

# We're going on a growth Hunt

Putting the 2023 Spring Budget in context

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March 2023



## Summary

Against a better, but still bad, outlook for the British economy and public finances, the Chancellor has announced a more action-packed Budget than many expected. His announcements focus on boosting employment and investment, but are likely to be more successful on the former than the latter, in large part because of the biggest increase in free childcare ever announced.

### An improved, but still grim, economic outlook

Following significant energy price falls, the Office for Budget Responsibility (OBR) has significantly upgraded its short-term economic outlook, with the economy expected to be 1.5 per cent larger by the end of the year than previously expected. The UK is forecast to see the sharpest one-year fall in inflation since the 1970s but avoid a technical recession in 2023, with growth supported by two temporary forces: households drawing down on their savings, and businesses bringing forward investment following Budget tax changes.

But most of the short-term good news does not last, with the economy in 2027 now set to be just 0.5 per cent bigger than previously forecast. The underlying growth rate potential of the UK economy is unchanged at 1.75 per cent (1 percentage point below its pre-financial crisis norm), with this small improvement driven by lower energy costs and a bigger population that raises employment by 160,000 (notably, the OBR attributes more than the 110,000 of this increase to the Chancellor's policy measures, equivalent to 0.3 percentage points). But over the Parliament as a whole, economic growth is forecast to average just 0.5 per cent a year, the lowest since Margaret Thatcher's first term in office.

### Lower borrowing, but little wriggle room

The fiscal forecasts saw similar but more enduring improvements. Borrowing is on course to come in almost £25 billion lower this year than expected, with the OBR handing Jeremy Hunt a nearly £150 billion-lower borrowing windfall cumulatively by 2027-28. He chose to spend around two-thirds of that from next year onwards – on cost-of-living support for households and investment incentives for firms in the short term, and measures to boost activity rates in the longer term. This leaves net debt peaking at 94.8 per cent, 2.8 percentage points lower than expected in November last year but a full 15 percentage points higher than forecast in March 2022 – reflecting the lasting impact on the public finances of the energy crisis.

Another legacy is a larger state relative to the size of the economy, partly as a result of higher debt interest payments, which are nearly 2 per cent of GDP, or £1,700 per household, higher in the medium term than expected pre-pandemic. Conservatives

wishing for tax cuts should recognise it is this bigger state – further extensions to which they have just applauded, with extra childcare and defence spending – not ideological softness that means a Conservative government is raising taxes to their highest level in 70 years (37.7 per cent of GDP by the end of the forecast). The rise since 2019-20 is 4.7 per cent of GDP or nearly £4,200 per household.

Fiscal firepower for future tax cuts also looks hard to come by, with the Chancellor's headroom against his fiscal rule to have debt falling in 2027-28 actually shrinking to just £6.5 billion – a quarter of the average headroom held by previous Chancellors. There is also no obvious other way to take a looser approach to the public finances: Chancellor Hunt's fiscal policy would not meet the fiscal rules adopted by Chancellors Sunak, Hammond or Osborne since 2015.

### Living standards stagnation continues

Some of the Chancellor's fiscal windfall has gone to one of his immediate priorities for spending, preventing rising energy costs due in April. Measures to delay the Energy Price Guarantee (EPG) and scrap the Fuel Duty increase will benefit a typical household to the tune of £230, on top of much bigger pre-existing measures to support households with rising energy bills that total £68.9 billion – or £2,460 per household – over this year and next.

But even with this help, family finances will remain under strain from higher energy bills today, and tax rises tomorrow. Typical energy bills will still be higher next year than this (up 17 per cent compared to a 24 per cent rise had the EPG rise not been delayed) as government support is pared back. Tax rises across this parliament are a longer-term drag to incomes, particularly for middle- and higher-income households. The permanent effects of tax and benefit changes in this parliament will boost the incomes of the poorest one-fifth of households by £420 per year (thanks to the lower Universal Credit taper), while reducing middle incomes by £740, and those of the richest one-fifth of households by £2,060 per year. Frozen income tax thresholds alone cost the typical household £1,110 by 2027-28.

Weak growth and high inflation also hold back wages which are not expected to return to their 2008 level in real terms until 2026: 18 lost years. The falls in household disposable incomes this year and next (totalling 5.7 per cent) are the worst in a century, and with a slow recovery thereafter incomes are expected to be lower in real terms at the time of the next election than at the last – for the first time on record.

## Employment has been boosted, investment only temporarily so

The Chancellor's answer to the longer-term drivers of stagnation is a major package of measures on labour supply, some of which have good prospects of long-term success, and an expensive and temporary measure on business investment that will have no impact in the long run.

Measures to boost employment include a very significant extension of the 30 hours a week free childcare to children of working parents from nine months old – the biggest increase in the free hours entitlement since its introduction in 2000. This will increase the number of parents working (the OBR estimates by 60,000), while also boosting the hours worked and living standards of many more households. Middle- and higher-income households will gain the most from the extension of the free hours, with the richest one-fifth of households (including those with and without children) benefiting by £180, the middle fifth benefiting by £130, and the bottom one-fifth benefiting by just £20.

Lower-income households on Universal Credit will also benefit from moves to pay childcare support upfront rather than in arrears, removing a barrier to some entering work, and increases in the maximum amount that can be claimed (up from £646 to £951 a month for one child). Combined with the increase in free hours, this will raise incomes for lower earners who work part-time and strengthen the incentive to work full time. Under the current childcare system, a single parent of a one-year-old earning the National Living Wage would see their annual income fall after childcare costs by £370 if they moved from 25 to 35 hours of work a week; under the new system, the same single parent would receive an income boost of £700. But these carrots to support people into work are combined with sticks to require over 800,000 more people on low incomes to look for work or face sanctions.

The Chancellor also set out plans to scrap the Work Capability Assessment (WCA), the gateway to higher levels of income support for those too ill to work, in what would amount to the biggest change in disability benefits in a decade. This has implications for 3.4 million working-age adults in receipt of such benefits. But this change will not be completed this decade, nor even begun in this parliament.

Going slowly is the right thing to do, given that the reform, which is motivated by the desire to avoid anyone in ill health facing multiple tests or being labelled as unable to work, involves significant losers as well as winners. The latter will include those with a disability who may keep more of their benefits on entering work. But up to 650,000



people currently receiving support after going through the WCA do not receive Personal Independence Payments (PIP). In future, some of this group, which includes people recovering from surgery or with mental ill-health, are likely to see support cut back.

A bid to keep more older public sector workers, most prominently doctors, in work saw the Chancellor announce a significant increase in the annual, and the abolition of the lifetime, limits on tax-free pension savings. While the freeze on the tax-free lump sum at its current level (£268,275) is welcome news, the abolition of the lifetime allowance does not appear well justified, with more than half of those with the largest pension pots actually in the private sector. These policies cost around £1.2 billion and are expected to increase employment by 15,000 – a cost of around £80,000 per extra worker. And even those employment gains may be overstated, given that very large wealth boosts (someone with a £2 million pension pot has just seen the value of their pension pot increase by £250,000) will actually encourage some people to retire earlier than they otherwise would have done. This amounts to a large giveaway to a small number of higher earners who already benefit most from our approach to pension tax relief, while doing nothing for the over 80 per cent of workers outside defined benefit schemes who are not saving enough to accrue adequate pensions.

On business investment, the Chancellor introduced yet another temporary regime for Corporation Tax (the fifth major change in just two years), with full expensing of qualifying investment over the next three years. While a permanent move in this direction would have been welcome, this time-limited move will encourage the biggest firms to bring forward investment, but not to increase it in the long term (99 per cent of firms already receive 100 per cent relief due to the £1 million Annual Investment Allowance). In fact, business investment in 2027-28 is forecast to be 4 per cent lower than it was without the measure, a poor return on the measure's £28 billion price tag.

### Public services were largely ignored in this Budget

While the Budget focused on some of the UK's longer-term growth challenges, it had far less to say about one huge area of Treasury responsibility: public services and their funding. The Budget took place against a backdrop of strikes, reflecting not only high inflation but declining public sector wages relative to similar workers in the private sector. Public sector workers have gone from having a 1 per cent pay premium over similar private sector workers to a 1 per cent deficit since the pandemic – well down on the long-run average of a 5 per cent premium. Future negotiations, rather than yesterday's Budget, will now determine how much additional funding departments require to manage public sector pay pressures, but that could amount to £2.5 billion just to keep pace with private sector wage growth this year.

The Chancellor did increase spending on defence and childcare, and trumpeted an average 3.2 per cent increase in day-to-day public service spending in this spending review period (between 2021-22 and 2024-25). But the bulk of those increases have already taken place, and public services are now visibly under strain, with planned spending growth highly constrained for the coming years. Given health, education, defence and aid spending are protected, Hunt's indicative plans for the next parliament implies unprotected departments face 10 per cent lower real day-to-day spending per capita by 2027-28 relative to today – rising to 14 per cent if the newly announced aspiration for defence spending to rise to 2.5 per cent of GDP was met over the next parliament. These post-election plans are very far from plausible.

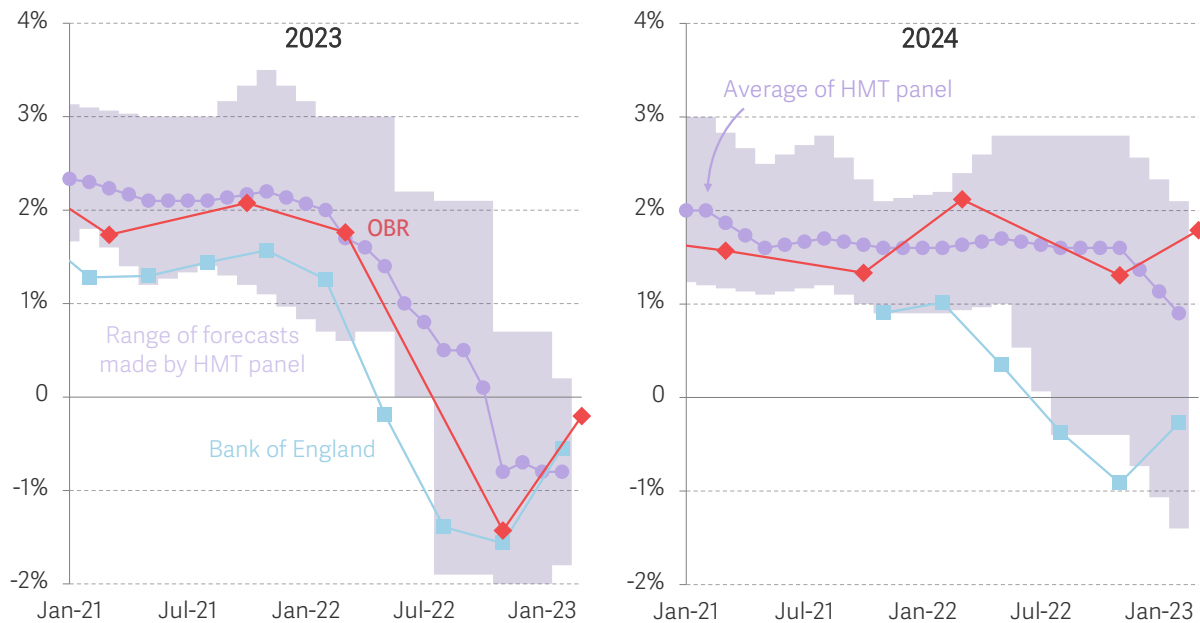
Overall, Jeremy Hunt's first Budget was a much bigger affair than many expected, combining improvements to the economic and fiscal outlook with a significant policy package aimed at boosting longer term growth in general, and the size of the workforce in particular. A step change in childcare support stands out. But, stepping back, the UK's underlying challenges remain largely unaddressed. We are investing too little and growing too slowly; our citizens' living standards are stagnant; and we are asking them to pay higher taxes while cutting public services.

## The economic outlook is better, but still bad

The OBR's forecasts confirm the UK economy is in a bad place, but not as bad as expected in November 2022, reflecting huge falls in energy prices. Wholesale gas prices have fallen by around 80 per cent since August last year, and around 50 per cent since the Autumn Statement. This has reduced the scale of the huge terms-of-trade shock hitting the UK. Along with falls in shorter-term interest rates, this means the OBR no longer expects the UK economy to fall into a technical recession in 2023, despite the biggest energy price shock since at least the 1970s (when the UK fell into a recession in which GDP fell by 3.9 per cent). Real GDP is still forecast to shrink this year – by 0.2 per cent, compared to a 1.4 per cent contraction forecast last November. As shown in Figure 1, the OBR's view on the outlook for the UK economy over 2023 and 2024 is now more optimistic than the Bank of England, and is towards the top end of a range of independent forecasts.

**FIGURE 1: The UK is no longer expected to fall into recession this year**

Forecasts for calendar-year GDP growth in 2023 and 2024, by date of forecast: UK



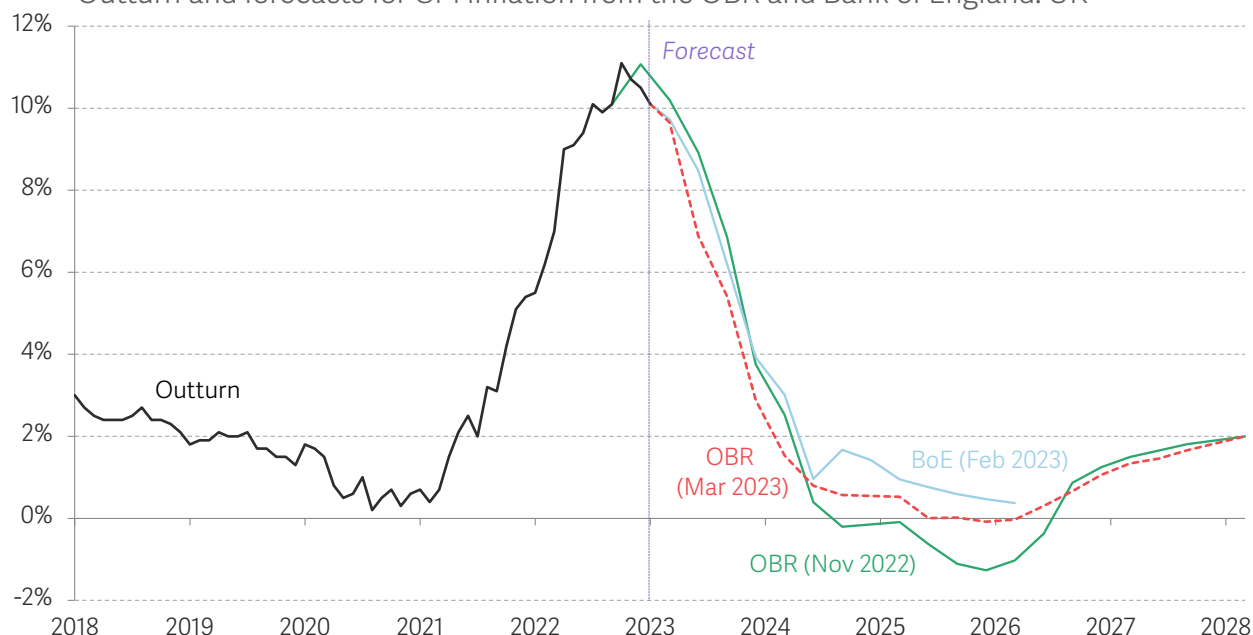
SOURCE: OBR, Economic and Fiscal Outlook, various; Bank of England, Monetary Policy Report, November 2022.

This better-but-still-bad picture is also true of the outlook for unemployment, which is now set to rise to a peak of 4.4 per cent in 2024. This is a significant improvement on the 4.9 per cent peak that OBR forecast in November 2022, but still constitutes a rise in unemployment of around 300,000 people from Q3 2022 to Q2 2024.

Good news on energy prices has also impacted inflation. The faster-than-expected fall in gas prices translates into a larger fall in inflation in the near term (see Figure 2). Inflation is forecast to fall from 9.7 per cent at the start of 2023 to 1.5 per cent at the start of 2024 – the sharpest one-year fall since the 1970s. But, looking ahead, the OBR expects medium-term inflation to be higher than it did in November 2022, as the-faster-than-expected fall in energy prices means less long-lasting downward pressures on prices: the OBR now forecasts average annual inflation of 0.8 per cent between 2024 and 2026, compared to -0.1 per cent in November.

