March

A deeper energy shock means a weaker GDP outlook

HMT’s panel and BoE forecasts suggest downgrade in the range of 2-4% by end-2024

Source: RF analysis of HM Treasury, Forecasts for the UK economy, various; Bank of England, Monetary Policy Report, various; and OBR, Economic and Fiscal Outlook, various.
Unemployment is set to rise above pandemic levels

BoE tightening will raise unemployment to stop high inflation becoming entrenched

BoE and IMF forecasts suggest unemployment rate will likely to rise to around 5% by 2024

That is the equivalent of around 500k increase in unemployment

And inflation is now expected to be higher for longer

Bank of England and OBR projections for CPI inflation

Notes: RF update assumes that EPG replacement has no impact on CPI inflation. Source: RF analysis of Bank of England, Monetary Policy Report; various; OBR, Economic and Fiscal Outlook, March 2022; and ONS, Consumer price inflation.

OBR will be making a big revision to its inflation forecast; price level by March 2024 likely to be around 6% higher than expected 7 months ago.

Nominal wage growth will also be higher: annualised pay growth was 5.5% in Q3 2022 compared with 4.8% expected in March.

Energy price guarantee (EPG) means inflation set to peak lower than BoE’s August forecast although scrapping it in April 2023 prolongs peak.
Weaker economy + policy choices = more borrowing
The difficult economic outlook means weaker public finances...

Economy-driven changes to the fourth year of the OBR borrowing forecast (reflecting the economy and related changes to the performance of the public finances), 2026-27 prices: UK

Weaker economic outlook increases borrowing by £23bn in 2026-27

This is a little larger than the average absolute revision to final year of OBR forecasts

Notes: Totals are adjusted for GDP deflator inflation. Underlying forecast changes include the impact of changes in outturn data, revisions to the economic forecast and judgements about how the performance of the public finances.
Source: RF analysis of OBR, Forecast revisions database.
...reinforced by the short-term costs of support for energy bills...

Gas prices have fallen significantly this autumn.

Despite this, energy bill support this winter will cost in region of £50bn.

The EPG will now end in April, transferring up to £40bn of costs to households, with the typical bill on course to hit £4,000.
Despite U-turning on 60 per cent of the tax measures announced in the mini-budget, the Government is still planning to:

i. Cancel the NICs rise (and the Health and Social Care Levy)
ii. Raise Stamp Duty thresholds
iii. Permanently increase the Annual Investment Allowance

In addition the Government has announced it will not cut the basic rate of income tax, saving around £6bn a year by 2026-27.

Forecast cost to government of mini-budget tax policy changes: UK

<table>
<thead>
<tr>
<th></th>
<th>2022-23</th>
<th>2023-24</th>
<th>2024-25</th>
<th>2025-26</th>
<th>2026-27</th>
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<tbody>
<tr>
<td>Total mini-budget tax changes</td>
<td>-£12bn</td>
<td>-£36bn</td>
<td>-£37bn</td>
<td>-£42bn</td>
<td>-£44bn</td>
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<tr>
<td>Total after U-turns</td>
<td>-£7bn</td>
<td>-£16bn</td>
<td>-£16bn</td>
<td>-£17bn</td>
<td>-£17bn</td>
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<tr>
<td>Share scrapped</td>
<td>41%</td>
<td>56%</td>
<td>55%</td>
<td>60%</td>
<td>60%</td>
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Estimated change in forecast government interest cost in 2026-27 as a result of interest changes since the mini-budget, by driver of interest rate change and date of market interest rates

Notes: Excludes changes in interest rates prior to the mini-budget – many of the measures were pre-briefed which means these estimates will underplay the domestic impact of policy and credibility issues. The global rate rise is calculated as the OBR’s short and long-term ready reckoners applied to an estimate of what would have happened if the UK had stayed in line with European rates (using changes in European AAA rated gov bonds rates). This includes the direct policy costs for changes in global interest rates after 22 September. Otherwise the chart uses the OBR’s short-term rate ready reckoner applied to the change in Bank rate expectations in 6 months’ time (i.e. the OIS forward curve with 6 month maturity) net of the change in short-term rates in European bonds. In principle, this will include compensation for uncertainty about changes in interest rates over the life of the bond – sometimes referred to as the ‘term premium’ – whereas the former does not (as both sides of the swap contract face uncertainty about the payoff over the life of the contract). This should not have a material impact on the changes in yields over time short time periods such as the one used in this chart. And the OBR’s long-term ready reckoner applied to the change in UK 10-year gilts relative to European 10-year bonds and also adds the rise in UK gilts increasing the direct policy costs. The exact distribution between global and domestic factors is not clear cut, the calculation may underestimate the domestic factors given the treatment of long rates vs short rates.

