

More, more, more

Putting the 2024 Autumn Budget in context

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Summary

This has been the most anticipated Budget of modern times. It had to wrestle with profound – and sometimes conflicting – challenges: fixing strained public services; repairing failing infrastructure; and breaking with the UK's dire record on public investment. And all of this had to be squared with pre-election pledges not to raise the rates of any of Britain's most important taxes.

In the event, the Chancellor has sought to find a way through by, first, increasing day-to-day resources for public services, and roughly covering this with a £41 billion tax hike – the largest on record. At the same time, she has decided to borrow more, mostly in order to reverse planned cuts in public investment, and has rewritten one of her fiscal rules in order to give herself room to do that. This is not without risks: the already-depressed outlook for family incomes redoubles the challenge of persuading the public to support the extra tax. Equally, while the economics of extra public investment are compelling, the politics are complicated by the fact that most of the return is recouped beyond the electoral cycle.

The latest economic news provided Rachel Reeves some modestly helpful context. This year's growth has turned out to be 1.2 per cent, twice the rate the Office for Budget Responsibility (OBR) had expected at the time of the final Conservative Budget in March. But this improvement is very short term: looking ahead, and after making allowance for the various measures within the Budget, the watchdog hasn't made any consistent alterations to its forecasts for future years. And after the spike of 2022-23, inflation is now firmly back in the normal range. But the fact it is now expected to run just-above, rather than just-below as in March, the Bank of England's 2 per cent target over the next couple of years means a somewhat bigger cash economy which, on balance, eases the fiscal arithmetic slightly. Altogether, changes in the economic forecast since March have reduced overall net borrowing by a projected (and decidedly modest) £5 billion a year by 2028-29.

Public services: no return to austerity?

Many warning lights have long been flashing across the public services, including: a surge in Crown court cases not being heard in six months (up from 22 to 48 per cent since 2019); dwindling parental satisfaction with local primary schools; and nine councils, including Birmingham, effectively putting themselves 'into administration' by issuing so-called Section 114 notices since 2020. Although the previous Chancellor, Jeremy Hunt, had pencilled in annual real growth in day-to-day public service spending of 1 per cent through till 2028-29, once allowance was made for population growth and for political

commitments to protect particular departments, such as Health, this modest total expenditure growth implied substantial fresh cuts in per-head resources for services elsewhere.

In opposition, Labour accepted the baseline provide by Hunt's plans. In Government, the Chancellor and Prime Minister vowed "no return to austerity", and the Budget has revealed the numbers implied by those words. Over the five years from 2023-24, day-to-day public service spending is now set for average annual real-terms growth of nearly 2 per cent, which means £44.1 billion more in real annual day-to-day public service spending by the end of the decade in current prices. This is the sharpest absolute increase since the 2000 Spending Review. But given the frail initial condition of public services, and the way in which a within-year overspend has already overtaken the plans, this looks more like a settlement for stabilisation than for transformation.

The front-loaded profile of the extra spending is striking. As well as confirming allocations for the current year (2024-25), the Budget gave us a new settlement for next year (2025-26), and then established the 'envelope' for the following four years, within which the 2025 Spending Review will then settle allocations. Assuming the Budget plans stick, day-to-day departmental spending now grows in real terms by 4.8 per cent this year, 3.1 per cent next year, and by an average of 1.3 per cent over the following three years. This is a very different pattern from that seen in the early days of New Labour when extra spending started slowly and then picked up.

The picture will also vary dramatically across departments. At the 'luckier' end of the departmental table are Education (for which another £4 billion has been found) and particularly Health (£10 billion). Health's share of day-to-day service spending will next year rise to 42 per cent of the total, against just 32 per cent back in 2010. The rises will then continue. Despite all the real and serious challenges of the NHS's current performance, Health is unique among the departments in this respect: its per-person spending will be far higher at the end of this decade than it was at the start of the last.

What is pencilled-in across 'unprotected' departments is very different. Despite emergency relief for some departments next year (the Ministry of Justice, for example, will be 7 per cent up on 2023-24) the long squeeze on day-to-day spending of others – including Environment, Food and Rural Affairs, Culture, Media and Sport and Transport – continues through the early part of this Parliament. After that, there is likely to be a fresh squeeze: the Chancellor's 'envelope' implies unprotected services collectively shouldering a further cut of £8 billion over the last three years of this Parliament. If it happens, their users might not accept that there has been "no return to austerity."

Paying for it: the tax rise

The increase in spending would, absent action, have been sufficient to leave non-investment spending outpacing revenues by the second half of the parliament, reaching a projected £26 billion by its final year. But this couldn't be squared with the Chancellor's prudent commitment to a 'current budget' rule, under which receipts must at least cover all expenditure other than investment, a rule she needs to plan to meet with some margin for error. Action was needed.

She has pencilled in £41 billion a year of tax rises by the end of the decade – the largest tax rise relative to the size of the economy in any formal fiscal event on record. And with overall taxation already historically high, this pushes the total tax take up to an all-time high of 38.3 per cent of the economy in 2027-28, smashing the record set way back in 1948. Compared with our neighbours, however, we are still not exceptional: indeed, our taxes remain lower than those in France, Germany and Italy, although this Budget might see them exceed those in Spain.

Before the election, Labour pencilled in small specific tax rises (such as imposing VAT on private school fees) and various promises to clamp down on avoidance and close loopholes. The Chancellor has now dispatched with campaign caution, but her task in raising serious money is still greatly complicated by her previous promises not to raise the rates of VAT, Income Tax or National Insurance. She has used National Insurance to raise the single biggest slice of the extra money (an annual £26 billion by the end of the decade), but through contributions that are paid by employers, rather than formally incident on 'working people', around whom the manifesto pledges were couched.

National Insurance rates have already oscillated wildly over the past few years – Boris Johnson announced big increases, before his Conservative successors indulged in repeated and ultimately even bigger cuts. Now the new Government is suddenly reducing the earnings threshold at which employer contributions become due (from £9,100 to just £5,000), simultaneously increasing the rate charged (up from 13.8 to 15 per cent) while softening the effect on smaller businesses, by expanding the tax-free Employment Allowance.

National Insurance is a tax whose base is uniquely restricted to earned, rather than unearned income, and as such unambiguously a tax on work. The OBR assumes three-quarters of this tax increase will ultimately be funded by employers squeezing pay. This change also increases the tax advantages of self-employment status, since there is then no Employer rate: already by last financial year, the total National Insurance due on self-employment was £6 billion less than it would have been on equivalent earnings. This disparity – and perhaps the temptation for bogus and unprotected forms of freelancing

– will only grow. The public services whom the National Insurance rise is designed to rescue are themselves major employers: around £5 billion of the money raised has to be handed straight back to departments to relieve them.

On the OBR assumption that three-quarters of the extra employer National Insurance is eventually passed on in lower wages, we can assess the effect of this tax rise across the income distribution. The earnings of richer households attract a higher charge in cash terms. But when we look at the picture on a proportional basis, and also factor in indirect tax changes and benefit cuts – the means-testing of the Winter Fuel Allowance, and a commitment to cut £2.0 billion by tightening the Work Capability Assessment – there is no clear distributional slant to the changes. Indeed, in proportional terms, the hit to the best-off is slightly less than it is for others.

However, a host of other tax changes in the Budget which can't readily be analysed in the same way are squarely aimed at the rich. The rate of Capital Gains Tax for most assets steps up in the direction of parity with Income Tax rates. The extra rate of Stamp Duty charged on additional homes is up from 3 to 5 per cent. Inheritance Tax relief for business and for agricultural assets has been capped at £1 million, with a new reduced rate of 20 per cent being charged on assets above that. Inheritance Tax thresholds are being frozen, and the growing loophole created by the exemption of inherited pension pots has rightly been closed. None of these measures is huge individually, but several remove distortions. Taken together, even if this Budget has not attempted any general effort to move the tax burden from work to wealth, they look like a non-trivial effort to ensure "those with the broadest shoulders carry bear more of the burden."

Still stagnant: living standards

The immediate outlook for real pay is far from rosy and, after this Budget, has worsened. From 2025, the two-year projection was – before yesterday's measures – for total growth of a mere 0.5 per cent over two years, and 1.7 per cent over four. After the Budget, and particularly the rise in employer National Insurance, this becomes a two-year shrinkage of 0.3 per cent and four-year growth of just 0.4 per cent. Average earnings (when deflated by CPI) are forecast to end up in 2029 just shy of where they were in 2008.

The picture on overall household incomes is only a little brighter. The expectation is for average annual growth of 0.5 per cent over the Parliament. This is just above the record-breaking low of 0.3 per cent registered over the 2019-2024 Parliament, but is otherwise the joint-lowest on record (matching the 2015-17 Parliament). The contrast between this bleak outlook and life under the 1997-2010 Labour governments – during which incomes rose by an average of 1.9 per cent – is stark.

There are particular concerns about what this stagnation of average living standards could be concealing for many vulnerable families at the bottom of the scale. The two-child limit continues to operate as a poverty ratchet, affecting another 63,000 children by April next year, likely the earliest plausible date for abolishing it in the context of the Child Poverty Strategy. And a failure to repeg the Local Housing Allowance to rents next year will contribute to a widening shortfall between the benefit and the housing costs they are designed to cover. We estimate that the average shortfall between rent at the lower end (30th percentile) and the allowance in the average area is already £14 per week, but far more in some places – over £60 in Inner London – and, absent regular indexation, this gap will only rise. Ongoing freezes in the household benefit cap are yet another feature of the system that leaves poor families vulnerable to inflation.

Other developments are pushing in a more positive direction. The National Living Wage is rising, and the Government has found some money to extend the Household Support Fund. The Treasury itself points to the progressive contribution of public services. That isn't necessarily unreasonable: the experience of using public services is one aspect of living standards, and improving them is one way to raise it. But whether voters will be content that the stabilisation of services is adequate compensation for a continuation of the two-decades long squeeze on living standards remains to be seen.

Borrowing to invest

The other big Budget judgment was to cancel growth-sapping public investment cuts in the inherited plans, and to fund this with borrowing. The cumulative effect is a £100 billion boost over five years, a welcome break from the UK's usual pattern of low and volatile public investment.

This would have been impossible under the inherited fiscal rule, which committed to get a particular measure of public debt falling within a five-year period, and which was already close to maxed out. So the Chancellor decided to replace it, switching to a wider measure of the public balance sheet, Public Sector Net Financial Liabilities. The stated aim – as voiced in the Chancellor's conference speech – is to recognise the value of assets that investment creates as well as the cost. But in fact, this measure only captures financial assets, created when the public sector makes loans or buys equity; it doesn't credit physical assets like school or hospital buildings. Nonetheless, in current circumstances it turns out to create significant extra scope for borrowing to invest – a total of £21 billion relative to the old rules.

Using this scope means debt is now set to rise by 4 per cent of national income from 2024-25, which obviously comes at some cost in terms of interest and exposure to

financial conditions. But this is a trade worth making. So long as the extra investment is sustained, in the very long-run the OBR estimates it will add 1.4 per cent to GDP.

But the move is not without problems. For one thing, even having rewritten this rule, the Chancellor is already pushing up close to its limits. She has only a £16 billion margin for error, almost a rounding mistake in the context of the stock of public liabilities and debts. For another, the big positive payoff on productive capacity is very long term. As late as 2029-30 the OBR estimates the boost will be as low as 0.14 per cent of GDP: in other words, the real reward is badly out of kilter with the electoral cycle.

This was a Budget that dispelled the previous fiscal fictions. The response has involved more spending, more tax and, ultimately, more borrowing. But it is also a Budget that takes place when families are already squeezed. Which means that while the Chancellor has made many hard choices, many other sharp dilemmas remain. The only way to soothe the punishing arithmetic of trade-offs is, as the Chancellor has previously argued, to raise Britain's stagnant growth rate. Public investment is one big part of the puzzle for achieving that. But it won't be adequate on its own. After this bold Budget, the other elements of the growth strategy – on skills, on planning, on industrial policy and more – are only looking more crucial.

This historic Budget lived up to the hype with huge tax and spend announcements

By any standards, this was a big Budget. Beyond the historical significance of it being the first by a Labour Chancellor in nearly 15 years, and the first ever delivered by a woman, it laid bare the new Government's desire to tackle crumbling public services and perennial under-investment. This was made more difficult by a backdrop of tight public finances, a baseline that implied deep cuts to public services, and self-imposed limits on tax changes.

The result was more spending, more tax, and more borrowing. Day-to-day public-service spending was increased by £44 billion by 2029-30 in today's prices, the biggest increase in such spending on record, with the NHS and education in particular benefiting from increases next year. But a commitment to balance current spending with tax receipts by the end of the decade meant this figure was all but matched by £41 billion of tax increases, also the largest rise on record. This was raised in a package dominated by a rise in employer National Insurance, but also featuring increases in Inheritance Tax and Capital Gains Tax. And in light of the UK's perennial under-investment, the Chancellor opted for a change to the fiscal rules – targeting net financial liabilities rather than debt – making space to reverse previously planned cuts to capital sending, and increasing capital spending by a cumulative £100 billion.

In what follows, we put these policy changes in context, explaining what they mean for the economy, public finances and living standards. We start with changes to the Office for Budget Responsibility's updated economic outlook before turning to the choices that have been made on public spending, tax and welfare policy, the public finances and longer-term growth.

Changes to the economic outlook have been helpful to the Chancellor overall

Policies announced in the Budget have affected the timing of future growth, but cumulative growth over the forecast is little changed since March

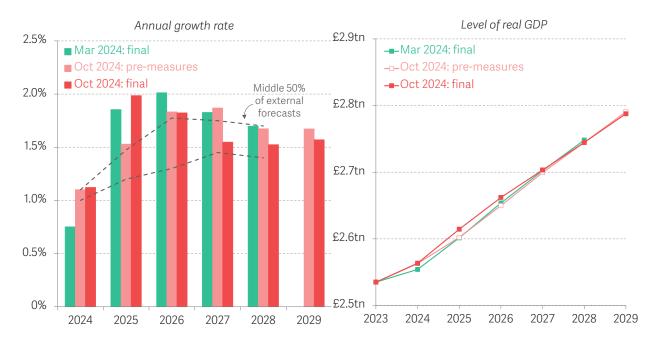
The UK economy has fared surprisingly well since the OBR's last forecast in March. Bouncing back from recession at the end of 2023, GDP grew by 1.2 percent in the first half of 2024. This was the fastest growth in the G7 and double the rate forecast by the OBR in March (0.6 per cent, as shown in the left panel of Figure 1).