**FIGURE 2: The OBR forecasts a steeper fall in inflation in 2023, but stronger inflation in the medium term**

Outturn and forecasts for CPI inflation from the OBR and Bank of England: UK



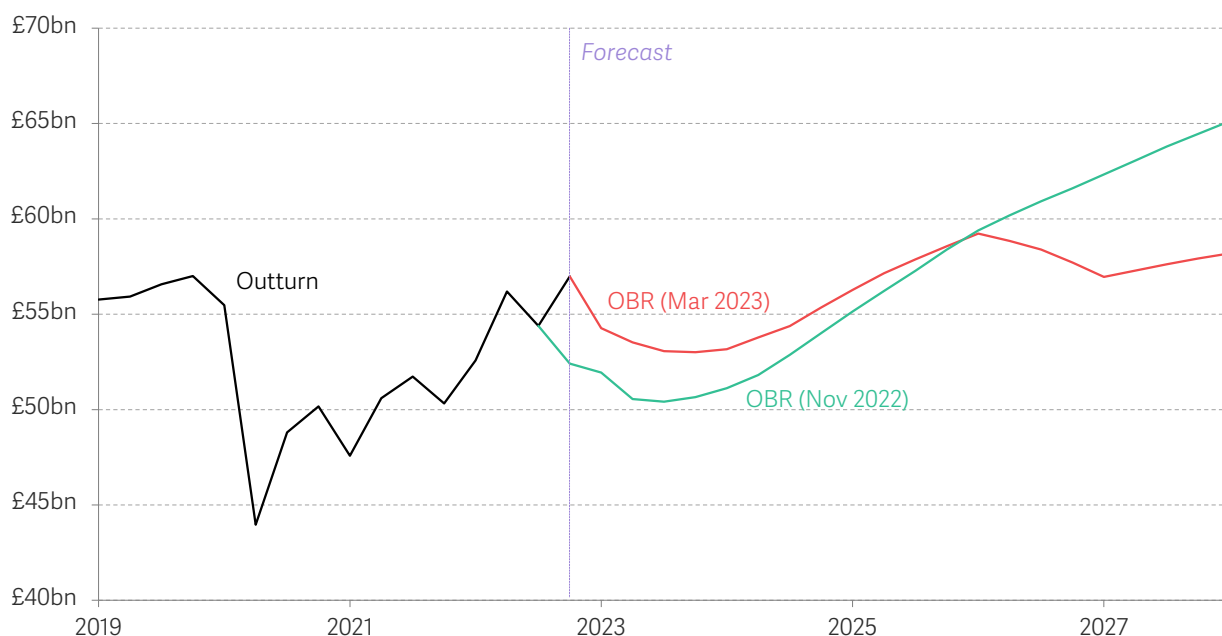
SOURCE: OBR, Economic and Fiscal Outlook, various; Bank of England, Monetary Policy Report, February 2023.

A key judgement underpinning the OBR's recession-free forecast is its rosy view of how households are responding to the ongoing hit to real incomes. In contrast to the Bank of England, the OBR assumes that households will save less to keep spending in the face of rising prices. Relative to the Bank, the OBR's assumption of lower saving means that UK households are expected to spend around £30 billion more in 2023. Another near-term boost to GDP has come from a shift in the timing of business investment over the OBR's forecast horizon following the Chancellor's announcement of full expensing for 2023-24 and 2024-25 (we discuss more below). As shown in Figure 3, the OBR is forecasting an extra £10 billion of business investment in 2023 compared to November 2022, as companies bring forward investment to take advantage of the temporary full offsetting of investment against their tax liabilities.



**FIGURE 3: The OBR has shifted the timing of business investment, but cumulative investment over the forecast is broadly unchanged**

Business investment outturns and OBR forecasts: UK



SOURCE: OBR, Economic and Fiscal Outlook, March 2023 and November 2022.

The OBR's medium-term outlook has changed less than that for the near-term. The assumed sustainable long-run level of output – or potential supply – in 2027-28 has been revised up, but only by 0.5 per cent. One reason for the lack of change is the temporary nature of the Government's support for investment, which means it is expected to have no long-run effect on potential supply. Cumulative investment over the forecast period is broadly unchanged from November, and there is no boost to productivity growth in the longer term.

The improvement in the medium-outlook comes mainly from a larger labour force. As shown in Figure 4, the OBR has revised up its forecast of 2027-28 employment by a net figure of 140,000, which is explained by three factors. First, the 16+ participation rate is expected to settle at 63.0 per cent and the negative effect on participation from higher rates of ill health in the OBR's pre-measures forecast is now expected to be more long-lasting (taking 130,000 off medium-term employment). Second and offsetting that, the OBR has taken a positive view of the measures announced by the Government yesterday, especially the expansion of free childcare, which together it expects will add 110,000 to employment (we discuss this later in this note). Third, the OBR forecasts higher expected net migration will add 160,000 to employment in 2027-28. This means that the lasting pandemic effect and new policy measures largely offset each other, leaving migration the main factor affecting potential labour supply in the medium term.

**FIGURE 4: The OBR expects the post-pandemic hit to participation to last, but policy measures and higher migration more than offset this**

Change in the OBR's forecast of 16+ employment in 2027-28: UK



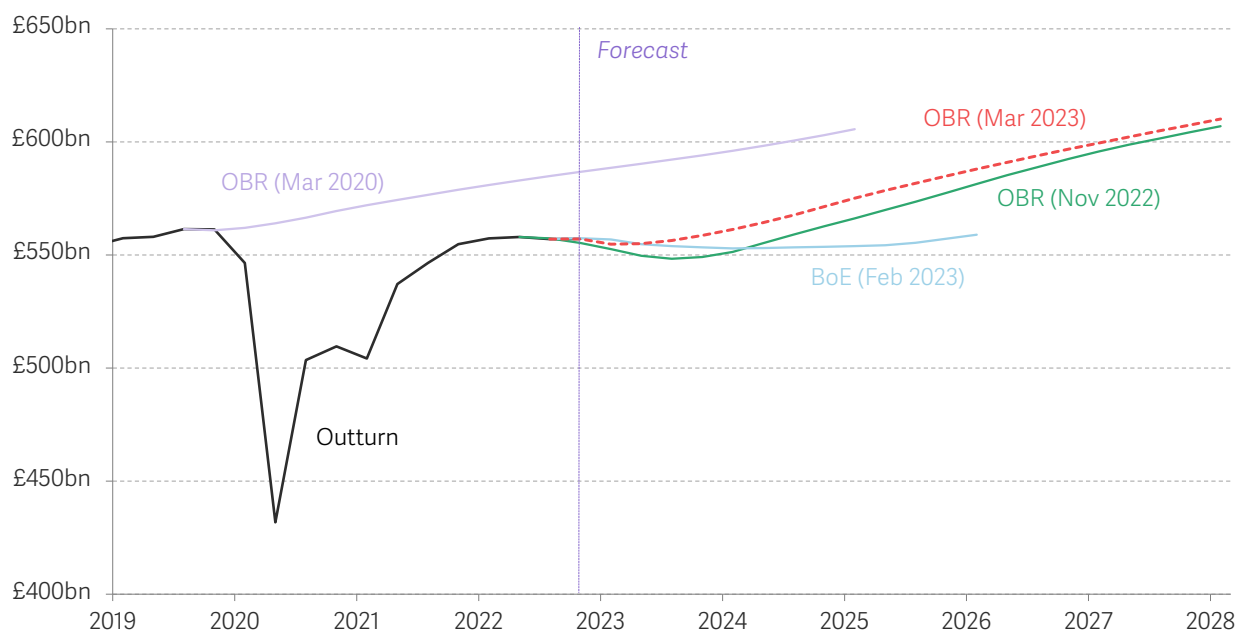
SOURCE: OBR, March 2023 Economic and Fiscal Outlook.

All this leaves the OBR's longer-term forecast for the level of GDP in roughly the same place as November 2022 (see Figure 5). But the combination of stronger near-term growth and unchanged level of GDP at the end of the forecast, means weaker growth in the longer term, with the OBR downgrading its forecast for GDP growth in 2027-28 from 2.1 per cent in November to 1.8 per cent. This increases the challenge of getting debt falling in the fifth year of the forecast, the Government's key fiscal target.

While optimistic compared to the Bank of England's longer-term outlook, the OBR's forecast should not be taken as a sign of strong growth returning to the UK economy. Economic growth over the current parliament is forecast to be the weakest since Margaret Thatcher's first term, at just 0.5 per cent per year, leaving GDP in 2024-25 around £2,300 per person less than expected before the pandemic. Further out, the OBR expects GDP growth to settle at around 1.75 per cent per year – around one percentage point below the average growth rate in the 15 years before the financial crisis. And the recent financial market volatility following the collapse of Silicon Valley Bank, which happened after the OBR's forecast closed, could have the potential to knock the UK economy further off course.

**FIGURE 5: The OBR's forecast for GDP is much stronger in the near term but little changed towards the end of the forecast period**

Real GDP outturns and forecasts: UK



NOTES: All measures are rebased and re-referenced to 2019.

SOURCE: OBR, Economic and Fiscal Outlook, various; Bank of England, Monetary Policy Report, February 2023.

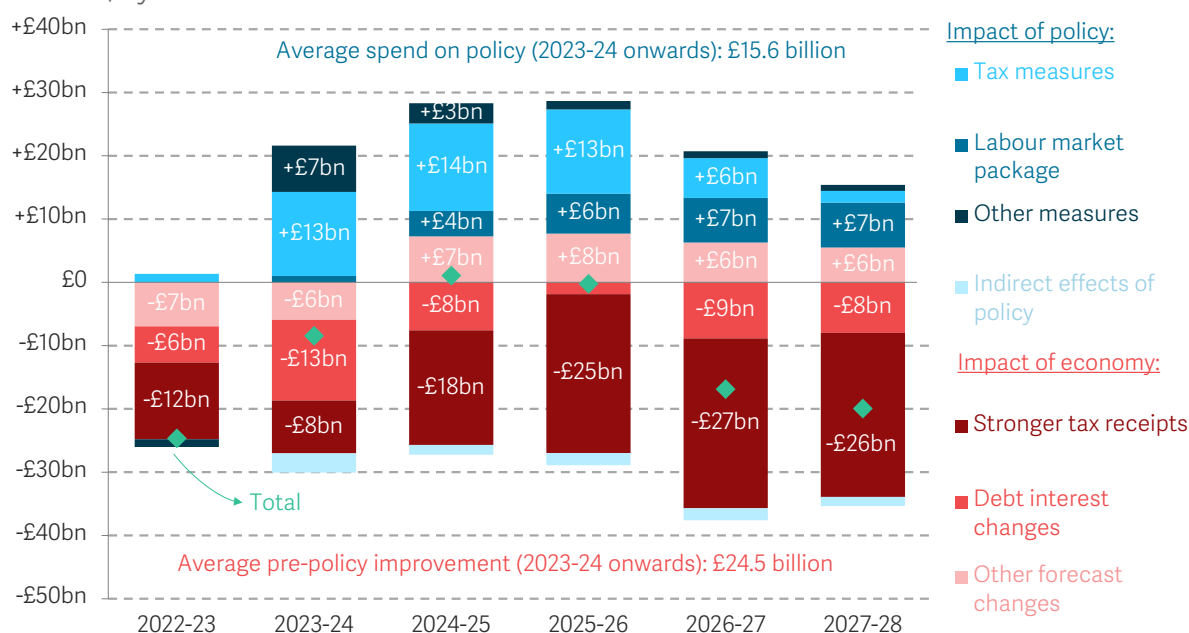
## The stronger economy and a tax windfall give the Chancellor room for manoeuvre

The fiscal outlook mirrors good news on the economy, but more of it lasts, with the Chancellor choosing to spend much of that improvement.

Borrowing for this year is now expected to be £24.7 billion lower than forecast in November (see Figure 6). Stronger tax receipts this year (£12 billion stronger than expected) are predicted to build over the forecast period to a £26 billion windfall by 2027-28. This, combined with reductions to debt interest payments from lower interest rates, gives the Chancellor a nearly £150 billion cumulative improvement in borrowing over the forecast period, before accounting for new policy. The Chancellor's policy package spends a cumulative £88 billion of this windfall directly (although there is a £10 billion offset from the indirect effects of higher labour-force participation), the equivalent of around two-thirds of his average fiscal improvement from next year onwards.

**FIGURE 6: The fiscal outlook is much improved from November**

Change in public sector net borrowing forecast between March 2023 and November 2022, by driver: UK

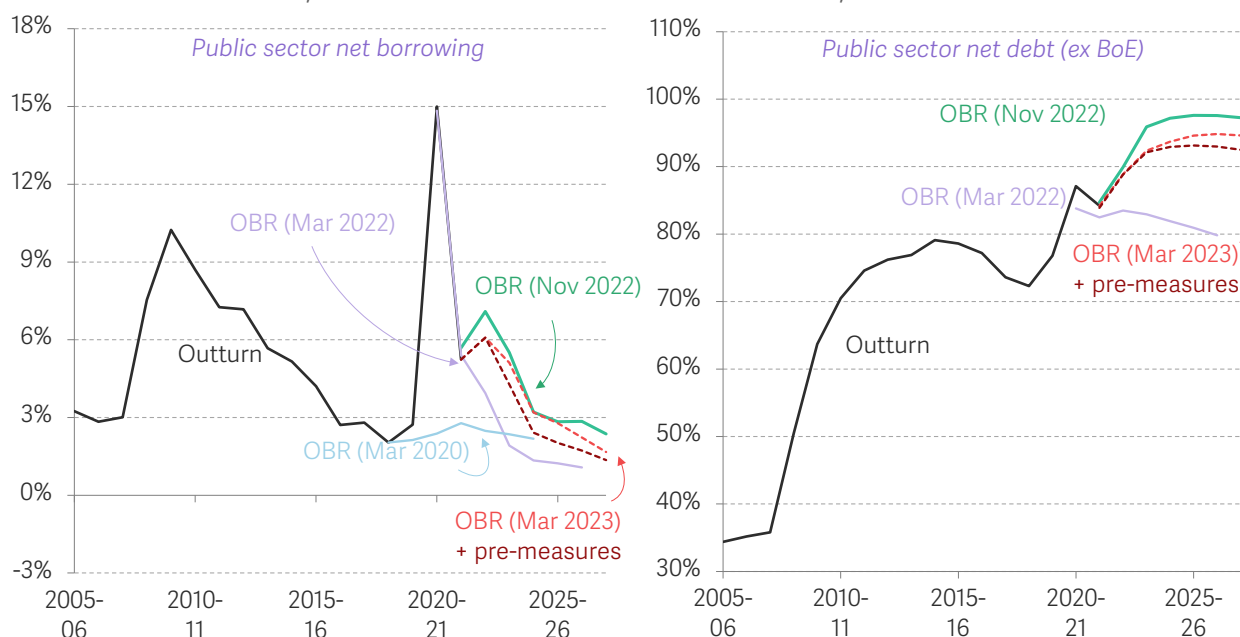


SOURCE: OBR, Economic and Fiscal Outlook, March 2023.

Despite this good news for the Chancellor, the big picture remains one of a huge deterioration in the public finances over the past year. This leaves net debt peaking at 94.8 per cent, 2.8 percentage points lower than expected in November but a full 15 percentage points higher than forecast in March 2022 – reflecting the lasting impact on the public finances of the energy crisis (estimated to be 2.0 per cent of GDP, see Figure 7). This is largely the result of the Chancellor mostly absorbing higher debt interest costs into borrowing at the Autumn Statement, adding to a ratcheting upwards of debt since the turn of the century. Combined with higher interest rates, this also burdens the economy with much higher debt interest costs. Although they are £6 billion per year lower on average across the forecast, debt interest payments remain the second biggest spending item in the Government's budget next year (after the NHS), costing £94 billion, and an average of £85 billion per year over the rest of the forecast. This is nearly 2 per cent of GDP, or £1,700 per household, higher (on average) than expected pre-pandemic.

