New Budget, same problems:

Spring Budget preview

Molly Broome, Adam Corlett, Emily Fry, Karl Handscomb, Louise Murphy, Felicia Odamtten, Cara Pacitti, Krishan Shah, Hannah Slaughter, James Smith, Gregory Thwaites & Lalitha Try

6 March 2023

Summary: the forecasts

There is finally some good news for the Chancellor in the short term:

- Wholesale energy prices are down 80 per cent since the summer.
- This means the 2023 outlook is much improved, with GDP fall for 2023 likely to be less than half that feared in the Autumn and;
- Borrowing looks set to come in around £30bn lower than expected in 2022-23.

The next year is unlikely to feel like good news for households:

- Typical household incomes are set to fall by 4 per cent (or £1,100) in 2023-24.
- That includes tax rises of £650 for a typical household from April (£1,500 for the richest fifth).

Looking ahead, the low growth and elevated debt big picture may not change hugely:

- Key judgement for the Office for Budget Responsibility (OBR) is whether it becomes as pessimistic as the Bank of England (BoE) on labour market participation, which could offset benefits of smaller recession.
- If stronger tax receipts this year are forecast to last that could mean somewhat lower borrowing (~£10bn/year).
- Medium-term public finances would be little changed, with higher debt than expected a year ago and only around £15bn of headroom against the Chancellor's target of debt falling in 5 years' time.

Summary: the policy choices in three key areas

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Cost of living support:

- Delaying the increase in the Energy Price Guarantee to £3,000 is likely and would cost a one-off £3bn.
- Scrapping planned rises in fuel duty would permanently cost £5bn a year.

Public sector pay:

- Day-to-day public service budgets are broadly flat over the next two years.
- Departments say a 3.5 per cent pay rise next year is affordable.
- Going further with a 5.5 per cent rise would cost a further £5bn.

Boosting growth:

- An agenda to raise labour market participation should focus on women and older or disabled workers.
- Corporation Tax reform would do better to focus on raising the generosity of investment allowances over a lower headline rate.

The good news:
things look less bleak in the short term

The really good news: huge falls in wholesale energy prices

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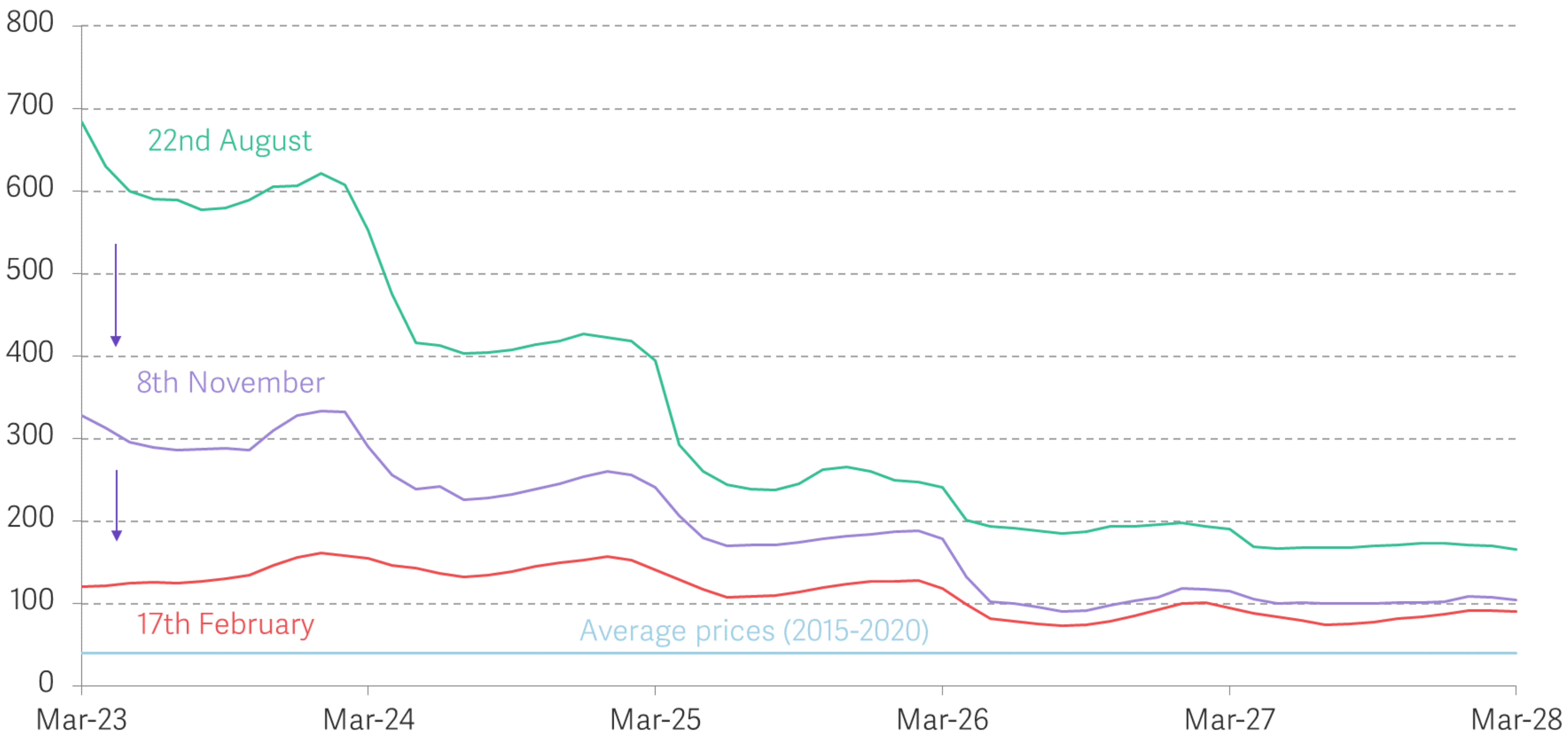
Wholesale gas futures prices, pence per therm: UK



Gas futures' prices for 2023-24 have fallen by around 80% since August…

…but are still around three times higher than 2015-2020 levels.

Notes: Average wholesale prices from 2015-2020 refer to prices of average day-ahead contracts.
Source: RF analysis of ICE Futures Europe.

GDP fall for 2023 likely to be less than half that feared

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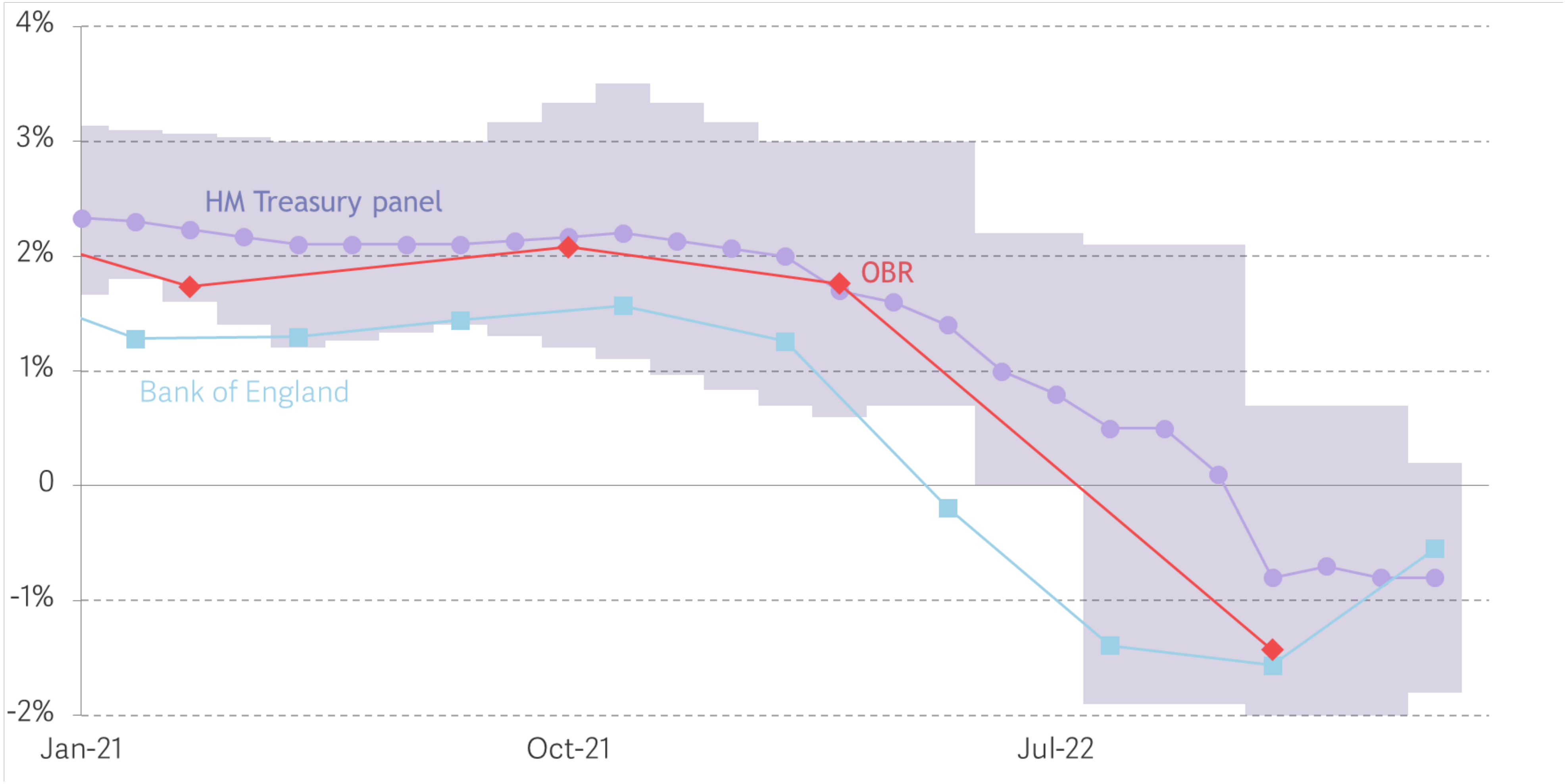
Calendar-year forecasts for real GDP growth in 2023, by date of forecast: UK



In November, OBR forecast GDP to fall by 1.3% this year…

…but following those huge falls in energy prices, this is likely to be nearer 0.5% - in line with the Bank of England (BoE).

This still means a technical recession but would be shallowest one since the 1950s.

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.

Key forecast judgement: will Brits spend their savings?

