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Research Report

Autumn 2017 budget: Options for easing the squeeze

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Institute for Fiscal Studies

Autumn 2017 Budget: options for easing the squeeze

Carl Emmerson
Thomas Pope

ICAEW

E·S·R·C ECONOMIC & SOCIAL RESEARCH COUNCIL

Autumn 2017 Budget: options for easing the squeeze

Carl Emmerson and Thomas Pope
Copy-edited by Judith Payne

The Institute for Fiscal Studies

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Foreword from ICAEW

ICAEW is very pleased to partner with the Institute for Fiscal Studies on the annual IFS Green Budget. We are especially delighted to be able to support this report in advance of the second Budget of 2017, in which IFS researchers set out some of the continuing and growing challenges the Chancellor faces.

Despite seven years of relative austerity, the government is still running a substantial budget deficit. Economic performance in terms of productivity and growth is nowhere near pre-crisis levels. That, and continuing uncertainty over Brexit, make it crucial that this Budget takes measures to restore confidence to our economy.

A willingness to be flexible needs to be at the heart of this Budget, so that models for funding public expenditure can adapt and fit as the economy requires. Tackling Britain's lacklustre productivity will also be key, which may require shrewd and targeted public investment. Finally, on the basis of feedback from ICAEW members, we can also attest to the strong desire across business to see a simplification of the tax system, and easing of the regulatory burden.

The Chancellor's success will lie in setting the conditions to promote greater investment, both publicly and privately. Ultimately we must nurture innovation and make the UK more competitive.

This IFS analysis sets out in clear and objective terms the nature and scale of these challenges. It is essential reading for those wanting to understand the circumstances faced by the Chancellor as he prepares his second Budget, the policy options he has, and the difficult trade-offs and judgements he will need to make.

Michael Izza

Chief Executive Officer of ICAEW

Preface

This report was funded by the Institute of Chartered Accountants in England and Wales (ICAEW). Co-funding was provided by the Economic and Social Research Council through the Centre for the Microeconomic Analysis of Public Policy at IFS (grant reference ES/M010147/1).

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Executive summary

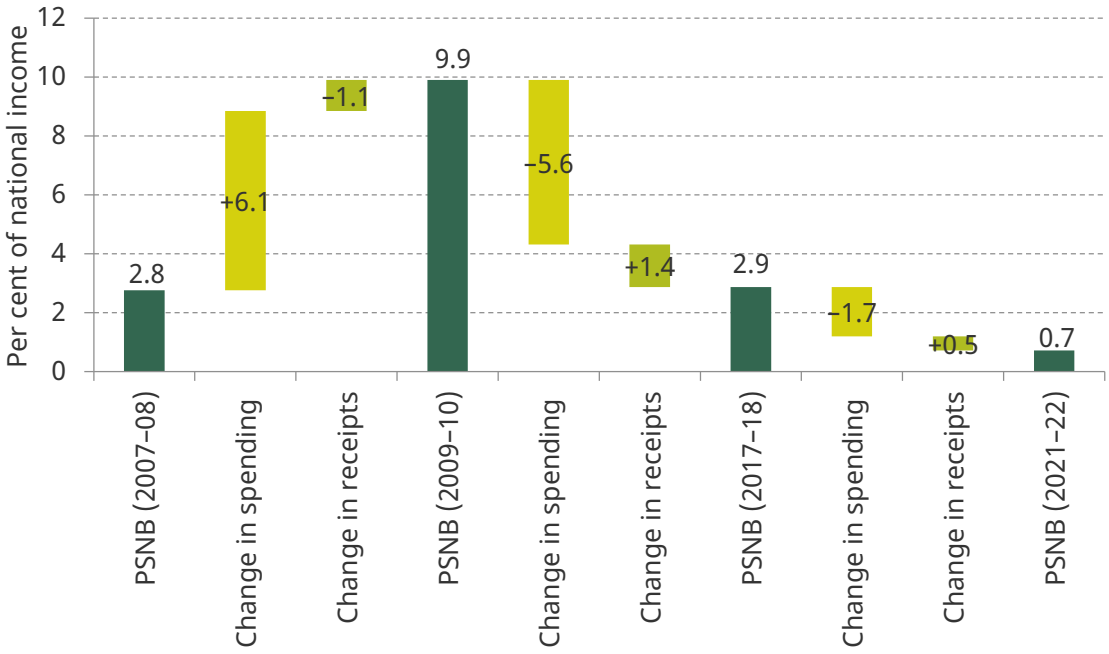
The March 2017 Budget plan

The key backdrop to all fiscal events in the UK since the financial crisis has been the weak performance of the economy. At the time of the March 2017 Budget, national income per adult was around 15% lower than it would have been had output per adult instead grown by 2% a year (close to the post-war average) since the start of 2008. Despite this historically poor performance, weak growth was forecast to continue. The March forecast implied that, by 2022, national income per capita would be 18% lower than it would have been if it had grown at 2% per year since 2008. That is astonishing.

The Office for Budget Responsibility (OBR)'s judgement over the implications of Brexit for growth and the public finances are included in all these figures. In November 2016, it attributed to the effects of Brexit lower economic growth and a £15.2 billion increase in borrowing by 2020–21. There would be much uncertainty around this forecast even if we knew the form that Brexit will eventually take. So-called 'no deal' or 'hard' Brexit scenarios would likely have a much bigger negative effect over the next five years than that currently assumed by the OBR, with much more uncertainty around the outcome.

Such future uncertainties apart, this weak growth has had severe implications for both household incomes and the public finances. Figure ES.1 shows public sector net borrowing (PSNB) as a share of national income in 2007–08 (pre-crisis), 2009–10 (the peak), 2017–18 (the current year) and 2021–22 (the end of the March 2017 Budget forecast horizon). The changes in borrowing between these years are decomposed into changes in spending, and changes in receipts, as a share of national income.

Figure ES.1. Latest out-turns and March 2017 Budget forecasts for taxing, spending and borrowing



Source: See Figure 2.2.