But there has been little change to cumulative growth over the entire forecast horizon, as shown in the right panel of Figure 1. In the OBR's final forecast, growth in 2025 is slightly higher than previously forecast, reflecting a large boost to demand from the fiscal

loosening announced in this Budget. But, as Box 1 sets out in more detail, higher taxes and crowded-out private investment hit growth in later years. These effects largely offset over the OBR's five-year horizon, with the level of real GDP in 2028 almost unchanged from March, and GDP per capita set to grow by a modest 1.2 per cent per year over the coming parliament. If achieved, this would be a marked improvement on the UK's recent past (GDP per capita fell by 0.1 per cent per year over the previous parliament) but looks to fall well short of the Government's aim of having the fastest growth in the G7: it would be half a percentage point below the 1.7 per cent growth that the IMF has recently forecasted for the US.¹

FIGURE 1: Newly-announced policies affect the pattern of future growth, but the real-terms size of the economy at the end of the forecast is largely unchanged

Forecasts for calendar-year real GDP growth (left panel) and real GDP (right panel): UK



NOTES: External forecasters are those collated by HM Treasury. In 2024 and 2025, the range shown only includes forecasts made within three months of the relevant forecast iteration. For later years, range includes all forecasts. The number of external forecasts in each year are: 22 in 2024, 22 in 2025, 14 in 2026, 11 in 2027, and 7 in 2028. The level of real GDP has been rebased to align with the latest Quarterly National Accounts.

SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various; HM Treasury, Forecasts for the UK Economy, various; and ONS, Quarterly National Accounts.

¹ Average annual growth in real GDP per capita from 2024 to 2029. International Monetary Fund, World Economic Outlook, October 2024

BOX 1: In the OBR's five-year forecast, policies announced in the Budget deliver a sharp but short-lived boost to growth

The OBR's projections for the public finances rest upon its 'post-measures' economic forecast, which combines its underlying view of the economy (the 'pre-measures' forecast) with an assessment of the impact of any policy measures announced in the Budget. This Box summarises the net impact of policy measures on the OBR's real GDP forecast, with a detailed discussion of individual measures presented later in this report.

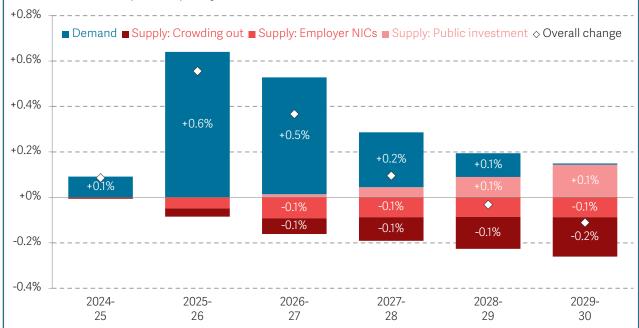
In the OBR's short-term forecast, policies can change the level of aggregate demand – moving output temporarily above or below the economy's long-run productive capacity. But the OBR assumes this demand-side impact is almost entirely offset by monetary policy by the end of its forecast period. So, in the longer term, only the impact of policies on

the supply side (i.e. those affecting the economy's productive capacity) matter.

Figure 2 shows the impact of policies announced in this Budget on the level of GDP across the OBR's forecast horizon. The peak impact comes in 2025-26, as a significant rise in government spending (only partially offset by higher taxes) provides a large boost to demand. Relative to the OBR's pre-measures forecast, the net effect of policy measures is to raise GDP by 0.6 per cent in 2025-26, accounting for a quarter of GDP growth in that year. Demand stimulus also provides a substantial boost to the level of GDP in 2026-27 but, because the effect is smaller than the year before, its impact on GDP growth turns negative.

FIGURE 2: Policy measures provide a large boost to demand in the short term, while their supply-side impact is slightly negative within the five-year horizon

Forecasted impact of policy measures on the level of real GDP: UK



SOURCE: OBR, Economic and Fiscal Outlook, October 2024.

Towards the end of the OBR's forecast, the supply-side impacts of policy measures become relatively more important. The OBR models three different effects of policies on the economy's productive capacity. It is boosted by the rise by public investment, which increases the size of the capital stock. On the other hand, labour supply is hit by the increase in Employers' National Insurance contributions, and the overall rise in government spending crowds out some private investment.² Other

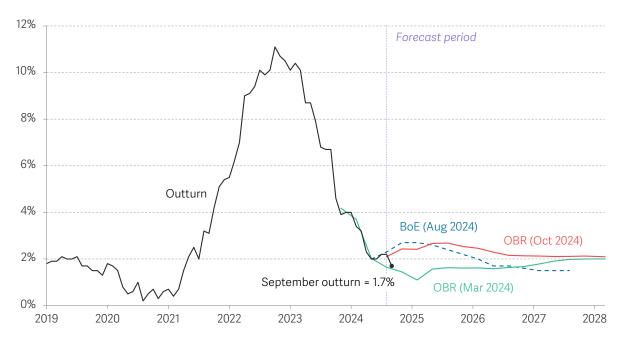
announcements, such as reforms to the planning system, are not reflected in the OBR's assessment, likely reflecting difficulties in quantifying their impacts. The net effect of these three supplyside impacts on supply is small over the OBR's forecast horizon: their biggest impact comes in 2029-30, where they weigh on the level of GDP by just 0.1 per cent. But the OBR notes that the full benefit of public investment won't be realised until after their five-year horizon. Growth policy is discussed in more detail later in this report.

² The OBR assumes that public investment itself crowds in, rather than crowds out, private investment. This is included in the impact of public investment shown in Figure 2.

The OBR joins the Bank of England in forecasting above-target inflation over the next two years, meaning a slightly larger economy in cash terms

Looser fiscal policy, higher employment taxes and stickier domestic inflation outturns have led the OBR to revise up its inflation forecast. Back in March, the OBR had forecast a period of below-target inflation starting in Q3 of this year. But now, as shown in Figure 3, the OBR has inflation running slightly above target in the coming years, bringing it more in line with the Bank of England. Sustained higher inflation means a higher price level at the end of the forecast – consumer prices in 2028-29 are set to be 2.3 per cent higher than in the March forecast – and therefore a bigger cash-terms economy.

FIGURE 3: The OBR has revised up its inflation forecast
Outturn and forecasts for CPI inflation from the OBR and Bank of England: UK



NOTES: Outturns are monthly; forecasts are for quarterly inflation and are plotted for the middle month of each quarter.

SOURCE: RF analysis of ONS, Consumer Price Inflation; OBR, Economic and Fiscal Outlook, various; Bank of England, Monetary Policy Report, August 2024.

The OBR thinks the measures in the budget will give a short-term boost to the labour market, but lead to lower employment and earnings by the end of the parliament

The boost to economic activity in the OBR's near-term outlook also shows up in the labour market. The OBR thinks looser fiscal policy in 2024 and 2025 will raise the employment rate (by 0.2 percentage points at the end of 2025, equivalent to 87,000 workers), and lead to stronger real wage growth in those years.

However, budget measures (in particular, the increase in employer National Insurance (NI)) work in the opposite direction at the back end of the forecast – giving an outlook of falling real pay in 2026 and 2027. Overall, the OBR judges that the measures in this Budget will reduce the level of real average earnings in 2029 by 0.7 per cent, equivalent to £217 per year for an average earner (in 2024-25 prices). Similarly, Budget measures are expected to reduce the employment rate by 0.1 percentage points at the end of 2029 as higher employer NI contributions lead to lower participation. These employment and earnings forecasts (including the impact of Budget measures) are shown in Figure 4.

FIGURE 4: The OBR thinks the Government's measures will boost employment and real pay in the near term, but do the opposite in the medium term

16+ employment rate (left panel) and cumulative change in real earnings level after 2023 (right panel), OBR forecasts: UK



NOTES: Problems with Labour Force Survey estimates mean it is best to disregard the first three data points of the October 2024 forecast vintages in the employment rate panel as these are based on outturn data.

SOURCE: OBR, Economic and Fiscal Outlook, October 2024.

As we have become used to, the OBR's forecasts imply a dire outlook for real earnings. Earnings are set to grow by just 1.6 per cent in real terms over this Parliament (2024 to 2029). This five-year total is substantially lower than the annual growth rate workers once enjoyed in the pre-financial crisis years. This will extend the UK's long pay stagnation: in 2028, average weekly earnings are set to be just £13 higher than they were in 2008 (adjusted for CPI inflation).

For much of the workforce, the next 12 months will mark a turning point in the labour market. Real-terms earnings growth is set to be half as high in 2025 (1.2 per cent) as in

2024 (2.4 per cent), while surging post-pandemic jobs growth has given way to falling jobs numbers this summer. The main group whose earnings will do well in 2025 are low earners, thanks to a sizeable 6.7 per cent National Living Wage uprating and larger pay rises still for younger minimum wage earners. Box 2 sets out the Government's minimum wage policy for 2025.

BOX 2: Revisions to earnings data mean the increase in the minimum wage in 2025 will be larger than expected

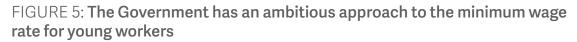
The Government announced yesterday that the National Living Wage (the hourly minimum wage for workers aged 21 and above) will rise to £12.21 in April 2025. This will be an increase of 6.7 per cent on the current rate, well above the expected rate of inflation in April 2025 (giving a real-terms increase of 4.0 per cent), and also almost one-and-a-half times the rate of expected wage growth in April 2025.3 The increase will be the seventh biggest percentage increase in the adult minimum wage on record (in both cash terms, and - if the OBR's inflation forecast is roughly correct - in real terms).

This relatively large increase – larger than the 5.8 per cent the Low Pay Commission (LPC) said it expected back in September – is the result of the LPC revising upwards the cash rate it thinks it needs to set to meet its remit of setting a minimum wage of at least two-

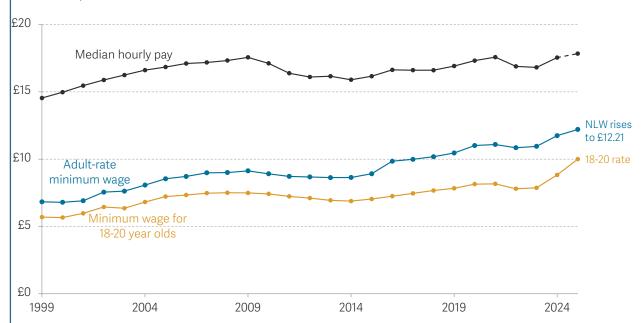
thirds of median hourly pay.4 The LPC have confirmed they think the £12.21 will fall on this 'floor'. Their estimates of median hourly pay in 2025 will have been revised up thanks to new Annual Survey of Hours and Earnings data, which showed a faster rate of growth in 2024 than the timelier Average Weekly Earnings series, and which also included a 13p levels increase thanks to a new methodology. This means the Government's new policy of asking the LPC to take into account the cost of living has not affected the NLW, as holding the rate steady relative to typical earnings already means it will rise by more than expected inflation. And this relatively cautious approach to raising the NLW is not unreasonable in the context of increases in employer National Insurance contributions, and large reforms to employment rights coming down the track.

³ The OBR forecast average hourly earnings to grow by 4.4 per cent between Q2 2024 and Q2 2025.

⁴ Low Pay Commission, How the LPC will respond to our updated remit, September 2024.



Median hourly pay and minimum wage (adult rate and rate for 18-20-year-olds), April 2025 prices: UK



NOTES: Median hourly pay for 2025 uprated from 2024 using OBR's projection of average hourly earnings. SOURCE: RF analysis of ONS, Annual Survey of Hours and Earnings; Low Pay Commission, minimum wage rates; ONS, Consumer Price Index; OBR, Economic and Fiscal Outlook, October 2024.

The biggest minimum wage increases are reserved for the youth rates. The rate for 18-20-year-olds is set to rise by 16 per cent, from £8.60 to £10, while the rate for 16-17-year-olds and apprentices is set to rise by 18 per cent (to £7.55). These are the largest increases in the youth rates that have ever been made and mark the start of the Government's plan to bring the youth rates into line with the adult rate. Ambition on the youth rates is supported by the fact

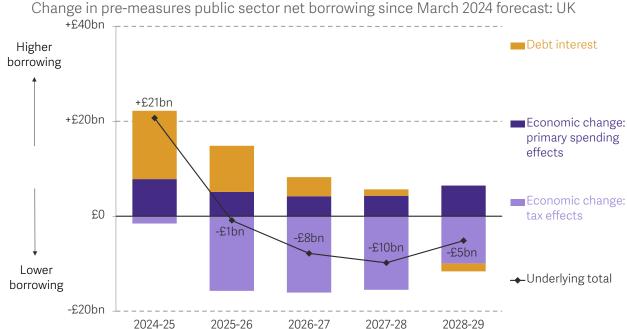
that the youth rates have risen more slowly than the adult rate for the past two decades; the large increase next year will take the gap back to its 2012 level. But there are nevertheless risks to youth employment from closing the gap, and the LPC and the Government will have to carefully monitor these. Unfortunately, the issues plaguing the Labour Force Survey will make this unusually difficult.⁵

Taking these changes to the economic forecast together results in a small improvement to the fiscal forecast (Figure 6). Higher inflation and a larger cash economy mean tax receipts will be higher, as shown by the light purple bars in Figure 6. This is partially offset by slightly higher spending on welfare payments (the dark purple bars). With interest

⁵ A Corlett & H Slaughter, <u>Measuring Up? Exploring data discrepancies in the Labour Force Survey</u>, Resolution Foundation, August

rates also little changed by the time of the OBR's data cut-off in mid-September, this leaves the debt interest forecast similar over the long term (the yellow bars in Figure 6), but £14 billion higher this year and £10 billion higher next year due to higher inflation impacts on index-linked debt and higher Bank Rate.⁶ As shown earlier in Figure 2, the Government's policy choices also have an impact on the economic forecast, and this has further reduced borrowing by a cumulative £15 billion over the forecast.





SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various.

Day-to-day public services spending has been increased significantly

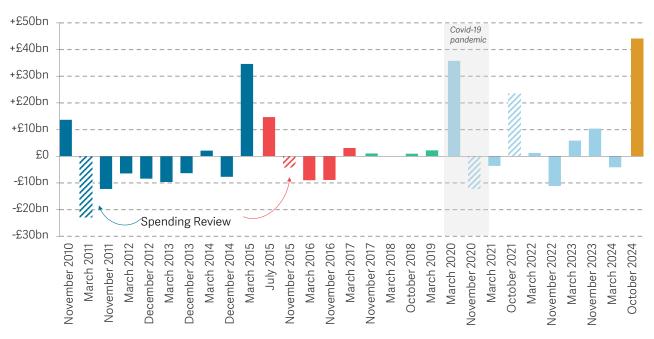
The big policy choice made by the Chancellor at this Budget has been to put in place the largest real-terms increase in day-to-day departmental spending (Resource Departmental Expenditure Limits, or RDEL) between forecasts since the 2000 Spending Review, eclipsing even the planned rise during the Covid-19 pandemic (Figure 7).⁷ This rise came in the form of a front-loaded increase in RDEL, which is now set to rise by 4.8 per cent in 2024-25 (the current year); 3.1 per cent in 2025-26, the year of the Government's mini Spending Review; and then a more modest average of 1.3 per cent per year between 2026-27 and 2029-30. In current prices, this leaves day-to-day spending on public services £44.1 billion higher than at the time of the March Budget by the end of the Parliament (2029-30).

⁶ However, since the OBR stopped taking on new data in mid-September, both short- and long-term interest rates have risen substantially. If the debt interest forecast had been calculated at the start of this week (28 October), over £7 billion would have been added to borrowing in 2029-30.

⁷ RF analysis of OBR, Economic and Fiscal Outlook and HMT Spending Review Documents, various.