Source: RF analysis of Bank of England, Yield Curves; ECB, Euro area yield curves; OBR, Economic and Fiscal Outlook (March 2022); OBR, Ready Reckoners.
…and the summer’s increase in relative UK borrowing costs remains.

The UK-specific rate rises since the mini-budget have unwound, but much of the damage happened over the summer and has not reversed.

Of the total rise in longer-term bond yields since Johnson resigned, half is UK-specific.

This lasting hit to UK credibility means £10bn a year of additional cost by 2026-27.
Government borrowing is expected to be c. £90bn in 2026-27 without further cuts or tax rises. Results are very dependent on interest rate assumptions: the OBR typically include a ten-working-day average of market interest rates, including data up to three weeks before publication, but may face pressure to use more timely data, given recent interest rate falls.

All this leaves the public finances in worse shape than expected.

### Change in public sector net borrowing forecast since OBR's March 2022 forecast: UK, 2026-27

<table>
<thead>
<tr>
<th>Description</th>
<th>Change in Net Borrowing</th>
</tr>
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<tbody>
<tr>
<td>OBR's March 2022 forecast</td>
<td>£32bn</td>
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<tr>
<td>Change in economy since March 2022</td>
<td></td>
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<tr>
<td>Mini-budget tax cuts</td>
<td>+£23bn</td>
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<tr>
<td>Higher interest payments between mini-budget and Hunt's U-turns</td>
<td>+£45bn</td>
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<tr>
<td>Mini-budget U-turns (including interest)</td>
<td></td>
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<tr>
<td>Lower rates since Hunt became Chancellor</td>
<td>-£29bn</td>
</tr>
<tr>
<td>RP’s latest PSNB forecast</td>
<td>-£11bn</td>
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<tr>
<td><strong>Total</strong></td>
<td><strong>£89bn</strong></td>
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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 (for more information see J Leslie, In the dread of winter: Prospects for inflation in the coming months ahead of the Bank of England’s Monetary Policy Report, Resolution Foundation, August 2022). Interest rates are based on market yield curves up to 24 October 2022. Energy guarantee costings are based on gas futures curves from 26 October 2022 and the replacement for the EPG from April 2023 is assumed to be half the cost of the expected full EPG for households.

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.
Public sector net borrowing, outturns and select forecasts: UK

Borrowing is expected to remain elevated throughout the forecast.

Borrowing is set to be far higher in 2022-23 mainly as a result of costs of energy support.

A weaker economy, higher interest rates and policy choices (tax cuts) mean borrowing is set to remain elevated.

These figures are uncertain both because markets remain volatile but also policy decisions are unclear (e.g. these figures assume the replacement for the EPG from April 2023 will cost half of the current scheme).
Meeting fiscal rules requires around £40bn of fiscal tightening
Jeremy Hunt has committed to two fiscal rules:

1. To ensure the government does not borrow for day-to-day spending (a ‘current balance’ rule).
2. Public sector net debt should fall as a share of the economy in the medium-term (a ‘debt-to-GDP’ rule).

The latter rule is likely to bind in terms of the scale of consolidation, but the former will shape its nature (limiting the role of investment cuts).

These rules are in line with the typical fiscal rules the UK has used this century, but the details are currently unknown, and these matter:

- The Government needs to choose a target year and whether the rule is over a rolling window or fixed year.
- Later target years are expected to be easier to meet and so require fewer savings cuts or tax rises, but delaying most consolidation until after the next election could reduce its credibility.
<table>
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<th>Change in public sector current deficit forecast since OBR's March 2022 forecast: UK, 2026-27</th>
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<td>RF's estimate of gap to current balance</td>
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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.