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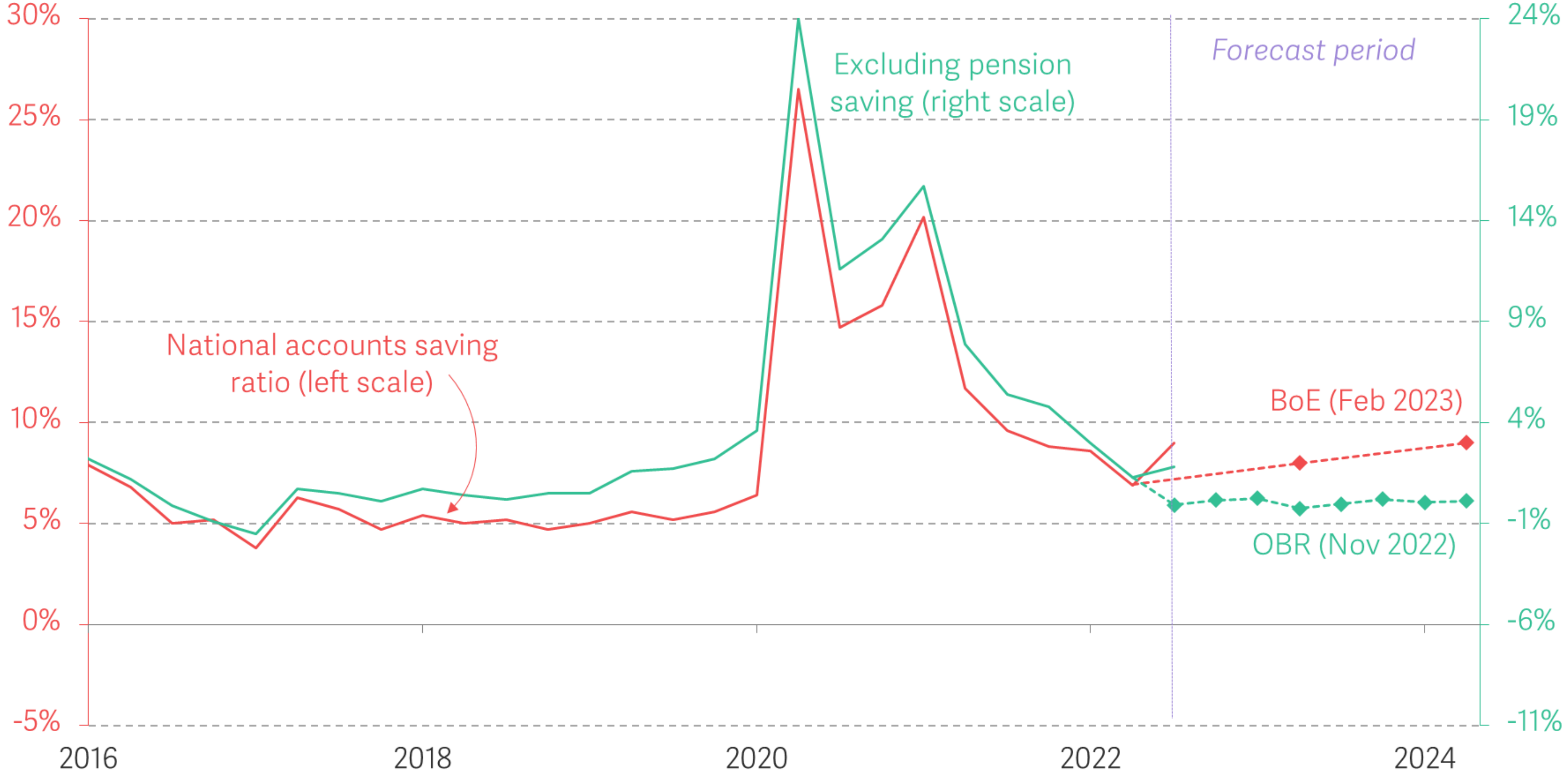
Household saving ratio, including and excluding pension saving, outturns and forecast: UK



BoE forecast a rise in the saving ratio from Q2 2022 level; OBR assume saving will fall as people run down savings in face of rising prices.

Difference is big: worth nearly £40bn on spending in 2023.

Data so far doesn't support idea of big saving falls (saving ratio increased in Q3 and households' deposits continued to rise at average rates in Q4).

Notes: The Bank of England provide a calendar-year forecast for the aggregate household saving ratio; the OBR forecast the saving ratio excluding pension saving.
Source: RF analysis of ONS, National Accounts; Bank of England, Monetary Policy Report, February 2023; and OBR, Economic and Fiscal Outlook, November 2022.

The fiscal good news: borrowing to come in ~ £30bn lower this year

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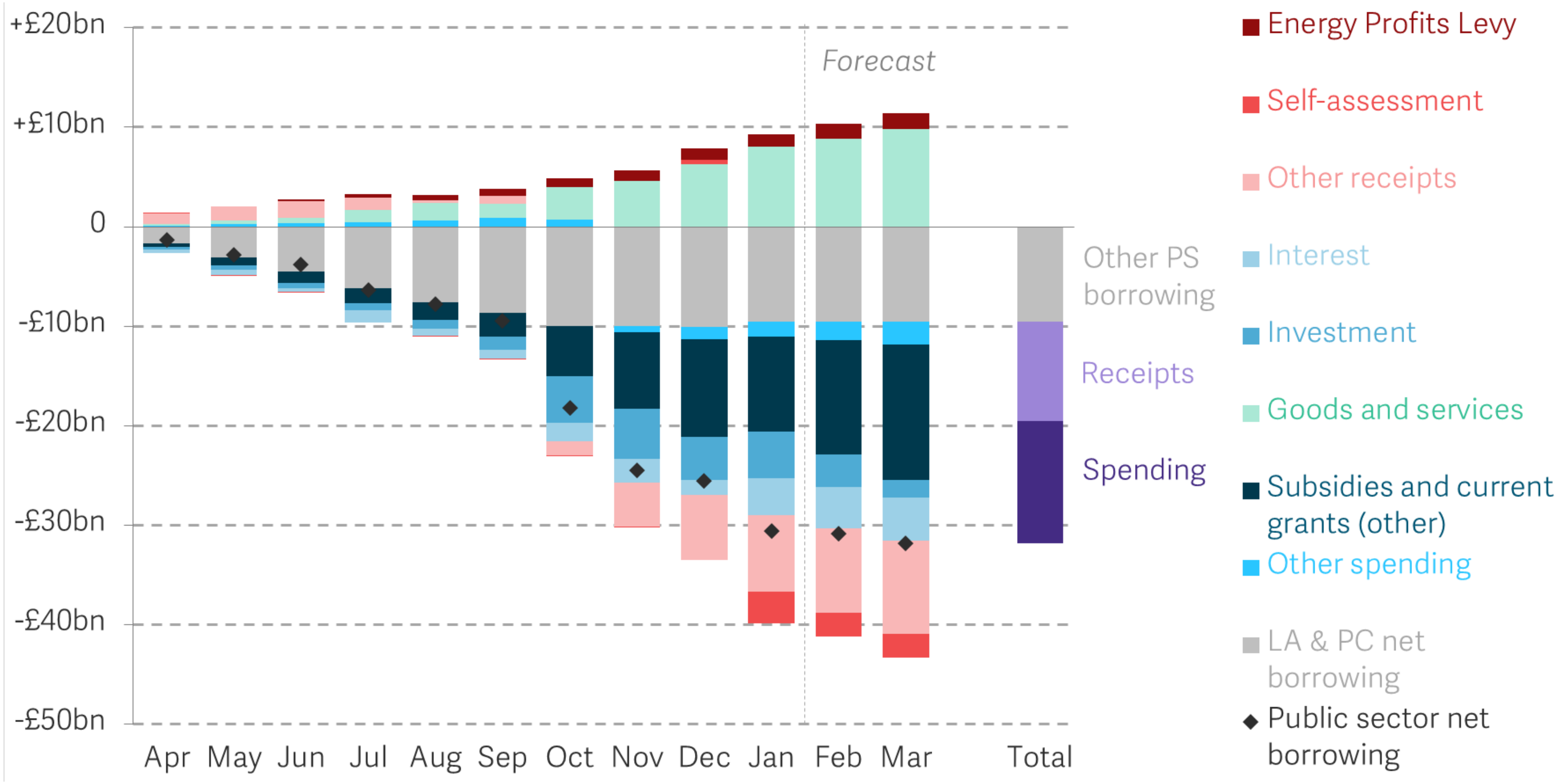
Cumulative public sector net borrowing by component, outturn relative to forecast: UK, 2022-23



Lower spending (the net of higher departmental spending and lower debt interest and energy support costs) drives a third of lower borrowing.

Another third relates to higher than expected receipts - particularly NICs and Self-Assessment.

Only the second of these is likely to have a lasting impact.

Source: RF analysis of ONS, Public Sector Finances; OBR, November 2022 Economic and fiscal outlook monthly profiles.

Household finances:
it won't feel like good news

Despite good news on energy, incomes will fall further

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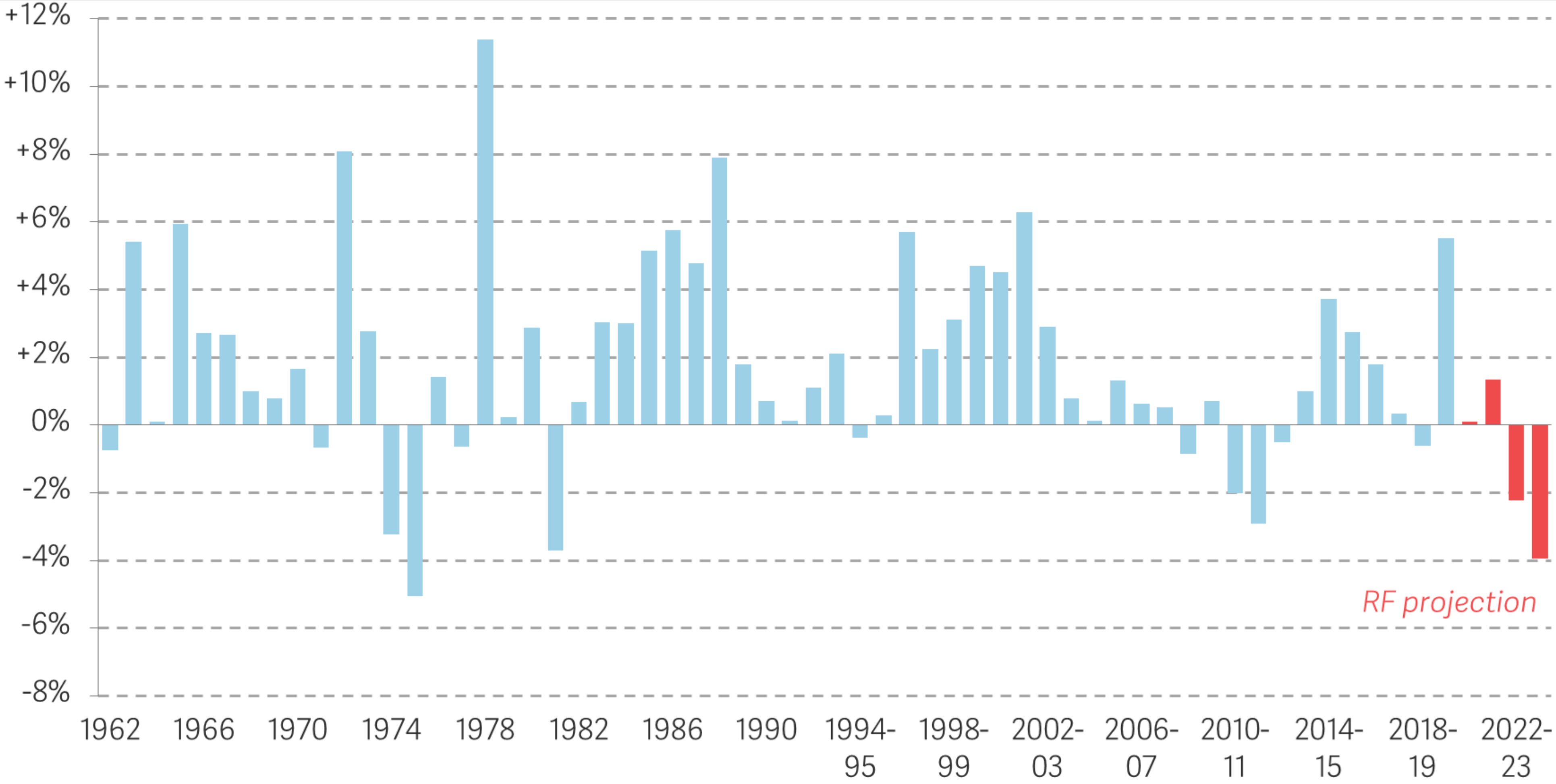
Real growth in median equivalised household disposable income for non-pensioners, after housing costs: GB/UK