FIGURE 7: This marks the largest spending increase since the 2000 Spending Review





NOTES: Shaded bars denote spending reviews. Excludes the 2019 spending review as this was not accompanied by a forecast. GDP deflated.

SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various; OBR Historical official forecasts database.

In essence, the Chancellor has addressed the large cuts baked into plans inherited from the previous Government.⁸ Under those plans, RDEL increased by just 1 per cent in real terms beyond 2024-25 and did not provide a credible funding path for public services – which, as Box 3 shows, are in a dire situation.

BOX 3: Public services are under severe pressure

The context to the Budget is public services that are struggling to cope following a period of deep cuts. A range of indicators tell a story of an erosion in quality of public services. For example, as Figure 8 shows, the share of Crown Court cases not heard

in six months has shot up, more than doubling from 22 per cent in 2019 to 48 per cent by 2023. Likewise, the proportion of people not satisfied with the way their council runs things has increased from 28 per cent in 2010 to 45 per cent in 2024. Warnings of financial

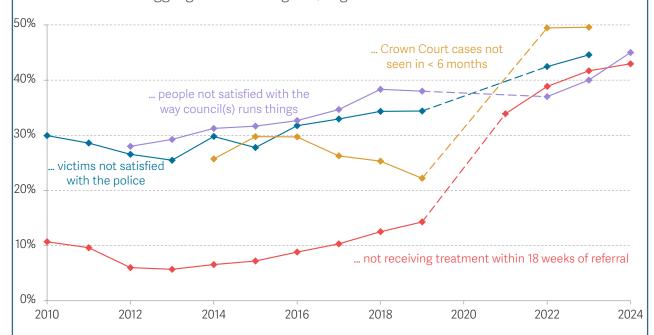
⁸ These plans did not account for extra RDEL needed to pay for the costs of the infected blood scandal and the Post Office Horizon scandal. See: E Fry, C Pacitti & J Smith, <u>Great expectations in hard times? Previewing the big decisions for the Chancellor in the new Government's first Budget.</u> Resolution Foundation. October 2024.

difficulties are crystallising into hard realities: since 2020, nine councils including Birmingham and Nottingham - have issued Section 114 notices, the local government equivalent to declaring bankruptcy, with 303 councils estimating a funding shortfall by 2026-27.9 Satisfaction with local primary schools is also at an all-time low: only six-in-ten people are satisfied with this service compared to nine-in-ten two decades ago.¹⁰ Even the NHS – which

has been relatively insulated from spending cuts – is struggling to recover from the pandemic. The Chancellor said that patients "should expect to wait no longer than 18 weeks from referral to consultant-led treatment".11 However, achieving this target is likely to be challenging: the proportion of patients not receiving treatment within 18 weeks of referral has quadrupled from 11 per cent in 2010 to 43 per cent in 2024.

FIGURE 8: Public services are under mounting pressure

Proportion of people, victims and patients reporting not being satisfied or where services are struggling to deliver: England/England & Wales



NOTES: Data on victims not satisfied with the police covers England and Wales. Victims not satisfied with the police figures are for financial years.

SOURCE: RF analysis of Institute for Government, Performance Tracker; ONS, Crime Survey for England and Wales; NHS England, monthly RTT data collection.

The Government's decision to increase RDEL by £23 billion in 2024-25 and £37 billion in 2025-26 (2024-25 prices), followed by slower increases for the remainder of the

⁹ A Pike & J Shaw, Townscapes: Mapping the gaps – the geography of local authority financial distress in England, October 2024.

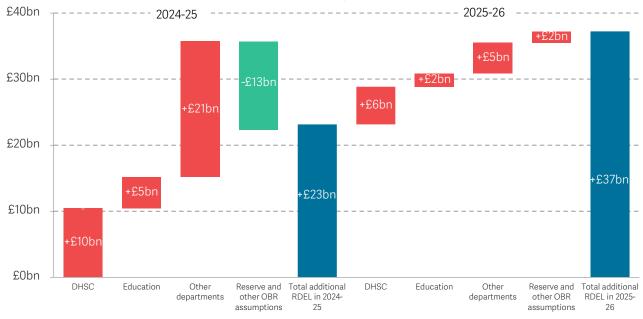
L Hughes, Satisfaction with UK public services sees sharp drop since 2021, Financial Times, June 2024.
 R Reeves, <u>Autumn Budget 2024 speech</u>, HM Treasury, October 2024. See also: NHS England, <u>Referral to treatment</u>, accessed 31 October 2024.

Parliament, follows a very different pattern to that seen in the early days of the New Labour Government from 1997 onwards, when spending top-ups started slowly and then picked up. This approach is at least partly born out of necessity: the projected 2024-25 overspend of £22 billion revealed by the Chancellor in July is already putting pressure on the public finances, with recent outturns on goods and services spending to September this year already £9.7 billion above the OBR's March forecasts.¹²

The new Government has also decided to continue to prioritise spending on health and schools. As shown in Figure 9, just less than 30 per cent of the additional policy spending in 2024- 25 – worth £10 billion in total – has been allocated to the Department of Health and Social Care (DHSC). And between 2024-25 and 2025-26, health spending is set to grow by a further £6 billion, leaving 40 per cent of the real boost to day-to-day public service spending between 2023-24 and 2025-26 in the form of higher health spending. The result is that day-to-day spending will continue to be concentrated in health in 2025-26: by 2025-26, 42 per cent of RDEL spending went to DHSC, up from 32 per cent of RDEL in 2009-10.

FIGURE 9: Spending increases in this Budget keep the state tilted towards health and education





NOTES: Reserve and other OBR assumptions include change in non-PSCE RDEL in both 2024-25, decrease at main supply estimates and change in OBR underspend assumption in 2024-25. The departmental analysis is based on the Treasury's measure of RDEL, including non-PSCE RDEL but excluding any assumptions about underspending.

SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various; HM Treasury, Budget and Spending Review documents, various.

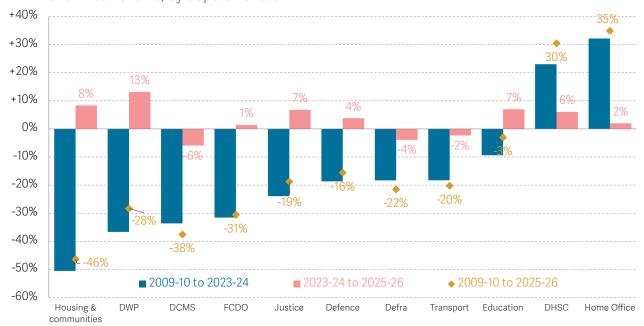
¹² RF analysis of ONS, <u>Public sector finances</u>, UK, September 2024.

Other departments will also benefit from the spending splurge announced at the Budget. Between 2023-24 and 2025-26, the Ministry of Justice will receive an additional £1.4 billion – equivalent to an increase of 7 per cent in real, per-person terms – to fund Crown Court sitting days and improved prison services. While seemingly a big increase, this is essentially emergency relief to a department that, even with this boost, will still be 19 per cent smaller per person than it was in 2009-10 (as shown in Figure 10). Similarly, the budget for the Department for Work and Pensions (DWP) will be topped up by £1.7 billion across the same period – an increase of 13 per cent. This funding has been allocated to target welfare fraud and error as well as extending the Household Support Fund in England and Discretionary Housing Payments in England and Wales. Despite this, the day-to-day DWP budget will remain 28 per cent smaller than it was pre-austerity.

However, not all departments will receive a such a top up. Take, for example, the day-to-day budget of Culture, Media and Sport (DCMS), which is down by 6 per cent in the first two years of this Parliament – bringing the cumulative decline since 2009-10 to 38 per cent. Environment, Food and Rural Affairs faces a similar fate, with a 4 per cent drop over the same period and a total decline of 22 per cent since 2009-10. And Transport budgets are set to shrink by 2 per cent, adding to a 20 per cent fall over the entire 16-year period. Even after this spending uplift, all departments apart from DHSC and the Home Office will be smaller per person than before the austerity era.

FIGURE 10: Frontloaded spending brings significant relief to many departments, but some still face real terms per person cuts

Change in real (GDP deflator-adjusted) per-person RDEL spending since 2009-10 and 2023-24 to 2025-26, by department: UK



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various; HM Treasury, Budget and Spending Review documents, various; HM Treasury, PESA Tables, various.

Despite the significant rises in RDEL in the next couple of years, spending settlements beyond that still involve cuts to unprotected departments

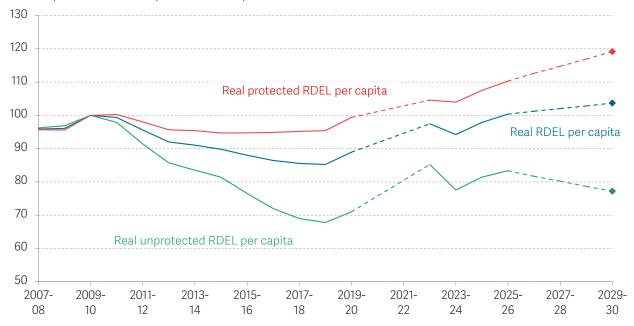
For the years after 2025-26, the Chancellor has not allocated day-to-day spending for individual departments, instead setting the stage for next year's Spending Review with an overarching RDEL envelope for the remainder of the Parliament. Between 2025-26 to 2029-30, then, the Chancellor has committed to a real-terms increase in the overall RDEL envelope of just 1.3 per cent on average each year, only slightly higher than former Chancellor Jeremy Hunt's 1 per cent annual real-terms increase in RDEL.

While this is certainly a significant improvement, an increase of this scale is not enough to completely rule out a "return to austerity". Once we account for commitments on NHS England, schools, childcare, defence and aid, this leaves spending in other 'unprotected' services – such as Culture, Media and Sport; Environment, Food and Rural Affairs; and Transport – falling by 1.1 per cent each year in real per-person terms between 2025-26 and 2029-30 (equivalent to a £10.8 billion real-terms cut by the end of the forecast). This is less than the 2.4 per cent annual real per-person fall implied by Spring Budget 2024 (equivalent to £19 billion), and from a healthier baseline. But settlements of this magnitude would clearly still be very challenging for a number of departments.¹³

Ultimately, the decision to frontload the bulk of day-to-day spending increases between 2023-24 and 2025-26 leaves the Chancellor with the unenviable job of allocating implied cuts to 'unprotected departments' at the 2025 Spending Review (set to take place in late Spring 2025).

FIGURE 11: The first Labour Budget in 15 years has resolved fiscal fictions, but 'unprotected' departments are locked in at 2015-16 levels of per-person spending, offering little room for manoeuvre

Indices of real (government expenditure deflator-adjusted) per-capita resource departmental expenditure limits (2009-10=100), all departments, 'unprotected' departments and 'protected' departments: UK



NOTES: Deflated using the OBR forecast for the GDP deflator to 2024-25 prices. Protected budgets include health, education, defence and foreign, commonwealth and development office. The health budget is assumed to grow by 3.6 per cent a year in real terms; the education budget is assumed to be flat in real terms and topped up for projected costs of childcare policies; the defence budget is assumed to grow with nominal GDP; and the foreign, commonwealth and development office budget is assumed to grow in line with 0.5 per cent of GNI. Figures include the impact of Barnett consequentials. SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various; HM Treasury, Budget and Spending Review documents, various.

Rachel Reeves' first Budget was the biggest fiscal event on record

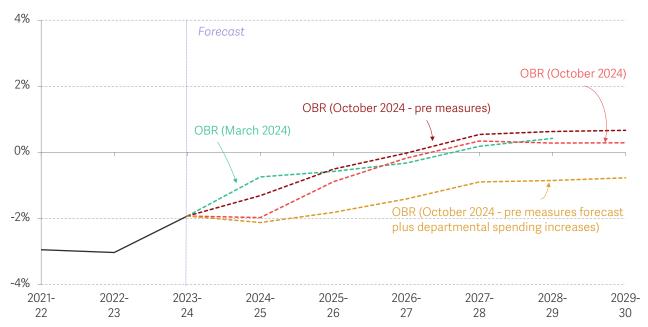
As the Government has committed to balancing day-to-day spending and taxes by 2029-30, this higher spending on day-to-day public services means tax increases. Modest improvements to the fiscal outlook from the OBR's changes to the economy forecast left the Chancellor with nearly £23 billion of headroom against this rule in 2029-30 (the dark red series in Figure 12). But the day-to-day spending plans, discussed above, more than erode this and lead to a current deficit in 2029-30 of £26 billion, breaking the Chancellor's fiscal rules (the yellow series below). As discussed below, the Chancellor has responded with a package of tax rises and some small cuts to the welfare budget. This significantly improves the current balance leaving the Chancellor with nearly £10 billion of headroom

¹⁴ This rule is set to remain binding in 2029-30 until that becomes the third year of the fiscal forecast, at which point the rule will consistently bind in the third year rolling forwards. This is a welcome move to make the fiscal rules gradually more binding over the near-term and bring them into line with the period that will be covered by detailed departmental Spending Review plans. This is particularly welcome in that it reduces the extent to which Chancellors can use spurious plans for future departmental spending in order to meet their fiscal rules, without having to provide detail of how those plans will be delivered, as was the case in the March 2024 Budget.

against the rule (the lighter red series below; see below for further discussion of fiscal headroom).

FIGURE 12: **Higher day-to-day public services spending means tax rises are required**

Public sector current balance, as a share of GDP: UK



NOTES: The yellow series above adds on cost of announcements of additional departmental spending to the pre-measures forecast, but not the additional debt interest costs associated with this spending. SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various.

It's hardly unprecedented for tax rises to be announced immediately after an election, but the net tax rise announced at this Budget was of a scale we have not seen for many years. Raising £41 billion by the end of the forecast period (2029-30), it was a bigger net tax rise than any under the last Labour government (the 2002 Budget raised around £26 billion of tax in 2029-30 terms). In fact, if we discount the combination of Jeremy Hunt's October 2022 statement and the budget of November 2022, which simply undid many of the never-implemented tax cuts announced just weeks before in the disastrous 'mini-budget', Reeves' first budget contained the biggest net tax increase on record, very narrowly surpassing Norman Lamont's post-election budget in 1993 which raised £40 billion in 2029-30 prices (see Figure 13). 15

¹⁵ Spring Budget 2021 raised far more than planned at that event or indeed in this Budget – an estimated £56 billion – when we account for the fact that announced tax threshold freeze was far more impactful than was expected at the time due to higher inflation.

FIGURE 13: £41 billion of new tax rises makes this narrowly the biggest fiscal event on record

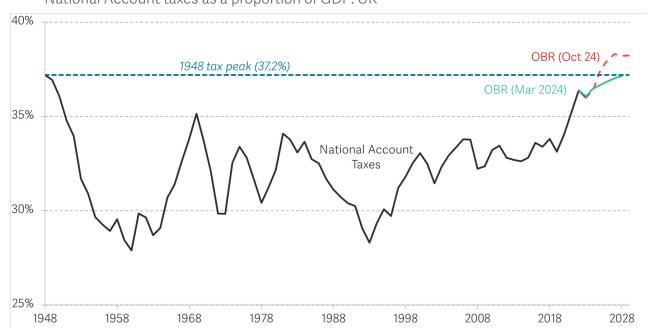
Net long-term annual impact of tax policy announcements at each fiscal event since 1992 (in 2029-30 prices): UK



NOTES: Impacts in 2029-30 prices, with past values uprated in line with nominal GDP. Based on forecasts from the time of each fiscal event (actual impacts on tax revenue may have differed). Autumn Statement and October U-turn 2022 includes mini-budget reversals and scrapping of 19 per cent rate of Income Tax. SOURCE: RF analysis of OBR, Policy measures database; HM Treasury, The Growth Plan 2022; HM Treasury, Autumn Statement 2022 Policy Decisions; HM Treasury, Autumn Budget 2024; OBR, Economic and Fiscal Outlook – October 2024.