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As national income fell between 2007–08 and 2009–10, public spending increased sharply as a share of national income while government revenues fell. Since then, most of the increase in spending has been unwound, such that it in 2017–18 it was 0.5% of national income greater than it was in 2007–08 (6.1% less 5.6%). This is an important fact. Seven years of cuts have served merely to return public spending to its pre-crisis level as a share of national income.

Total government receipts have risen by more as a share of national income since 2009–10 than they fell over the preceding two years, such that they are now 0.4% of national income greater than in 2007–08 (–1.1% plus 1.4%; numbers do not sum due to rounding). So overall borrowing is now only slightly greater than it was in 2007–08, with both receipts and spending slightly above their pre-crisis shares of national income.

Going forwards, the Budget plan was for receipts to continue growing, and for spending to continue falling, as a share of national income, such that the deficit would decline to 0.7% of national income in 2021–22. This would be the lowest deficit since 2001–02. The forecast rise in receipts was driven by an increase in tax revenues which, if delivered, would see taxes reach a share of national income that has not been maintained in the UK since the 1950s. Spending would fall to its lowest share of national income since 2003–04.

This forecast deficit reduction came neither from strong rates of growth, nor from any underlying improvement in the public finances. Rather, it was almost entirely driven by the estimated impact of further net tax rises, further cuts to working-age benefits and further cuts to spending on public services as a share of national income. Net tax rises up to 2021–22 (relative to 2017–18) amounted to around £6 billion, while benefit cuts – many of which are already in place but apply to more claimants over the next few years – save £12 billion.

By far the largest contribution to deficit reduction was to come from spending by government departments, which was set to fall substantially as a share of national income, equivalent to £24 billion by 2021–22. These cuts were not planned to be spread evenly. Investment spending was set to increase to, and be maintained at, over 2% of national income, a reasonably high level by recent UK historical standards. This meant that the planned spending restraint came entirely through day-to-day spending, with real spending per capita set to fall almost 5% between this year and 2021–22 on top of falls of 13% between 2010–11 and the current year. And planned cuts were not shared evenly across departments, either. While the budgets of International Development, Health, Education and Defence were all relatively protected, real-terms cuts of almost 20% were planned for DEFRA and the Ministry of Justice over the next two years, despite the fact that these departments have already experienced large cuts since 2010.

In the March forecast, the combined effect of the substantial fiscal tightening planned over the next few years was a below-average deficit of 0.7% of national income by 2021–22. However, even if this were to be achieved, it would still be tough for the Chancellor to meet his overarching fiscal objective of eliminating the deficit by the mid 2020s. The pace of tightening would have had to accelerate beyond 2021–22 (there was a considerable easing off after 2019–20), while at the same time demographic pressures were set to put upwards pressure on spending worth 0.8% of national income by 2025–26. Overall, therefore, these plans implied a tight fiscal position over the next few years, with the prospect of more austerity measures further down the road if the overarching fiscal objective was to be achieved.

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Developments since March

Data for the first six months of the financial year paint a rosier picture for the public finances than at the time of the March forecast. The latest estimate for borrowing last year – at £45.7 billion – is £6 billion below the March forecast, and the out-turns for the year to date suggest higher tax revenues, and lower spending, than the OBR thought in March. This is likely to outweigh any negative effects from weaker growth this year, with the combined effect that borrowing this year might come in at around £51 billion, or around £7 billion lower than forecast. That this improvement has arisen in spite of weaker-than-expected growth (which would otherwise have been expected to add around £4 billion to the deficit this year) implies an even greater underlying improvement in the public finances. Assuming this underlying strength persists, this public finance good news also puts downward pressure on medium-term borrowing to the tune of around £12 billion a year (set out in detail in Table ES.1).

On the other hand, forecast government borrowing over the next five years will be pushed up by the fact that the Bank of England's Monetary Policy Committee is now expected to raise interest rates sooner. This will increase measured debt interest spending, although the difference from March is most stark in the next couple of years: while it adds £1.5 billion to borrowing in 2018–19, it only adds £0.7 billion to borrowing in 2021–22.

Policy measures announced since March – in particular, the reversal of the Budget measure on self-employed National Insurance contributions and additional spending pledges in Northern Ireland – combine to increase borrowing slightly over the next few years (peaking at an estimated £1.4 billion in 2019–20). The most significant giveaway since the Budget is the increased generosity of the student loan system in England, which will eventually increase borrowing by around £2 billion a year. But this is a long-term effect with little impact on the public finances in the next decade.

As ever, the public finance forecast is most sensitive to the anticipated size of the economy. Independent forecasters, including the Bank of England, have slightly downgraded their medium-term growth forecast since the beginning of the year. Downgrading in line with these forecasts would lead to the economy being 0.4% smaller in 2021–22 than forecast in the March Budget. But we expect the OBR to downgrade by more, given that it has indicated its likely intention to reduce its forecast for future productivity growth. This view is based on the terrible productivity growth that the UK has experienced since 2010. Any substantial downgrade to productivity forecasts would easily dwarf the other factors affecting borrowing and lead to the medium-term outlook being worse than in March.

Quite how the borrowing forecast changes will depend on the extent of the productivity downgrade. Were the OBR merely to downgrade its growth forecasts in line with the Bank of England and independent forecasters, other factors could mean borrowing forecasts being revised down overall (the 'moderate' scenario in Figure ES.2 and Table ES.1).