### FIGURE 7: Borrowing is expected to remain permanently higher and debt is ratcheting upwards again

Public sector net borrowing and public sector net debt (excluding the Bank of England) as a share of GDP, outturn and selected OBR forecasts: UK, 2005-06 to 2027-28



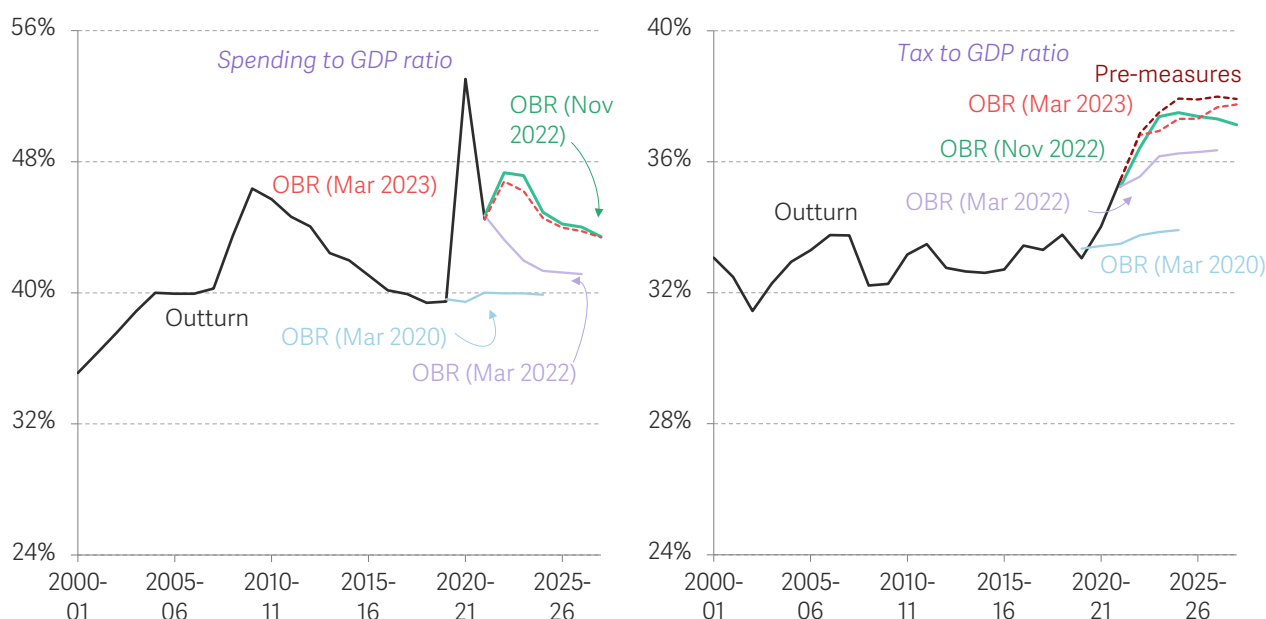
SOURCE: OBR, Economic and Fiscal Outlook, March 2023.

This is a Budget that will upset many of Jeremy Hunt's own party, resulting in a larger state and a bigger tax take. Both spending and taxation as a proportion of GDP are increasing further on already historically high levels (see Figure 8). Spending as a proportion of GDP now peaks at 46.8 per cent this year – with total spending now equivalent to nearly £42,000 per household – mainly due to much higher spending on debt interest, but also because departmental spending will take up a larger proportion of a smaller economy than expected last March. The public finances still manage to reach current balance in the final years of the forecast, due to the tax-to-GDP ratio reaching its highest level in 70 years at 37.7 per cent by the end of the forecast. This is a rise of 4.7 percentage points from 2019-20 (or nearly £4,200 per household), nearly half of which is due to discretionary tax rises over the period.



**FIGURE 8: The size of the state has grown significantly since March 2022**

Total managed expenditure (left) and National Accounts taxes (right) as a proportion of GDP, outturn and selected OBR forecasts: UK, 2000-01 to 2027-28



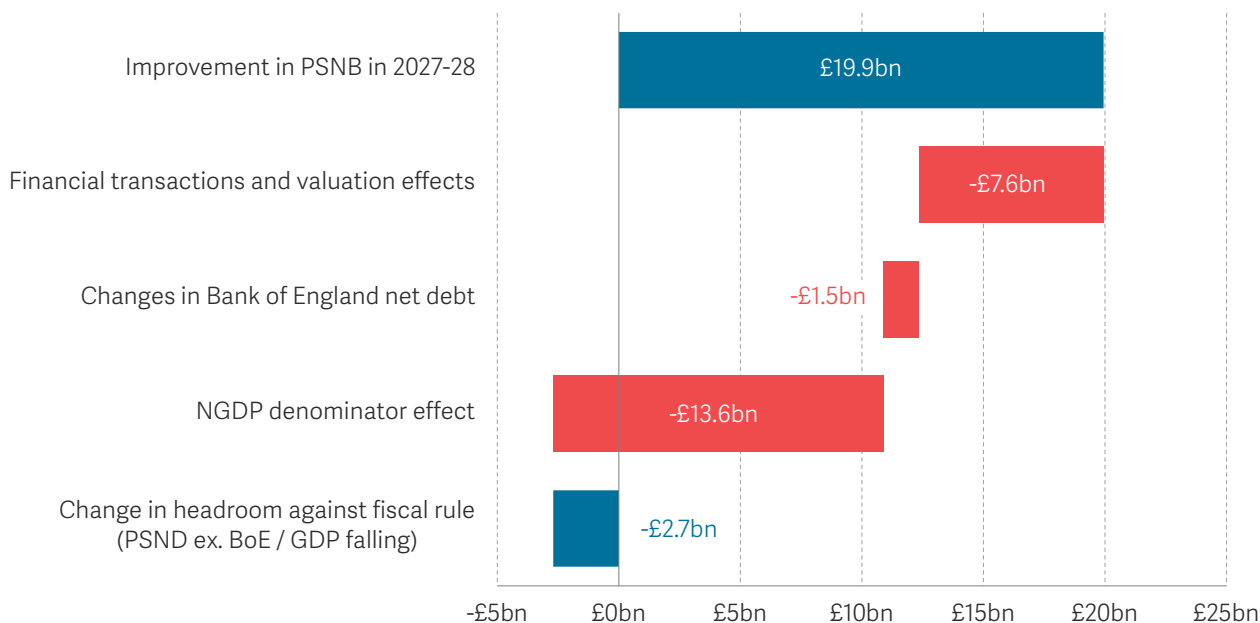
SOURCE: OBR, Economic and Fiscal Outlook, March 2023.

While borrowing has improved significantly, the Chancellor's headroom against his fiscal rules remains slim

The Chancellor's inability to bring down the tax take – something he has said repeatedly he'd like to do – reflects the constraints put on him by his own fiscal rules. Here the problems with trying to target debt in a specific year are laid bare in the OBR's Budget forecast: while borrowing in the final year of the forecast is lower by nearly £20 billion, the Chancellor's headroom has actually decreased by £2.7 billion since November, mainly because of weaker GDP growth in the final year of the forecast mentioned above (see Figure 9). Headroom is also smaller in the cash measure of public sector net debt (excluding the Bank of England) due to the stripping out of accrued timing effects relating to Corporation Tax policy changes, and timing effects relating to public sector pensions and student loans. The combined effects of these factors have left the Chancellor with very little wriggle room to announce any tax giveaways at this (or future) Budgets.

### FIGURE 9: While borrowing has fallen by nearly £20 billion in 2027-28, the Chancellor's headroom has reduced by £2.7 billion

Improvement in headroom against public sector net debt (excluding the Bank of England) fiscal rule, by component: UK, 2027-28



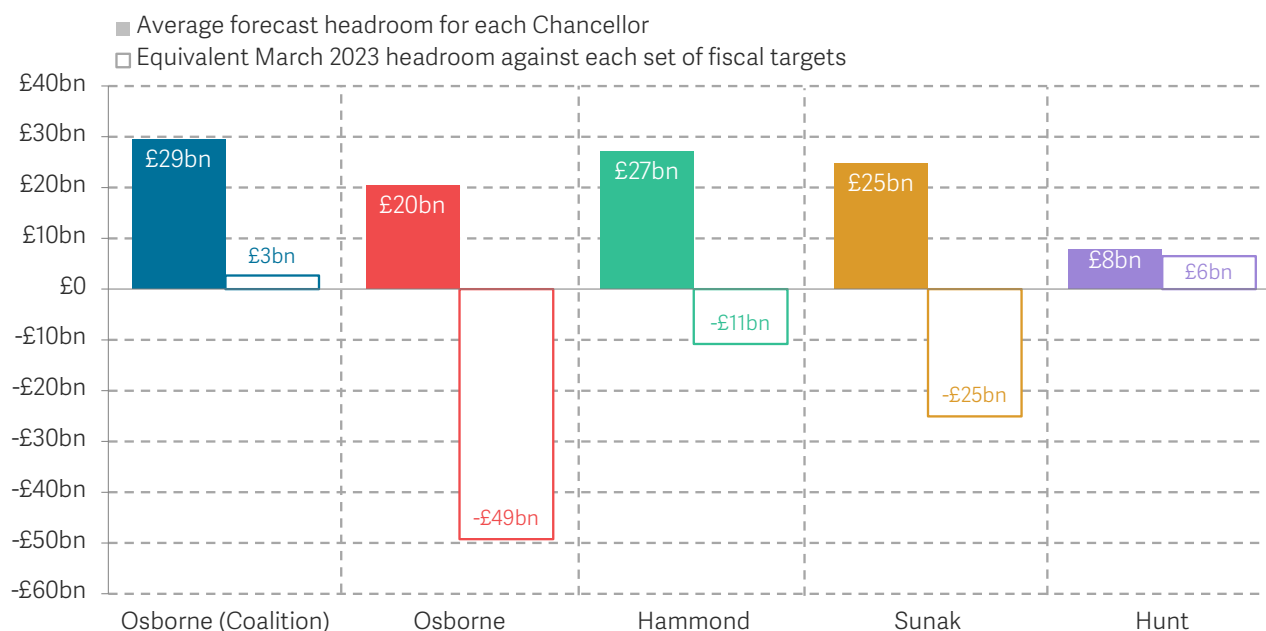
SOURCE: OBR, Economic and Fiscal Outlook, March 2023.

This constraint from the fiscal rules is not because the Chancellor is building up buffers for difficult times ahead, far from it: the Chancellor's £6.5 billion of 'headroom' is extremely low, only a quarter of the average headroom held by previous Chancellors against their fiscal rules. And this is despite adopting the least-strict rules since George Osborne. Indeed, as shown in Figure 10, if the Chancellor had instead adopted the fiscal rules of George Osborne, Philip Hammond or Rishi Sunak, he would have missed them by an average of £28 billion. The Chancellor has therefore chosen to hope that fiscal good news appears, rather than bank any headroom for future giveaways.

Even the small level of headroom he currently holds could be quickly eroded by several fiscal risks on the horizon. Interest rates have been volatile since the five-day window to the 8 February used by the OBR to condition their forecasts, with 10-year gilts rising by nearly 60 basis points to the beginning of March then falling back by just over 40 basis points to the day before the Budget. As illustrated in the autumn, the public finances are very sensitive to these interest rate risks, with a 1 percentage point increase (or decrease) in short- and longer-term rates adding (or removing) nearly £17 billion to debt interest (and so net borrowing) by the forecast horizon. This is without factoring in the impact of future policy giveaways the Chancellor may feel political pressure to make. Fuel Duty is now set to rise by 6p from April 2024, the first rise in over a decade, and a failure to uprate this in line with RPI over the forecast (which successive Governments have failed to do) would narrow the Government's fiscal headroom to just £2.8 billion.

**FIGURE 10: The Chancellor has very little headroom, by historical standards, and on a relatively loose fiscal rule**

Average forecast headroom by Chancellor, and equivalent March 2023 headroom against previous fiscal targets



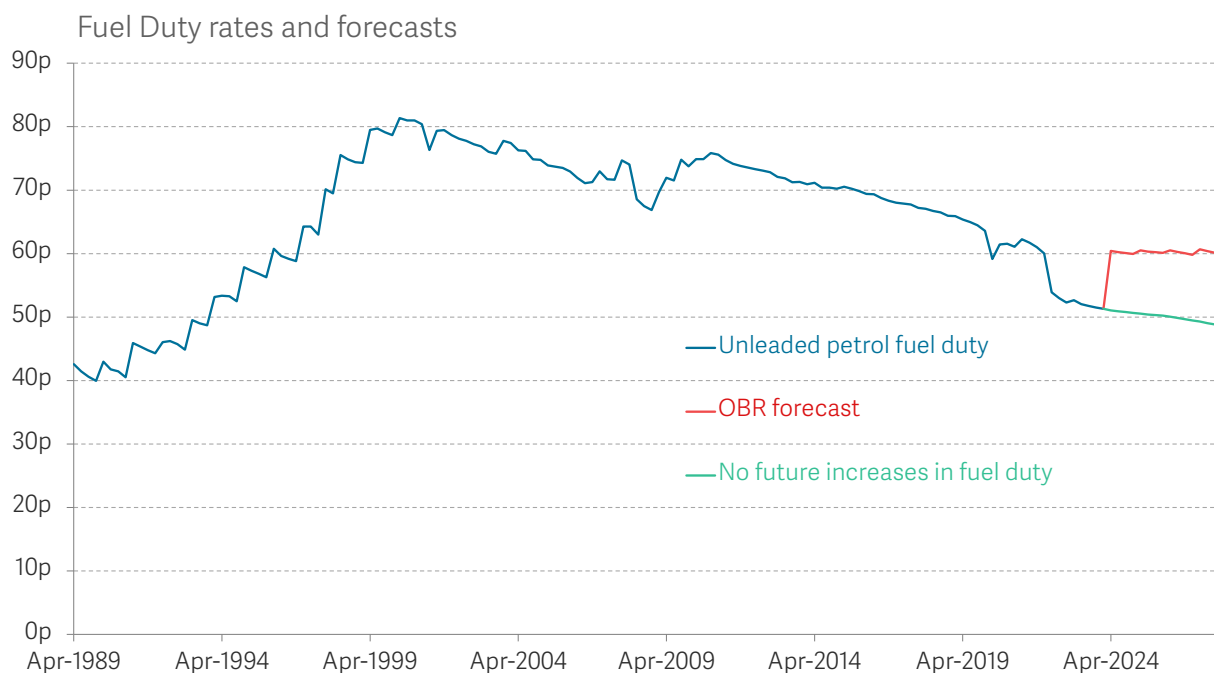
NOTES: The equivalent March 2023 headroom measures compare to the following past fiscal targets: 'Osborne (Coalition)' fiscal targets relate to balancing the cyclically-adjusted current deficit in three years; 'Osborne' relates to balancing public sector net borrowing in five years (original rule required this to be met in 2019-20, and then in each subsequent year); 'Hammond' relates to cyclically adjusted public sector net borrowing being less than 2 per cent of GDP in three years (rule referred to a fixed target year while it was in place, so comparison uses the average time left to reach the rule over the term it applied); 'Sunak' relates to public sector net debt (excluding the Bank of England) falling as a proportion of GDP in three years. SOURCE: OBR, Economic and Fiscal Outlook, March 2023.

## Despite the good news, the cost of living crisis is still casting a long shadow

The Chancellor has chosen to share some of his fiscal good fortune with households, with the bulk of this spending going on more temporary help with energy costs, and a permanent reduction in fuel duty.

The Government has decided to extend the 5p cut to Fuel Duty for another 12 months, and cancelled the 12.6 per cent rise in Fuel Duty that would have happened had it followed the typical RPI inflation-uprating, at a combined cost of £4.8 billion in 2023-24. Even if the Government reverses the 5p cut in April 2024 (as is its current plan), the cancelled inflation-uprating has a permanent fiscal cost of £2.5 billion. Overall, the rates of Fuel Duty (GDP-deflated) are now, in 2023-24, 31 per cent lower than in 2010 (see Figure 11).

**FIGURE 11: Another Fuel Duty freeze means a 19 per cent real-terms fall since the start of 2020**



NOTES: GDP-deflated to 2022-23 prices.

SOURCE: HMRC, Historical hydrocarbon oils duty rates; OBR, Economic and Fiscal Outlook, March 2023.

**FIGURE 12: Maintaining the EPG at £2,500 will smooth the worst of the energy bills spike**

Historical and forecast annualised energy bills for a typical household: October 2018-March 2024



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. Price cap forecasts from Cornwall Insight.