U-turns and interest rate falls since Jeremy Hunt became Chancellor have filled in two-thirds of the fiscal hole for a current balance rule in 2026-27.

Under central expectations, the debt rule is harder to hit than the current balance rule (see next slide) but these forecasts suggest at least around £20bn of the total savings need to be from tax rises or cuts to day-to-day (i.e. non-investment) spending.

@resfoundation
The debt-to-GDP rule likely requires a £30bn+ tightening

Estimated fiscal consolidation required to keep debt-to-GDP ratio constant, by rate of nominal GDP growth: UK, 2026-27

The challenge of reducing debt-to-GDP is very sensitive to the growth rate. Our central expectation is that around £30bn of spending cuts/tax rises are required.

Note: the consolidation itself temporarily reduces growth. The OBR typically treats the peak impact on GDP as occurring in the year following the announcement, even for tax rises/spending cuts that only actually happen in the future. This means that after five years, the impact on the growth rate is small but still likely to push up required consolidation somewhat.

Notes: Public sector net debt is measured excluding the Bank of England. 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 (for more information see J Leslie, In the dread of winter: Prospects for inflation in the coming months ahead of the Bank of England’s Monetary Policy Report, Resolution Foundation, August 2022). Interest rates are based on market yield curves up to 24 October 2022. Energy guarantee costings are based on gas futures curves from 26 October 2022 and the replacement for the EPG from April 2023 is assumed to be half the cost of the expected full EPG for households.

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.
Even a minimum headroom requires extra £12bn of tightening

Fiscal headroom at introduction for fiscal rule regimes since 2010 and the average error in the OBR's current balance forecast, both as a share of GDP: UK

Notes: The headroom for rules introduced in 2010 and the first set in 2015 were based on the cyclically adjusted current balance, the second set of rules in 2015 was based on public sector net borrowing, the set in 2016 was based on cyclically adjusted public sector net borrowing and the set in 2021 was based on the change in public sector net debt excluding the impact of the Bank of England.

Source: OBR, Economic and Fiscal Outlook - October 2021.

To avoid fiscal policy having to respond to even small future forecast changes, Chancellors maintain headroom against their fiscal rules.

Matching the previous lowest level of headroom against a set of rules at introduction means finding roughly £12bn of additional tax rises/spending cuts (0.4% of GDP) on top of that needed to meet the new rules.
The Chancellor will be looking to deliver a fiscal consolidation of around £40bn to ensure debt is falling with even minimal headroom – half of which relates to tax cuts that remain from Liz Truss’s short premiership.

The current balance rules mean that around £30bn needs to come from tax rises or cuts in day-to-day spending. This sets a cap of around £10bn that investment cuts can contribute to meeting rules.
Tax rises, not just spending cuts, are likely
History tells us HMT turns to public investment cuts when ‘belt tightening’

£10bn in cuts implied by fiscal rules takes investment to around 2.1% of GDP

This would mark a big move away from recent political consensus which favoured a step change up in public investment levels

Notes: Values of real public sector net investment per capita prior to 1955-56 are calculated using a composite GDP deflator.
£10bn of cuts reverse most of Sunak’s planned investment rise

Share of departments in total capital spending (capital DEL): UK, 2018-19 to 2024-25

Cutting £10bn would unwind three-quarters of the remaining rise in investment planned by Rishi Sunak in SR21

Cuts likely to be concentrated in areas of recent increases including transport and BEIS (which includes net zero and science investment)

Notes: DLUHC stands for Department of Levelling up, Housing and communities. Local government is CLG in 2010 and is DLUHC and levelling up fund in 2024-25. Business, energy and climate change includes Department of Energy and Climate Change plus Department for Business Innovation & Skills in 2010-11, and the Department of Business, Energy & Industrial Strategy in 2024-25, not adjusting for machinery of government changes e.g. the transfer of Higher Education spending to the Department for Education. Departmental lines shaded in red have seen investment levels remain flat over the years, whereas departments shaded in Blue have seen investment increase.