But a more significant downgrade to growth prospects is likely. If the OBR were to decide that the terrible productivity growth of the last seven years were now the new normal (the 'very poor' scenario, under which output per hour grows at just 0.4% a year), without further policy action structural borrowing would rise above 3% of national income (almost £70 billion) in 2021–22 and rise further thereafter. Even if future productivity growth is

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Table ES.1. Borrowing under different real growth scenarios (£ billion)

	2017–18	2018–19	2019–20	2020–21	2021–22
OBR March borrowing forecast	**58.3**	**40.8**	**21.4**	**20.6**	**16.8**
'Moderate' total change	–6.9	–4.9	–5.3	–5.5	–5.4
Of which:					
Total underlying change	–6.9	–5.7	–6.7	–6.4	–6.3
Of which:					
Real growth downgrade	+3.7	+3.4	+2.9	+4.0	+4.8
Higher base rate expectation	+0.4	+1.5	+1.3	+1.1	+0.7
Underlying improvement	–11.0	–10.6	–10.9	–11.4	–11.8
Total policy change	0.0	+0.8	+1.4	+0.9	+0.9
'Moderate' borrowing forecast	**51.3**	**35.9**	**16.0**	**15.1**	**11.4**
'Weak' total change	–6.9	+0.2	+6.1	+12.0	+19.1
Of which:					
Total underlying change	–6.9	–0.6	+4.8	+11.1	+18.1
Of which:					
Real growth downgrade	+3.7	+8.5	+14.4	+21.5	+29.3
Higher base rate expectation	+0.4	+1.5	+1.3	+1.1	+0.7
Underlying improvement	–11.0	–10.6	–10.9	–11.4	–11.8
Total policy change	0.0	+0.8	+1.4	+0.9	+0.9
'Weak' borrowing forecast	**51.3**	**41.0**	**27.5**	**32.6**	**35.8**
'Very poor' total change	–6.9	+10.7	+23.4	+37.4	+53.1
Of which:					
Total underlying change	–6.9	+9.9	+22.0	+36.5	+52.2
Of which:					
Real growth downgrade	+3.7	+19.0	+31.7	+46.9	+63.4
Higher base rate expectation	+0.4	+1.5	+1.3	+1.1	+0.7
Underlying improvement	–11.0	–10.6	–10.9	–11.4	–11.8
Total policy change	0.0	+0.8	+1.4	+0.9	+0.9
'Very poor' borrowing forecast	**51.3**	**51.5**	**44.8**	**58.0**	**69.9**

Note and source: See Table 3.3.

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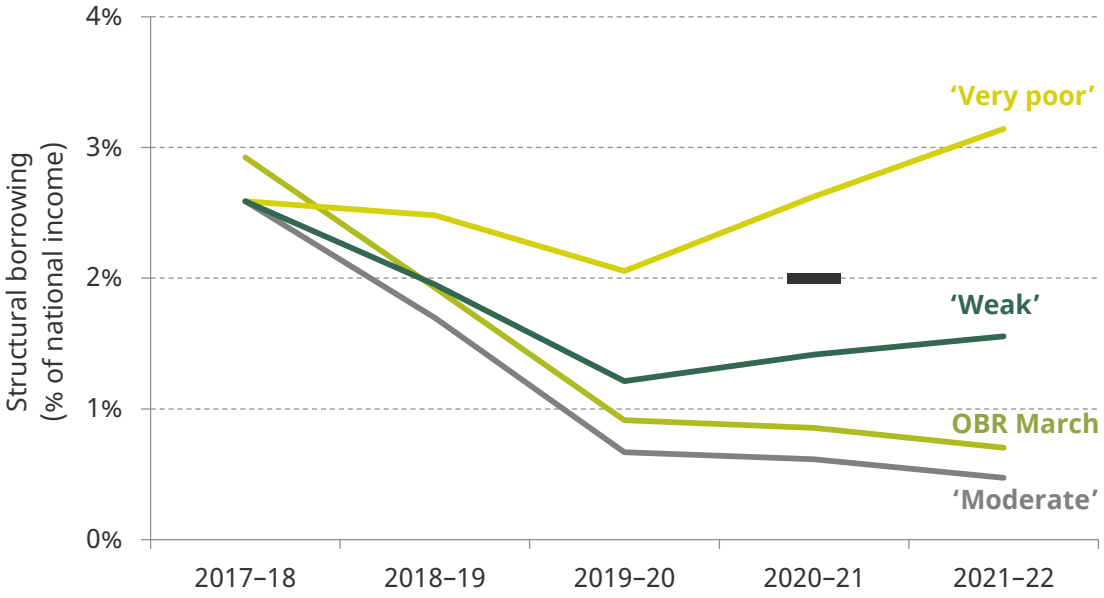
Figure ES.2. Structural borrowing under different growth scenarios



Note and source: See Figure 3.7.

downgraded halfway towards that seen over the last seven years (the 'weak' scenario, under which output per hour grows at just 1.0% a year), the deficit in 2021–22 could be around 1.6% of national income. At around £36 billion, this would be almost £20 billion higher than the £17 billion forecast by the OBR back in March. This could be even higher if the underlying improvement in the public finances this year were judged to be a temporary phenomenon (rather than acting to reduce 2021–22 borrowing by £12 billion) or if the downgrade to growth were deemed to be particularly tax-rich.

Under our 'weak' productivity scenario, the Chancellor would still be on course to meet his fiscal mandate (requiring structural borrowing below 2% of national income in 2020–21), albeit having lost around 50% of the headroom he had just eight months ago. Based on historical forecast errors, there would be a 40% chance that the target would be missed unless further policy action were taken. Achieving the Chancellor's overarching fiscal objective of eliminating the deficit by the mid 2020s – a challenge even on the March forecasts – would be considerably more difficult if this weak productivity growth were to materialise.

Absent offsetting policy measures, under our 'weak' productivity growth scenario the national debt would be almost 4% of national income higher in 2021–22 than on March forecasts (Figure ES.3).

In our 'very poor' productivity scenario, the fiscal mandate – for structural borrowing to be below 2% of national income in 2020–21 – would be missed. The fiscal objective – to eliminate the deficit entirely by the mid 2020s – would seem almost sure to go the same way. Debt would still be hovering around 90% of national income (although expected repayments of loans made by the Bank of England would still leave the Chancellor on course to meet his target of having lower debt as a share of national income in 2020–21 than in 2019–20: the fact that this target could be met in this way highlights how flawed it is).