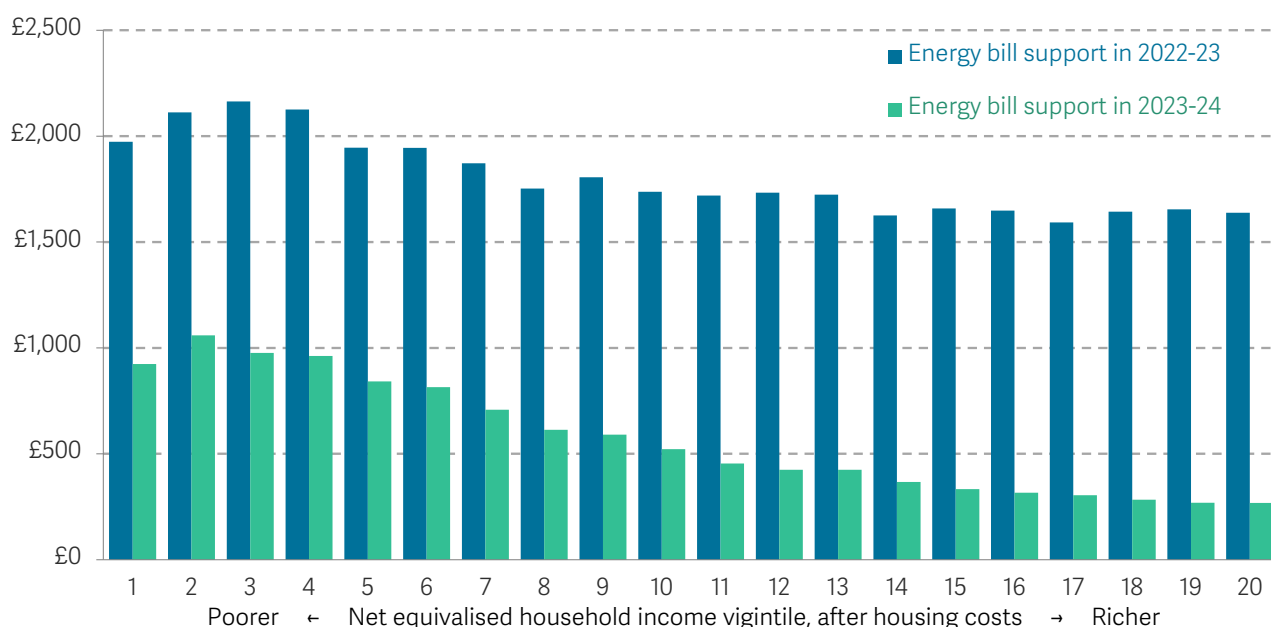
SOURCE: RF analysis of Ofgem price cap methodology, Government Energy Price Guarantee, Cornwall Insight.

In addition to this, the Government has increased the support to households provided by the EPG by extending the £2,500 price cap for a further 3 months until the end of June 2023 (as shown in Figure 12). This extension costs £2.9 billion, bringing the total cost of the EPG to £27 billion. On current forecasts, typical bills are forecast to be below £2,500 after July, so the EPG is not due to have any impact beyond this date.

However, despite this additional three months of support, and the fact that global energy prices are forecast to be lower next year (2023-24), households will have higher net energy costs in 2023-24 than in 2022-23, after accounting for government support: typical households net energy bills will be 17 per cent higher in 2023-24 than this year (this would have been 24 per cent higher had we not had the extension of the £2,500 EPG announced yesterday). This rise is because the Government is providing far less energy support in 2023-24: just £19 billion for households compared to £49 billion in 2022-23 (£68.9bn – or £2,460 per household – over this year and next combined). This equates to £490 for the typical household compared to £1,730 in the previous year, as Figure 13 shows.

**FIGURE 13: Total energy and cost of living support is generally targeted to low- and middle-income families**

Total value of energy support in 2022-23 and 2023-24 by income quintile, in nominal prices: UK



NOTES: Energy support in 2022-23 includes the £2,500 Energy Price Guarantee, £400 energy bills payment, £150 Council Tax payment, £650 means-tested benefit payment, £300 pensioner payment, and £150 disability payment. Energy support in 2023-24 includes the £2,500 Energy Price Guarantee, additional support for households with pre-payment meters, £900 means-tested benefit payment, £300 pensioner payment, and £150 disability payment. Chart assumes Cornwall Insight energy bill forecasts as of March 2023.

SOURCE: RF analysis of DWP, Family Resources Survey using the IPPR tax-benefit model; DWP, Households Below Average Income; ONS, Living Costs and Food Survey.

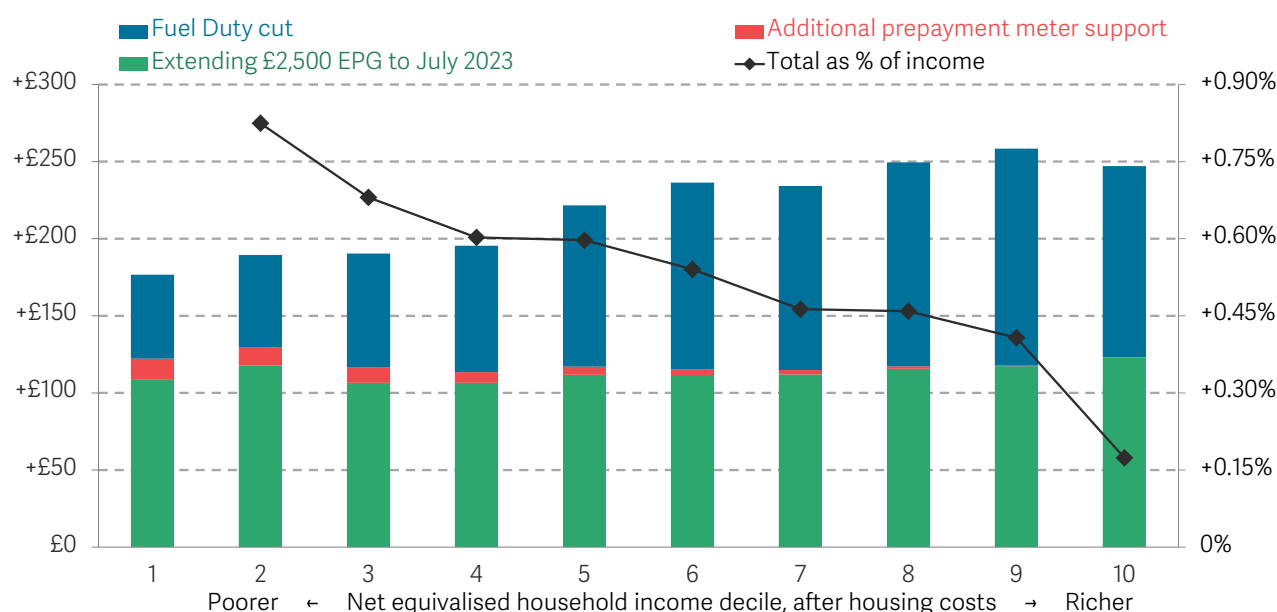


Although less generous overall, the energy support in 2023-24 will, however, be more targeted towards low-income households, with 70 per cent of the support going to the poorest half of the income distribution (compared to 54 per cent in 2022-23). This is because most of the support is being provided through direct payments to benefit claimants – although this support is not without its drawbacks.<sup>1</sup>

Taken together, the lower EPG for the next three months and the fuel duty cut provide an income boost of £230 to middle-income households in 2023-24. But, as Figure 14 shows, the new policy changes are worth more in cash terms to higher-income households (£250) than for lower-income households (£180) (because they are all worth the most to households that spend the most on energy/fuel/alcohol). Relative to incomes, though, the changes are progressive, worth 0.9 per cent of income for the poorest fifth of households and 0.2 per cent for the richest fifth.

**FIGURE 14: Taken together, the new energy support and Fuel Duty cuts announced yesterday are worth more for higher-income than lower-income households**

Impact on household budgets of new policy changes affecting household spending, by income decile: UK, 2023-24



NOTES: We exclude the bottom 10 per cent from the total as a % of income due to concerns about the reliability of income data for this group.

SOURCE: RF analysis of ONS, Living Costs and Food Survey; DWP, Households Below Average Incomes.

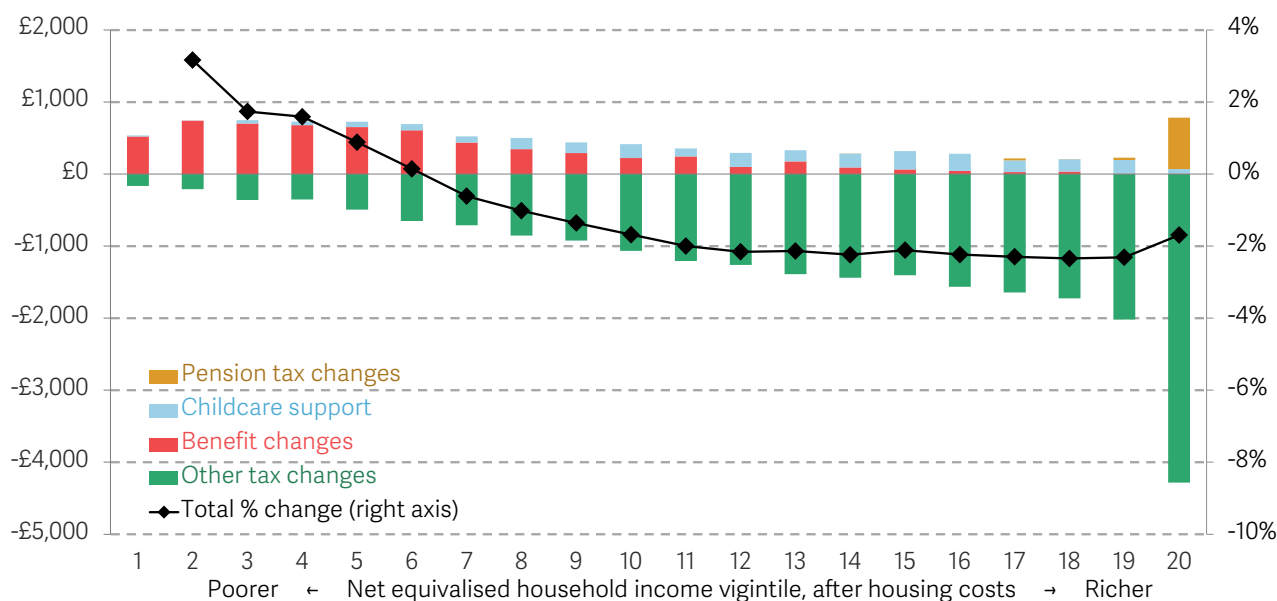
<sup>1</sup> An estimated 2.3 million households who are in the poorest fifth of the population do not receive means-tested benefits and so will not qualify for lump-sum payments. In particular, someone earning £1 too much to qualify for Universal Credit could potentially miss out on £900 of support – a powerful disincentive for some to increase their earnings next year. Third, those with harder-to-heat homes or larger families will also remain particularly hard hit by rising energy bills. The Government is investigating a longer-term solution to this issue, and a structure such as a social tariff could resolve some of these difficulties.

## But the outlook for living standards remains grim

As well as the measures to reduce household's costs (discussed above), yesterday's Budget also included measures to boost labour supply (which we discuss towards the end of this note), some of which also increase household incomes. However, the broader context is that decisions taken by this Government earlier in the Parliament are still weighing down on income growth. In particular, the freeze to income tax thresholds since 2022-23 means that typical households will be worse off by £1,110 by 2027-28 (when the freeze ends). Together, the permanent changes to personal tax and benefits will increase average incomes for the poorest fifth of households by £420 (largely due to the reduction in the Universal Credit taper rate), and reduce incomes by £740 for the middle fifth of households (driven by a £1,110 tax increase from frozen income tax thresholds), and by £2,060 for the richest fifth (driven by a £1,990 tax increase from frozen Income Tax thresholds and the reduction to the additional rate threshold) (see Figure 15).

**FIGURE 15: Taken together, all the personal tax and benefit changes made over the course of this parliament are progressive**

Impact of permanent personal tax and benefit changes announced this Parliament in 2027-28 by income quintile: UK



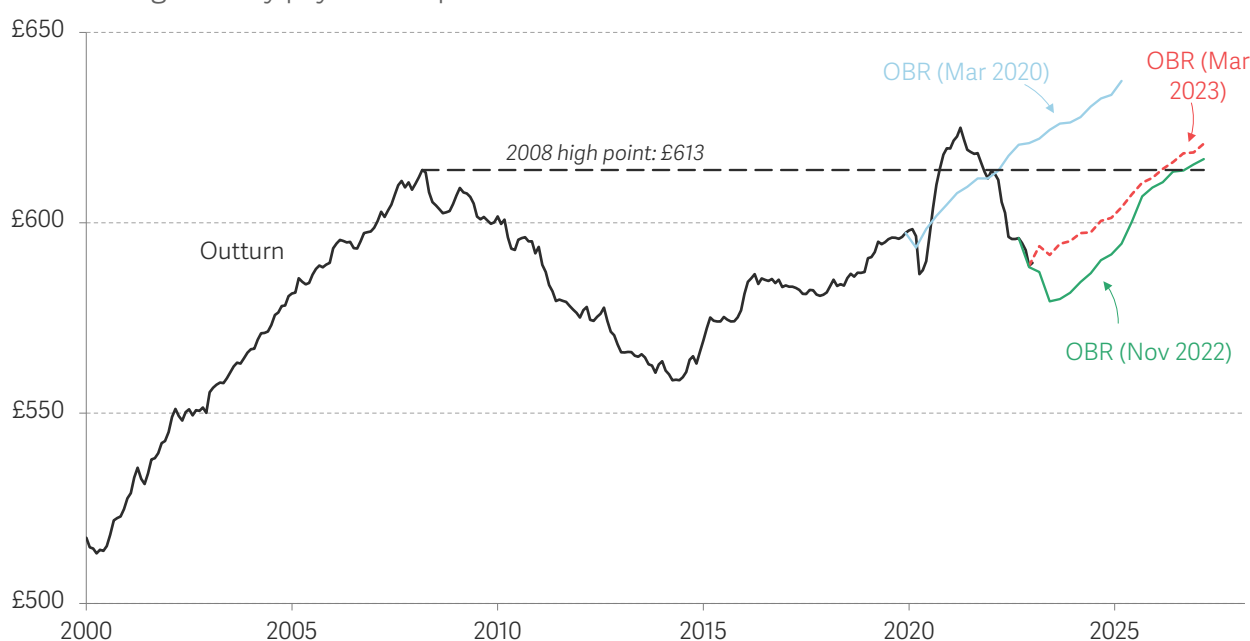
NOTES: Calculated in 2023-24 prices. We exclude the bottom 10 per cent from the % change due to concerns about the reliability of data for this group. Pension tax changes include increase to annual allowance and abolition of lifetime allowance. Childcare support includes free hours in England and higher caps for UC childcare. We assume Capital Gains Tax changes affect the top quintile only. Benefit changes include the reduction in the UC taper rate, higher UC work allowances, increases to LHA rates, social rent uprating changes. Other tax changes include increase in National Insurance threshold, Income Tax threshold freezes, reduction in the additional rate of Income Tax.

SOURCE: RF analysis of DWP, Family Resources Survey using IPPR tax-benefit model; DWP, Households Below Average Income.

On top of this headwind to living standards coming from policy, the big picture for wages is one of long-term pay stagnation, even though the OBR's forecast is stronger than last autumn (see Figure 16). Real wages were falling at an annual rate of 3.9 per cent in January. But the OBR now expects annual real wage growth to turn positive in Q4 2023, six months earlier than in November. Average weekly pay at the end of 2024 is now set to be 1.6 per cent higher (worth £500 per year) in real terms than in the OBR's previous forecast. Longer term, however, the outlook remains dire, and particularly so relative to the kind of real pay growth UK workers enjoyed before the financial crisis. According to the OBR's latest forecast, real wages will not get back to their 2008 level until 2026: 18 years without real wage growth.

**FIGURE 16: Despite falling inflation, real wages are not forecast to return to their 2008 level until 2026**

Average weekly pay in 2023 prices: UK



Note: Prices deflated by CPI. Forecasts are calculated from successive OBR forecasts of average weekly wages and CPI, and indexed to the latest outturn available at the time of the relevant Economic and Fiscal Outlook. OBR's CPI forecasts have been seasonally adjusted. ONS CPI data is a trailing three-month average so as to match Average Weekly Earnings.

SOURCE: RF analysis of ONS, Labour market statistics; OBR, Economic and Fiscal Outlook, various.