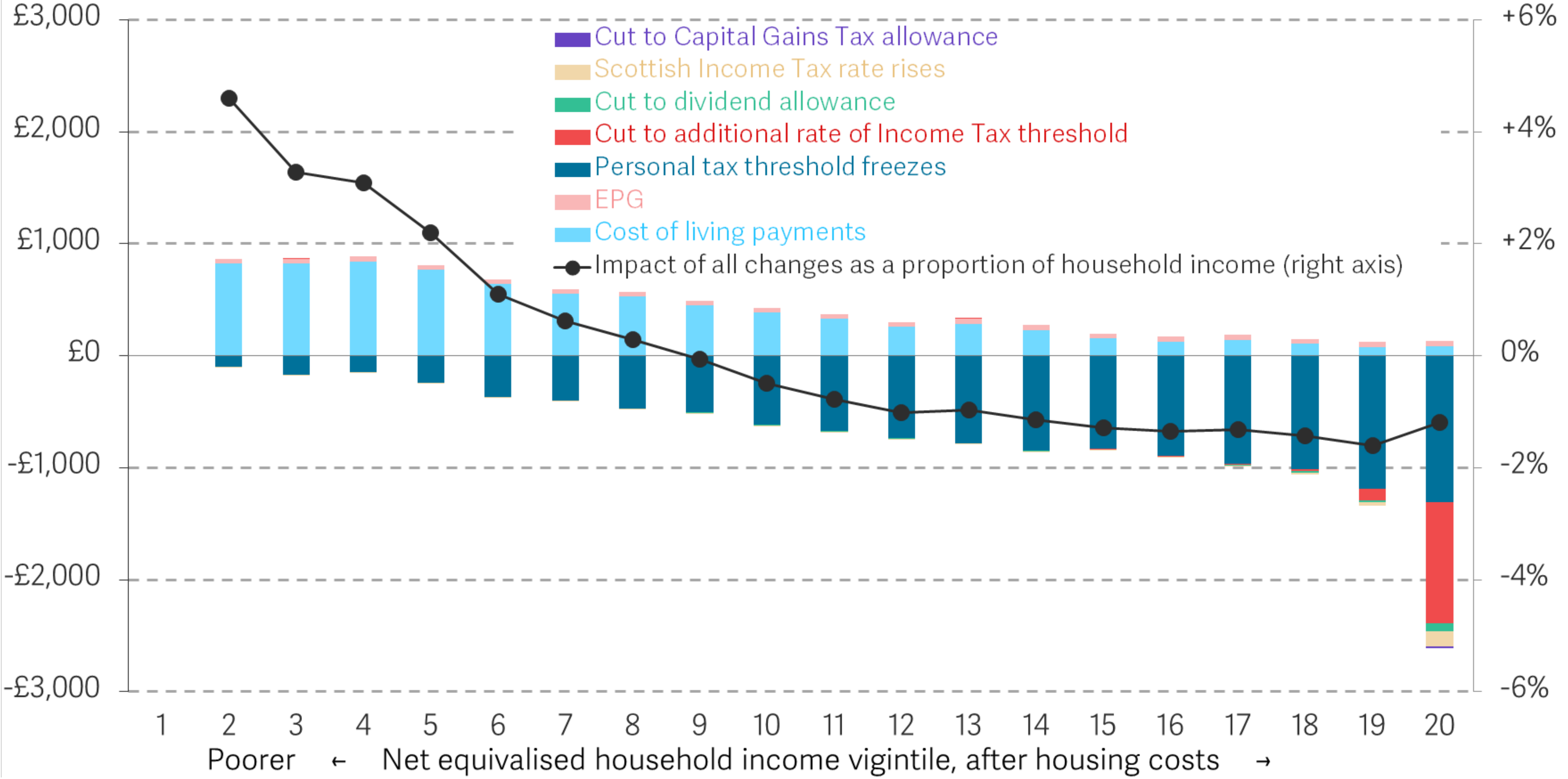


Typical non-pensioner income is projected to fall by 2% (£700) in 2022-23 and a further 4% (£1,100) in 2023-24

Notes: GB from 1994-95 to 2001-02.
Source: RF analysis of DWP & IFS, Households Below Average Income; RF projection including use of the IPPR Tax Benefit Model, OBR and Bank forecasts.

Policy is supporting poorer, and taxing richer, households…

Average impact of tax changes taking effect in April 2023 and cost of living support in 2023-24 by income vigintile, in 2023-24 prices: UK



Tax rises coming into effect in April mean a £650 hit to a typical household's income and a £1,500 hit for the richest fifth of households.

Notes: Capital Gains Tax change reduces the annual exempt amount from £12,300 to £6,000 from 2023-24. We assume Capital Gains Tax changes affect the top vigintile only. Dividend allowance change reduces the threshold from £2,000 to £1,000 in 2023-24. Additional rate of Income Tax threshold reduced from £150,000 to £125,140 in 2023-24. Personal tax threshold freezes refers to 2023's Income Tax and National Insurance freeze (excluding employer NI). Scottish Income Tax rates are rising by 1p for higher and additional rate payers. We do not include changes in Council Tax.
Source: RF analysis of DWP, Family Resources Survey using IPPR tax-benefit model; DWP, Households Below Average Income.

…but not all poorer households will get cost of living payments

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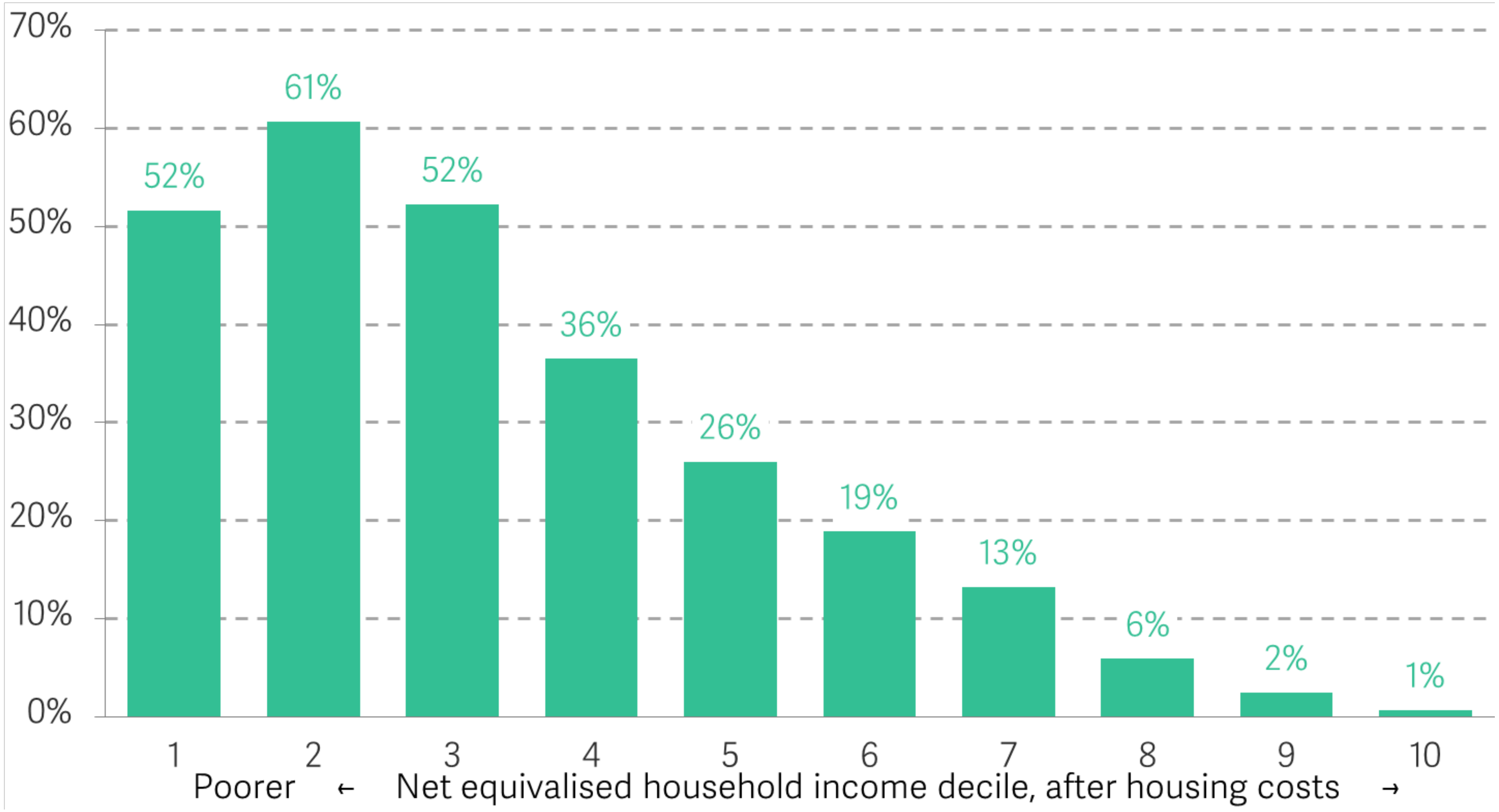
Estimated proportion of households in receipt of means-tested benefits, by household income decile, 2022-23: UK



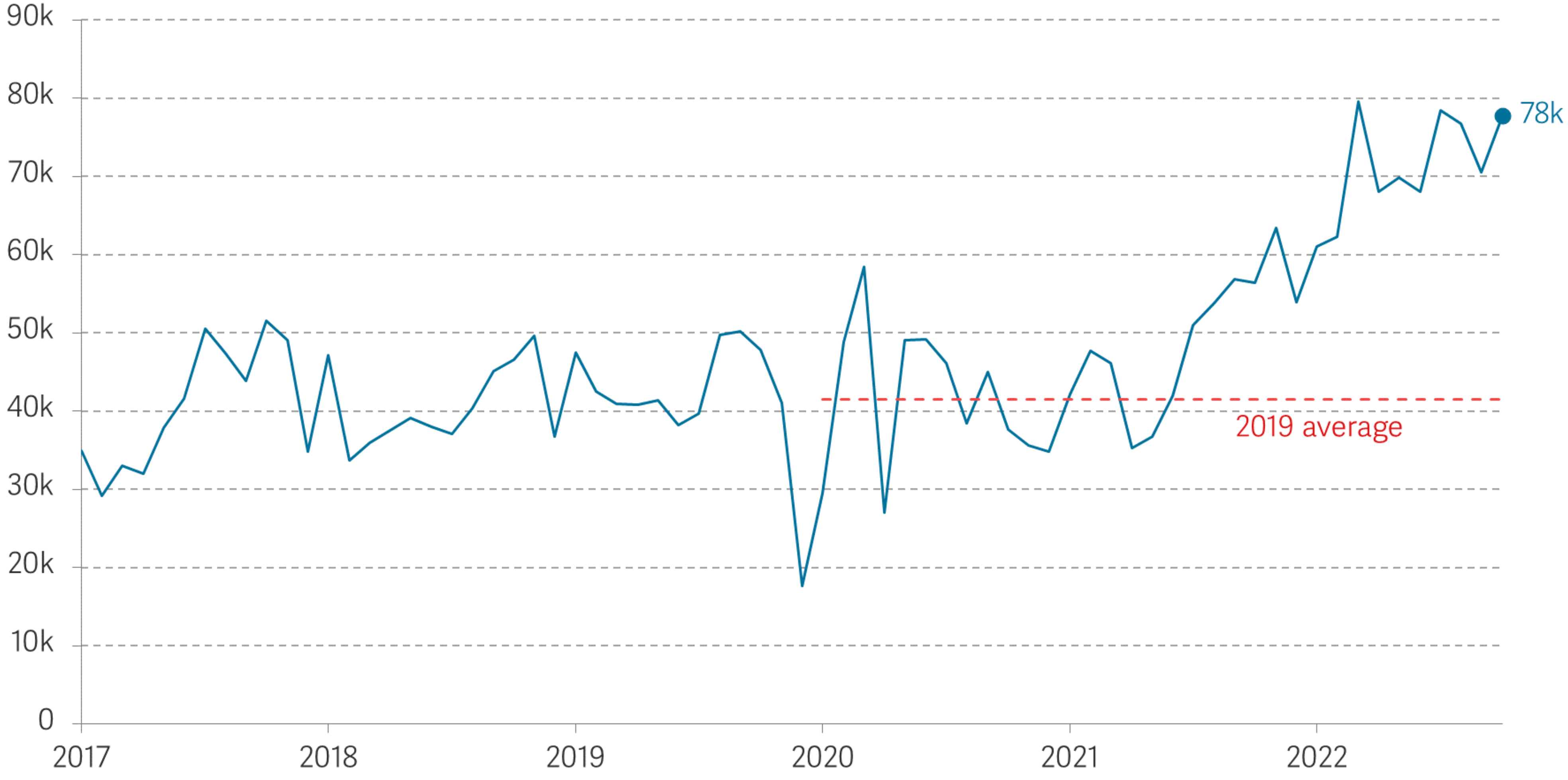
Non-take-up of benefits is the main reason why many low-income households are not in receipt of benefits (1.5 million in bottom two deciles), alongside non-entitlement for low-earners (0.5m) and students and those with high savings (0.5m).