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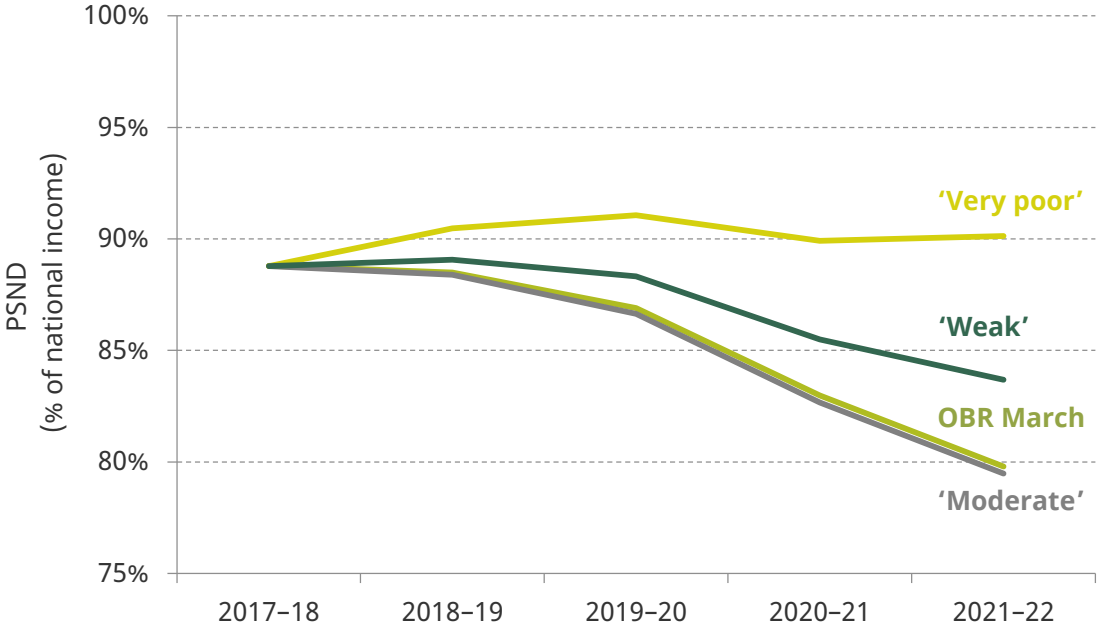
Figure ES.3. Public sector net debt under different growth scenarios



Note and source: See Figure 3.7.

Policy options for the Budget

This likely downgrade to the forecasts for borrowing poses a dilemma for the Chancellor. Ordinarily, we might expect a medium-term fiscal tightening in response – at least based on fiscal events since 2010. And given that this is the first Budget since a general election, we might have expected some tax rises to be announced this time around. However, the Chancellor must balance the needs of the economy, strains on public services and other pressures with the costs of having higher debt. Much of the public debate in the lead-up to the Budget has been about ways to ease the squeeze rather than options for reducing borrowing, and any takeaway measure would have to pass a vote in the House of Commons – no small challenge given current parliamentary arithmetic.

If economic growth disappoints, then meeting the fiscal objective will require further tax rises or spending cuts at some point. Neither seems likely at this Budget. Tax rises may be limited to the seemingly obligatory package of anti-avoidance measures. Some small tax cuts seem likely. Conservative manifesto commitments on raising income tax thresholds are now less expensive due to higher-than-expected inflation (just £1.1 billion a year needed to deliver a personal allowance of £12,500 and a higher-rate threshold of £50,000 in 2019–20), while it would also be a surprise if rates of fuel duties were not frozen in cash terms for a seventh consecutive year (at a cost of £¾ billion a year).

On the spending side, too, there appears to be more appetite for giveaways than takeaways. Welfare measures already in place will reduce spending over the next few years as they apply to more claimants. As universal credit continues to be rolled out nationwide, one concern that has been raised is the typical six-week period before payments are usually made – the Chancellor could choose to devote additional funds to reducing this. The largest cut to come over the next couple of years is the continued freeze to the rates of most working-age benefits, which is now a bigger saving to the

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exchequer – and a bigger cut to real household incomes – than originally intended due to higher inflation. In order to achieve the apparently originally intended savings, the freeze could be stopped a year early, or the increase over the next two years could be 1% instead of zero. Cancelling the policy entirely would cost £4 billion in 2019–20.

Pressures on public service spending abound. Three particular areas where there is quantitative evidence indicating pressure are public sector pay, the NHS and prisons. Relative to private sector wages, public sector pay has already been returned to around the level it was before the financial crisis. Based on current forecasts, the 1% pay cap planned for the next two years would see public sector pay fall to its lowest level relative to private sector pay for at least 20 years, which is likely to risk greater problems with recruitment, retention and morale. Loosening the cap is expensive, however. Increasing pay in line with inflation for two years would (relative to the 1% cap) cost £6 billion more in 2019–20, which could either mean more borrowing or, if departments are not allocated extra funds, an even greater squeeze on departmental budgets.

While the NHS has seen modest per-capita real-terms funding increases since 2010, these settlements are the tightest in the NHS's history. Activity levels have continued to grow, but there are clear signs of strain. Both the four-hour A&E target and the 18-week waiting period target are being missed nationally. The indicators paint a worrying picture for prisons, which, unlike the NHS, have seen large real-terms cuts (over 20%) since 2009–10. Statistics compiled by the Institute for Government show that while the prison population is at roughly its 2009 level, staffing is down and violence (both against fellow prisoners and prison staff) and prisoner self-harm rates are on an alarmingly steep upwards trajectory. The Chancellor has already abandoned the pay cap here and provided more money for recruitment at last year's Autumn Statement, but he may decide that more support is required.

So what's a Chancellor to do?

So what is a Chancellor to do? The first Budget of a new parliament is often the best chance a Chancellor has to set out her stall. She can raise taxes if need be, set an agenda for the next five years, and set in train economic and fiscal reforms. Mr Hammond, though, has been dealt a very tricky hand indeed. The political arithmetic makes any significant tax increase look very hard to deliver. It looks like he will face a substantial deterioration in the projected state of the public finances. He will know that seven years of "austerity" have left many public services in a fragile state. And, in the known unknowns surrounding both the shape and impact of Brexit, he faces even greater than usual levels of economic uncertainty.