As a result, the Budget leaves the tax-to-GDP ratio heading towards an all-time high of 38.3 per cent in 2027-28 – dropping only slightly to 38.2 per cent in 2029-30 (Figure 14). This is higher than the previous tax-to-GDP ratio peak of 37.2 per cent in 1948, and higher than the expected tax-to-GDP ratio under Jeremy Hunt of 37.1 per cent by 2028-29 (although Hunt's last budget also set the tax-to-GDP ratio on an upward trajectory). The increase in the tax-to-GDP ratio between 2024-25 to 2029-30 is equivalent to £1,800 per household on average in today's prices.

FIGURE 14: Taxes are rapidly heading to a record-high share of GDP National Account taxes as a proportion of GDP: UK



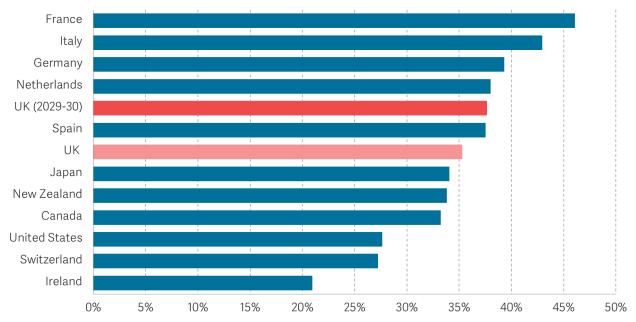
NOTES: Final data point is 2029-30.

SOURCE: OBR, Economic and Fiscal Outlook, various.

However, it is worth noting that although the UK's taxes as a proportion of GDP have now reached their highest rate on record, they are still lower than in many countries we would consider peers. Figure 16 shows taxes as a proportion of GDP in a range of OECD countries above and below the UK's relative position. When the estimated tax to GDP ratio of the UK in 2029-30 is included in this chart (38 per cent), the UK looks set to pull further away from other Anglosphere countries like Canada (33 per cent) and New Zealand (34 per cent), but still lags countries such as France (46 per cent) and Germany (39 per cent).

FIGURE 15: Despite the big tax announcements in the Budget, the UK's tax to GDP ratio likely still lags many other European countries





NOTES: Implied tax take for the UK in 2029-30 is based on the latest OBR forecast adjusted for the historical difference in outturn between the ONS and OECD since 2010. 2021 data are used for Japan and Australia.

SOURCE: OBR, Economic and Fiscal Outlook - October 2024.

Substantial tax rises were inherited from the previous Government and preannounced in the Labour Party's manifesto

Tax rises in the Budget were not unexpected, not least for the following reasons:

- The Labour Party's manifesto outlined five specific tax hikes, all of which the Government has followed through on: higher taxes for private schools; closing further 'non-dom' tax loopholes; reforming 'carried interest'; a Stamp Duty rise for non-UK residents; and extensions to the North Sea 'windfall tax'. Together these measures are expected to raise around £3 billion by 2029-30.
- The Government also outlined plans in its manifesto to combat tax non-compliance through increased HMRC funding, which the OBR estimate could raise another £6.5 billion by 2029-30.
- A number of measures were inherited from the previous Conservative Government, the largest of which was the freeze to the Income Tax and National Insurance thresholds until 2027-28.¹⁷

¹⁶ In fact, the Budget announcement went beyond this manifesto pledge and increased Stamp Duty rates on all additional property purchases.

¹⁷ For more information on why these legacy measures increase the tax-to-GDP ratio see: A Corlett, <u>Hiding in plain sight: The Government's record on taxes and the challenges ahead</u>, Resolution Foundation, June 2024.

However, the Chancellor went beyond these and announced several other significant tax measures. With her room for manoeuvre constrained by manifesto red lines which ruled out at least some increases in Corporation Tax, National Insurance, Income Tax, or VAT, the Chancellor set out reforms to employer National Insurance rates and thresholds; increases in Capital Gains Tax (CGT); adjustments to Inheritance Tax (IHT) reliefs; changes to transport taxes; and increases to a variety of other duties and levies.

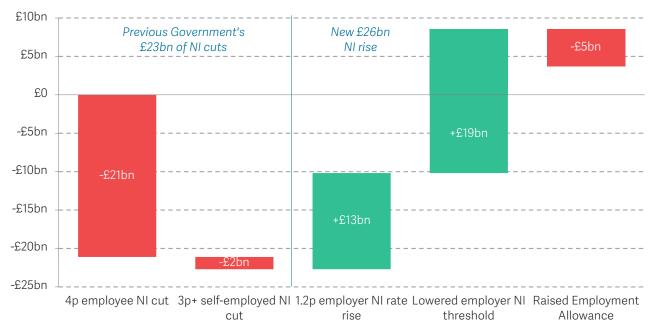
The Government has raised National Insurance for employers in an attempt to stay within its manifesto red lines

By far the biggest tax rise in the Budget was a £26 billion rise in employer NI – driven by a higher rate (rising from 13.8 to 15 per cent) and a lower threshold (falling from £9,100 to £5,000 a year per worker) but limited by an increased per-employer allowance (rising from £5,000 to £10,500 per firm).

In the broadest sense, this can be seen as offsetting the cost of the £23 billion of NI cuts made before the election, as shown in Figure 16 – with the threshold cut actually raising more than the new rate rise. The net result of the pre-election giveaway and post-election tax rise is roughly a £5 billion increase in the amount of NI being paid. The OBR estimates that total NI revenue equated to 16 per cent of economy-wide wages in 2023-24 (and more in the previous two years) but just 14.3 per cent in 2024-25: while with the new measures this will now rise back to 16.3 per cent in 2025-26.18

FIGURE 16: The £26 billion of employer NI increases can be seen as paying for the £23 billion of personal NI cuts announced over the past year





NOTES: Self-employed cut includes the end of compulsory Class 2 contributions. Division of Autumn Budget employer NI changes is based on averages over the parliament. Dynamic impacts are dominated by the impact of lower earnings on tax revenue.

SOURCE: RF analysis of OBR, Policy measures database; OBR, Economic and Fiscal Outlook, October 2024.

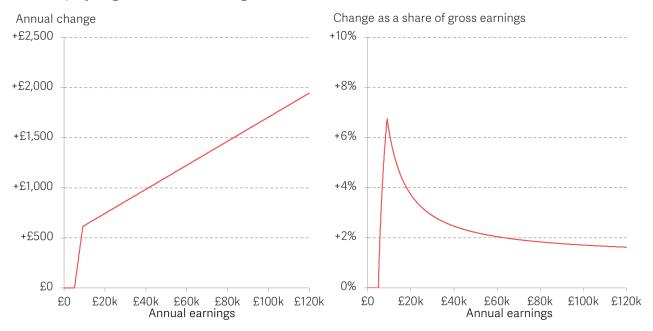
This does raise the question of whether it would have been better in theory simply to cancel the worker NI cuts. There is a strong case for that – as some of our findings below suggest – but clearly the Labour manifesto was seen to explicitly rule out a worker NI rise. There are, however, significant differences between employer NI increases and the last Government's employee NI cuts, as we explain below.

Low-paid jobs take the biggest hit from employer NI increases

Figure 17 shows the impact of the employer NI rate and threshold change, at different levels of employee earnings in 2025-26. As this makes clear, the biggest proportional increase in employer liability is for low-paid workers – a function of the secondary threshold being reduced to £5,000. These employers have had a tax rise equivalent to 6.8 per cent of pay for someone with gross annual earnings of £9,100. (It should also be noted that the Employment Allowance has been raised to £10,500 to help compensate some employers for this change; we do not show the impact of this in Figure 17). For a worker earning £30,000, employers will have a tax rise equivalent to 2.9 per cent. But at the same time, there is no threshold above the secondary NI threshold after which employer NI contributions reduce. So for employers of high earners the liability in cash terms keeps increasing: for example, employers will have a tax rise of £1,400 for an employee with a worker on £75,000.

FIGURE 17: Changes to employer NI made at this Budget are more significant than the 4p cut to National Insurance, for the most part

Change in employer National Insurance liabilities as a result of Autumn Budget 2024, by employee gross annual earnings: UK, 2025-26



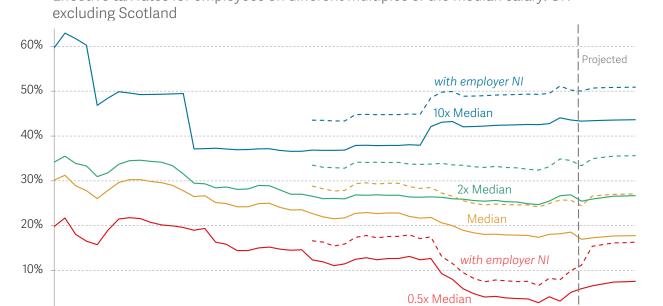
NOTES: Does not include the change to the Employment Allowance. SOURCE: RF analysis.

One good reason for this threshold change is that the existing £9,100 per worker threshold may be an unwelcome incentive for employers to provide multiple part-time roles instead of more full-time ones. A Resolution Foundation survey of employers suggested that 13 per cent of those using flexible arrangements for staff were doing so to reduce their responsibilities for employer NI or auto-enrolment. The new lower threshold will make it less worthwhile for employers to try and keep workers' pay below it, although there are large trade-offs here given that at least some of the tax rise is likely to fall on the workers themselves (as we explore in more detail later on).

The potential importance of the tax rise for low earners or their employers can also be seen reflected in Figure 18, which shows historical and projected effective tax rates at different levels of wages. Before accounting for employer NI, effective rates are not set to change dramatically – although the previous Government's personal allowance freeze plans will push up effective rates for low earners (those on only half the median salary). But when we account for employer NI, the total effective tax rate on low-earning roles will increase more dramatically to its highest since 2010: a return to the norms of the 2000s but a sharp break from those of the 2010s. This change is more dramatic than those for mid- and higher-earners, although tax rates for high-earning employees will in many cases be higher than they have been for decades.²⁰

¹⁹ H Slaughter, <u>Firm foundations: Understanding why employers use flexible contracts</u>, Resolution Foundation, April 2024. 20 A Corlett, <u>Hiding in plain sight: The Government's record on taxes and the challenges ahead</u>, Resolution Foundation, June 2024.

FIGURE 18: Employer NI increases will push up effective tax rates on wages Effective tax rates for employees on different multiples of the median salary: UK



NOTES: Dashed lines give the effective tax rates including employer NI, as a share of the total cost to the employer. For consistency, tax rates are for unmarried employees under 65 with non-volatile earnings and ignore mortgage interest and pension tax reliefs. Scottish tax differences are not included. Based on financial years. 2022 and 2023 use the tax parameters that applied in October of those years. Employer NI figures only calculated from 1999 onwards, and non-structural employer NI tax reliefs not included. SOURCE: RF analysis using median earnings figures from ASHE/NESPD and tax history from HMRC and IFS. Earnings projected using OBR, Economic and Fiscal Outlook, October 2024.

1975 1978 1981 1984 1987 1990 1993 1996 1999 2002 2005 2008 2011 2014 2017 2020 2023 2026 2029

The increase in employer NI will not be felt equally across all firms – both because of the differences by level of pay and because of the increased, per-employer Employment Allowance. The OBR notes that 250,000 employers will actually gain from this package, while 820,000 will see no change – leaving 940,000 who will lose out. This extra tax bias (on top of many others) towards small employers is not warranted on grounds of efficiency.²¹

Employer NI changes have worsened the bias against wages in tax system, despite welcome – if limited – CGT reform

Another unwelcome feature of the employer NI rise is that no change has been made to the treatment of employer pension contributions. Consideration was reportedly given to applying employer NI to these contributions, but instead the new NI rise further increases the value of pension NI relief and the bias towards employer contributions. This increase in incentive perhaps only highlights the complaint that this tax relief is opaque and more accidental than designed.²²

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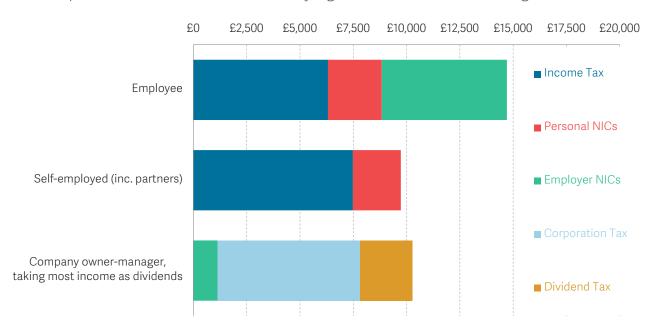
²¹ Resolution Foundation & Centre for Economic Performance, LSE, <u>Ending Stagnation: A New Economic Strategy for Britain</u>, Resolution Foundation, December 2023.

²² S Adam et al., A blueprint for a better tax treatment of pensions, IFS, February 2023.

Moreover, a tax increase on wages alone further worsens the tax system's biases against this income. In 2023-24, the self-employed paid £6 billion less than if this income had been taxed equivalently to wages.²³ This gap is now set to grow. Comparing workers with the same productivity, Figure 19 shows the big tax differences that will persist between alternative employment structures. The total tax due on £50,000 of work is now £5,000 higher for an employee (at £15,000) than for a self-employed worker (at £10,000), and also over £4,000 higher than for a personal company owner-manager. These arbitrary differences push people to structure their affairs to minimise tax rather than maximise productivity.

FIGURE 19: Someone with self-employed profits of £50,000 will now be taxed £5,000 a year less than if they did the same work as an employee

Tax paid on £50,000 of market income, by legal form, 2025-26: UK excluding Scotland



NOTES: Employee salary is around £44,000 given the impact of employer NI. Pension contributions are not modelled. Example company owner-managers pay themselves a salary equal to the personal allowance. Profits are taxed at the small profits rate of 19 per cent. SOURCE: RF analysis.

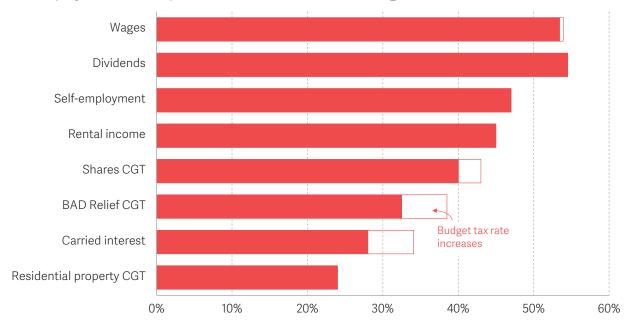
These considerations should not necessarily dominate how we assess a rise in employer NI to help fund public services. But these exacerbated differences only add to the need for future efficiency and fairness-driven reform.