Notes: Chart shows proportion of households that have a least one family member in receipt of a means-tested benefit such as Universal Credit (or legacy equivalent except Housing Benefit).
Source: RF analysis of IPPR Tax-Benefit Model; DWP, Households Below Average Income.

The longer term:
a weak growth outlook is likely to remain

Ill-health and disability are on the rise

Monthly number of new PIP cases with entitlement: England, Wales and Northern Ireland, January 2017 – October 2022



Rising ill-health and disability can be seen in the:

Labour market - working-age inactivity due to long-term sickness has risen by 350,000 since the start of the pandemic.

Benefits system - claims among young people (largely mental health problems) and among older people (largely physical health problems) up.

Notes: Data is for England, Wales and Northern Ireland only, since PIP is being replaced with the Adult Disability Payment (ADP) in Scotland, which has a knock-on impact on PIP caseloads.
Source: RF analysis of DWP, Stat-Xplore data.

Key forecast judgement: should OBR forecast fewer workers?

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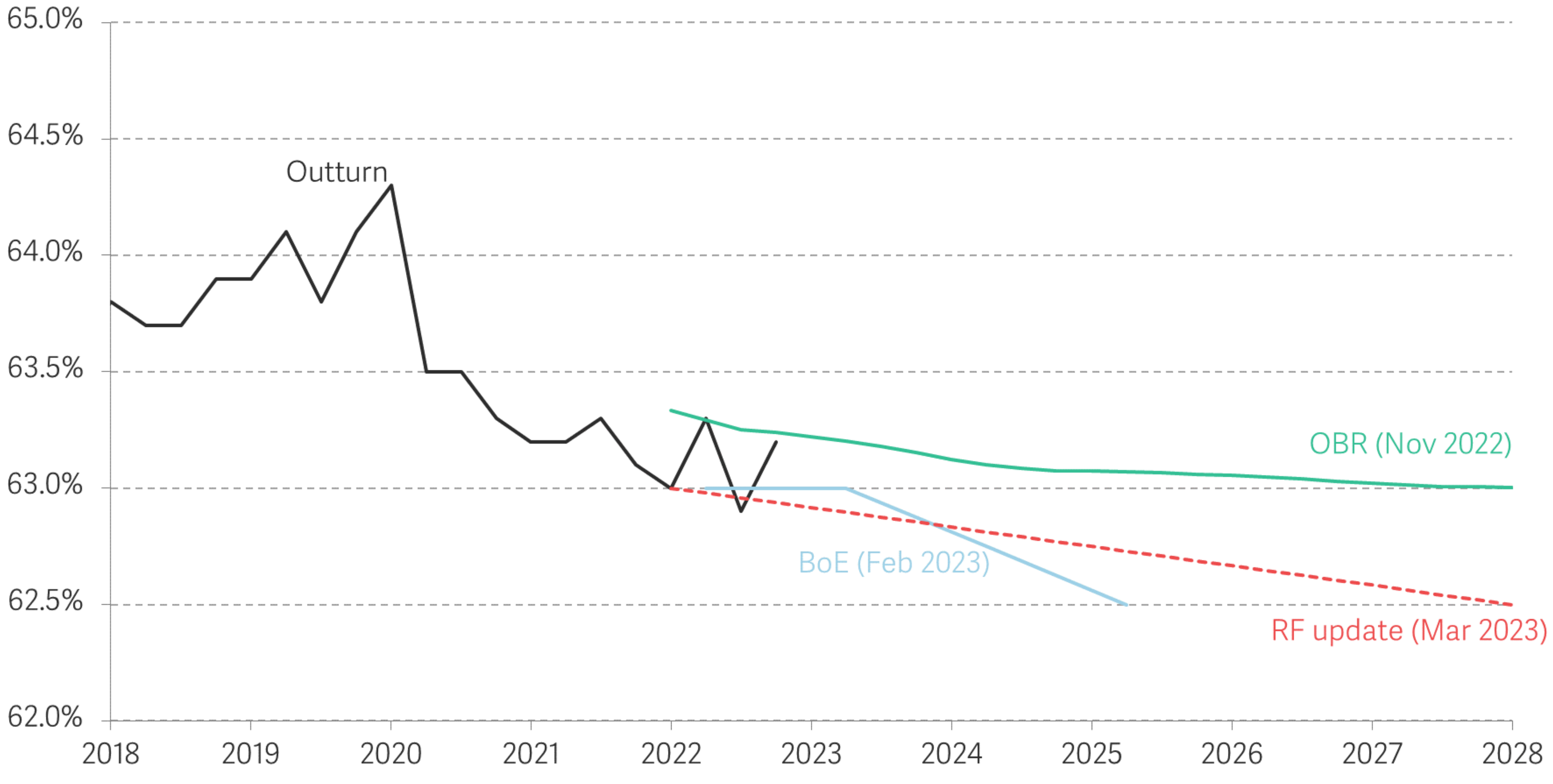
16+ participation rate, outturn Bank of England and OBR forecasts: UK



Key judgement is whether recent falls in participation will continue, given the rising ill health trends that predate the pandemic.

Notes: All measures are potential participation rate - that is, the long-run sustainable level of the participation rate - except for the Bank of England which is a forecast for the actual participation rate.
Source: RF analysis of ONS, Labour Market Statistics; Bank of England, Monetary Policy Report, February 2023; OBR, Economic and Fiscal Outlook, November 2022.

Bigger economy now + weaker participation = little change to medium-term GDP forecasts

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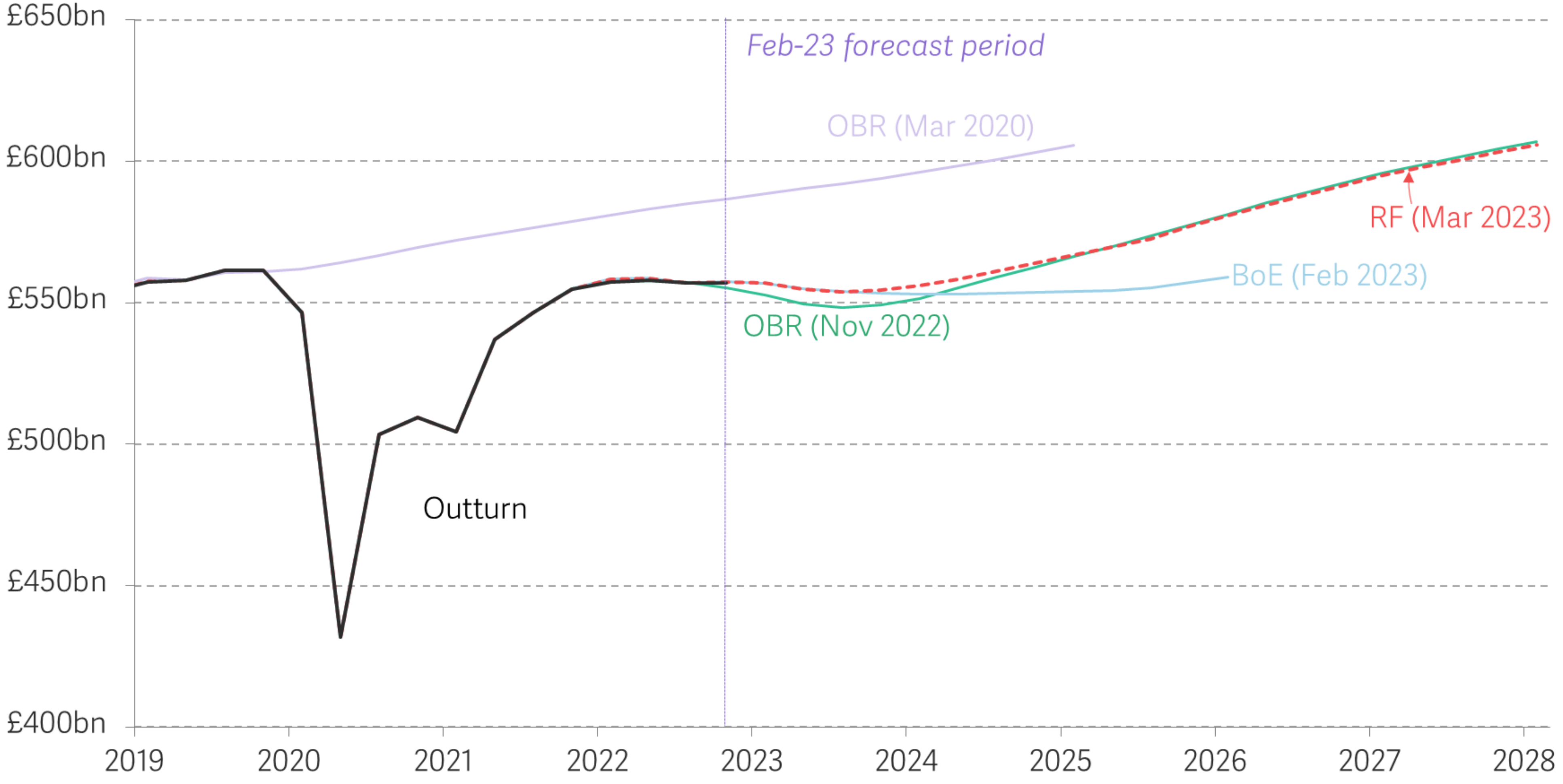
Real GDP, chained-volume measure, outturn Bank of England and OBR forecasts: UK