Even if he does find some money, unless it did represent a very big change of direction, it won't mean 'the end of austerity'. Tight spending settlements, net tax rises and cuts to working-age benefits are all putting significant downward pressure on borrowing over the next two years in particular.

Mr Hammond is likely still to be on course to meet his target of a structural deficit of no more than 2% of national income by 2020–21, if by a much reduced margin. It looks increasingly unlikely that the ever-receding target to get rid of the deficit altogether will be achieved by the mid 2020s, which is when that is currently supposed to happen. Of

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course, it is possible that the economy, or the public finances, will perform much better than expected. But given all the current pressures and uncertainties – and the policy action that these might require – it is perhaps time to admit that a firm commitment to running a budget surplus from the mid 2020s onwards is no longer sensible.

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1. Introduction

The Chancellor, Philip Hammond, is currently preparing for his second Budget, which will be the UK's first Autumn Budget since Ken Clarke's statement in November 1996. It will also be the second Budget of this year. This report looks at developments – to the economy, to the underlying public finances and to policy – since the March Budget, to explore what fiscal room-for-manoeuvre, if any, the Chancellor might have.

On the policy side, there have been many developments since March. The proposal to increase the rate of Class 4 National Insurance contributions, paid by the self-employed, from 9% to 11% was shelved a week after the Budget. Not doing this will reduce forecast revenues by about £½ billion a year. The outcome of the general election led to the Conservative Party agreeing a 'confidence and supply' arrangement with the Democratic Unionist Party (DUP), which commits the government to boost spending in Northern Ireland by almost £1 billion over two years. And, on the eve of the Conservative party conference, the Prime Minister announced additional support for some first-time homebuyers and an increase in the generosity of the student loan system for higher education in England.

There have also been developments in the economy and the underlying public finances. The Chancellor will doubtless have been pleased to see borrowing in 2016–17 come in around £6 billion lower than forecast in the Budget, driven by greater-than-expected tax receipts. Strong receipts growth has persisted over the first half of 2017–18 which, all else equal, would suggest an improvement in the medium-term outlook for the public finances. But far less good news is that productivity growth has, once again, turned out to be terrible. And the date at which the Monetary Policy Committee of the Bank of England starts to increase interest rates from their current historically low level is now expected to be sooner than thought in March. Continued weak economic growth combined with increased interest rates would adversely affect both the public finances and the finances of many households.

This report proceeds as follows. Chapter 2 examines the fiscal forecasts published alongside the March 2017 Budget, highlighting in particular the extent to which forecast reductions in the deficit over the next two years were being brought about through a combination of further tax rises, further cuts to working-age benefits and further cuts to the day-to-day budgets of central government spending departments. Chapter 3 describes changes since the Budget that will affect the outlook for the public finances. This quantifies the public finance impact of changes in the outlook for the economy and interest rates, and also the impact of policy announcements, made since March. A particular focus is attempting to quantify what lowering the assumed rate of productivity growth would do to the Office for Budget Responsibility (OBR)'s public finance forecasts. Chapter 4 discusses some policy options that may be available to the Chancellor. Chapter 5 concludes.

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2. The March 2017 Budget plan

Key findings

Government receipts, spending and borrowing are now around their pre-crisis shares of national income.	The deficit this year will be close to the 2.8% recorded in 2007–08, with both public spending and government receipts slightly above their pre-crisis shares of the economy.
The March Budget forecast the deficit to continue falling over the next five years.	Tax receipts (that is, ignoring non-tax receipts of government) were forecast to increase to, and remain at, a level not sustained since the 1950s. Spending in 2021–22 was forecast to fall to its lowest share of national income since 2003–04. This would be sufficient to reduce the deficit to 0.7% of national income, its lowest level since 2001–02.
Delivering planned spending cuts would not be risk free.	Benefit cuts were forecast to help reduce spending on working-age benefits back to its lowest share of national income since 2000–01. While investment spending was forecast to remain relatively high by recent (pre-crisis) standards, day-to-day spending on public services was forecast to fall to its lowest share of national income since 2002–03.

The key backdrop to all fiscal events in the UK since the financial crisis and associated recession has been the weak performance of the economy. National income was only 9.4% higher in 2016–17 than it was nine years earlier in 2007–08, prior to the onset of the financial crisis and associated recession. And much of this growth was due to a growing population rather than to greater national income per head. Figure 2.1 shows the evolution of national income per adult since the first quarter of 2008. What is particularly striking is that the sharp drop in output between 2008Q1 and 2009Q1 has been followed by a period of very slow growth. National income per adult only returned to its pre-crisis level around the end of 2015.

This is a huge reduction in the size of the economy – and therefore the average living standards of UK households – relative to what we would reasonably have expected prior to the financial crisis. At the time of the March 2017 Budget, national income per adult was around 15% lower than it would have been had output per adult instead grown by 2% a year since the start of 2008.