The Budget's CGT reforms did reduce some gaps in the tax treatment of different forms of income, as Figure 20 shows. The generosity of 'BAD Relief' and the carried interest tax arrangement are being notably reduced. But these reforms are a far cry from the comprehensive changes to CGT and other forms of income taxation – i.e. much closer

alignment of rates – that might be considered both economically optimal and fairest to employees.²⁴ Academic work has suggested that comprehensive CGT reform could raise substantially more revenue than this Budget has done, with the majority of this coming from the richest 0.1 per cent.²⁵

FIGURE 20: Increases in CGT rates have narrowed some gaps in the tax treatment of different income sources, although taxes on wages have also risen

Top marginal tax rates before and after Autumn Budget 2024 changes, including employer NI and Corporation Tax, 2026-27: UK excluding Scotland



NOTES: Tax rates for additional rate payers. Wage rates account for employer NI, i.e. total tax as a share of the total cost to the employer. Dividend and share CGT rates account for Corporation Tax, assuming a 25 per cent Corporation Tax rate. BAD Relief = Business Asset Disposal Relief. SOURCE: RF analysis.

We must assume that employer NI increases will primarily fall on workers

Of course, an important question is who will ultimately pay the bill for higher employer NI. The OBR assume that the rise will primarily be felt through lower nominal wages, with smaller contributions from higher prices and lower profits – and that total hours and employment will be slightly reduced. These considerations are explored in Box 4.

This also matters for the actual revenue impact. Although the employer NI increases are a headline tax rise of £26 billion in 2029-30, the OBR's modelling assesses that lower wages and other impacts will lead to £10 billion of this being lost through lower personal taxes and other factors, while £6 billion (on paper) is being set aside to refund public sector employers (as also happened in 2021 with the aborted Health and Social Care Levy).

²⁴ M Broome, A Corlett & G Thwaites, <u>Tax planning: How to match higher taxes with better taxes</u>, Resolution Foundation, June 2023.

BOX 4: Who ultimately pays employer NI?

The single biggest tax rise announced yesterday, by far, was the increase in employer NI. So the question of who ultimately pays this tax is important for any assessment of the macroeconomic or distributional impact of this Budget.

A simple benchmark would suggest that employers decide how much they can afford to pay an employee inclusive of payroll taxes, so an increase in taxes just pushes wages down. Alternatively, employers could raise prices to pay the extra tax. But either way, workers would end up paying the payroll tax. Lower post-tax wages might in turn affect labour supply, either boosting it if workers feel poorer and work more, or reducing it if workers react more strongly to the lower benefit of working an extra hour. Early evidence from employer NI reforms in 1999 bore this out, finding that tax increases reduced nominal wages, increased prices and potentially lowered working hours.²⁶

However, more recent evidence suggests a complex picture. Payroll tax cuts in Sweden and increases in Greece, both for younger workers, did not appear to affect their relative wages. Instead, the cost was absorbed by employers or spread more evenly among their workers.²⁷ This suggests that the impact on workers of the announced tax increase, expected to be largest for jobs paying between the old £9,100 and new £5,000 threshold, may in practice be shared by workers throughout the firm. Low-paying firms will be hit harder; if this shifts employment towards high-wage firms, then this could boost wider economic growth.²⁸

The National Living Wage will, on the face of it, protect the lowest hourly paid workers from wage cuts. However, the payroll tax cut in Sweden had a particularly big effect on low-wage jobs, suggesting that the minimum wage there had previously been reducing employment.²⁹ The Budget's Employer NI increases represent a 3.2 per cent rise in the cost of paying someone the National Living Wage for 35 hours per week (but without the worker benefiting from this).³⁰ Over time, the Low Pay Commission may factor higher employer NI into its calculation of what employers can afford, and higher payroll taxes will push down on the median wage against which the National Living

²⁶ B Bell, J Jones & J Thomas, <u>Estimating the impact of changes in employers' National Insurance Contributions on wages, prices and employment</u>, Bank of England, December 2002.

²⁷ Y Benartzi, <u>Tax Incidence Anomalies</u>, NBER working paper 32819, August 2024 and D Carloni, <u>Revisiting the Extent to Which Payroll Taxes Are Passed Through to Employees</u>, Congressional Budget Office, June 2021.

²⁸ R Branyiczki et al., Firm heterogeneity and the impact of payroll taxes, IFS, November 2022.

²⁹ For one empirical example see: S Daunfeldt, A Gidehag & H Seerar Westerberg, Does reduced labor costs increase employment among minimum wage workers? Evidence from a Swedish payroll tax cut, HFI Working Papers 26, Institute of Retail Economics (Handelns Forskningsinstitut), 2023.

³⁰ Labour cost

Wage is referenced, such that low-paid workers could also end up effectively paying a large part of the tax.

Consistent with this nuanced picture, the OBR's treatment of employer NI has been evolving. In 2021, the OBR assumed that the increase in employer NI (as part of the Health and Social Care Levy) would fall entirely on real wages (i.e. on workers) in the medium term, primarily through lower nominal pay growth but with 20 per cent of the impact coming through higher prices. This time around, the OBR has judged

that three-quarters of the tax will show up in lower real wages, with the rest in lower profits. Lower wages and profits mean lower labour supply and demand respectively, pushing potential GDP down by 0.1 per cent.

Overall, while some firms' profits will take a hit, workers will pay the lion's share of this tax increase, through lower wages, higher prices and slightly fewer jobs or hours (and we show later how this will impact household income if it leads to lower earnings).

The Chancellor made welcome changes to Inheritance Tax

The Chancellor announced changes to Inheritance Tax (IHT) that are expected to raise £2.5 billion by 2029-30. These changes include: charging IHT on pension pots transferred at death; limits to Agricultural and Business Reliefs; and extending the freeze in nil-rate bands to 2029-30. These changes will contribute to a rise in the proportion of deaths subject to IHT over the forecast period, from 5.2 per cent in 2023-24 to 9.5 cent in 2029-30. But this means that over 90 per cent of deaths will continue to attract no Inheritance Tax, and the effective tax rate on inheritances is likely to remain low. For instance, in 2019-20 the effective tax rate was 3.8 per cent; the new IHT reforms would have increased this to 4.5 per cent in that year.

The Chancellor's reforms to IHT are a positive step. Business Relief and Agricultural Relief have both previously allowed relevant assets to be transferred entirely free of IHT³², significantly contributing to 'horizontal inequity', whereby estates with similar wealth levels faced different effective tax rates.³³ However, from April 2026, a £1 million cap will apply jointly to assets claimed under these reliefs (on top of existing nil-rate bands), with a reduced 50 per cent relief applied to amounts above this threshold. The government will also reduce the rate of Business Relief available from 100 per cent to 50 per cent for shares designated as "not listed" on the markets of recognised stock exchanges, such as AIM.

³¹ OBR, Economic and fiscal outlook - October 2024, October 2024.

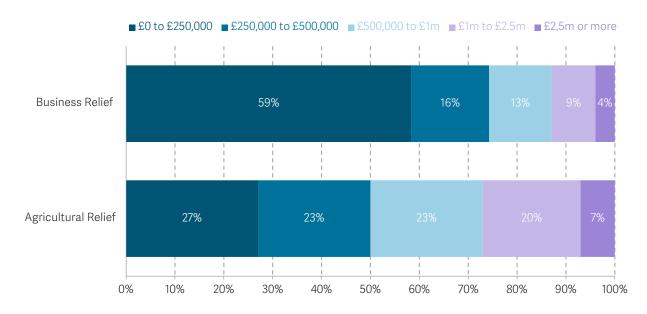
³² The argument for these reliefs was that it might be harmful if family-owned businesses and farms needed to be broken up at the owner's death in order to provide the liquidity to pay IHT. But the economic case here is not strong. For more information see: OECD, Inheritance Taxation in OECD Countries, May 2021; A Advani et al., Inheritance Tax reliefs: Time for reform?, Centre for the Analysis of Taxation, October 2024.

³³ A Advani et al., Inheritance Tax reliefs: Time for reform?, Centre for the Analysis of Taxation, October 2024.

These changes are projected to raise £0.5 billion by 2029-30, with the impact expected to be concentrated among a limited number of estates. In 2021-22, for example, only around 1,173 estates claimed Agricultural Relief, and 4,140 claimed Business Relief. Within these, 117 estates claiming over £2.5 million of Agricultural Relief (on top of nil-rate bands) accounted for 40 per cent of its cost, while 53 per cent of Business Relief's cost was accounted for by 158 estates.³⁴ As shown in Figure 21, data for 2021-22 suggests that a cap of £1 million would only affect around 13 per cent of Business Relief claims and 27 per cent of Agricultural Relief claims. Furthermore, half of English farms have a net worth of under £1.5 million – implying that the majority may be entirely tax-free under the existing nil-rate bands plus the additional £1 million cap.³⁵

FIGURE 21: Reforms to Agricultural and Business Relief would only affect a small number of estates

Proportion of total claims for Agricultural Relief and Business Relief, by banded value of assets qualifying for relief: UK, 2021-22



SOURCE: RF analysis of HMRC data.

Another welcome change was the removal of the IHT exemption on pension pots. Previously, inherited pension pots were not subject to IHT. This created a perverse incentive for people to run down their other assets first while leaving pension pots as vehicles for bequests: which is not the intended use of our pension systems. Putting pension pots within the scope of IHT is a welcome reform, expected to raise £1.5 billion in 2029-30. And the revenue from this change is anticipated to increase over time, for two reasons. First, as shown in Figure 22, there is a growing value of inheritable

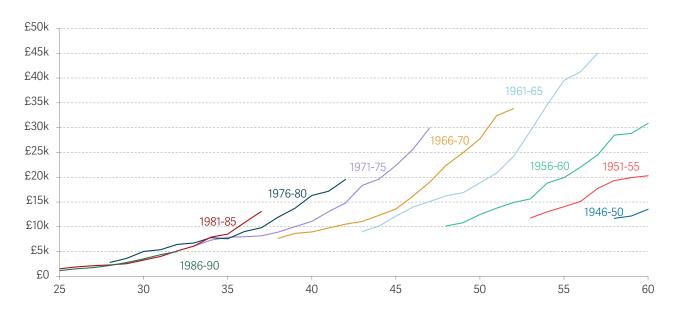
³⁴ HM Treasury, Summary of reforms to agricultural property relief and business property relief, October 2024.

³⁵ Defra, Balance sheet analysis and farming performance, England 2022/23, September 2024.

pension wealth across successive cohorts. Second, while deaths during the medium-term forecast period will be more weighted towards those who converted their Defined Contribution (DC) pension wealth into annuities, over the long term this will shift toward those who retired after the pension freedoms reforms, where most have chosen not to purchase an annuity.³⁶

FIGURE 22: The revenue raised from the IHT changes announced today will increase over time as each cohort accumulates more inheritable pension wealth

Mean defined contribution pension wealth, by age and cohort: GB, 2006-08 to 2018-20



NOTES: Data adjusted to July 2024 prices using CPIH. SOURCE: RF analysis of ONS, Wealth and Assets Survey.

The Chancellor made several changes to transport taxes, with mixed effects on households

Transport taxes were a big feature of this Budget. The Chancellor made seven changes to car and plane taxes, amounting to £6.9 billion of cuts and £5.5 billion of rises over the Parliament.³⁷ The biggest was the decision to follow the practice of the previous Governments for the last 13 years and leave the 'Fuel Duty freeze' in place for another year, at a cost of £3 billion in 2025-26. This will further erode the tax cost of driving, which has already declined by 38 per cent in real terms since 2010.³⁸ Indeed, inflation since 2022 means that the real value of Fuel Duty is currently around 8p per litre lower than

³⁶ FCA, Retirement income market data 2023/24, September 2024.

³⁷ As well as the changes to Fuel Duty, Air Passenger Duty and Vehicle Excise Duty discussed in this note, the Chancellor also announced two changes to Company Car Tax, capital allowances for business spending on electric vehicles, and a change to the way Van Benefit Charge is uprated.

³⁸ RF analysis of HM Revenue & Customs, Historical hydrocarbon oils duty rates, July 2024.

it was even after Rishi Sunak first brought in the emergency 5p reduction, and it would have remained lower even with future scheduled increases. This is also bad news for the climate: petrol and diesel drivers are not incentivised to drive less, while the incentive to switch to an electric vehicle to avoid Fuel Duty is weakened.

To offset this – for the Exchequer and the environment – the Chancellor has increased the cost of flying and buying non-electric cars. The changes to Air Passenger Duty (APD) will bring in £0.7 billion by 2029-30, a modest rise equivalent to 17 per cent of 2024-25 levels. The 50 per cent rise in APD rates on private jets will attract attention, but the bulk of the revenue rise comes from the increases to reduced and standard rates. Vehicle Excise Duty will go up substantially for most new car buyers, and to levels that should drive cleaner purchasing decisions. The median increase on a new car will be £220, but the increase on the most-polluting cars will be up to £2,745, representing a substantial disincentive to opt for one of these vehicles.

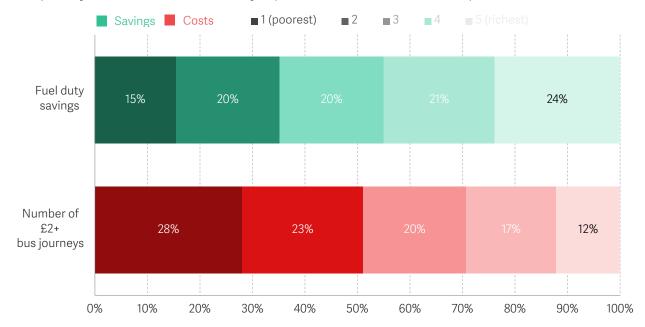
The changes will have varied distributional effects. Higher duties on flights will be borne mostly by richer frequent flyers. Lower-income households mainly buy cars second hand so should be mostly sheltered from taxes on new non-electric cars.³⁹ However, the benefits of the cuts to Fuel Duty will flow mostly to richer households, who own more cars and drive them further.⁴⁰ The Chancellor's decision to prioritise further cuts in the cost of petrol and diesel use is particularly disappointing when the Budget also includes rises in public transport costs: regulated rail fares are set to rise 4.6 per cent next year, and some bus fares will go up as the £2 bus fare cap (due to expire at the end of the year) is replaced by a higher cap of £3. As Figure 23 shows, Fuel Duty savings will be disproportionately captured by higher-income households, but it is the poorest who suffer most from higher bus fares.

³⁹ The poorest 40 per cent of households account for just 13 per cent of spending on new cars. Source: RF analysis of Living Costs and Food Survey.

⁴⁰ More than three times as many households in the lowest income quintile lack ready access to a car than in the top. For more, see: A Corlett, Z Leather & J Marshall, Getting the green light: The path to a fair transition for the transport sector, Resolution Foundation, October 2024

FIGURE 23: The richest will benefit from freezing Fuel Duty the most and notice bus fares rises the least

Proportion of bus journeys over £2 taken by people (England, 2019-2022), and Fuel Duty paid by households (UK, 2022), by equivalised household income quintile



NOTES: All bus journeys between £2 and £15 are included. Excludes journeys in London, which are covered by a separate fare cap, but includes journeys in Greater Manchester and West Yorkshire that are also covered by other fare caps.