Context to new day-to-day spending cuts is inflation hit budgets

Percentage change in real (government expenditure deflator adjusted) RDEL spending, by department: 2022-23 to 2024-25

Lower day-to-day spending after the current spending review will play a big role in the consolidation

But high inflation is already hitting those budgets during current spending review period

Planned real increases have become cuts for some departments:

Education was expecting a real-terms rise of £1.5bn but now faces a £0.6bn cut

Notes: Foreign, Commonwealth and Development Office values ignores the planned increase in ODA previously expected in 2024-25. Deflated using the RF forecast for the government expenditure deflator (adjusted to assume the EPG ends in April 2023).

Source: RF analysis of HM Treasury, PESA tables, various.
Higher inflation means real day to day spending will be around £22bn lower in 2024-25 than expected in October last year.

Notes: Nominal RDEL values are deflated using the Government Expenditure Deflator, values are in 2021-22 cash terms. The October 2022 RF forecast is produced by assuming one-third of the difference between the OBR March EFO CPI forecast and the RF CPI forecast passes through into the Government Expenditure Deflator, and two thirds of the difference between budgeted public sector wage increases and wage increases suggested by the public sector pay review bodies passes through into the Government Expenditure Deflator for 2022-23 and 2023-24. Following this period we assume the difference in the growth rate of public and private sector pay since 2000 is closed linearly over the following 5 years from 2024-25 to 2029-30. Energy Bill Relief Scheme’s support for public services is assumed not to continue beyond April.

Source: RF analysis of HMT, PESA Tables, various; OBR, Economic and Fiscal Outlook, March 2022.

With real terms day-to-day spending £22bn lower by 2024-25
Further aid cuts only help meet rules if 0.7% goal is dropped

Nominal year-on-year increase in RDEL and Overseas Development Assistance spend: UK

Delivering return of ODA to 0.7% of GNI to 2026-27 (when fiscal targets are met) would deliver £5bn of savings in 2024-25 & 2025-26.

The Government would need to move away from 0.7% commitment more permanently if ODA cuts are to help meet fiscal rules (in 2026-27 or 2027-28).

ODA spending increasingly dominated by foreign office, home office and defence budgets.

Source: RF analysis of HMT, PESA Table 2022.
Day-to-day spending (RDEL) cuts look inevitable

<table>
<thead>
<tr>
<th>Scenario</th>
<th>Protected RDEL</th>
<th>Unprotected RDEL</th>
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<tbody>
<tr>
<td>Real freeze</td>
<td>3.7%</td>
<td>-9.3%</td>
</tr>
<tr>
<td>Nominal freeze</td>
<td>3.7%</td>
<td>-14.6%</td>
</tr>
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Notes: Coloured bars show changes in real RDEL required to cut spending under different scenarios in 2026-27. All figures are deflated using the Government Expenditure deflator in 2022-23 cash terms, as forecast by RF (assuming EPG ends in April 2023). Protected departments are assumed to be health, defence, education, foreign office. Assumed ODA uplift occurs in 2026-27 rather than 2024-25 as expected in the Spring Statement 2022.

Source: Analysis of HMT, PESA Tables various and OBR, EFO March 2022.
Cash-terms freeze means a return to peak austerity

Indices of real (government expenditure deflator adjusted) per capita RDEL (2009-10=100), all departments and projection: UK

A cash-terms freeze in day-to-day spending would take spending on unprotected departaments back to the peak of austerity in 2018-19 (if real, per-capita spending on protected departments was maintained).

Notes: All values are in 2022-23 cash terms, deflated using a government expenditure deflator forecast (assuming EPG ends in April 23). Assumed that uplift in ODA spend to 0.7% of GNI is delayed until 2026-27. Protected departments assumed to have unchanged real, per capita RDEL between 2024-25 and 2026-27.
Source: RF analysis of OBR EFO, March 2022 and HMT, PESA various.
A linear increase in defence spending to meet the 3% by 2030 target means £13bn extra spending in 26-27 and £28bn extra in 28-29.
Uprating benefits in line with earnings would save low billions...