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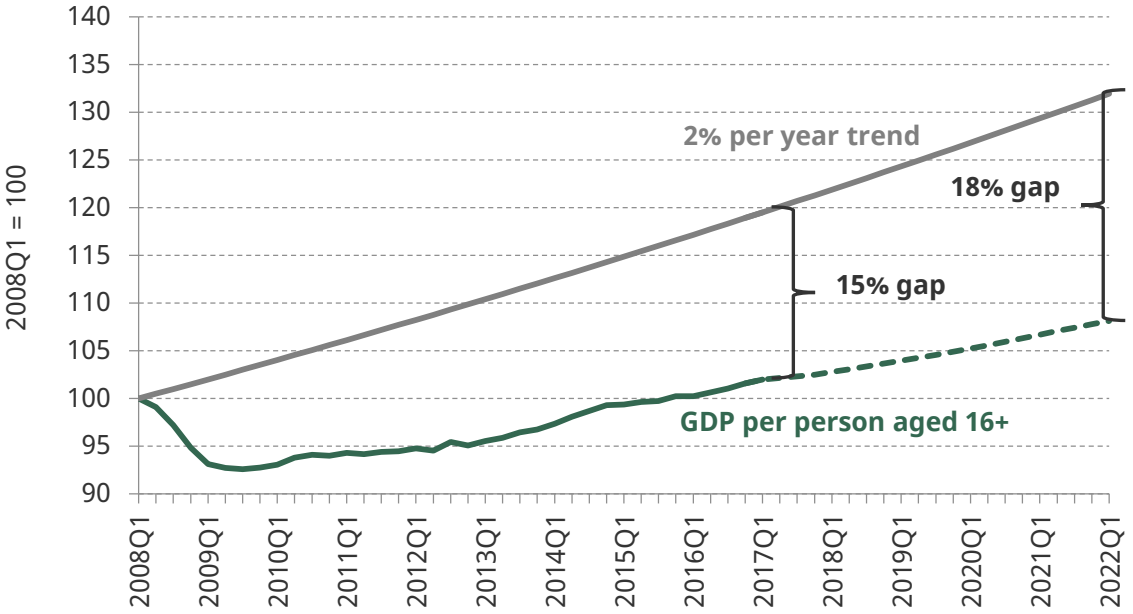
Figure 2.1. GDP per adult since 2008Q1 (at time of March 2017 Budget)



Source: Office for Budget Responsibility, *Economic and Fiscal Outlook Supplementary Economy Tables*, March 2017 (http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/).

Despite this historically poor performance, weak growth was forecast to continue. The March forecast implied that, by 2022, national income per capita would be 18% lower than it would have been if it had grown at 2% per year since 2008. That is astonishing. In today's terms, this gap is equivalent to every adult in the UK being approximately £8,400 a year worse off than they might have expected to be a decade ago. Note that this figure is simply the downgrade to GDP divided by the number of adults, and includes the loss from lower spending on public services, not just loss to income.

2.1 Fiscal aggregates

The evolution of the key fiscal aggregates since 1948, along with the March 2017 Budget forecasts, is presented in Figure 2.2 (tax and spend), Figure 2.4 (borrowing) and Figure 2.5 (debt).

The financial crisis pushed up total public spending ('total managed expenditure') as a share of national income so that in 2009–10 it reached its highest level since the mid 1970s. Since then, spending has fallen as a share of national income and is now back, almost, to the share that it was prior to the financial crisis. The March 2017 Budget plans were for spending to continue to fall as a share of national income so that by 2020–21 it would be at its lowest share since 2003–04. Further details on the composition of public spending, and how this has evolved over time, can be found in Box 2.1.

While the financial crisis led to government receipts falling in cash terms in 2009–10, when measured as a share of national income the drop is smaller. Since then, current receipts – that is, tax and non-tax receipts flowing to government – have risen slightly as a share of national income. In March, this was forecast to continue such that in 2018–19 current receipts would edge above 37% of national income for the first time in over 30 years (since 1986–87). Looking at just tax receipts – that is, ignoring government receipts from interest

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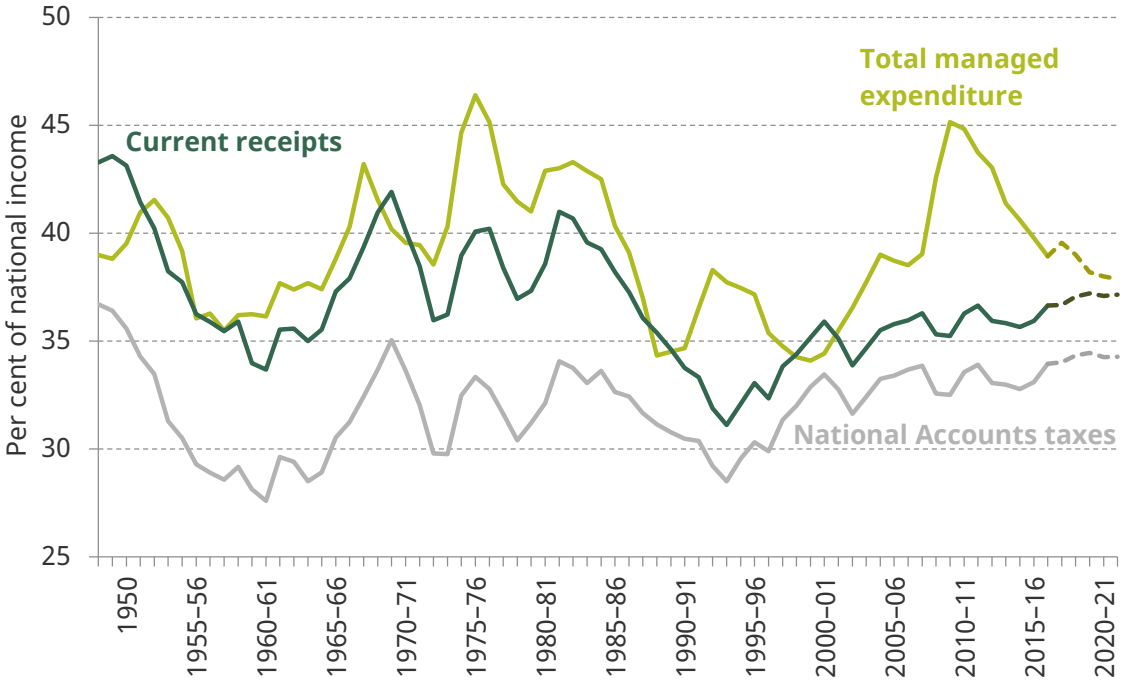
and dividend income, and from public corporations' gross operating surpluses – Figure 2.2 shows that National Accounts taxes were forecast to stabilise at just over 34% of national income. If this were realised, it would be the first time tax receipts were maintained at this level since the early 1950s.