SOURCE: RF analysis of ONS, Effects of taxes and benefits on household income; DfT, National Travel Survey.

Overall, given the Government's spending choices and the self-imposed constraints of its manifesto pledges, the Chancellor had little choice but to raise revenues in something like the way she did. In so doing she has reduced distortions in some places, such as IHT. But she has increased other distortions (such as the self-employment bias), set back the transition towards electric vehicles and public transport, and her measures will reduce post-tax wages in the medium run in much the same way that a rise in Income Tax or employee NI would have.

This Budget was as notable for the benefit rules it did not change as for those that it did

The Chancellor confirmed two key cuts to benefits to help balance the books

Alongside a very significant package of tax rises, the Chancellor also made cuts to some benefits in the Budget to meet the current balance rule. Despite the controversy when first announced, the Government has proceeded with its plans to means-test Winter Fuel Payments (WFP), paying the benefit only to those on Pension Credit (PC) from October 2024 onwards. This decision means that 7 million pensioner families have lost between

£200 to £300 this winter, saving the Government £1.4 billion in 2024-25, a figure that rises to £1.7 billion by the end of the forecast period in 2029-30.41

The Chancellor also confirmed that the Government will make changes to the Work Capability Assessment (WCA), achieving similar levels of savings to the Exchequer as the WCA reforms announced by Jeremy Hunt in the 2023 Autumn Statement. The WCA acts as a gateway for those who are out of work because of long-term sickness or disability to access additional financial support via Employment Support Allowance (ESA) or its equivalent in Universal Credit (UC).⁴² Under the previous Government's plans, from September 2025 the rules governing these decisions were to be tightened considerably, affecting those with mobility or mental health problems. As a result, at least 420,000 claimants were due to lose this additional support, saving the Government £2.0 billion by 2029-30.⁴³

Regardless of how exactly the current Government implements these reforms to the WCA, if their total savings are to match those of the previous plan, they will inevitably have a downward effect on the incomes of many low-income families. ⁴⁴ As Figure 24 shows, both the WFP cut and changes to the WCA will hit those from lower-income families hardest. Indeed, by 2029-30, those in the lower half of the income distribution will lose, on average, £140 per year (in 2024-25 prices), whereas those in the upper half of the income distribution lose £80 per year.

⁴¹ For further details, see: A Clegg & J Marshall, <u>Cold comfort: Mitigating the Winter Fuel Payment cut</u>, Resolution Foundation, October 2024. When modelling the impact of means-testing Winter Fuel Payments, we assume there is a 5-percentage-point increase in Pension Credit take-up, in line with OBR assumptions.

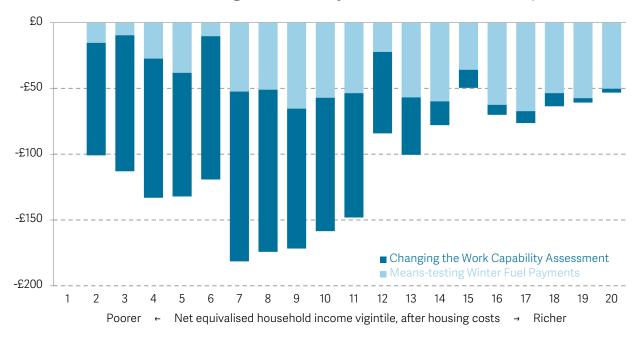
⁴² The WCA also sets the conditions that claimants need to meet to receive the benefit. There are three possible outcomes to a WCA: a decision that the claimant has 'limited capability for work-related activity' (LCWRA), which results in an additional award and no job-seeking conditions; has limited capability to work (LCW), which does not result in an additional award but does reduce work-search requirements; or a 'fail' decision meaning the claimant is treated as equivalent to other job-seekers.

⁴³ Estimates for the number of claimants affected are only available up to 2028-29. Department for Work and Pensions, Work Capability Assessment Reform: update to estimated number of claimants affected, April 2024.

⁴⁴ The changes announced in the 2023 Autumn Statement are included in full in the OBR forecasts. However, the latest OBR EFO does state that: "The Government is considering changes to the delivery of reforms to Work Capability Assessments which were announced at Autumn Statement 2023, including through fundamental reforms of the health and disability benefits system early next year. Savings related to the reforms, which are due to take effect from 2025-26 are reflected in our forecast, and we will incorporate the impacts of any further reform once they are sufficiently certain."

FIGURE 24: The changes to Winter Fuel Payments and the Work Capability Assessment disproportionately affect families in the lower half of the income distribution

Estimated change in annual income as a result of changing the Work Capability Assessment and means-testing Winter Fuel Payments: UK, 2029-30 (2024-25 prices)



NOTES: 'Means-testing Winter Fuel Payments' modelling assumes a 5-percentage-point rise in take-up of Pension Credit, as per OBR estimates. We show the change in unequivalised household income per person after housing costs. People are sorted into income vigintiles by equivalised household income after housing costs, before any policy changes. We exclude the bottom 5 per cent, due to concerns about the reliability of data for this group.

SOURCE: RF analysis of DWP, Family Resources Survey, using the IPPR tax-benefit model.

The benefit cuts vastly outweigh the benefit 'giveaways' in the Budget

Alongside these benefit cuts, yesterday's Budget also included some benefit 'giveaways'. These were:

- £1 billion in 2025-26 for the Household Support Fund and Discretionary Housing Payments. This is key funding for local authority-administered discretionary support, enabling councils to continue providing support for residents in crisis and to mitigate some of the sharpest edges of the benefit system. The 12-month extension of the Household Support Fund is an improvement on recent extension packages lasting six months, as it gives councils more time to plan the delivery of their schemes, but a permanent funding settlement would be preferable.
- Introducing a new 'Fair Repayment Rate' by reducing the amount of debt deductions that can be taken from Universal Credit payments. The maximum deduction will be reduced from 25 per cent to 15 per cent of a family's standard allowance. This is set to affect 1.2 million families whose Universal Credit income

will be £420 per year higher on average as a result. But this is not a straightforward giveaway, as families will pay back the same debts over a longer period. As such, this change is not expected to cost the Government any additional money.

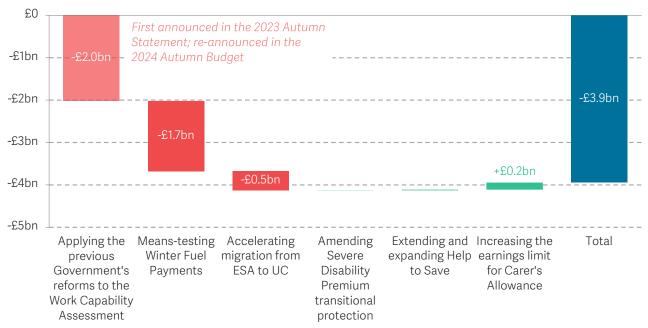
- Increasing the earnings limit for Carer's Allowance. The Government announced that an additional 60,000 carers will become eligible for Carer's Allowance between 2025 and 2030, as the weekly earnings limit used to determine eligibility for this benefit has been increased from the equivalent of 13 hours per week at the National Living Wage, up to 16 hours (an increase of around £45 per week). This change will cost £166 million in 2029-30.
- Ahead of the Get Britain Working White Paper which is due later in the autumn, the Government announced £240 million of investment for employment support 'trailblazers' in local areas, to trial new ways of getting people back into work.

But as Figure 25 shows, these benefit 'giveaways' are vastly outweighed by the benefit cuts. Combined, changing the Work Capability Assessment and means-testing Winter Fuel Payments (as well as accelerating the migration of claimants from ESA onto UC) will reduce the welfare bill by £4.1 billion by 2029-30, whereas the benefit increases amount to an overall rise of just £0.2 billion. Overall, these changes amount to a net welfare cut of £3.9 billion in 2029-30.

⁴⁵ Although welcome, this change does not fix the central problem with Carer's Allowance: there is a 'cliff-edge' in entitlement, meaning that carers lose all support (or accrue overpayments) if they earn even £1 more than the earnings limit. The Government has launched a review into this issue, led by Liz Sayce OBE; see: Department for Work and Pensions, <u>Government to launch independent review into Carer's Allowance overpayments</u>, October 2024.

FIGURE 25: The benefit 'giveaways' announced in the Autumn Budget are vastly outweighed by the takeaways

Annual cost and savings from benefit changes announced in the 2024 Autumn Budget: UK, 2029-30



NOTES: Excludes measures focused on fraud and error; these amount to a £3.5 billion reduction in spending in 2029-30. Excludes spending on enhancing Pension Credit take-up for new Housing Benefit claimants and extending the Universal Credit surplus earnings threshold for one year, since these policies do not impact spending in 2029-30. Changes shown in 2029-30 prices.

SOURCE: RF analysis of HMT, Table 5.1 Autumn Budget 2024 Policy Decisions; HMT, Table 5.2 Measures announced at Spring Budget 2024 or earlier that will take effect from October 2024 or later.

The Chancellor chose not to repeal some of the most poverty-producing benefit rules, leaving the pressure on lower-income families to build

This Budget was just as notable for the changes to the benefit system that the Chancellor chose not to make as for those that she did. There have been a multitude of changes to working-age benefit rules over the last 15 years, but three have had a particularly dire effect on the living standards of the poorest UK households: the benefit cap, the two-child limit and the on-and-off-again freezing of the Local Housing Allowance (LHA). These policies break the link between families' circumstances and benefit entitlements, and therefore have a particularly high impact on poverty rates.⁴⁶

But despite extensive evidence showing that these three policies have extremely negative effects on the living standards of already low-income families, the Chancellor has left the benefit cap and the two-child limit in place at least for the remainder of this fiscal year, while the LHA remains assumed frozen from April 2025. The Government has committed to developing a Child Poverty Strategy, slated to be published in Spring 2025,

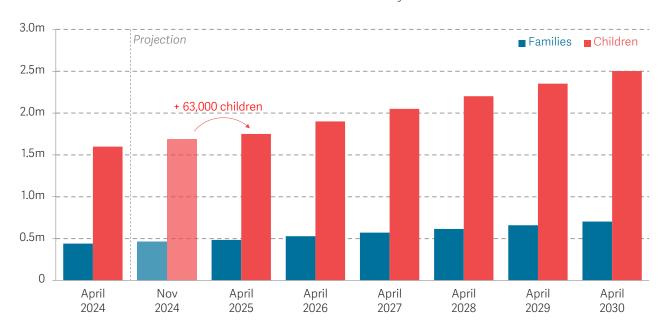
⁴⁶ For more detail on the benefit cap and two-child limit, see: L Try, <u>Catastrophic caps: An analysis of the impact of the two-child limit and the benefit cap</u>, Resolution Foundation, January 2024. For more detail on LHA uprating, see: A Clegg, <u>A temporary thaw: An analysis of Local Housing Allowance uprating over time</u>, Resolution Foundation, December 2023.

and given the two-child limit's clear link to child poverty rates, it is difficult to envision this policy at least surviving for long after this strategy has been outlined. Added to this, failing to repeal the benefit cap at the same time would significantly blunt the poverty-reducing effect of scrapping the two-child limit given that many families who would no longer affected by the latter policy would be at risk of being capped by the former.⁴⁷

But leaving the two-child limit and the benefit cap intact even for the next five months prolongs the burden on low-income families already hit by the policies and intensifies the effect as new families are affected too. Even if the two-child limit were removed from April 2025, following the publication of the Government's Child Poverty Strategy, we estimate that an additional 63,000 children will become affected by the policy from now until that date (see Figure 26), a number that only rises each day the policy remains in place.

FIGURE 26: The number of families and children affected by the two-child limit continues to increase over time





NOTES: Assumes the numbers affected by the two-child limit increases in line with the average rate of increase between April 2021 and April 2024. Children includes all children in affected families. SOURCE: RF analysis of DWP, Universal Credit and Child Tax Credit claimants: statistics related to the policy to provide support for a maximum of two children.

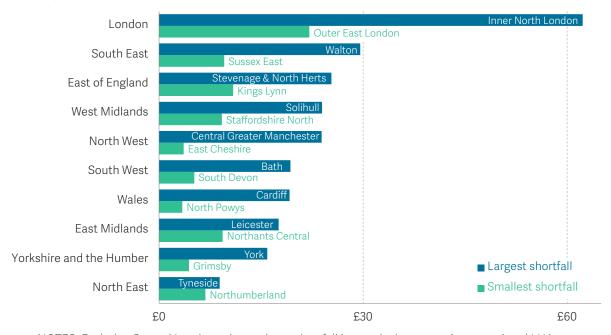
Maintaining the freeze to the LHA will also have a growing impact over time, as any rent increases are not matched by increased housing support for families whose rents are higher than the local limit. Moreover, the LHA freeze has vastly different impacts geographically as private rent growth is uneven across the country. We estimate that the

⁴⁷ L Try, Catastrophic caps: An analysis of the impact of the two-child limit and the benefit cap, Resolution Foundation, January 2024.

average shortfall between the 30th percentile of rents and the LHA in each Broad Rental Market Area today is £14 per week, but with significant differences across the country and even within regions (see Figure 27). The highest shortfalls in London are now more than £60 per week, for instance, compared with £24 in the North West, £18 in the East Midlands, and just £9 in the North East. These gaps will continue to grow should the LHA remain frozen in the next fiscal year, whereas scrapping the two-child limit, the benefit cap and unfreezing the LHA in April 2025 would immediately lift around 1 million people, including 600,000 children, out of relative poverty.⁴⁸

FIGURE 27: Shortfalls between local rents and the Local Housing Allowance vary greatly across the country

Estimated largest and smallest weekly shortfall between private rents at the 30th percentile and the Local Housing Allowance, by BRMA and region: England and Wales, September 2024



NOTES: Excludes Central London, where a large shortfall is mostly due to maximum national LHA caps, rather than the freeze. Assumes that 30th percentile rents for two-bedroom properties grow in line with the BRMA average.

SOURCE: RF analysis of ONS, Price Index of Private Rents; Valuations Office Agency, LHA rates.

Higher taxes to improve public services come at the price of tepid income growth this Parliament

The tax and benefit policies announced at the Autumn Budget will dampen incomes across the distribution, which the Government is presumably hoping the public will accept as a trade-off for the (progressive) increase in investment in public services. Figure 28 shows the impact on household income of changes to regular taxes and benefits announced in the Autumn Budget. These include the pass-through to wages

⁴⁸ A Clegg & A Corlett, The Living Standards Outlook 2024, Resolution Foundation, August 2024.