Looking at household disposable incomes – so accounting not just for levels of pay but also employment, taxes, benefits and more – makes it even clearer that we are still in the midst of a profound cost of living crisis, and that it may be a long recovery. The new OBR forecast is for average Real Household Disposable Income (RHDI) per person to have fallen by 5.7 per cent between 2021-22 and 2023-24. As the OBR notes, this would be the

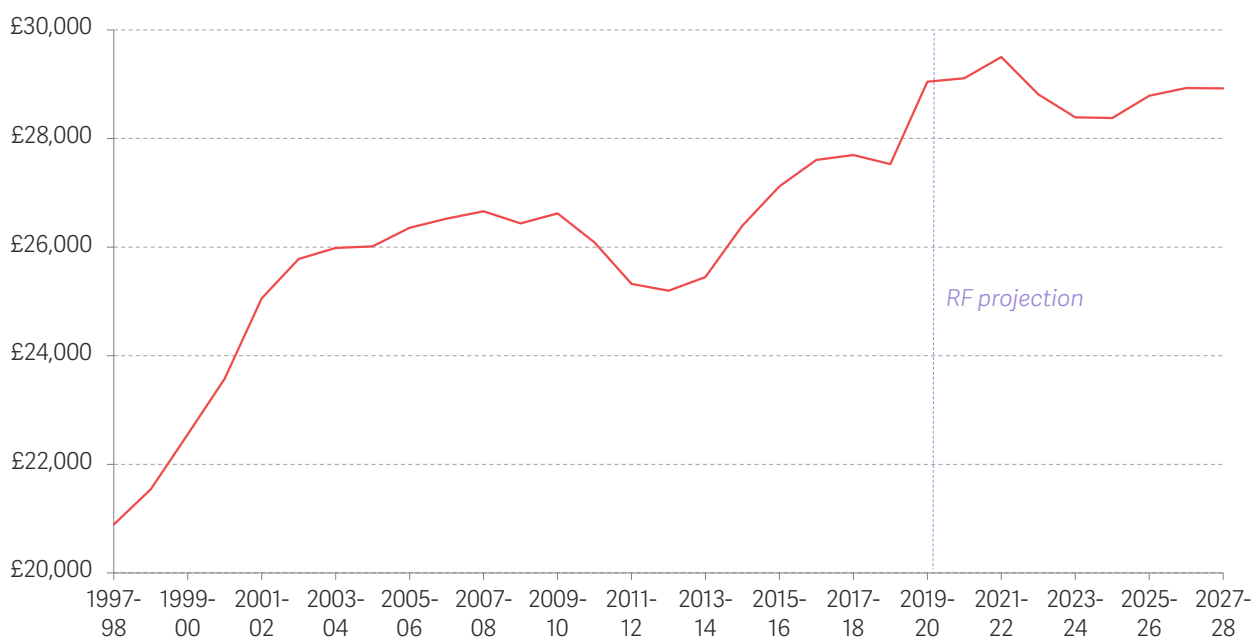
largest two-year fall on record (going back to 1956-57), and our analysis of historic Bank of England data suggests it would in fact be the largest fall in at least a century.

Income per person does not tell us anything about the distribution of incomes, though. Taking the OBR's labour market, inflation and housing cost forecasts, together with outturn data and the Government's tax and benefit policies (including those announced in the Budget), we can produce projections for disposable household incomes after housing costs across the non-pensioner income distribution. These similarly suggest that the typical non-pensioner will be 4 per cent (£1,100) worse off in 2023-24 than in 2021-22, with both 2022-23 and 2023-24 delivering significant falls.

Household incomes are projected to be no higher in 2027-28 than in 2019-20, using either RHD per capita or the median non-pensioner's equivalised household income after housing costs. As shown in Figure 17, although 2023-24 may be the low point for incomes in this crisis, the typical income is expected to grow by only 2 per cent between 2023-24 and 2027-28, reversing only half of the 4 per cent drop since 2021-22. If even the relatively slow average annual growth of 2007-08 to 2019-20 – 0.7 per cent a year – had continued in each year since then, the typical equivalised income would be £1,800 higher than currently projected for 2027-28.

**FIGURE 17: In our projections, real incomes are forecast to be 4 per cent lower in 2023-24 than 2021-22, with only half of that drop reversed by 2027-28**

Real median non-pensioner equivalised household disposable income, after housing costs, in 2022-23 prices: GB/UK



NOTES: GB only prior to 2002-03.

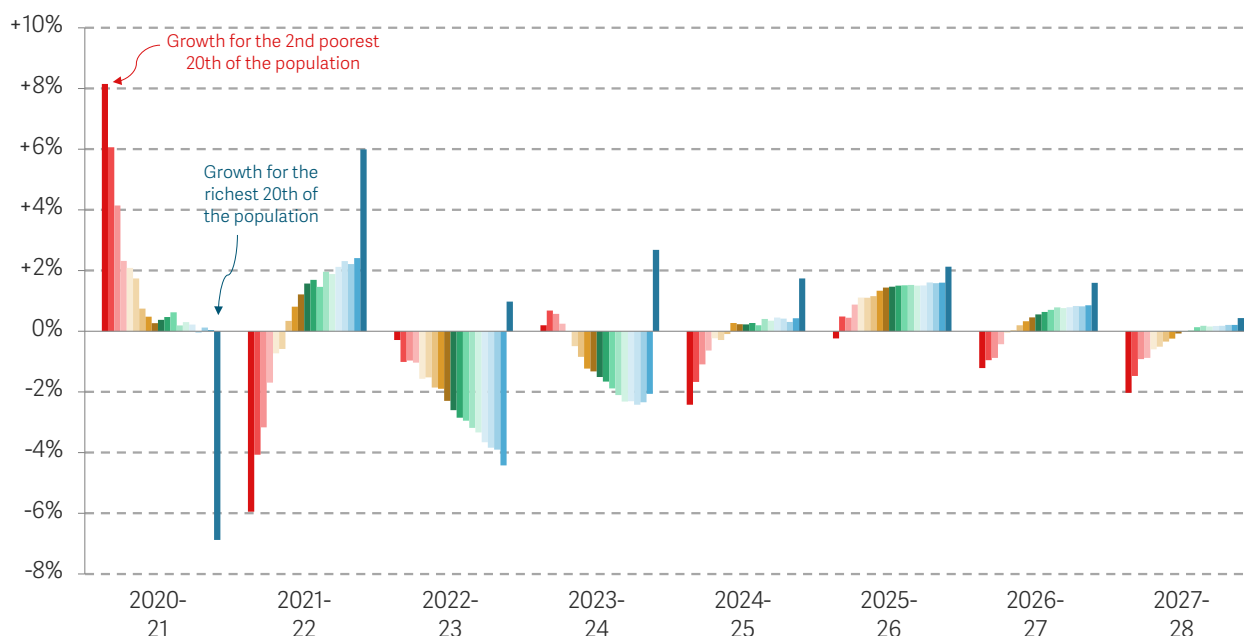
SOURCE: RF analysis of DWP & IFS, Households Below Average Income; and RF projection including use of the IPPR Tax Benefit Model, ONS data, and OBR forecasts.

Over the current parliament as a whole – which can run until January 2025 at the latest – real incomes are also forecast to fall. Real incomes per person are projected to be 5 per cent lower in Q1 2025 than in Q4 2019 (equating to £1,200 in 2023 prices), which would make this clearly the worst parliament on record for living standards growth, given that incomes have grown overall in every previous parliament back to the 1950s at least.

The impact of the crisis and recovery will vary across the income distribution, however. As shown in Figure 18, thanks to substantial policy interventions such as the Cost of Living Payments, as well as standard benefit uprating, poorer households will now see relatively small real income falls between 2021-22 and 2023-24.<sup>2</sup> The top half of the income distribution will, in general, see even larger real falls than at the median – due to the decline in real earnings, as well as rising mortgage costs. But our modelling suggests that the top of the income distribution may actually see growth in total real incomes, as rising interest rates deliver a substantial increase in savings income.

**FIGURE 18: Poorer households are relatively well protected in 2022-23 and 2023-24, but it is the top 5 per cent who may do best, thanks to rising savings income**

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



NOTES: All figures are projected. 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 OBR forecasts.

<sup>2</sup> This does not account for differences in the experience of inflation. As shown in M Brewer, E Fry and L Try, [The Living Standards Outlook 2023](#), Resolution Foundation, January 2023, this makes a difference, but does not change the big picture.

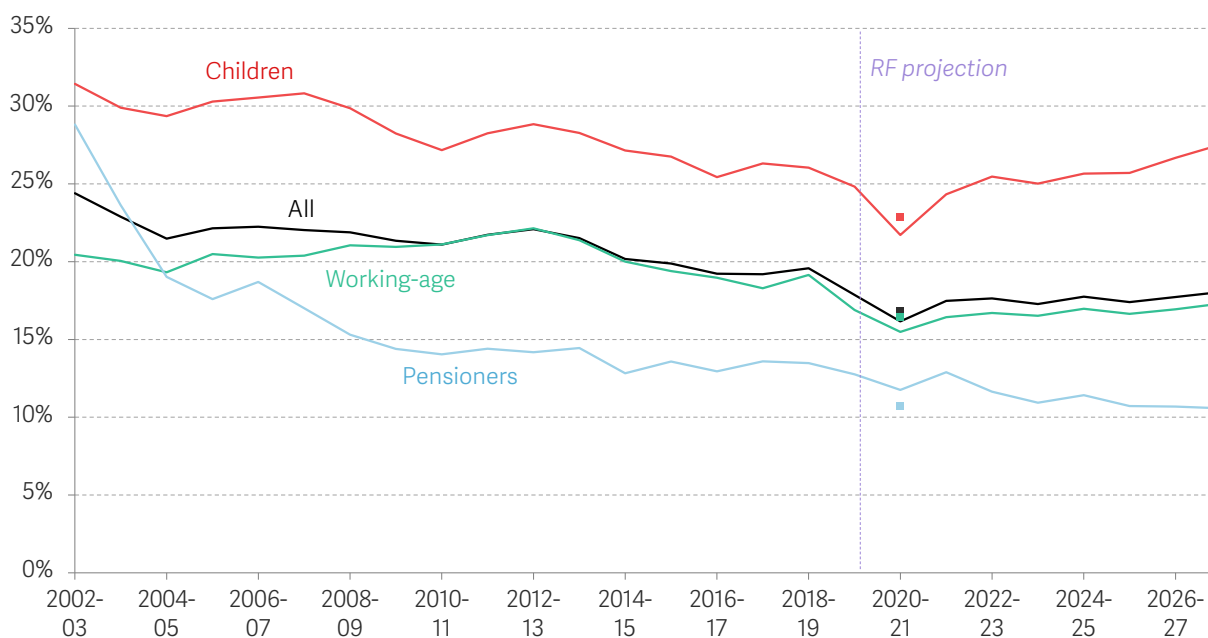


Income growth projections for 2024-25 to 2027-28 are inevitably even more uncertain, but the outlook remains weak for lower-income households (despite expectations of another substantial benefit uprating in April 2024). This reflects the end of the Cost of Living Payments; the fact that benefit uprating continues to be lagged relative to inflation; and the growing impact of benefit policies such as the freeze to Local Housing Allowances and the two-child limit. Some growth is projected for higher-income households, but it remains a slow recovery, driven by the relatively weak economic forecasts as well as tax threshold freezes.<sup>3</sup>

This forecast for weak real income growth also lies behind the outlook for absolute poverty, shown in Figure 19. As the Chancellor hinted at in his Budget speech, absolute poverty did reach record lows in 2020-21.<sup>4</sup> However, our nowcasting suggests that poverty in 2020-21 was kept down by the temporary boosts to UC and other benefits, and that there has since been an increase. Thanks to significant policy interventions in this current crisis, we do not project large absolute poverty increases for 2022-23 or 2023-24. However, the proportion of children living in absolute poverty is projected to be higher in 2026-27 than in 2016-17: potentially the first 10-year period on record in which this has risen rather than fallen.<sup>5</sup>

FIGURE 19: **Absolute child poverty is likely now higher than in 2020-21**

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



NOTES: Square markers show outturn 2020-21 data. Due to the impacts of Covid-19, we use 2019-20 rather than 2020-21 data as the starting point for our projections.

SOURCE: RF analysis of DWP, Households Below Average Income; and RF projection including use of the IPPR Tax Benefit Model, ONS data, and OBR forecasts.

<sup>3</sup> We do not model the auto-enrolment reforms implied by the Pensions (Extension of Automatic Enrolment) Bill, as no timetable has been announced. By increasing pension contributions, these will lower working-age disposable incomes in the medium-term.

<sup>4</sup> Outturn poverty data for 2021-22 will be released by DWP on 23 March 2023.

<sup>5</sup> By convention, the measure of income used to calculate poverty statistics does not include the benefits of free childcare hours.

## The Government's ambitious childcare reforms will boost the economy, help working families, and may eventually narrow the gender wage gap

Childcare was a major focus of the Budget, with a total of £5.4 billion projected to be spent on new childcare and early years support for parents by 2027-28, a near-doubling of public expenditure in this area.<sup>6</sup> There were three significant changes designed to boost labour supply:

- An extension of free childcare, with working parents of children aged 9 months to 36 months now eligible for 30 hours of free childcare for 38 weeks of the year. Parents must be in work and earning at least the equivalent of 16 hours per week at the National Living Wage, and not earning more than £100,000. This will be gradually rolled out from April 2024, and the OBR predicts this to boost labour supply by 60,000 by 2027-28.
- Increasing the monthly caps on Universal Credit childcare costs, from £646 for one child and £1,108 for two or more children (values that have been frozen since 2005-06), to £951 for one child and £1,630 for two or more children. There was also a commitment to pay Universal Credit childcare costs upfront rather than in arrears when parents start work or up their hours. These two changes to Universal Credit are set to be introduced in 2023-24, and the OBR predicts them to increase labour supply by 15,000 by 2027-8.
- A commitment to launch a new wraparound 'pathfinder scheme' to support the expansion of school-based childcare provision, and an increase to the hourly funding rate paid to childcare providers. There are important changes, but are not expected to have significant labour supply impacts.

There is evidence that having children creates long-lasting gender gaps in earnings, by harming women's career prospects (but not men's).<sup>7</sup> Figure 20 shows that even when their children become older and require less childcare, the labour force participation rate for women with children remains below that of childless women. For example, the participation rate of single mothers and coupled mothers of 10-year-old children is 76 per cent and 79 per cent respectively – compared to a participation rate of 91 per cent for 25-34-year-old women without children. The changes in the Budget are therefore well-

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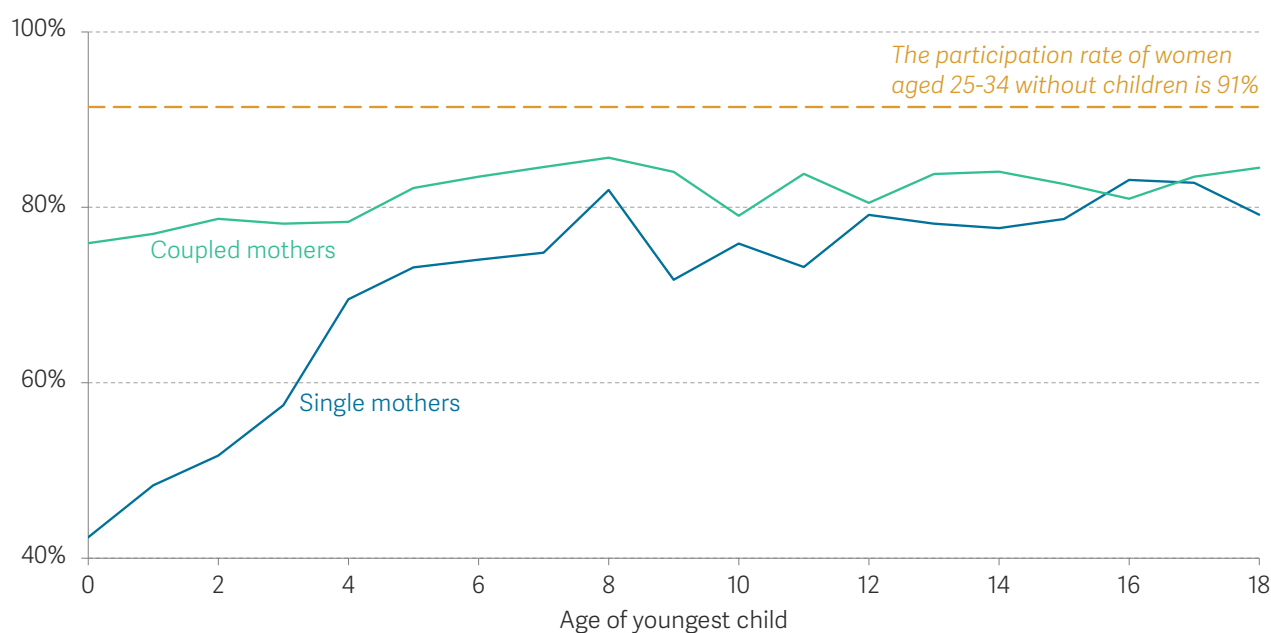
<sup>6</sup> Public expenditure on early years in England alone was £5.3 billion in 2021-22. See: E Drayton & C Farquharson, [Early years spending update: The impact of inflation](#), Institute of Fiscal Studies, November 2022.

<sup>7</sup> H Kleven, C Landais & J E Sogaard, [Children and Gender Inequality: Evidence from Denmark](#), NBER Working Paper 24219, September 2018; A Andrew et al., [Women and men at work](#), IFS Deaton Review of Inequalities, December 2021.

targeted on the stage at the lifecycle that can be crucial for some parents' labour market trajectories, given those who change jobs or reduce their hours when they have young children often face permanently lower wages as a result.