Figure 2.2. Tax and spend since 1948: latest out-turns and March Budget forecast



Source: Office for Budget Responsibility, *Public Finances Databank*, October 2017 (http://budgetresponsibility.org.uk/data/); Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2017 (http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/).

Box 2.1. Composition of public spending over time

As shown in Figure 2.2, the large deficit that opened up in 2009–10 was driven, in large part, by public spending increasing as a share of national income. And – perhaps related to this – a large part of the reduction in the deficit since then has been through falling public spending as a share of national income. In 2018–19 (next year), public spending is expected to return to its pre-crisis share of national income. The March 2017 Budget forecasts that public spending will continue to fall as a share of national income.

Figures 2.3a and 2.3b provide a decomposition of the evolution of public spending as a share of national income since 1978–79. Figure 2.3a shows the amounts spent by the public sector in each year on social security benefits for pensioners and for working-age families and on debt interest payments. Figure 2.3b shows the amount spent on the remainder, which – in broad terms – could be considered as spending on the administration and delivery of public services, with this split into public sector net investment and 'day-to-day spending on public services'.

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Figure 2.3a. Spending on benefits and debt interest, 1978–79 onwards

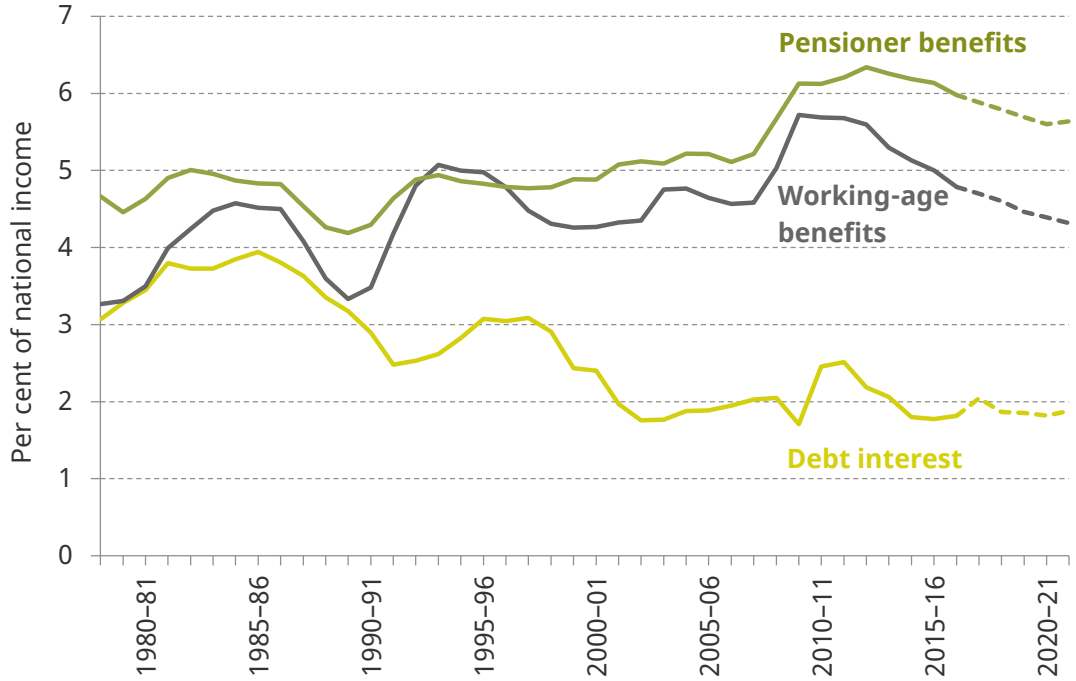
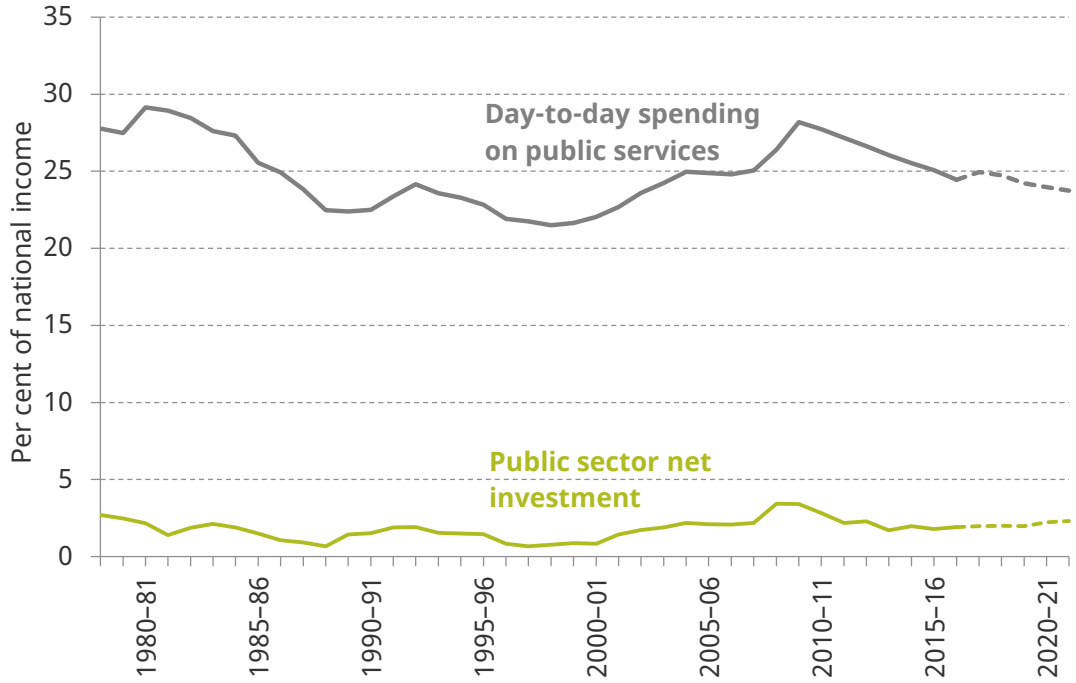


Figure 2.3b. Spending on public services, 1978–79 onwards



Source: Office for Budget Responsibility, *Public Finances Databank*, October 2017 (http://budgetresponsibility.org.uk/data/); Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2017 (http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/); Department for Work and Pensions, *Benefit Expenditure and Caseload Tables, September 2017 Update* (https://www.gov.uk/government/publications/benefit-expenditure-and-caseload-tables-2017).