Value of selected benefits in real-terms (September 2022 prices): UK

- Basic State Pension
- Unemployment benefits
- Child Benefit (1st child)
- Child Benefit (2nd child)

Notes: In earnings uprating scenario, benefits are uprated by earnings in 2023-24 and 2024-25, then inflation in the following years.
Source: RF Analysis of DWP, Abstract of Benefit Statistics; ONS, Average Weekly Earnings; ONS, CPI.

Uprating with earnings (5.5 per cent) instead of inflation (10.1 per cent) would save around £9bn by 2026-27 if applied to working-age and pensioner benefits.

Limiting it to Universal Credit and Child Benefit would only save £2.9bn and see unemployment benefit hit its lowest level since 1982-83.
Income loss in 2023-24 if benefits are uprated by earnings instead of inflation in 2023

- Income loss in 2023-24 for different scenarios:
  - Family with two children only receiving Child Benefit: £86
  - Single unemployed adult on UC: £185
  - Single disabled adult on ESA: £324
  - Pensioner receiving the Basic State Pension: £342
  - Single disabled adult on UC: £380
  - Working single parent with one child on UC: £478
  - Working couple renting with two children on UC: £752
  - Working couple not renting with three children on UC: £978

Notes: The single parent with one child in work is assumed to be renting, working at least 20 hours a week and earning NLW, and having a child born after 6 April 2017. The working couple with two children are assumed to be renting, working at least 20 hours a week and earning NLW, and having two children born after 6 April 2017.

Source: RF analysis of DWP, Benefit Statistics; ONS, Consumer prices inflation & Labour market statistics.
Further working-age benefit cuts could hit disability or child benefits

Non-pensioners welfare spending as a proportion of GDP: GB

Notes: Child benefits includes Child Benefit, One Parent Benefit and Guardian’s Allowance. Incapacity benefits include Employment and Support Allowance, Incapacity Benefit, Invalidity Benefit, Severe Disablement Allowance and Sickness Benefit. Unemployment benefits includes Jobseeker’s Allowance and Unemployment Benefit. Disability benefits includes Armed Forces Independence Payment, Attendance Allowance, Disability Living Allowance, Mobility Allowance and Personal Independence Payment. All others includes Bereavement Benefits, Carers Allowance, Christmas Bonus, Council Tax Benefit, Family Credit, Industrial Injuries Benefits, Maternity Allowance, Social Fund (discretionary), Statutory Maternity Pay and Statutory Sick Pay. Fora small number of benefits where no age split was available for earlier, we split benefit spend by age based on the most recent available age split data for that benefit.

Challenges of further austerity mean we should expect tax rises

Estimated fiscal impact of selected potential tax measures in 2026-27: UK

- £4bn  £0  +£4bn  +£8bn  +£12bn  +£16bn

Keep the Health and Social Care Levy: 15
Raise all Income Tax rates by 1p: 9
Scrap IHT business, agricultural and residential reliefs: 4
Abolish the non-dom regime: 3
Remove capital gains uplift on death: 2
Extend Income Tax / NI threshold freezes by 1 year: 2
Extend VAT to private school fees: 2
Scrap Lifetime ISAs (spending policy): 1
End the tax-free treatment of inherited pensions: 1
Extend VAT, IHT and CGT threshold freezes: 0
Halve 2023 Business Rates multiplier increase: -2
Make 5p Fuel Duty cut permanent: -2

Notes: Income Tax / NI threshold freeze costing based on a counterfactual uprating of 1.2%. Also freezing in 2027-28 would raise an additional amount.
Source: RF analysis.

Pencilling in continued threshold freezes beyond 2025-26 is likely, but more tax rises may be needed given there may also be tax cuts that need funding.

Fuel Duty is due to rise by 5p + RPI in April, while Business Rates and other taxes are due to rise by CPI or RPI.
Key takeaways:

New PM inherits grim economic outlook that combines lower growth and high inflation, with rising interest rates and unemployment.

That combines with the policy legacy of Liz Truss to require a fiscal tightening of around £40bn.

Moving away from recent focus on higher public investment may save £10bn (at price of lower growth):

- Not credible that day-to-day spending cuts can top £20bn – even that would mean unprotected departments returning to peak austerity.

Further tax rises, not just spending cuts, are coming.
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