**FIGURE 20: Women with young children – particularly single mothers – have lower participation rates than childless women**

Labour force participation rate of mothers, by age of youngest child and family type: UK, 2022

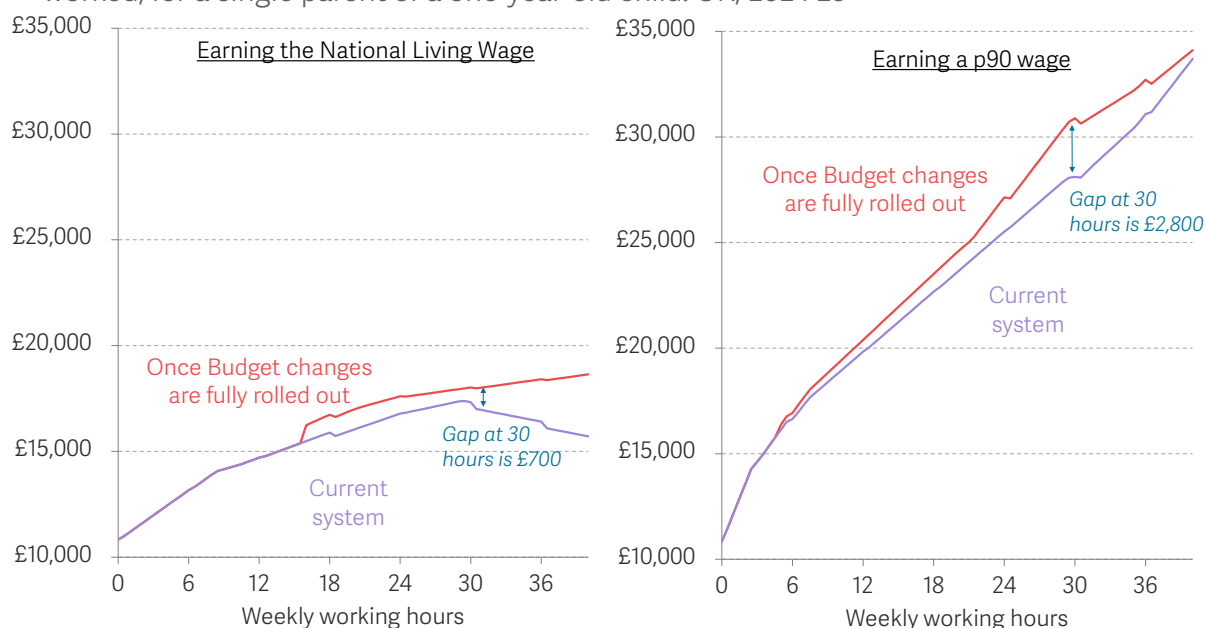


SOURCE: RF analysis of ONS, Labour Force Survey.

The reforms announced in the Budget strengthen the financial gain to work for parents of young children. Under the current system, a lower-income parent of a one-year-old child would be able to claim support through Universal Credit for 85 per cent of their childcare costs, up to a cap of £646 per month for one child, an amount rarely enough to cover full-time childcare costs. When the Budget changes take effect, however, lower-income families will benefit from both the 30 hours of free childcare and support through Universal Credit, under which the monthly cap on childcare costs for one child will rise to £951. Under the current childcare system, a single parent of a one-year-old earning the National Living Wage would see their income fall after childcare costs by £370 a year if they moved from 25 to 35 hours of work a week; however, under the new system, the same single parent would receive an income boost of £700 (see the left-hand panel of Figure 21).

### FIGURE 21: Changes to childcare support will boost full-time work incentives for lower-income parents

Annual family disposable income after housing and childcare costs, by weekly hours worked, for a single parent of a one-year-old child: UK, 2024-25



NOTES: All figures in 2023-24 prices. Family assumed to be renting in the social rented sector. Child is aged 1, and childcare costs are average childcare costs. Parent is assumed to need childcare hours proportional to their hours worked.

SOURCE: RF Case Study Model.

However, these measures will be of even more benefit to middle-to-higher income households who currently receive very little support at all for childcare of children aged under 3. As the right-hand panel of Figure 21 shows, for those on a relatively high wages, the additional free childcare could boost take-home pay by £2,800 if the single parent works 30 hours a week. At the very top of the income distribution, though, this expansion of free hours of childcare could weaken incentives: the fact that families where someone earns over £100,000 are ineligible for the free childcare creates another (and very large) cliff edge in our tax and benefits system – a parent earning £100,000 would lose out on free childcare support worth at least £6,900 per year if they were to earn an extra pound (on top of a 60 per cent marginal tax rate).<sup>8</sup>

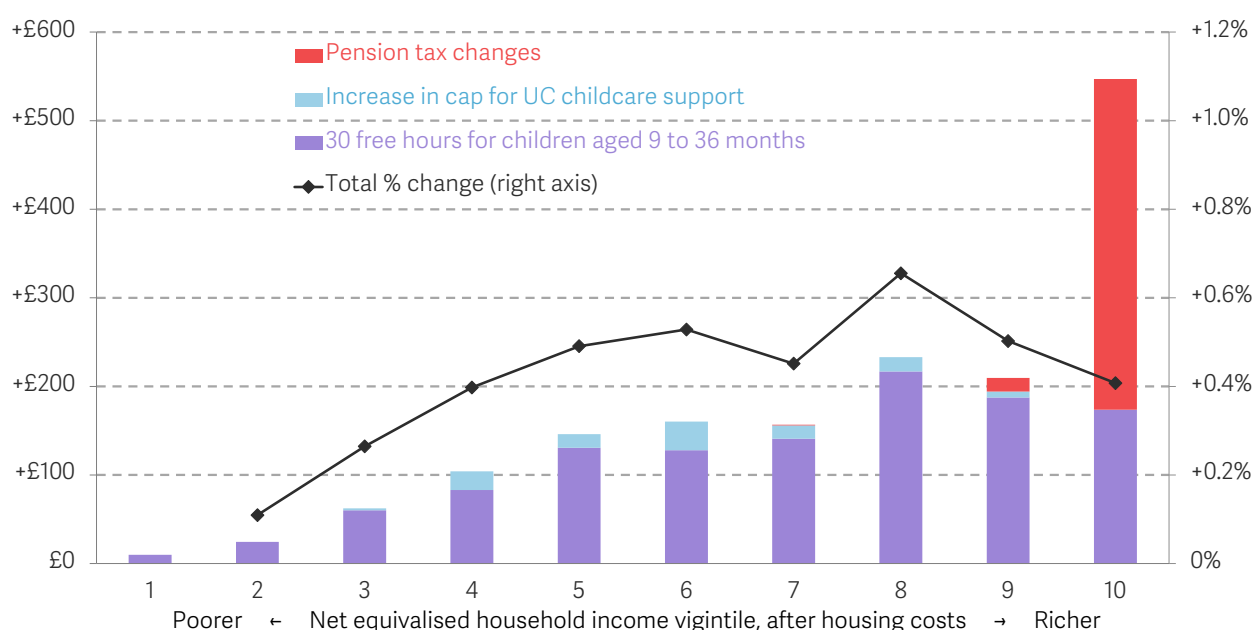
These different impacts between high- and low-income families, plus the fact that low-income families may not have all adults working at least 16 hours a week (and will therefore not qualify for the free childcare), mean that the gains from this policy are skewed towards the top of the income distribution. Figure 22 shows the estimated value of the introduction of 30 free hours of childcare for children from 9 to 36 months old,

<sup>8</sup> £6,900 is the value of the average hourly funding for free childcare for 30 hours a week, 38 weeks a year, in 2022-23 prices. See: Education & Skills Funding Agency, [Early years 2022 to 2023 hourly funding rates for 2, 3 and 4-year-olds: technical note](#), November 2021.

the increase in the cap for childcare support in UC, and the effect of changes to pension tax allowances (which we discuss in more detail later) to household incomes across the income distribution. Middle and higher-income households are set to benefit the most from the free hours policy, with the richest fifth of households (including those with and without children) benefiting by £180, the middle fifth benefiting by £130, and the bottom fifth benefiting by £20.

**FIGURE 22: Permanent changes to childcare provision and pension taxes benefit middle- and high-income households the most**

Combined value of childcare and pension changes announced in Spring Budget in 2027-28, by income decile: UK



NOTES: All figures in 2022-23 prices. Increase in free hours of childcare data is for England only. HMT aggregate cost has been split among eligible families. Results ignore any behavioural changes of the policy. Adjustments have been made to account for those using the UC childcare element or tax-free childcare switching to the 30 free hours (with the assumption that they will use the UC childcare element or tax-free childcare to pay for care outside of the 38 weeks of 30 free hours).

SOURCE: RF analysis of DWP, Family Resources Survey; DWP, Family Resources Survey using the IPPR tax-benefit model; DWP, Households Below Average Income.

Finally, up-front payment of Universal Credit childcare costs is a welcome change that will improve the incentive to move into work among many low-income parents. Up-front childcare payments are often cited by parents in receipt of Universal Credit as being a barrier to work.<sup>9</sup> Figure 23 shows how moving to upfront payment will smooth lower-income parents transition into work: for example, a typical single parent with a two-year-old child would currently face an income hit of £250 – or 40 per cent – if they moved into

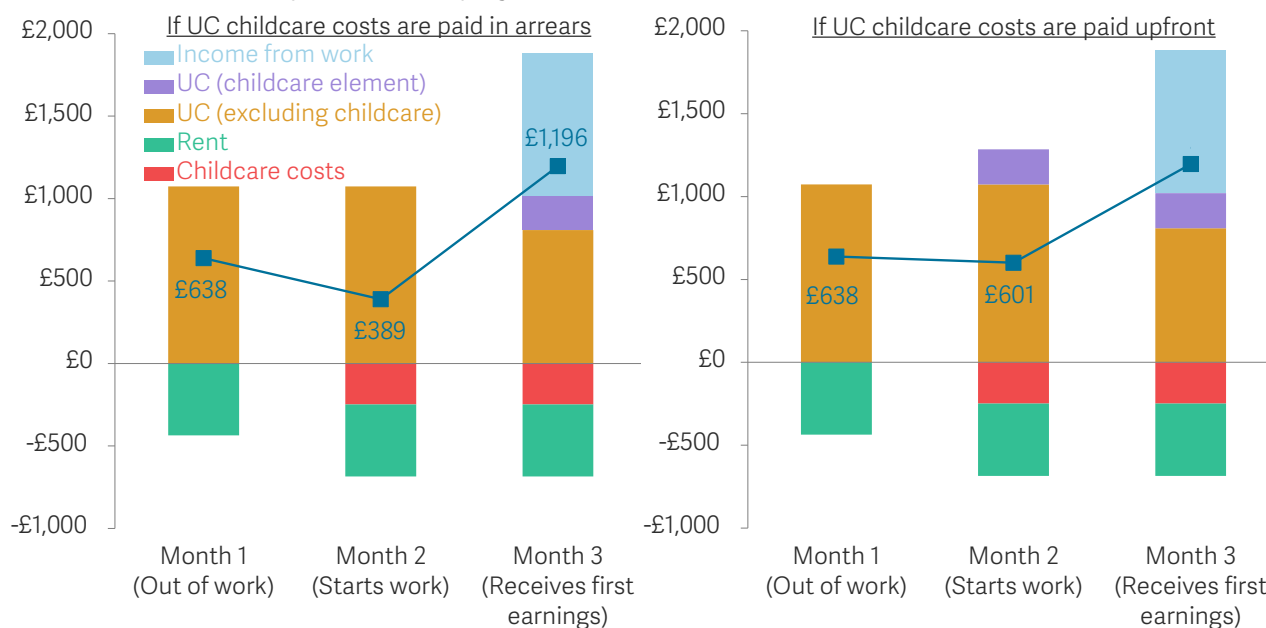
<sup>9</sup> For example, research from Citizens Advice found that families receiving UC with children under 5 have, on average, only £200 left over for food and other costs every month, including childcare, once they have paid housing costs and essential bills, and just £121 in savings. House of Commons Work and Pensions Committee, *Universal Credit and childcare costs*, December 2022.



part-time work and had to pay typical childcare costs. This change is set to come into effect in 2023-24, and will make a big difference to low-income parents of young children in the gap before the extension of free childcare hours is rolled out from April 2024.

**FIGURE 23: Paying Universal Credit childcare costs upfront will help to smooth parents' transitions into employment**

Monthly income and costs for a single parent with one child, as they move from being out of work into part-time employment: UK, 2023-24



NOTES: Family assumed to be renting in the social rented sector. Parent moves into working 20 hours per week at the National Living Wage. Child is aged 2, and childcare costs are average childcare costs, after free childcare hours are taken into account. Extended provision of free childcare hours are not taken into account, since these will be gradually introduced from April 2024 onwards.  
SOURCE: RF Case Study Model.

Overall, the OBR expects the free childcare for under threes to increase employment by around 60,000, and the other changes to UC to bring a further 15,000 into the labour force. Work cited by the OBR estimated that providing free care for 30 hours a week (in the form of reception classes for four-year olds) compared to part-time care during the 2000s increased the employment of mothers who had no younger children by 3.5 percentage points after a year. Given that there are around 1.4 million children in England who could potentially receive this care, the OBR's estimate seems reasonable.<sup>10</sup> When viewed solely through the lens of employment, these measures are expensive: spending £5.4 billion to increase employment by 75,000 works out at £72,000 per job. But the policy is also likely to increase hours for people already in work and, by keeping (mostly women) parents in closer contact with the labour market, may help to lower the gender pay gap in the long run.

<sup>10</sup> M. Brewer et al. *Does more free childcare help parents work more?*, Labour Economics, 74, January 2022.

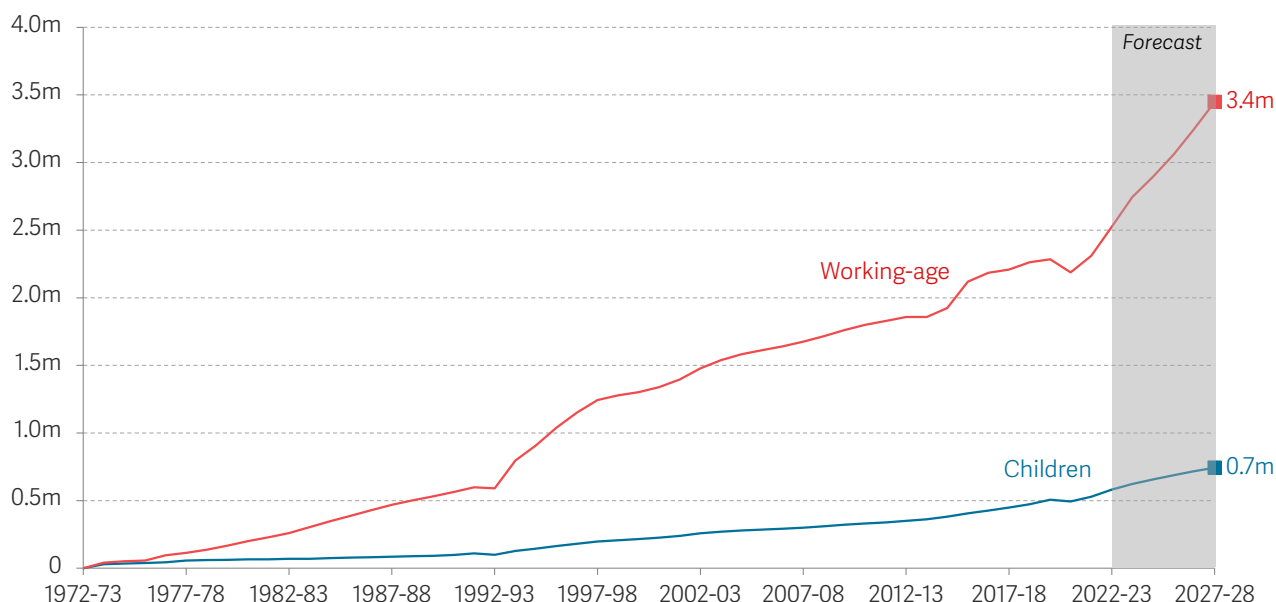
Finally, the flipside of more generous childcare provision is the introduction of tighter work search requirements for lead carers of children. While details are currently unclear, the Government claims that over 700,000 lead carers of young children will face increased requirements to look for work. This represents a continuation of the trend for benefits recipients with successively younger children to be expected to work; only in 2008 were lone parents with children over 12 prevented from making a claim for Income Support. Moreover, around 100,000 UC claimants with low household earnings will face tighter requirements to look for work. Despite over 800,000 people being affected by these measures, the OBR expects that they will increase employment by only 10,000.