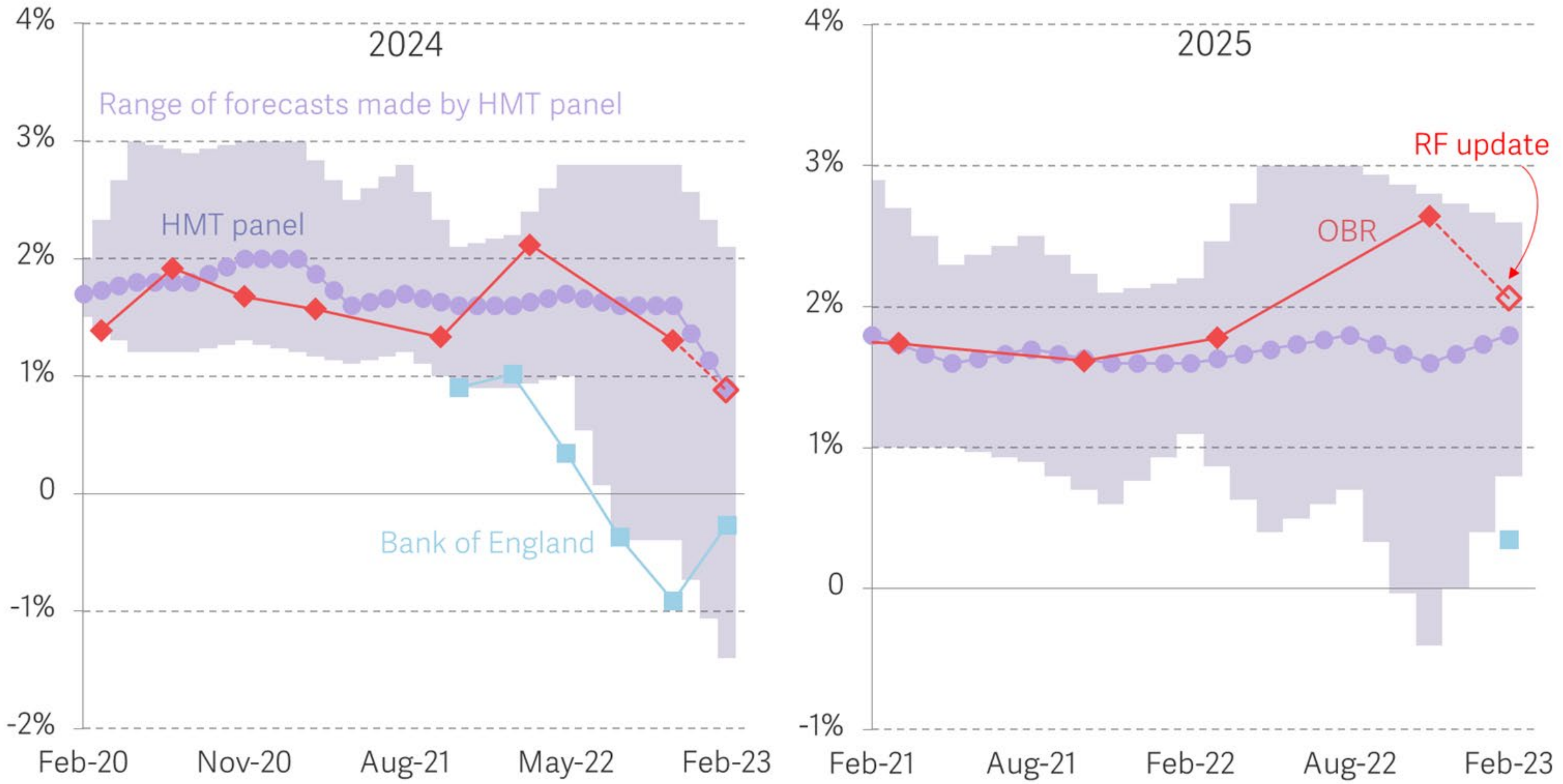


A similar profile to the BoE in the next few quarters *plus* an outlook that is little changed from the Autumn Statement in the medium term seems plausible given participation headwinds.

Notes: All measures are rebased and re-referenced to 2019.
Source: RF analysis of ONS, National Accounts; Bank of England, Monetary Policy Report, various; OBR, Economic and Fiscal Outlook, November 2022.

We expect the OBR to remain more optimistic than BoE

Calendar-year forecasts for real GDP growth in 2024 and 2025, by date of forecast: UK



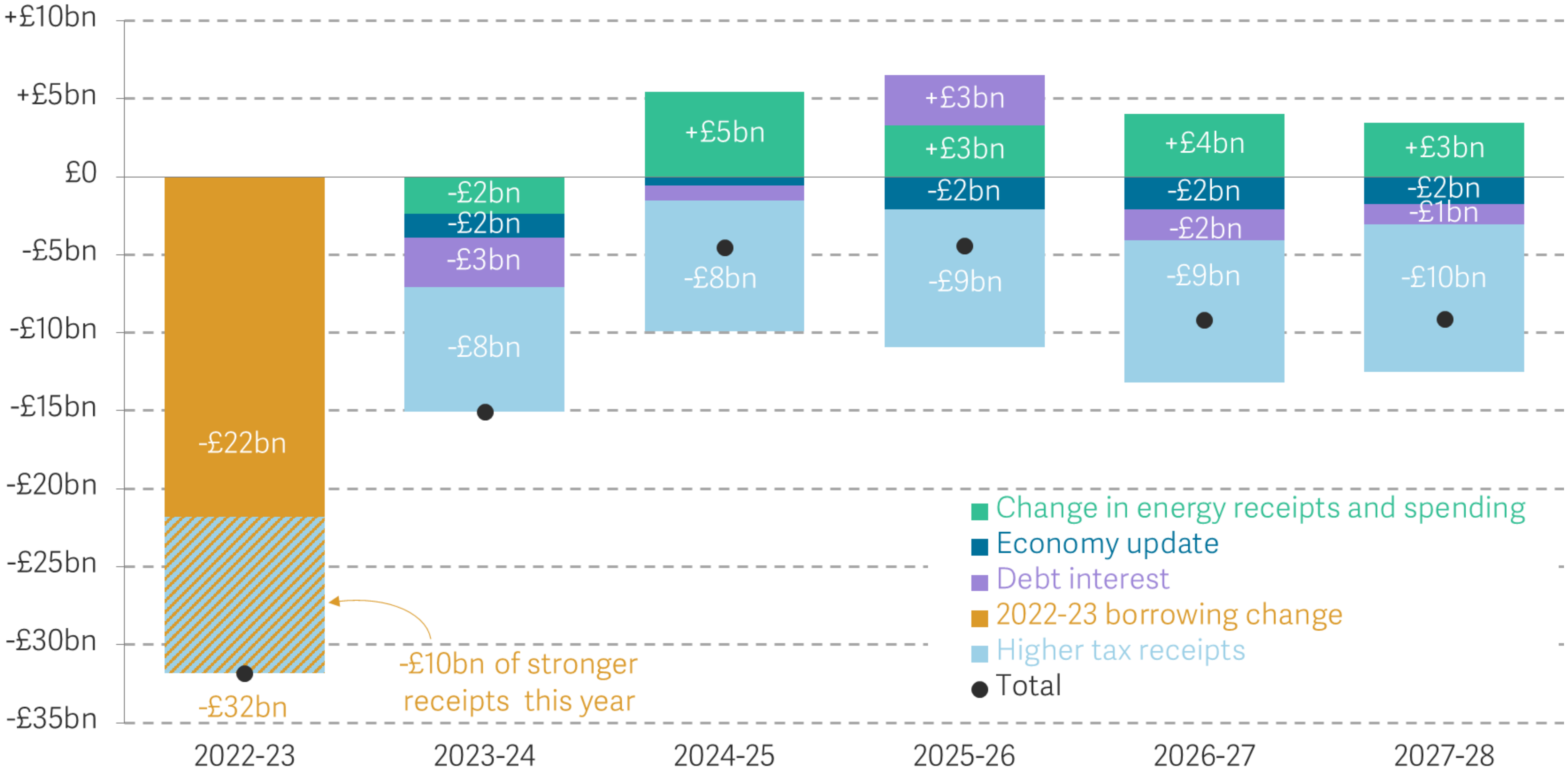
Unless the OBR downgrades its forecast for productivity as well as participation, its medium-term growth forecasts will remain significantly more optimistic than BoE – in line with most external forecasters.

Medium-term inflation forecasts are likely to be revised up significantly.

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.

Key judgement: will stronger tax receipts last?

Change in public sector net borrowing forecast: UK



In the near term, improved economic outlook & reduced energy spending reduces borrowing, partially offset by lower energy-related taxes in future years.

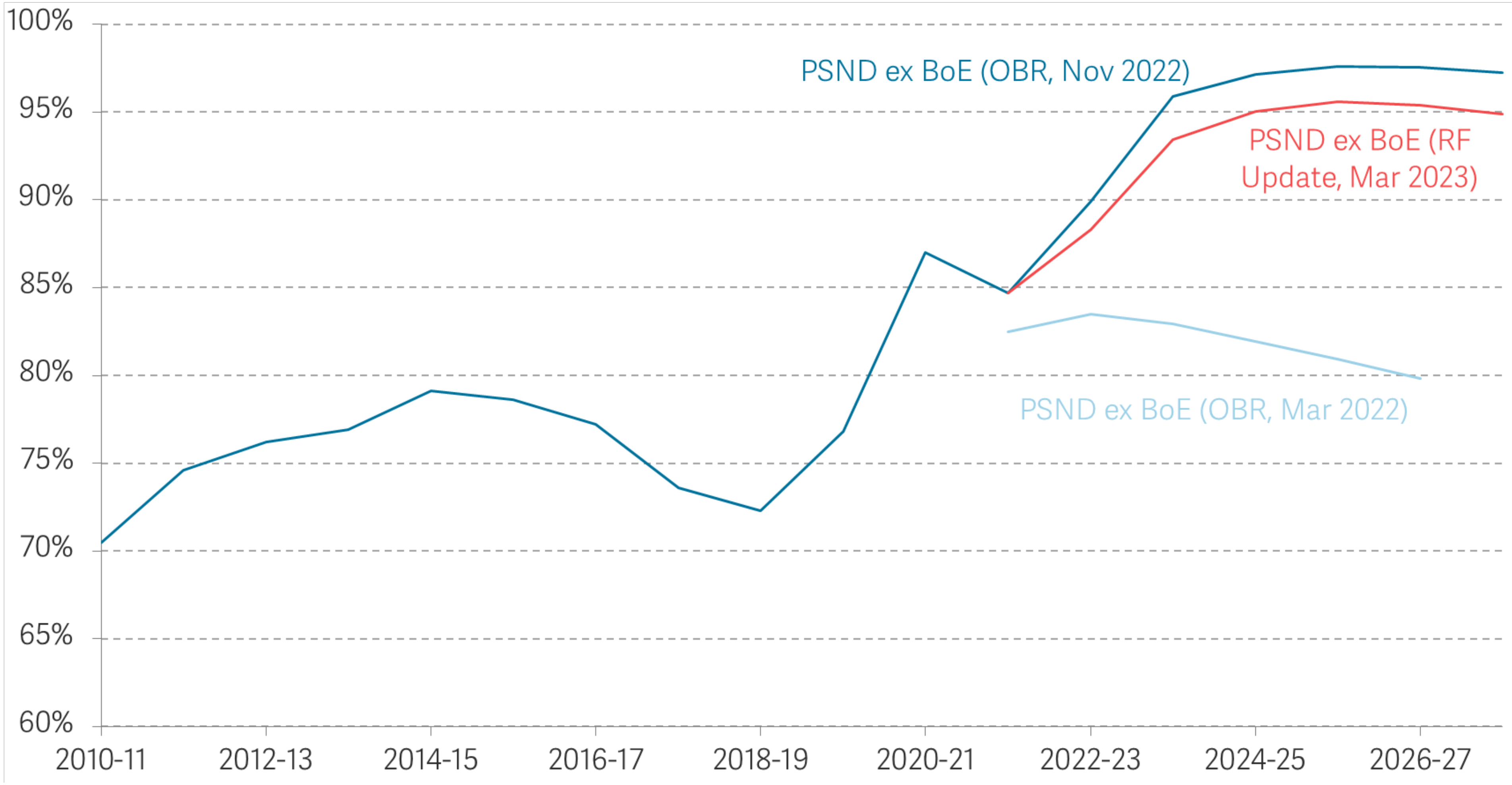
If current tax richness of the economy is forecast to last, borrowing might be around £10bn lower in the medium term.