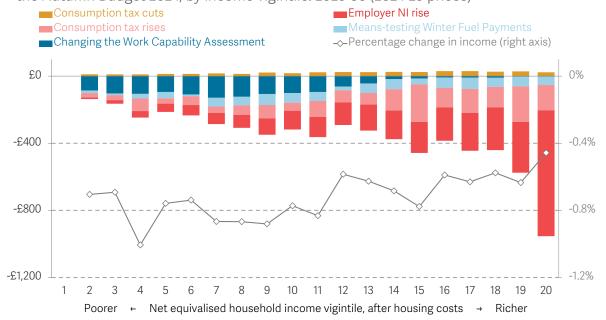
from the rise in employer NI (as discussed in Box 4), losses from increased consumption taxes on private school fees, flying, vehicles, tobacco and soft drinks (as well as gains from cuts to fuel and alcohol duties), and the previously announced cuts to Winter Fuel Payments and changes to the Work Capability Assessment. In total, the tax changes included in this analysis account for two-thirds (£28 billion) of the total £41 billion in tax rises announced at the Budget. (We do not include rises in Capital Gains Tax and Inheritance Tax as they are taxes on wealth transfers rather than regular incomes, and because of difficulties in determining precisely where in the income distribution they fall.)

As Figure 28 shows, the combined impact of benefit cuts, employer NI rises and consumption tax changes hits richer and poorer households relatively evenly: households in the bottom half of the income distribution will face a 0.8 per cent reduction in their annual income on average, compared with a 0.6 per cent fall for households in the top half of the income distribution. However, increases to Capital Gains and Inheritance Taxes are more progressive, meaning that richer households will face the largest cash impact overall.⁴⁹

⁴⁹ The shape of our distributional analysis looks different from that published by HM Treasury as we include the impact of the pass-through to earnings from the employer National Insurance rise, and we do not include the impact of benefits in kind from public services. See: HM Treasury, Impact on households: distributional analysis to accompany Autumn Budget 2024, October 2024.

FIGURE 28: Changes to regular tax and benefits announced at the budget have a negative effect on incomes across the distribution

Change in annual income as a result of tax and benefit policy changes announced at the Autumn Budget 2024, by income vigintile: 2029-30 (2024-25 prices)



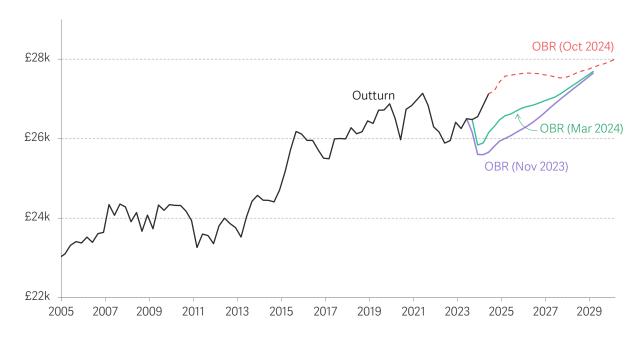
NOTES: Consumption tax rises include tobacco and vaping duties, Vehicle Excise Duty, air passenger duty (APD) and private school taxes. Consumption tax cuts include fuel and alcohol duties. 'Means-testing Winter Fuel Payments' modelling assumes a 5-percentage-point rise in take-up of Pension Credit, as per Government estimates. We assume a 0.5 per cent decrease in earnings as a result of the rise to employer NI, in line with OBR assumptions. Shows change in unequivalised household income per person after housing costs. People are sorted into income vigintiles by equivalised household income after housing costs, before any policy changes. We exclude the bottom 5 per cent, due to concerns about the reliability of data for this group.

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

These tax and benefit changes – combined with the weak earnings growth discussed earlier in the document – leave future income growth looking relatively modest next year, and sluggish from then on. Indeed, the outlook for living standards looks weaker than the OBR projected in March 2024, with real household disposable income (RHDI) per person set to increase slightly (up 1.5 per cent) between 2024 and 2025, compared to a projected increase of 1.7 per cent in the March 2024 forecast. Notably, the living standards outlook later in the forecast period has been revised down more significantly. This is shown clearly in Figure 29. In March, the OBR projected RHDI per person to grow by 1.3 per cent between 2027 and 2028 – but in its latest set of forecasts, the OBR projected RHDI per person to grow by just 0.4 per cent during this period (and then to grow by only 0.7 per cent between 2028 and 2019).

FIGURE 29: The forecast rate of growth in real household disposable income has been revised down since March

Average Real Household Disposable Income per person, in 2024-25 prices: UK

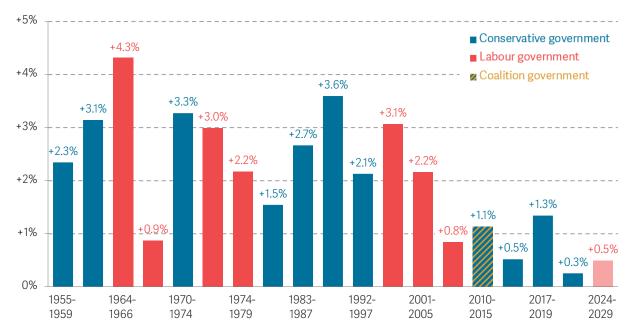


NOTES: Includes non-profit institutions serving households (NPISH). SOURCE: ONS, UK Economic Accounts; OBR, Economic and Fiscal Outlook, various.

Some might view any income growth as a cause for celebration, since the last Parliament remains the worst since at least the 1950s for living standards improvements. As Figure 30 shows, RHDI per person rose by an average of just 0.3 per cent a year during the 2019-2024 Parliament. But the forecast for this Parliament is not much better: RHDI is set to rise by 0.5 per cent a year across this Parliament, equating to a total income gain of £700 per person between the 2024 and 2029 elections (in 2024-25 prices). This projected income growth is a far cry from the living standards increases that were experienced during the last Labour Government, during which even the worst term for living standards (the 2005-2010 Parliament) recorded 0.8 per cent annual growth. When we look across the entire period of the last Labour Government (between 1997-2010), RHDI rose by a relatively strong 1.9 per cent on an annualised basis – equating to an overall income boost of £5,400 per person – even though this period of government included the financial crisis.

FIGURE 30: Household income growth is set to be the second worst in recent history – and well below that of the last Labour Government

Annualised growth in average Real Household Disposable Income per person, by Parliament: UK



NOTES: Includes non-profit institutions serving households (NPISH). Based on election dates and quarterly data.

SOURCE: ONS, UK Economic Accounts; OBR, Economic and Fiscal Outlook, various.

That said, this historically tepid projected real income growth over the course of the Parliament needs to be seen in the broader context. Given its inheritance, the Government presumably felt that increasing taxes to better fund day-to-day public services was the priority, even if that put downward pressure on incomes directly or, in the case of the employer NI rise, indirectly through the second-order earnings and employment effects. In this respect, the Government has clearly gambled on the hope that the public will accept limited income growth over the Parliament in exchange for improvements to public services. But there is another gamble the Government has taken: that the measures in the Budget will indeed stimulate growth in the longer term, which is so urgently needed to underpin sustained living standards improvements in the future.

The Government has announced more investment at this Budget as part of its strategy to boost growth

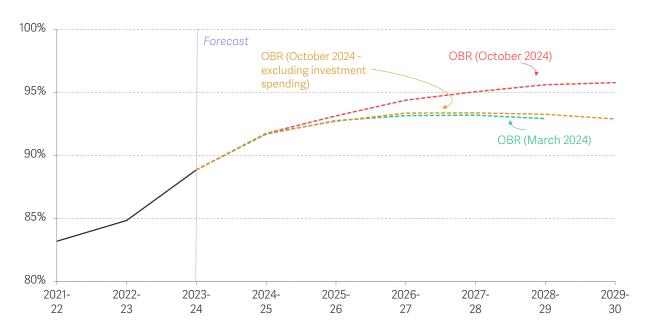
The other big policy decision taken at the Autumn Budget was to boost public investment by a cumulative £100 billion over the next five years. Prioritising investment is a move in the right direction given the UK's record of low and volatile public investment.⁵⁰

⁵⁰ For more on the UK's previous record on public investment, see: F Odamtten & J Smith, <u>Cutting the cuts: How the public sector can play its part in ending the UK's low-investment rut</u>, Resolution Foundation, March 2023.

But such a move would have been impossible under Jeremy Hunt's previous fiscal rule – to have public sector net debt (excluding the Bank of England) falling in the fifth year of the forecast. This is because the 'headroom' against that rule would have been just \mathfrak{L}_{13} billion before investment measures (the yellow series in Figure 31). Including the Chancellor's \mathfrak{L}_{100} billion investment spending over the forecast (plus the debt interest increase resulting from issuing debt to finance it) leaves debt rising and the previous set of fiscal rules being broken by \mathfrak{L}_{6} billion by the end of the forecast period (the red series below).

FIGURE 31: There is little scope to borrow to invest against the 'debt-falling' fiscal rule the Chancellor inherited

Public sector net debt (excluding the Bank of England), as a proportion of GDP: UK



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various.

So the Chancellor has instead taken the bold and creative step of adopting a wider definition of the public sector balance sheet for her second fiscal rule, requiring 'public sector net financial liabilities' (PSNFL) to be falling in the final year of the forecast. PSNFL includes relatively illiquid financial assets and liabilities, in addition to the liquid financial assets and liabilities captured in measures of public sector net debt (Figure 32). The main impact of this is to capture the corresponding assets created when the public sector makes loans or buys equity, rather than just capturing the liabilities associated with these financial transactions (as is the case in net debt measures) – making them largely fiscally neutral.

FIGURE 32: Public sector net financial liabilities includes illiquid assets and liabilities

Various public sector balance sheet measures by component assets and liabilities

Public Sector Net
Debt
Financial Liabilities
(PSND)
(PSNFL)

Assets

Liquid financial assets

Liquid financial assets

Liquid financial assets

Government debt

Other financial liabilities*

*Including funded public sector pensions

SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various.

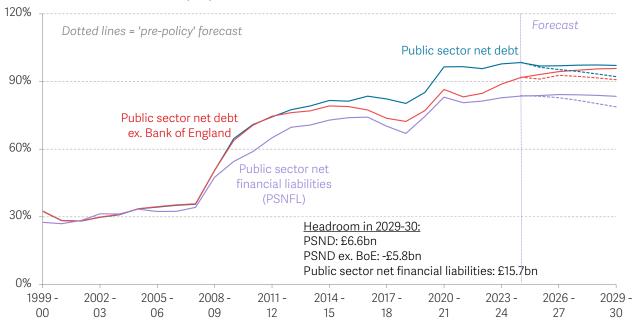
There are two key ways in which moving to this measure gives the Chancellor significant scope to borrow to invest.

First, there is much more room under a PSNFL rule to borrow than under a rule based on total debt. This is because PSNFL is falling more quickly than public sector net debt excluding the Bank of England (Figure 33, dotted series). This is partly due to the inclusion of the Bank of England in the public sector balance sheet, which reduces the impact of quantitative easing-related transfers in pushing up public sector net debt excluding the Bank of England. But it is also due to the inclusion of the financial assets created when student loans are issued in PSNFL (these assets offset student-loan liabilities, which appear in debt). Pre-measures 'headroom' under a PSNFL target was £49 billion, an increase of £21 billion relative to a rule based on public sector net debt excluding the Bank of England.⁵¹ The Chancellor's package of spending and tax decisions reduced the headroom against this rule to £16 billion via a combination of capital and current spending.

⁵¹ This £21 billion figure is much smaller than the over-£50 billion impact of changing the fiscal rules projected by ourselves and others before the Budget (see E Fry, C Pacitti & J Smith, <u>Great expectations in hard times? Previewing the big decisions for the Chancellor in the new Government's first Budget</u>, Resolution Foundation, October 2024). This smaller impact is due to an OBR error in previously published estimates of PSNFL, which suggested it was falling much more rapidly in the March 2024 forecast than reality, due to the exclusion of some quantitative-easing-related fiscal flows.

FIGURE 33: Public sector net financial liabilities is falling much more quickly than net debt by the end of the forecast period

Public sector net debt, public sector net debt ex. Bank of England and public sector net financial liabilities as a proportion of GDP: UK



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, October 2024.

Second, the move to a PSNFL target has also made it much easier fiscally to invest via financial transactions such as loans to the private sector, as these loans broadly become fiscally neutral and so are much less constrained by a PSNFL fiscal target than a target based on net debt.

Overall, this change to the fiscal rules has enabled a large loosening of fiscal policy in order to boost public investment. This is a welcome intervention to prioritise growth, but the choice of a PSNFL rule does also create some risks (see Box 5).

BOX 5: Benefits and risks of moving to a PSNFL fiscal target

Fiscal rules play a crucial role in transparently setting out the Government's tax and spending strategy. Most importantly, they clarify for financial markets (i.e. those lending the Government money) how policy will be changed to prevent the public finances from moving onto an unsustainable path. In that context,

frequent changes to the rules are unwelcome, as they 'de-anchor' expectations, and can be perceived as a government moving the goal posts. It is, however, entirely expected and understandable that a new government would want to introduce their own new set of fiscal rules, to reflect their new fiscal priorities.

The key point is that the Government's fiscal rules should convey the Government's fiscal strategy. Here the Chancellor has been clear that day-to-day spending will be covered by tax revenues by the fifth year of the forecast (sensibly moving to the third year over time), but that the Government is open to borrowing to invest. As set out above, moving to a PSNFL rule immediately created £21 billion of headroom to borrow, in comparison to a rule based on total debt.

The move to a fiscal framework based on the combination of a current balance and a PSNFL rule is a creative step in the right direction towards a framework to enable much higher levels of public investment, while keeping current spending sustainable. Given the UK's poor investment record, this is a welcome development and an understandable compromise, given the concerns expressed by the Treasury around the implementation of a more radical but theoretically preferable rule that excludes public investment directly (i.e. a public sector net worth rule).⁵²

There are, however, two key drawbacks to the way that a PSNFL rule creates the 'space' to increase borrowing, by allowing some financial assets (e.g. assets related to loan schemes and

purchases of equity) to offset debt liabilities.

First, contrary to the Chancellor's Budget speech, a PSNFL rule does not "count the benefits of investment, not just the costs" to provide extra incentives for direct public investment in assets such as schools or hospitals once the significant headroom afforded to the Chancellor at this fiscal event is used up. The rule change has created a one-off, temporary 'windfall', primarily due to the offsetting of student loan liabilities across the forecast under a PSNFL measure. But once this additional headroom is used up (as it largely has been by the end of the forecast), the Government will instead be able to borrow to invest to a much smaller extent determined by nominal GDP growth in future years (assuming it maintains a current balance). Under a rule that explicitly excludes public investment, the capacity to borrow to invest would remain essentially unlimited.

Second, a PSNFL rule does not disincentivise the Government from cutting investment spending during future fiscal consolidations (and this remains likely given it is usually easier for governments to cut capital projects than current spending). This means the adoption of a PSNFL rule does not automatically solve the UK's problem of

⁵² For an assessment of why a public sector net worth rule is theoretically preferable, see: R Hughes et al., <u>Totally (net) worth it: The next generation of UK fiscal rules</u>, Resolution Foundation, October 2019. The Treasury's practical reservations about adopting this rule are expressed in HM Treasury, <u>A strong fiscal framework: Explaining the government's new fiscal framework and rules</u>, October 2024

significant volatility in the level of public investment. A rule that instead made public investment essentially fiscally neutral (i.e. a net worth rule) would remove the incentive for a government to cut capital spending if they were implementing a fiscal consolidation.