## Disability and ill-health benefits are set for a big change, though these will take time to have an impact on labour supply

The Chancellor also announced a major reform to disability and sickness related benefits - the largest reform in over a decade. It is right to look at this: the number of working-age disability benefit claimants increased by 480,000, or 26 per cent, in the decade leading up to 2021-22, and is set to increase further to reach 3.4 million by 2027-28 (see Figure 24).

**FIGURE 24: The number of working-age people in receipt of disability benefits has risen sharply in the past decade**

Number of working-age and child disability benefit claimants, outturn and forecast: Great Britain



NOTES: Data is only claims in payment. Includes Personal Independence Payment, Disability Living Allowance, and historical Attendance Allowance and Mobility Allowance.

SOURCE: DWP, Autumn Statement 2022 benefit expenditure and caseload tables.

The most significant change is that Government intends to scrap the Work Capability Assessment (WCA), the process used both to determine eligibility for the additional ill-health related element within Universal Credit (the LCWRA element, worth £354 per month in 2022-23) and to determine whether or not claimants are exempted from work-search requirements on the grounds of ill health. The Government will also remove the LCWRA element of Universal Credit and replace it with a new health element, which will be awarded to all people receiving Universal Credit who are also in receipt of Personal Independence Payment (PIP - the main non-means-tested disability benefit for those with a long-term health problem or disability that affects their day-to-day life).<sup>11</sup>

The impact of this reform should not be understated – there are currently just over 1 million households in receipt of Universal Credit with a LCWRA element, almost one-quarter (23 per cent) of all households in receipt of UC. But there are at least two good reasons for the Government to be considering this change. First, at present, there are separate processes to apply for PIP and the LCWRA, but there is a high degree of crossover between the two benefits: two-thirds (66 per cent) of PIP claimants, and more than three-fifths (63 per cent) of UC claimants with ill-health estimated to be in receipt of both benefits.<sup>12</sup> Second, the current out-of-work benefit system is characterised by a large gulf in support between those deemed too ill to work (those with the LCWRA element) and those who are not – the fear of losing this support will likely discourage some people with disabilities or health problems from entering work.

History teaches us that the employment rate among people with disabilities can rise quickly: the employment rate among people with disabilities rose considerably in the 2010s, especially for those with depression.<sup>13</sup> But the Government's proposed changes will have no impact on labour supply in the short term given they will be rolled out gradually in different regions from 2026-27 at the earliest. This gradual approach is welcome: people with disabilities are already much more likely to be poor than the non-disabled population, so reforms that may affect their benefit income should be considered carefully.<sup>14</sup>

There will definitely be winners, and probably losers, from these changes. For example, there are currently around 180,000 people in receipt of PIP and Universal Credit but without the LCWRA element; they stand to gain (through receiving the new health element of UC). On the other hand, households who are would qualify for the LCWRA element in Universal Credit, but do not receive PIP, would lose support – there are up to

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<sup>11</sup> HM Treasury, *Policy paper: Spring Budget 2023 factsheet – Disability White Paper*, March 2023.

<sup>12</sup> RF analysis of DWP Stat-xplore data and administrative data referenced in a recent parliamentary question: [Question for Department for Work and Pensions, UIN 156196](#), tabled on 1 March 2023.

<sup>13</sup> C McCurdy, *Labour Market Outlook Q3 2022*, Resolution Foundation, October 2022.

<sup>14</sup> O El Dessouky & C McCurdy, *Costly differences: Living standards for working-age people with disabilities*, Resolution Foundation, January 2023.

650,000 people in this situation.<sup>15</sup> Although the Government has noted in the Disability White Paper that it intends to provide additional support to some of these people, claimants with mental health problems are particularly at risk of losing out.<sup>16</sup>

Finally, it is welcome that the Chancellor is investing in wider employment support for people with health problems and disabilities, including tailored employment support for those with mental health and musculoskeletal health problems, and consulting on ways to boost UK occupational health coverage. The latter is likely to be particularly effective at boosting labour supply, by retaining people with health problems and disabilities in employment rather than encouraging them to return to work after an absence.<sup>17</sup>

## The Chancellor announced generous pensions tax allowances for the very wealthy, with limited effects on participation

As well as getting sicker, the country is ageing. Aiming to increase labour market participation among older workers, the Chancellor has substantially cut taxes for people with large private pension pots by changing two rules which limit how much people could benefit from the tax advantages to pension saving:

- The lifetime allowance (LTA), which was set at £1,073,100 for 2022-23, will be abolished from April 2024, with the LTA charge removed from April 2023; and,
- The annual allowance (AA), which is the amount an individual can contribute each year to their pension before contributions are subject to a tax charge, will increase to £60,000 (from £40,000) in April 2023.

The Chancellor was under pressure to reform both of these in an attempt to retain older, highly paid public sector workers, such as NHS consultants and GPs. But the changes are not well targeted: 61 per cent of non-retired individuals with pension pots over £750,000 are employed in the private sector (see Figure 25).

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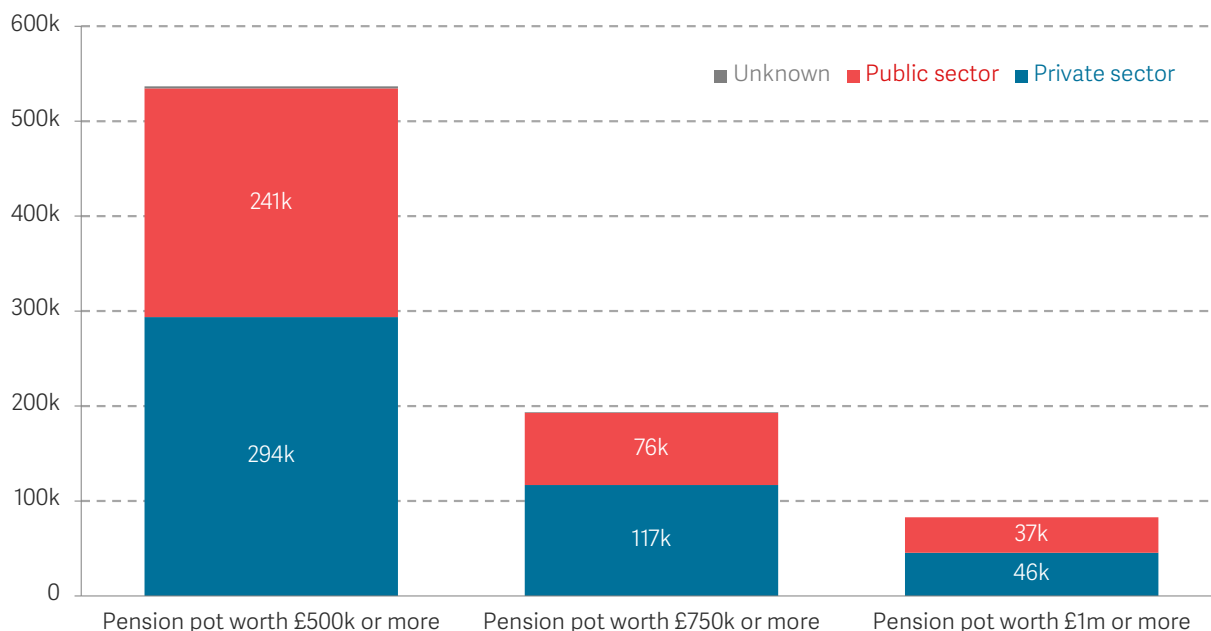
<sup>15</sup> RF analysis of DWP Stat-xplore data and administrative data referenced in a recent parliamentary question: [Question for Department for Work and Pensions, UIN 156196](#), tabled on 1 March 2023.

<sup>16</sup> For example, in 2022, people with mental health problems made up a greater share of the ESA Support Group caseload (the legacy benefit system equivalent to UC LCWRA) than the PIP caseload. (There is no available equivalent data for Universal Credit claimants). In August 2022, 50 per cent of ESA Support Group claimants had 'Mental and Behavioural disorders', whereas 37 per cent of PIP claimants had 'Psychiatric disorders'.

<sup>17</sup> L Murphy & G Thwaites, [Post-pandemic participation: Exploring labour force participation in the UK, from the Covid-19 pandemic to the decade ahead](#), Resolution Foundation, February 2023.

**FIGURE 25: Over half of non-retired people with pension pots over £1 million work in the private sector**

Number of non-retired individuals working in the public sector and private sector with pension pots in excess of different thresholds: Great Britain, 2018-20



NOTES: The analysis excludes those that are retired and those aged under 16. Total pension wealth includes DC and DB pension pots. The value of DB pension pots has been calculated using HMRC's methodology i.e. the sum of DB lump sum entitlement and annual pension income multiplied by 20. The following SIC codes have been used to identify public sector workers: 84, 85, 86, 87, 88. SOURCE: RF analysis of ONS, Wealth and Assets Survey Round 7, 2018-20.

Overall, the OBR estimates that the changes to the LTA and AA will increase employment by around 15,000. At a total cost of £1.2 billion per year, this comes at a cost of around £80,000 per job, meaning that these pro-work policies come with a great deal of deadweight. But there is considerable uncertainty over this. For some, particularly among workers that have inflexible DB schemes and are close to the lifetime limit, scrapping the LTA and increasing the AA will strengthen the financial payoff to earning more, as pay rises and extra hours will no longer lead to very large tax bills. However, others will find that the rise in the LTA increases the effective value of their pension pot – someone with a pension pot worth £2 million will see the value of their pension pot increase by £250,000 – and this may lead them to retire earlier than would have been the case.

The beneficiaries from these reforms stand to gain large amounts, and they are heavily concentrated among the very rich. Almost 9,000 people paid the charge on exceeding the LTA in 2020-21; they would have stood to gain £44,000 on average from its abolition. Of the roughly 80,000 non-retired people with pension pots in excess of £1 million who are likely to benefit at some point from the changes to the LTA, almost all (96 per cent) were in the top income decile. As Figure 22 shows, the average gain among households

in the top income decile is £370, and no households in the bottom half of the income distribution benefit from the policy. The policy does nothing to help the over 80 per cent of workers outside of DB schemes who are not saving enough to accrue an adequate pension.<sup>18</sup> And if the Chancellor had wanted to address the issue of premature retirement more forcefully, then there were other policies he could have considered, such as increasing the normal minimum pension age (NMPA) beyond 57, and bringing in further caps to tax-free lump sums.<sup>19</sup> That said, it is worth noting that the capping of the value of the tax-free lump sum also reduces the gains to the richest.

By contrast to the abolition of the LTA, the benefits from the increase to the value of the AA will accrue to the rich, but not the super-rich, because this is already tapered away from those whose income and pension contributions are together over £260,000. Indeed, the way that the AA is tapered away is helpful to a government wanting to protect public sector workers from high tax charges, as it only affects those whose earnings exceed £200,000. But some very high earners will benefit from a change to the minimum AA, which will return to its 2019-20 level of £10,000 (from £4,000 currently), giving these individuals an additional £2,700 in tax relief.

## Temporary changes to investment allowances are expensive and will not boost long-term growth

The Government announced yesterday that it is planning to spend an average of £9 billion a year for the next three years to allow companies to fully offset their investment on plant and machinery against their Corporation Tax (CT) liabilities, easily the largest single measure in the Budget. The aim is to neutralise the effect that CT has on firms' incentives to invest by treating investment in qualifying assets as identical to wages and materials – a cost of doing business that does not count against taxable profits. This is more important now that the main rate of CT is higher. At present, the first £1 million of qualifying investment is treated this way, covering the full investment of 99 per cent of firms. But a large fraction of investment is done by large firms whose investment is not fully covered. Alongside the headline measure, the Government modified a range of reliefs for research and development and cultural industries.

While CT is not the main reason that the UK's investment rate is low, there is good evidence that such cuts can boost investment. The OBR thinks that this measure will raise the level of business investment by up to 3 per cent over the medium term – about one-tenth of the gap between the UK and comparable countries (see Figure 26).<sup>20</sup>

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<sup>18</sup> N Cominetti and F Odamtten, *Living Pensions*, Resolution Foundation, July 2022.

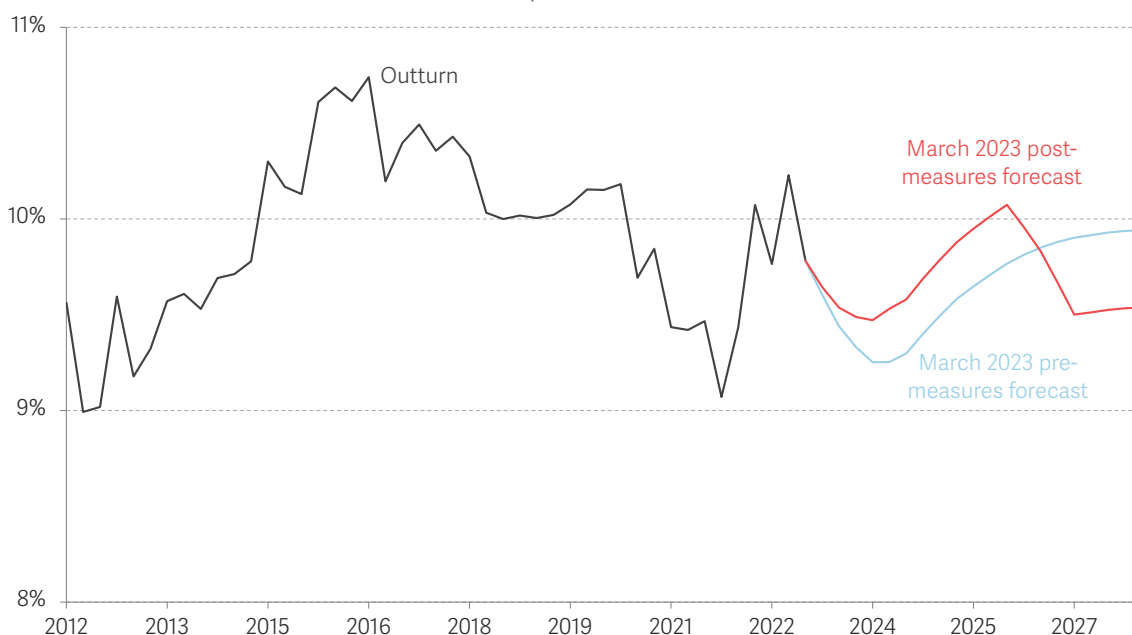
<sup>19</sup> L Murphy & G Thwaites, *Post-pandemic participation: Exploring labour force participation in the UK, from the Covid-19 pandemic to the decade ahead*, Resolution Foundation, February 2023.

<sup>20</sup> J Oliveira-Cunha et al., *Business Time: How ready are UK firms for the decisive decade?*, Resolution Foundation, November 2021.

Crucially, though, because the measure is temporary, it will have no effect on investment in the long run: the forecast is for investment to fall 4 per cent below baseline once it expires. At its peak, the OBR estimates that this measure will increase the capital stock by a maximum of 0.2 per cent, and increase demand and hence GDP by about 0.05 per cent or £1 billion per year on average over the forecast horizon, a small fraction of the over £5 billion average annual cost of the measure over 2022-28.

**FIGURE 26: Temporary capital allowances provide a temporary boost to investment**

Business investment as a share of GDP, actual and forecast: UK



SOURCE: OBR, Economic and Fiscal Outlook – March 2023

To get firms to commit to more capital-intensive business models, something that is vital if we are to raise productivity in the long run, the Government should introduce a permanent, predictable regime: instead, this is the fifth major change to corporate taxes in two years, and the second time the announcement has come a month before it takes effect. When it comes to corporate taxes, the stability of the regime is as important as its generosity.

Overall, the Government's efforts to boost labour supply, while regressive in places and expected to cost £60,000 per job on average, look likely to move the participation dial in the right direction. In contrast, the hugely expensive plans for corporation taxes and investment will have no long-run effect.