This is tiny (vs £140bn average 5-year ahead OBR forecast error) and would be wiped out if GDP levels were downgraded in line with the BoE.

Notes: Forecasts are based on the Bank of England's February 2023 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. Interest rates are based on market yield curves up to 17 February 2023. Energy guarantee costings are based on gas futures curves from 17 February 2023.
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.

Slight improvements to debt levels and fiscal headroom are possible

Public sector net borrowing and debt, outturns and forecasts: UK



Headroom against debt falling (still the binding fiscal rule) would be around £15bn in 2027-28, up from £9bn in November.

But big picture is still one of much higher borrowing and debt than expected a year ago.

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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.

Three key areas for policy

1) Cost of living support

To avoid an energy bills rollercoaster, Energy Price Guarantee rise is likely to be delayed

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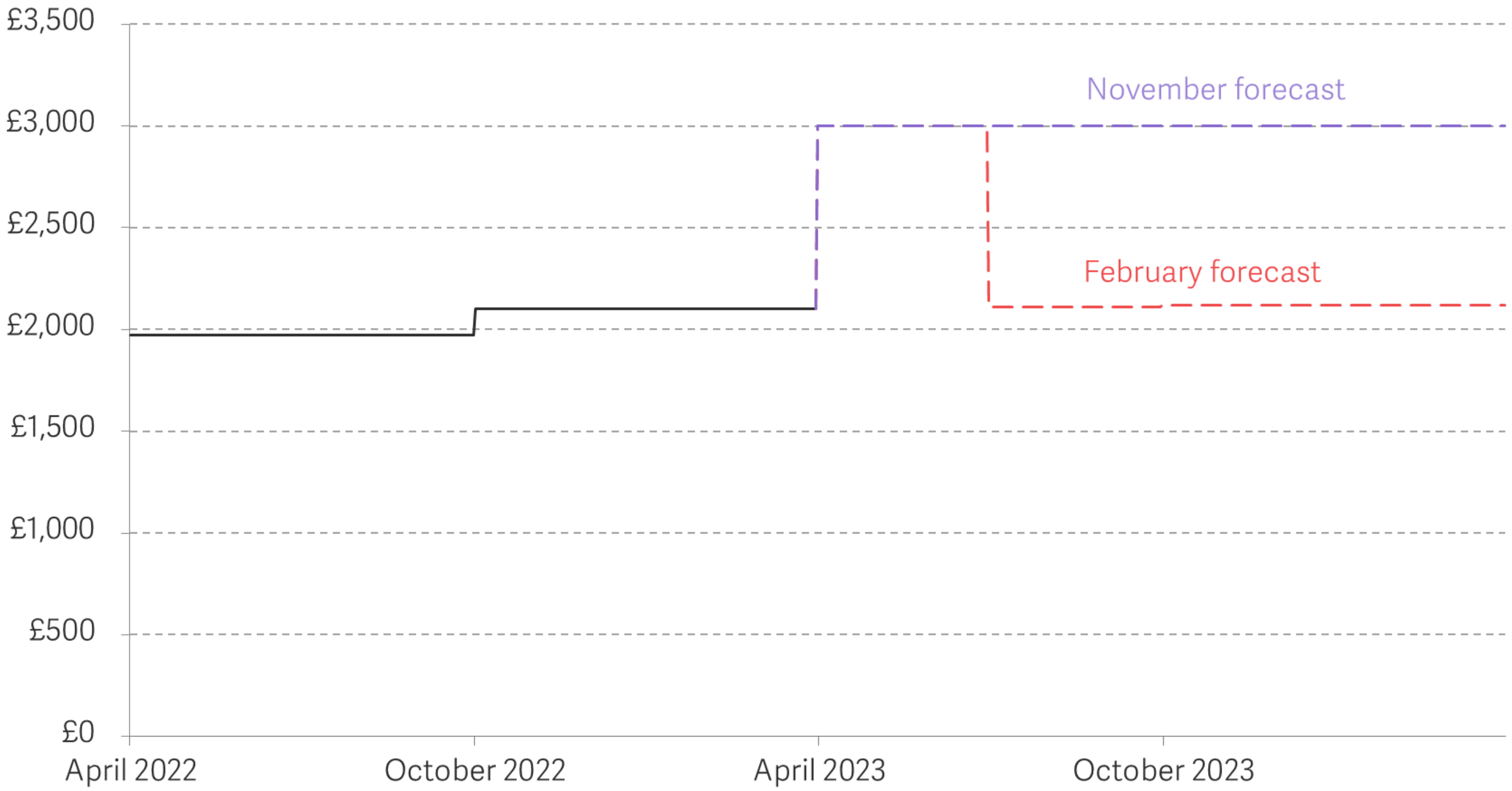
Historical and forecast annualised energy prices for a typical household: UK



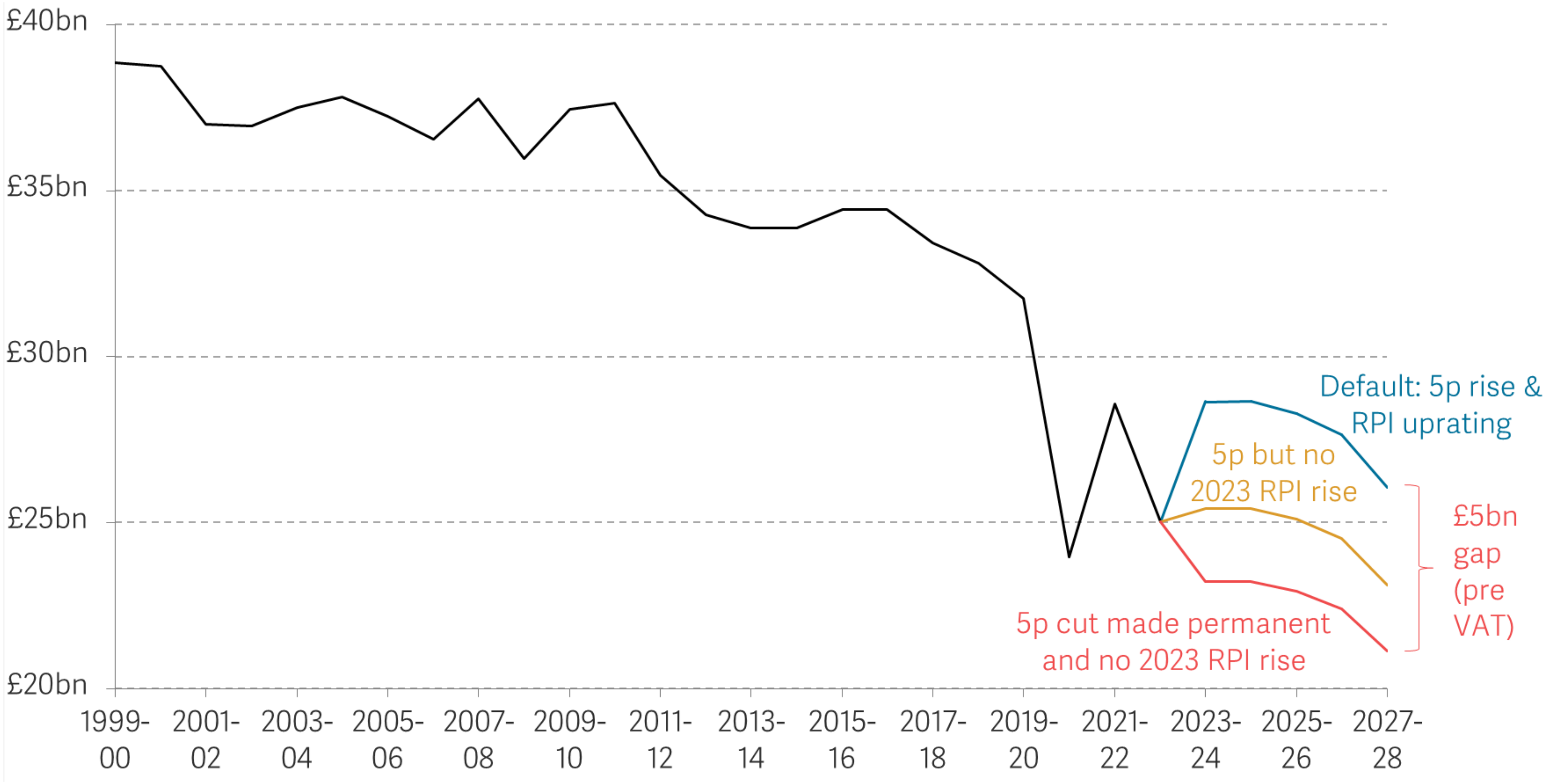
Lower wholesale energy prices mean EPG costs in 2023-24 are set to be £1.4bn; this is over £11bn, or almost 90 per cent, lower than expected in the Autumn.

Avoiding a sharp rise in energy bills by maintaining EPG at £2,500 for 3 months would cost around £3bn.

Notes: Figures net of £400 Energy Bills Support Scheme rebates but no other cost of living payments such as those delivered through the benefits or council tax system. Forecast based on Cornwall Insight in November and February 2023.
Source: RF analysis of Ofgem price cap methodology, Government Energy Price Guarantee, Cornwall Insight, UCL SERL data.

Government is likely to cancel some or all of the Fuel Duty rise

Real Fuel Duty receipts, CPI-adjusted: UK



Temporary 5p cut expiring and default RPI uprating could add up to 12p/litre to prices (if fully incident on consumers), though petrol prices have fallen by 44p/litre since their peak in July.

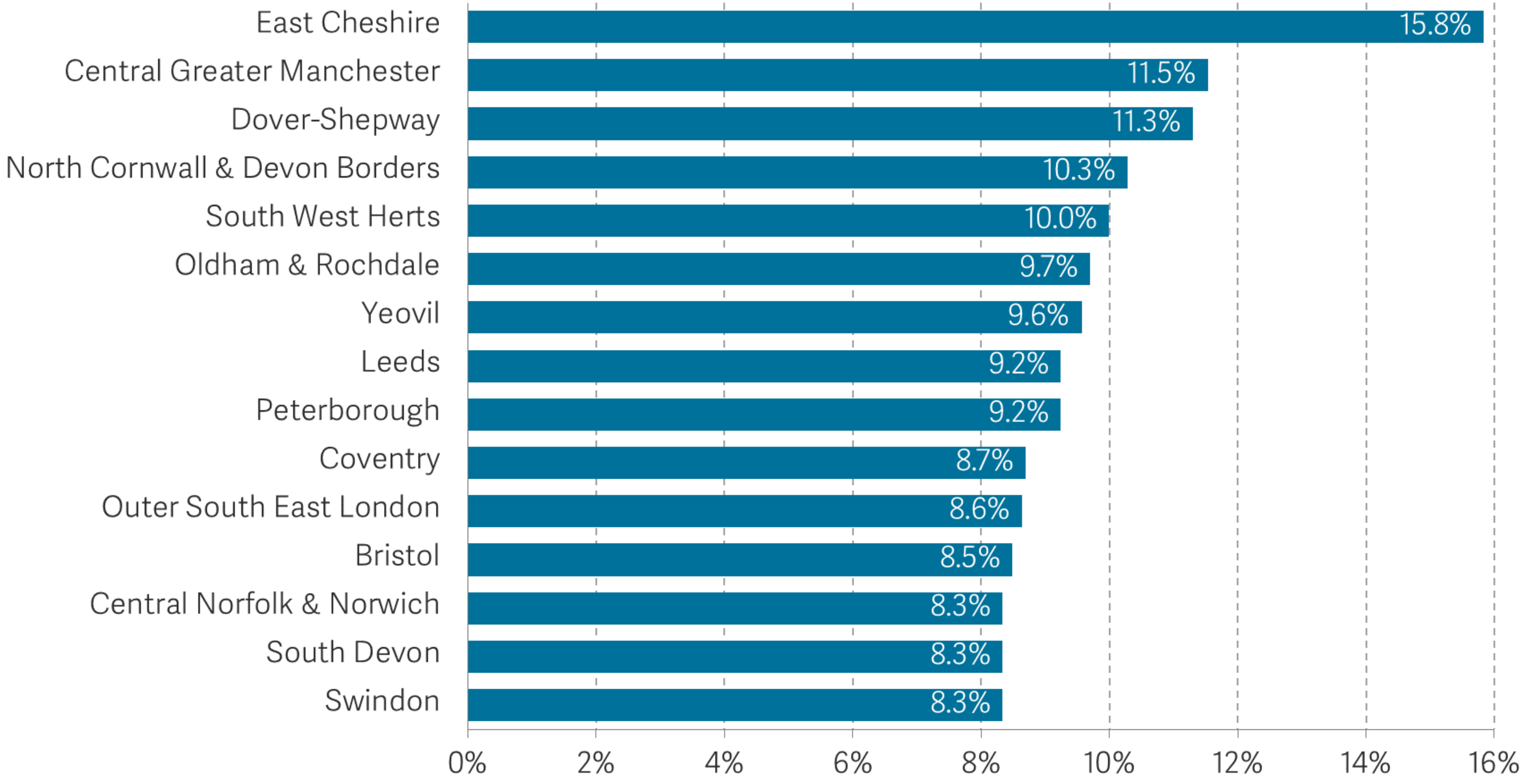
Cancelling both rises would cost £5bn, plus a small impact on VAT. That falls to £3bn if just RPI rise is scrapped.