Finally, the significant fiscal loosening enabled by the adoption of a PSNFL rule is not without fiscal sustainability risks, with debt servicing costs sitting above £100 billion in every year of the

fiscal forecast. The limited headroom left against the PSNFL rule should, however, reduce the extent to which the Government can dramatically increase borrowing (and so further increase the risk of unsustainable debt servicing costs in the future) at subsequent fiscal events. This should mitigate some of the fears that the move to a PSNFL rule could mean dramatically less-sustainable public finances going forward.

The Chancellor has used the additional space afforded by her new balance sheet rule to fund a large increase in public investment, totalling £100 billion more than the previous forecast over the next five years. The 0.7-percentage-point increase in public investment as a share of GDP by the end of the forecast is the biggest planned increase in public sector net investment (PSNI) since the first Sunak Budget in March 2020.⁵³ The planned investment rate of 2.6 per cent of GDP on average over the forecast would be the most in any five-year period since 1980-81. The plans translate into government capital formation of 3.3 per cent of GDP by 2029-30, close to the 2022 advanced country average of 3.5 per cent.⁵⁴

This increase is welcome in an area where the UK has historically lagged behind.⁵⁵ The OBR have judged that this increase in public investment will boost the supply capacity of the economy by 0.14 per cent in 2029-30 (Figure 34). This is a worthwhile gain, but will only go a very small part of the way towards fulfilling the Government's ambition of making the UK the fastest-growing economy in the G7: the IMF currently forecasts US GDP per capita to grow 0.5 percentage points faster than the OBR forecast for the UK over the next 5 years. And, as we saw in Box 1, over the next five years this boost is more than offset by the assumed crowding out of private investment by higher public spending and borrowing, and the hit to employment from higher taxes, leaving productive capacity broadly unchanged by the end of the forecast period.

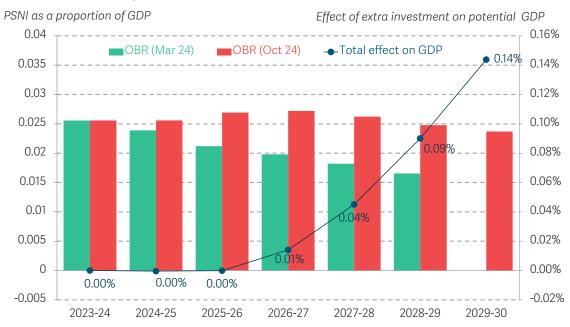
⁵³ Office for Budget Responsibility, <u>Historical official forecasts database</u>, March 2024.

⁵⁴ An international comparison of PSNI is not available, so we use the closely related general government gross fixed capital formation here. This calculation is based on OECD data.

⁵⁵ F Odamtten & J Smith, <u>Cutting the cuts: How the public sector can play its part in ending the UK's low-investment rut</u>, Resolution Foundation, March 2023

FIGURE 34: The OBR judge that the big rise in public investment will boost the productive capacity of the economy

Public sector net investment (PSNI) forecast as a proportion of GDP and the effect of extra investment on potential GDP: UK



SOURCE: RF Analysis of OBR, Economic & Fiscal Outlook, various, 2024.

However, the benefits of higher investment will continue to build over time. The OBR judges that if the increase in public investment is sustained, the long-run effects on GDP will be more positive – 0.43 per cent in 10 years and 1.4 per cent in the very long run. On the OBR's estimate, it won't be until 2038-39 that the extra public investment leaves more domestic resources available for consumption (i.e. increasing GDP by more than the direct increase in investment, of 0.6 per cent of GDP), and 2067-68 before it might raise tax revenues by enough to pay the ongoing fiscal cost. (If investment is executed and bears fruit quicker, the payback will happen quicker too.)

But the modest and distant impact on GDP underlines that much more needs to be done to boost growth. The policies mentioned in the Budget are limited in this regard.

On tax, the Government made some changes that will affect potential growth, and omitted some potentially growth-enhancing measures. The Employment Allowance, which forgives the first £5,000 of employer National Insurance payments for employers with total NI bills of less than £100,000, shifts employment towards small firms – which are on average less productive – for no good reason. The cliff-edge at £100,000, beyond which the Allowance is lost, discourages firms from growing just above this level. The increase in the Allowance to £10,500 is a retrograde step, but the removal of the cliffedge at £100,000 works in the opposite direction, removing a tax on firm growth. The

⁵⁶ This calculation assumes that 45 per cent of any increase in GDP accrues to the public sector through higher revenues.

Government also announced plans to cut business rates for smaller retail, leisure and hospitality properties, funded by an increase in the rate on larger properties. Again, this will push activity towards smaller, less efficient firms for no good reason. Finally, the Government ducked comprehensive reform of the highly distortionary Capital Gains and Inheritance Tax regimes, relying instead on more minor changes in rates and allowances (see above).

Finally, the OBR's growth forecasts highlighted the fact that economic growth is delivered by much more than policies announced in Budgets. Reforms to planning and infrastructure, for example, could increase potential output. Furthermore, while two of the new Government's primary vehicles for delivering growth – GB Energy and the National Wealth Fund – featured heavily during the Chancellor's speech, neither are yet up and running and therefore do not feed through fully into forecasts. Manifesto funding for Great British Energy was reconfirmed at £8.3 billion over this Parliament, but detail on how these funds will be allocated is now expected at the 2025 Spending Review (once GB Energy's strategic priorities and plans have been laid before Parliament, as stipulated in the GB Energy Bill). And while the Government expects its National Wealth Fund – subsuming the UK Infrastructure Bank and being capitalised by an additional £5.8 billion – to catalyse more than £70 billion of private investment, more detail on how this would be achieved, beyond an initial focus on aerospace, automotive and life science sectors, is yet to materialise.

So far, and including in this Budget, the Government's early actions on growth are yet to live up to their laudable ambitions in this area.⁵⁸

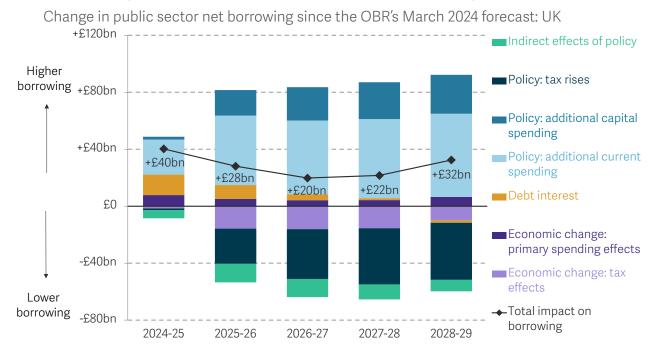
As a result of the Budget, borrowing is higher and fiscal policy is looser

So, where does the significant set of tax and spending changes leave the public finances? As discussed earlier, changes to the economic outlook are slightly favourable to the Exchequer, but these changes offset just 2 per cent of the spending decisions the Chancellor has taken which add £145 billion to borrowing across the forecast (Figure 35). This is the net effect of nearly £240 billion of current spending increases (including £35 billion of debt interest), £97 billion of additional capital spending announced by the Chancellor, offset by £140 billion of tax rises between 2024-25 and 2028-29 and £50 billion of 'indirect' effects of policy on the economic forecast. Overall, this leaves borrowing £32 billion higher than the OBR projected in March 2024 by 2028-29, primarily as a result of the decision to borrow to fund higher public investment spending.

⁵⁷ The GB Energy Bill is still passing through Parliament. For more, see: A Walker et al., <u>Great British Energy Bill 2024-25</u>, House of Commons Library, October 2024.

⁵⁸ E Fry & G Thwaites, The growth mindset: Sizing up the Government's growth agenda, Resolution Foundation, September 2024

FIGURE 35: Changes to the OBR's economic forecast improve the public finances slightly, but this is more than offset by policy changes



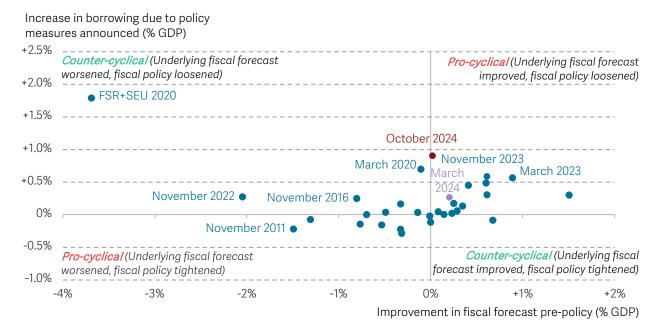
SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various.

All this means that this fiscal event has been a significant net 'giveaway' and a significant loosening of fiscal policy relative to the Spring Budget.

On the face of it, looser policy is hard to justify given a stronger economy and higher inflation – a fundamental principle for fiscal policy is that it should adjust to dampen changes in the economy rather than amplify them. As shown in Figure 36, the October 2024 Budget is the largest loosening of fiscal policy since the OBR's formation (other than interventions during the height of the pandemic), a significant pro-cyclical policy intervention. Looser policy will add to inflationary pressure and will mean the Bank of England does not cut interest rates as quickly. It is therefore not surprising that long-term interest rates have risen slightly in response to yesterday's announcements.

FIGURE 36: This Budget is a procyclical fiscal loosening overall

Increase in public sector net borrowing due to policy measures announced (vertical axis) and change in pre-measures fiscal forecast as a proportion of GDP over five years (horizontal axis), by fiscal event: November 2010 to October 2024

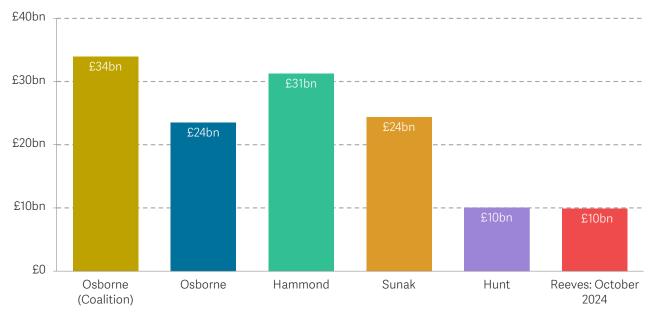


SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various.

The risk of fiscal policy amplifying changes in the economic forecast is heightened by the relatively slim margin of headroom the Chancellor has chosen to hold against her fiscal rules. There is just £10 billion of headroom left against the current balance rule (as shown in Figure 37), slightly less than the £16 billion held against her second 'PSNFL-falling' fiscal rule, making this the main binding constraint on fiscal policy going forwards. Such a margin is just over a third of the average of the £28 billion headroom held by Chancellors since 2010. Given significant risks to the economic outlook, this is unwise, especially since the Government's fiscal targets currently bind in five years' time, a point at which shocks to the fiscal forecast can have a large impact. The OBR's average forecast error at the five-year horizon for the current budget is nearly 10 times the Chancellor's existing headroom.⁵⁹ In this context, it is welcome that the Chancellor is aiming to turn her fiscal targets into three-year, not five-year, targets.

FIGURE 37: The Chancellor has chosen to hold a slim margin of headroom against her current balance rule





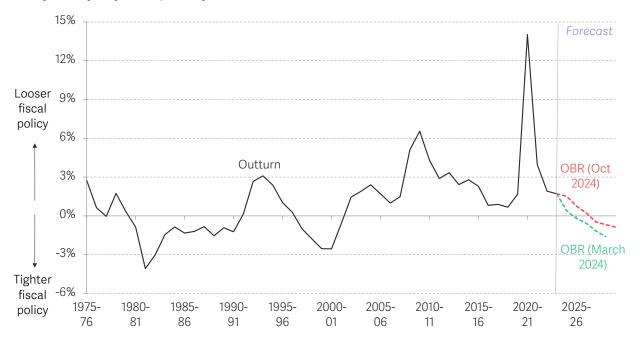
NOTES: Average headroom relates to the following past fiscal targets: 'Osborne (Coalition)' fiscal targets relate to achieving cyclically-adjusted current balance by the end of the rolling, five-year forecast period; 'Osborne' relates to balancing public sector net borrowing in five years (original rule 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. Historical headroom is here presented as a proportion of GDP, multiplied by October 2024 NGDP in 2029-30 for comparability with this forecast.

SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, October 2024; OBR, Historical official forecasts database.

However, although there has been a significant fiscal loosening at this Budget, as shown in Figure 38, fiscal policy is still on course to tighten rapidly and end the forecast as tight as it has been since Gordon Brown was Chancellor. Such a stance of fiscal policy is broadly appropriate in the context of an economy operating close to full capacity and with ample room for cuts to interest rates.

FIGURE 38: Fiscal policy is still on course to tighten rapidly

Cyclically-adjusted primary deficit as a share of GDP, outturn and forecasts: UK



SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various.

The Chancellor has put an end to the fiction of a shrinking state

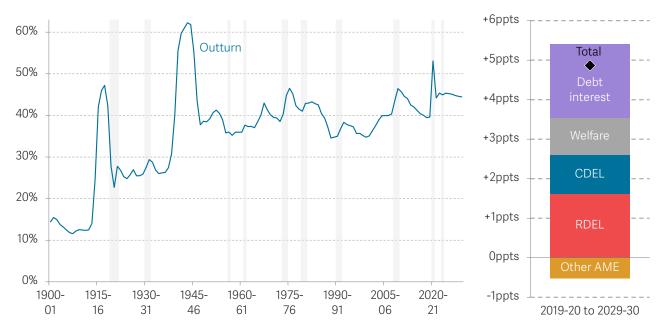
The Autumn Budget has lived up to expectations in terms of its size and significance, with the biggest increase in spending plans since 2000, funded in part by the largest tax rises in history. But even these tax rises were not enough, and so the Chancellor has had to increase public borrowing, made possible by a welcome change in fiscal rules.

Holding the spending share close to its current high level will result in the largest sustained state on record (Figure 39). But stepping back, all the Chancellor has done is reverse most of the previous Government's planned cuts to public spending as a share of the economy. As we have previously argued, those cuts were not realistic in a country with creaking public services, rising interest rates, an ageing population and no more room to cut defence spending. This was the biggest call the Chancellor made yesterday, and it was the right one.

⁶⁰ C McCurdy, C Pacitti & J Smith, <u>Debt dramas: Putting the public finances in context ahead of general election 2024</u>, Resolution Foundation, June 2024.

FIGURE 39: The size of the state is set to remain close to historically high levels

Total managed expenditure (TME) as a proportion of GDP (left panel) and change in TME as a proportion of GDP, by component (right panel): UK



NOTES: Other AME (Annual Managed Expenditure) includes unfunded public service pensions, environmental levies, and locally financed expenditure.

SOURCE: RF analysis of OBR, Economic and Fiscal Outlook, various; DWP, Benefit Expenditure Tables.

Raising taxes without being seen to break manifesto pledges has led the Chancellor to a combination of welcome revenue-raising reforms to Inheritance Tax and Capital Gains Tax and further threshold freezes and a rise in employer NI falling disproportionately on low-paid jobs. And despite some welcome tweaks to help carers and those with debts on UC, the emphasis on public services has left the Government with unfinished business in the benefits system. Keeping the freeze on Local Housing Allowance and rolling the two-child limit out further will push almost a million more people below the poverty line in the short term.

To fix these problems without further rises in taxes or borrowing will require either lower interest rates or faster GDP growth. Both depend a lot on luck. But they also respond to good policy. The early omens are mostly positive, but not exclusively so. The main challenge lies ahead.



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