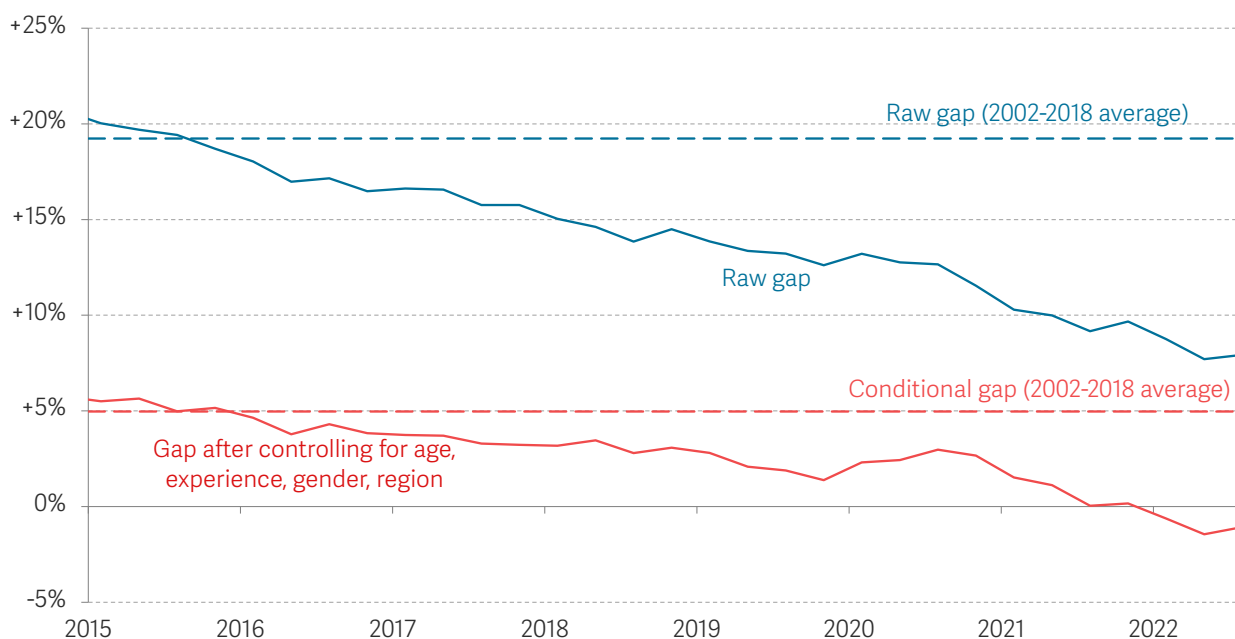


## Lack of action on spending challenges save up problems for the future

While the Budget contained lots of new policy announcements, one area which was left relatively untouched was public services. The Chancellor put off big decisions, particularly those addressing public sector pay and the implausibly tight spending plans pencilled in beyond the current spending review period; one smaller-scale but desirable development was the new 'trailblazer' devolution deals with the Greater Manchester and West Midlands Combined Authorities, giving both Authorities full control over flexible block grants at future Spending Reviews, and representing a welcome change to how some public services will be delivered.

**FIGURE 27: Public sector pay has declined markedly relative to the private sector since the pandemic**

Estimated raw and characteristic-adjusted average hourly pay gap between public sector and private sector workers: UK



NOTES: Gap is a four-quarter moving average. The average difference controlling for age, education, experience and region includes interactions with sex and interactions between education and experience. Excludes pension contributions. Based on Fig 4.7 in B Bolieau et al., Public spending, pay and pensions, IFS Green Budget 2022, Oct 2022.

SOURCE: RF analysis of ONS, Labour Force Survey.

With industrial action across the public sector, the Chancellor needed to decide whether to top up departmental spending limits to ease pressures from higher wage costs and inflation. The context here is the sharp fall in public-sector pay relative to the private sector since the start of pandemic (although there is uncertainty about the sustainable

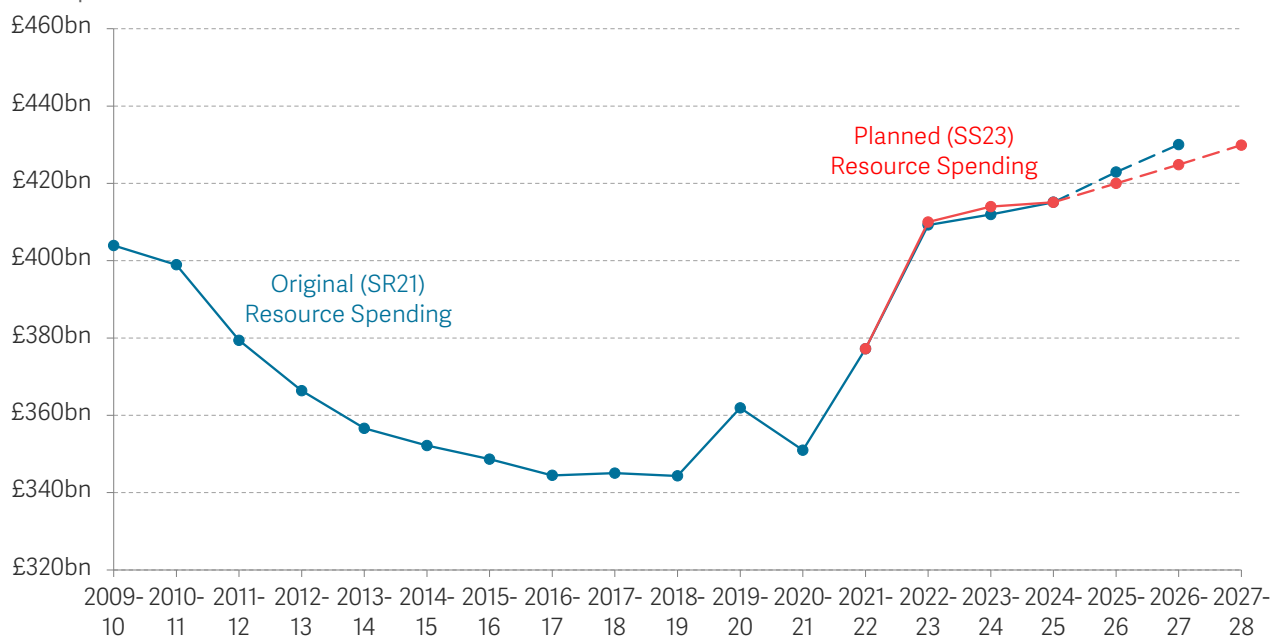
level of that gap). The raw gap in hourly pay has fallen from a near 13 per cent premium to just under an 8 per cent premium between Q1 2020 and Q4 2022, compared to a long-run average of 19 per cent (see Figure 27). But this measure doesn't take the differing characteristics of private and public-sector workers into account. If we do so, the gap has moved from a 1 per cent premium to a 1 per cent deficit, well below its long-run average of 5 per cent. This decline in relative pay has come alongside a 54 per cent increase in vacancies since March 2020 in the public sector, relative to a smaller 37 per cent increase in the private sector.

In the end, there was no new money for public-sector workers in the Budget, nor were there big changes to other spending assumptions. This leaves departments needing to meet pay increases from their existing budgets. Departments have stated that pay increases of 3.5 per cent in 2023-24 are affordable. Unless budgets are topped up at a later date, the OBR believes that departments will, therefore, need to absorb around £2 billion higher spending on staff costs in 2023-24 to fund this increase. But this figure could rise to £4.5 billion if public sector pay awards simply keep pace with forecast private sector pay growth this year.

Looking at overall resource spending, the Chancellor announced boosts of £0.6 billion from 2023-24 onwards for defence, and a £2.5 billion increase to the education budget in 2024-25 to pay for increased childcare provision. Accounting for changes in the OBR's inflation forecast, overall real resource spending is roughly back to levels originally planned in the 2021 Spending Review, with a 3.2 per cent annualised increase in budgets between 2021-22 and 2024-25 (see Figure 28). The Government can rightly point to this being an historically large increase which has taken overall resource spending above 2010 levels. However, two issues moderate the extent to which planned spending levels can be seen as sufficient: first, the bulk of these increases have already happened and, despite this, public service performance continues to suffer; second, highly restrained spending levels are planned for the coming five years, with particularly worrying consequences for 'unprotected' departments.

**FIGURE 28: Plans for overall government day-to-day spending remain unchanged from the autumn statement in November**

Real Resource Department Expenditure Limits excluding depreciation, outturn and planned: UK



NOTES: Original (SR21) Resource Spending is deflated using the OBR GDP deflator forecast March 2022, Planned (SS23) Resource Spending is deflated using the OBR GDP deflator forecast of March 2023. All values are in 21-22 cash figures. Adjusted to include OBR assumed shortfall, excludes money allocated to compensate local government for Business Rates changes.

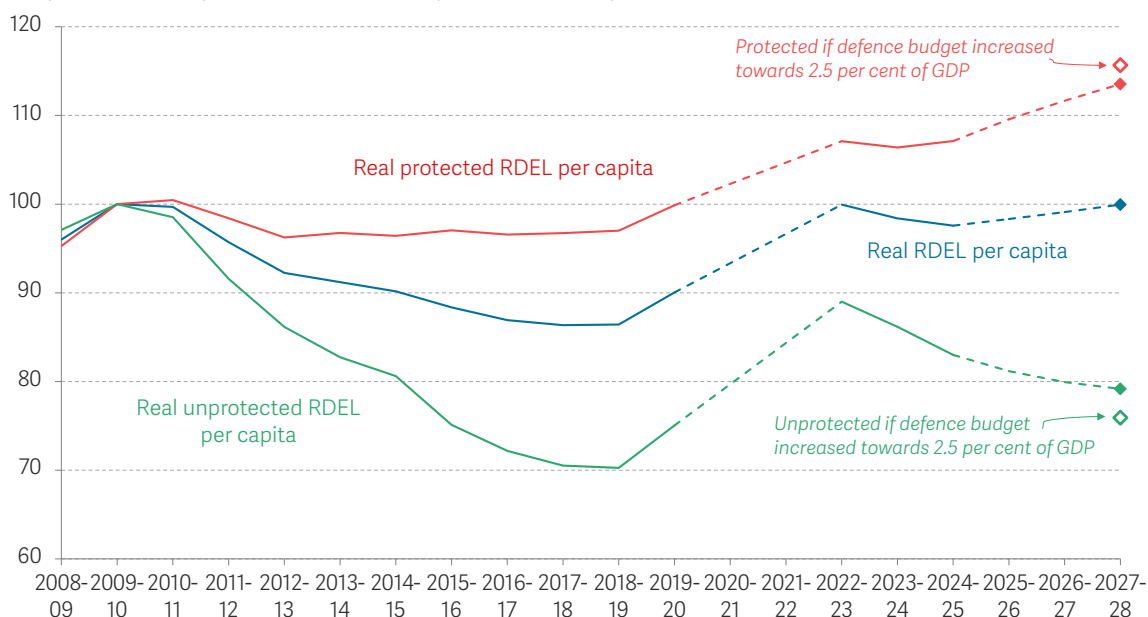
SOURCE: RF analysis of HMT, Spending Review 2021, Autumn Statement 2022, Spring Statement 2023; OBR, Economic and Fiscal Outlook March 2022, November 2022 and March 2023.

In the medium term, the roll out of 30 hours free childcare a week to all parents of children between nine and 36 months adds £5.3 billion to the Education department, and the resource spending on Defence benefits from a £0.6 billion uplift. However, public spending will continue to grow at 1 per cent in real terms into the next spending review period – lower than the 2.5 per cent rate ordinarily assumed. Assuming Health and Social Care, Foreign Office, Education and Defence budgets see spending protected as they have been historically, this would imply real resource spending cuts in unprotected departments of 1.2 per cent per year between 2024-25 and 2027-28, leaving real per person spending 10 per cent lower than today.

However, should the Chancellor aim to meet the newly announced aspiration for Defence spending to rise to 2.5 per cent of GDP over the next parliament, then unprotected departments will be put under further pressure. As shown in Figure 29, this will leave real per person spending in unprotected departments 14 per cent lower than today. It is not clear that such spending restraint is deliverable; as it is, these totals would likely be finalised only after the next general election, at the time of the next Spending Review.

**FIGURE 29: Unprotected departments are set to see large cuts to their budgets over the next spending review period**

Indices of real per person resource departmental expenditure limited (2009-10=100), all departments, 'protected' and 'unprotected' departments: UK, 2008-09 to 2027-28



NOTES: Deflated using the OBR forecast for the GDP deflator to 2022-23 cash terms. Protected budgets include health, education defence and foreign, commonwealth and development office.

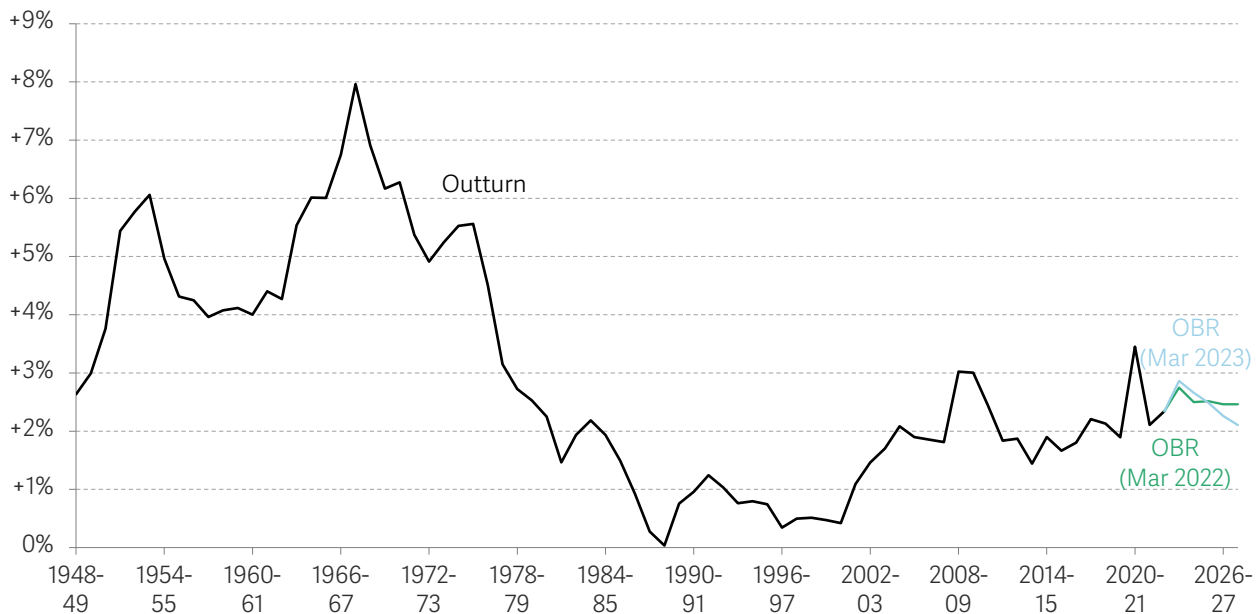
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various; HM Treasury, Spring Budget 2023 and PESA Tables various.

Public Sector Net Investment (PSNI) will average 2.5 per cent of GDP over the next five years – the highest sustained level of capital spending since the late 1970s. The Government has topped up capital spending on Defence up by an extra £1.7 billion a year, on average, from 2023-24 onwards. But the Treasury has stuck with the big cuts announced in November 2022, with PSNI expected to fall to 2.1 per cent of GDP by 2027-28 (making a saving of £12 billion this Parliament) (see Figure 30). Moreover, recently announced delays to HS2 appear short-sighted: the delays may well increase costs, and put construction firms at risk of going bust. And the Government made no further commitments (beyond the £6 billion announced in the Autumn Statement from 2025 onwards) to decarbonise the country's homes. Overall, cuts to public sector investment are disappointing, given that such spending has the potential to support growth, improve living standards and protect the environment.<sup>21</sup>

<sup>21</sup> A Anis-Alavi et al, *Hitting a brick wall: How the UK can upgrade its housing stock to reduce energy bills and cut carbon*, The Resolution Foundation, December 2022.

### FIGURE 30: Public sector investment will fall this Parliament – but remains elevated compared to recent history

Public sector net investment as a proportion of GDP: UK, 1948-49 to 2027-28



NOTES: Values of public sector net investment prior to 1955-56 are calculated using a composite GDP deflator.

SOURCE: Analysis of OBR, Public Sector Finances Databank; Bank of England, A millennium of macroeconomic data for the UK, 2020.

## Conclusion

Jeremy Hunt's first Budget was a much bigger affair than many expected, combining improvements to the economic and fiscal outlook with a significant policy package aimed at boosting longer term growth in general, and the size of the workforce in particular. A step change in childcare support stands out. But, stepping back, the UK's underlying challenges remain largely unaddressed. We are investing too little and growing too slowly; our citizens living standards are stagnant; and we are asking them to pay higher taxes while cutting public services.

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T Bell, M Brewer, M Broome, N Cominetti, A Corlett, E Fry, S Hale, K Handscomb, C

McCurdy, L Murphy, F Odamtten, C Pacitti, S Pittaway, K Shah, J Smith, G Thwaites & L Try,

*We're going on a growth Hunt: Putting the 2023 Spring Budget in context*, Resolution Foundation, March 2023

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