History says RPI-linked rise is unlikely, but note Australia and Germany successfully ended temporary fuel tax cuts in 2022.

Notes: 2022-23 prices. Based on inflation forecasts from November 2022.
Source: RF analysis of OBR, Economic and Fiscal Outlook, November 2022.

Rent support is not rising with rent levels

Average growth in 30th percentile of market rents for a two-bedroom property: selected BRMAs in England, 2019 - 2022



LHA rates have been frozen at 2019 rental price levels for another year.

Rents in some areas have risen by over 10% since, with significant variation (chart shows the fifteen BRMAs experiencing the largest rent rises between 2019-2022).

LHA rates were last uprated in March 2020, at a cost of around £1bn.

Notes: Rental prices for both years are a twelve month average to September.
Source: RF analysis of VOA, Local Housing Allowance (LHA) Rates.

2) Public sector pay

The Autumn Statement topped up spending levels but spending is flat in the years to come

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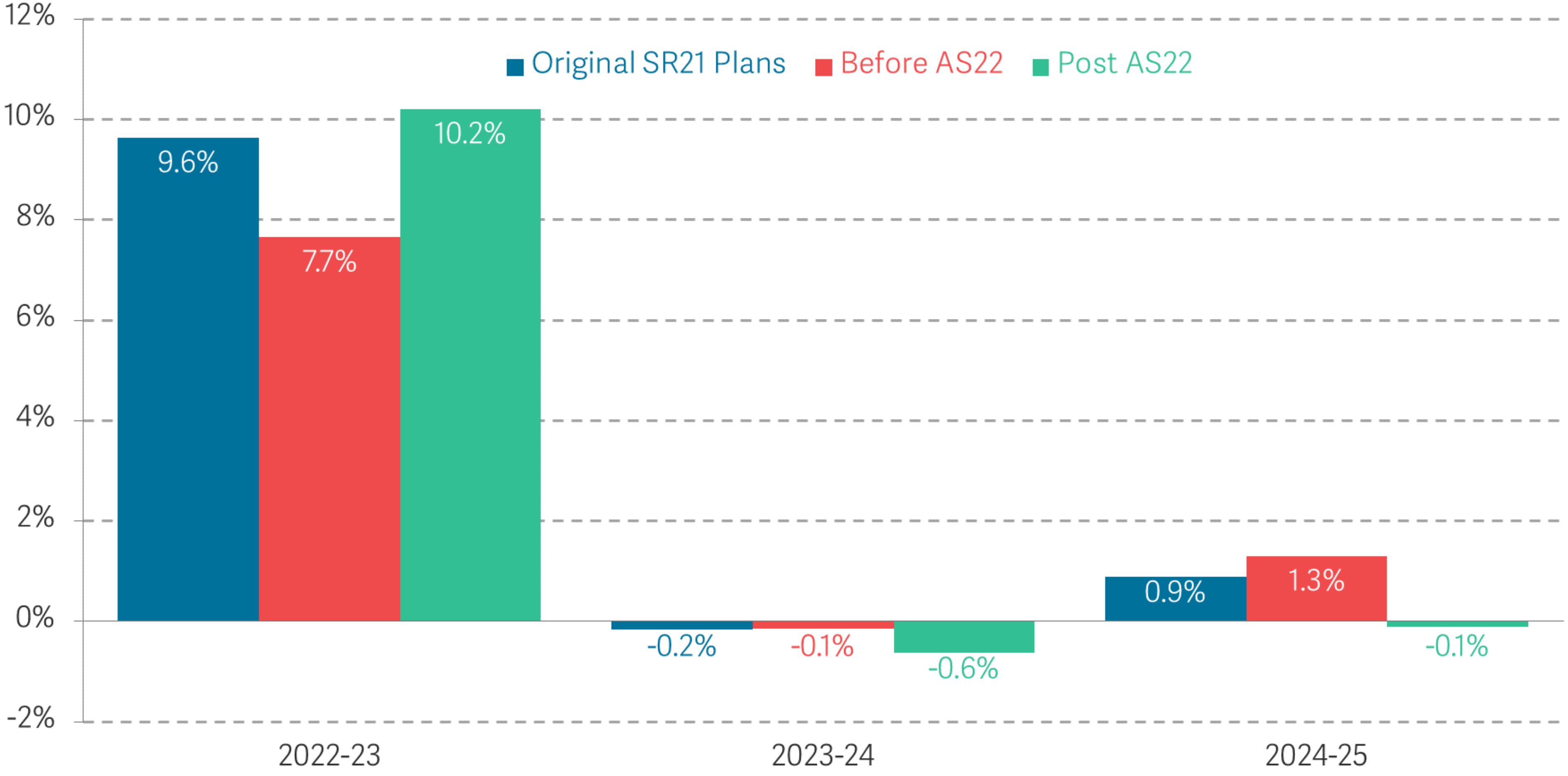
Planned annualised growth in real RDEL: UK



Notes: SR21 refers to Spending Review 2021, AS22 refers to Autumn Statement 2022. Growth figures are relative to 2021-22 baseline which excludes ring-fenced Covid budget and subsequent years exclude energy support funding in DEL. Post AS22 figures do not include extra spending allocated to DLUHC, Local Government to compensate for Business Rates support. All figures include the impact of shortfall allowances. Figures deflated using contemporaneous OBR GDP deflator.
Source: RF analysis of HMT, Spending Review 2021, Autumn Statement 2022; OBR, Economic and Fiscal Outlook, October 2021 and November 2022.

The Autumn statement saw top-ups to departmental budgets over the Spending Review period which reflected higher inflation and left generosity largely unchanged.

More significant cuts (~0.8 per cent per year) were pencilled in for 2025-26 to 2027-28, assuming NHS, schools, defence and ODA remain protected.

Public sector pay pressure reflects that public sector workers have experienced far larger real falls than the private sector

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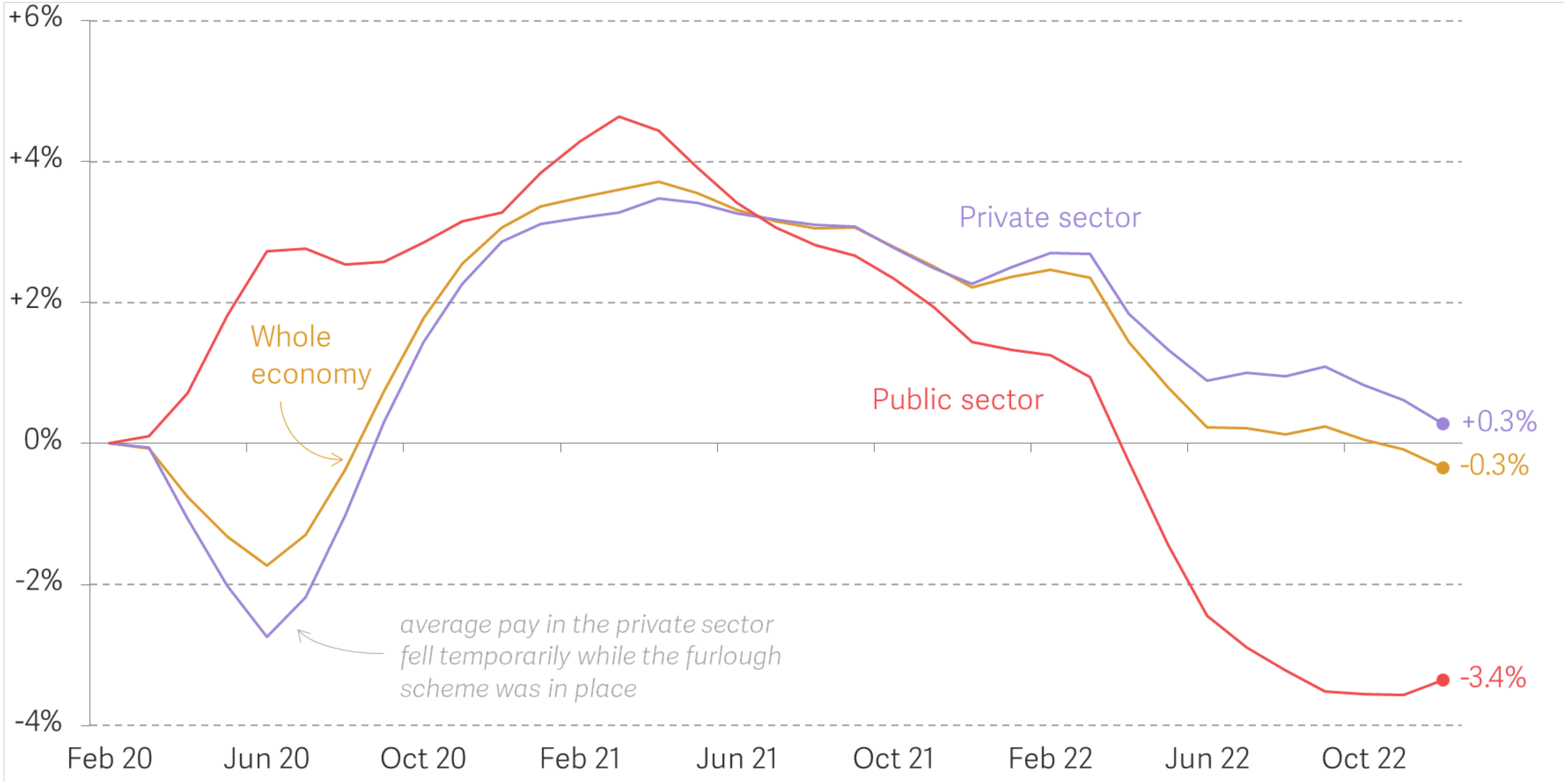
Cumulative real growth in average weekly earnings since Dec-Feb 2020: GB



In Feb 2020, average weekly pay in the public sector was 8.8 per cent higher than in the private sector; by Dec 2022, the gap had fallen to 5.0 per cent.

Over the same period, vacancies in public sector industries (public admin, education, health) grew by 54 per cent, compared to 39 per cent in other industries.

Notes: Growth is change in three-month average since Dec-Feb 2020, adjusted for CPIH inflation. Pay is regular pay, i.e. excludes bonuses and arrears. Figures are seasonally adjusted.
Source: RF analysis of ONS, Labour market statistics; ONS, Consumer price inflation.

Further Treasury support will be required if significant public sector pay rises are to be awarded in 2023-24

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- Pay awards granted by the Pay Review Bodies for 2022-23 averaged 5 per cent, leading to £4.5bn higher-than-budgeted spending on staff costs last financial year.
- The cost of awarding a 3.5 per cent increase in 2023-24 would be £5.6bn more than was budgeted in SR21, although departments have told the pay review bodies this would be "affordable".
- An increase of around 5.5 per cent in 2023-24 would cost a further almost £5bn and close around half the gap that has opened between private and public sector pay since the start of 2020.
- Closing this gap would completely wipe out the top-ups the Government made to the NHS and schools budgets in the Autumn Statement.

3) Boosting growth

The UK's headline Corporation Tax is set to jump to above the OECD median

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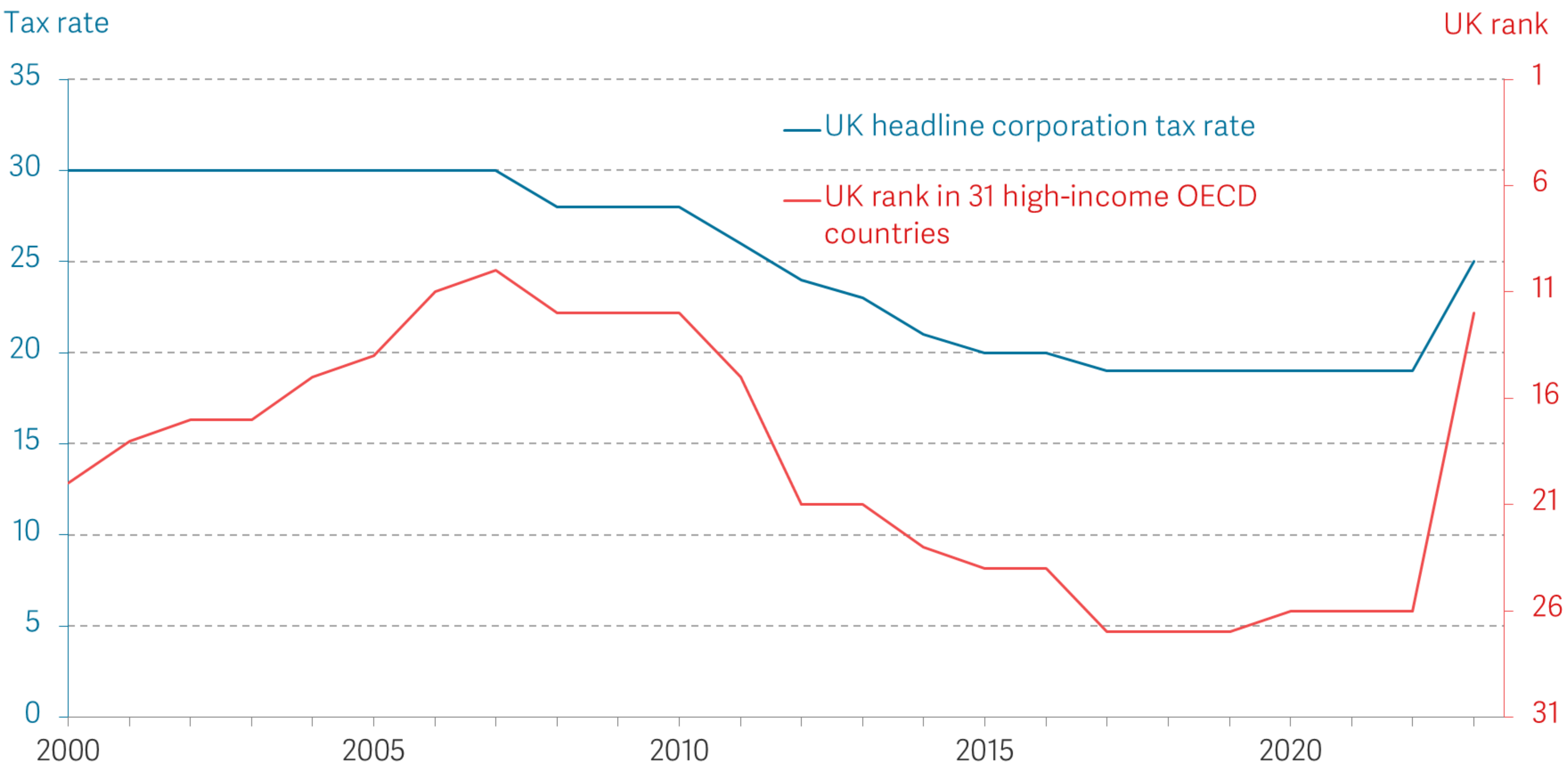
UK headline Corporation Tax rate and rank of UK rate among 38 OECD countries



Headline Corporation Tax rate will increase to 25% from April for companies with profits of £250,000+.

The Treasury is considering ways to ease the impact of this rise.

Notes: Comparison group is the 31 OECD countries also classified as 'High Income' by the World Bank. Assumes no change in 2023 tax rate in other countries.
Source: OECD and RF calculations.

Options on Corporation Tax: investment allowances or rate cuts

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Illustrative static costs, investment impacts and long run growth costs

Reform	Static impact on revenues	Potential investment impact	Long-run net revenues after investment effect
Reversing 6 ppt rise in main Corporation Tax rate	£12-16bn cost	+1%	£8-12bn cost
Full expensing of investment [i.e. offsetting all investment costs against profits in the year they're incurred]	£11bn cost	+5%	£0-6bn benefit

Cutting headline CT rate is expensive.

Increased investment allowances have high upfront costs but focus support on new investments and are more likely to drive higher growth in long run, reducing net costs.

Note that headline rate more important for some multinationals.

Notes: Investment impact comes from steady state of neoclassical growth model with CES production function. Investment boosts GDP in line with standard elasticities. Net cost assumes ratio of non-CT revenues to GDP is unchanged.
Source: HMRC, Potential Reforms to UK's Capital Allowance Regime – Inviting views, 2022; OBR, November 2022 Policy measures database, 2022; RF calculations.

Drive to reduce inactivity should learn from previous progress by focusing on women and older or disabled workers

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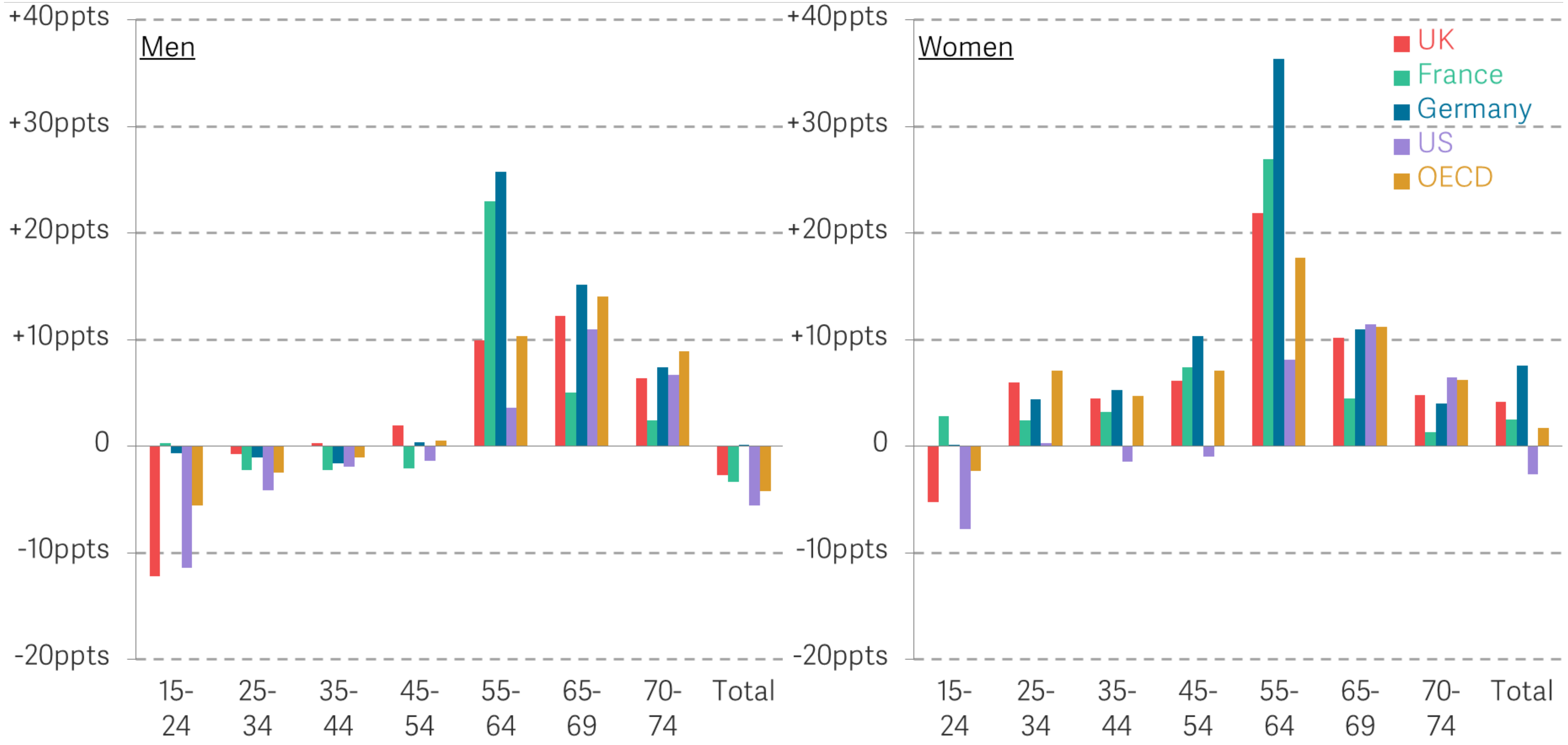
Change in labour force participation rates for men (left) and women (right) between 1999 and 2019, by age group: selected OECD countries



Between 1999 and 2019, participation rose by 6 percentage points for women aged 25-34, by 22 percentage points for women aged 55-64, and by 10 percentage points for men aged 55-64.

The disability employment gap fell by 5 percentage points between 2013 and 2022.

Source: RF analysis of OECD Labour Force Statistics.

The Chancellor's options for building on past success

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For older workers:

- Proposals for tax cuts for older workers are likely to be expensive and ineffective.
- Briefings have focused on earlier state pension age rises in 2030s, but private pension reforms are more pressing (e.g. the fact that tax-relieved private pension wealth can be accessed early and the scale of tax-free lump sums both support early labour market exits).

For women with children:

- Briefing has focused on extending free childcare hours, costing £3-6 billion to extend to 1-and-2-year-olds. Will support living standards of parents with young children more than employment.
- Low take-up of tax-free childcare and complexity of UC childcare support should be addressed.
- Giving second earners a work allowance in UC would strengthen work incentives but cost £2.1 billion.

For those with ill health:

- Small change: no sooner-than-planned Work Capability Assessment (WCA) if returning to work.
- Radical: scrap WCA altogether (a complex, long-term change).
- Also consider: a 'right to return' period, during which employers must keep jobs open to workers who are away from work due to sickness or disability.

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The next year is unlikely to feel like good news for households:

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- That includes tax rises of £650 for a typical household from April (£1,500 for the richest fifth).

Looking ahead the low growth and elevated debt big picture may not change hugely:

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- Departments say a 3.5 per cent pay rise next year is affordable.
- Going further with a 5.5 per cent rise would cost a further £5bn.

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