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Despite the large increases in public sector net debt, the amount spent on debt interest has remained – and is forecast to remain – relatively low by historical standards. This has been due to the low cost of government borrowing and, in particular, the low interest rates set by the Bank of England. But as described in Chapter 3, the large amount of government debt effectively financed through the Bank of England's programme of quantitative easing means that government spending on debt interest is now very sensitive to when, how quickly and by how much interest rates rise.

Spending on benefits – both for working-age families and for pensioners – increased as a share of national income during the financial crisis. Pensioner benefit spending has been maintained at around this level as changing demographics, the 'triple lock' and other increases in the state pension system have offset the reductions in spending brought about by increases in the female state pension age. Spending on pensioner benefits is forecast to fall as a share of national income over the next few years as, for example, the state pension age for men and women is to rise to age 66. But even by 2020–21 this would still leave spending on pensioner benefits above its pre-crisis (2007–08) share of national income. In contrast, spending on working-age benefits has already fallen as a share of national income and is forecast to continue falling over the remainder of the forecast horizon. If the March 2017 Budget forecasts prove correct, then spending on working-age benefits in 2021–22 would be at its lowest share of national income since 2000–01.

The evolution of the rest of public spending – that is, broadly speaking, spending on public services – as a share of national income is shown in Figure 2.3b. Spending on public sector net investment increased as a share of national income during the financial crisis. Since then, it has been cut back to around pre-crisis levels. Going forwards, the forecasts imply investment being sustained at around 2% of national income (with some increases pencilled in by Mr Hammond for 2020–21 and 2021–22). If delivered, this would mean public sector net investment being maintained at a reasonably high level, at least by recent UK historical standards.

'Day-to-day spending on public services' increased in the financial crisis and has subsequently been cut back to its pre-crisis share of national income. The March 2017 Budget forecasts are for this spending to continue to fall as a share of national income such that in 2021–22 it would be at its lowest level since 2002–03.

The difference between total public spending and total government receipts is public sector net borrowing. Figure 2.2 shows that, in most years, spending has run ahead of receipts, and Figure 2.4 shows the resulting level of public sector borrowing. The deficit reached particularly high levels in the mid 1970s and following the recession of the early 1990s. But this was surpassed by the 9.9% of national income deficit in 2009–10. Since then, the deficit has fallen sharply and borrowing for this year (2017–18) was forecast in the March 2017 Budget to be 2.9% of national income, which is almost back to the level it was at prior to the financial crisis. In 2018–19, it was forecast to be 1.9% of national income, which would be equal to the average budget deficit that the UK ran over the 60 years prior to the financial crisis. This would, however, still be some way off meeting the Chancellor's stated objective to eliminate the deficit and run a budget surplus. As Figure 2.4 shows, an overall budget surplus is something the UK has seldom achieved in recent times and not on a sustained basis since at least the early 1950s.

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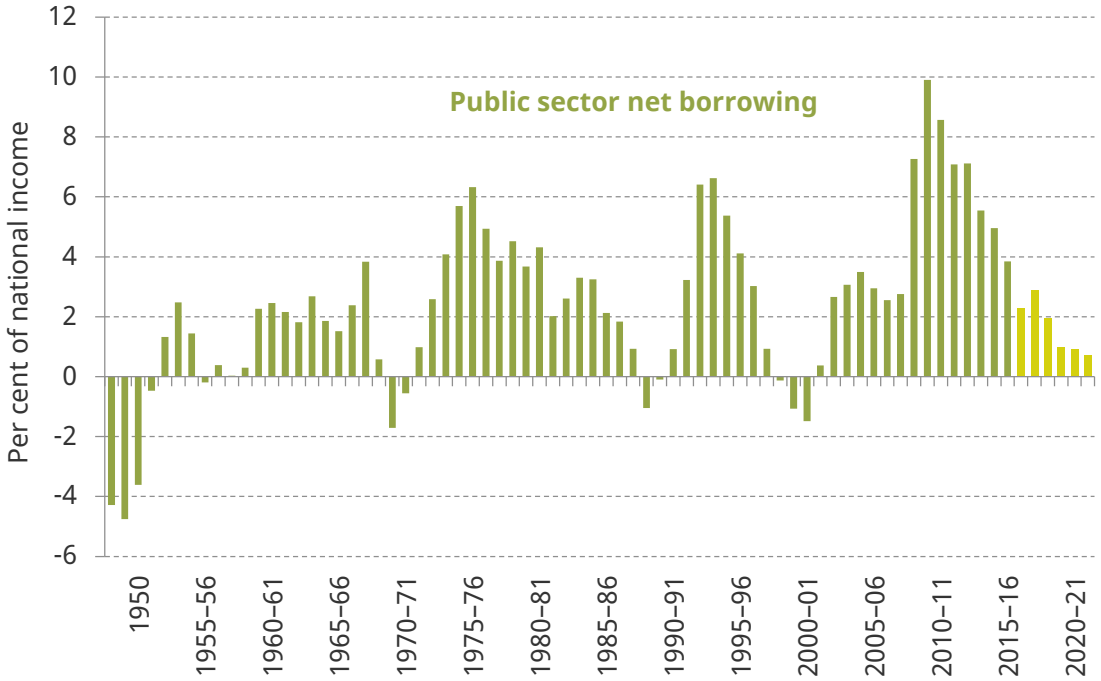
Figure 2.4. Public sector borrowing since 1948: latest out-turns and March Budget forecast



Source: Office for Budget Responsibility, *Public Finances Databank*, October 2017 (http://budgetresponsibility.org.uk/data/); Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2017 (http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/).

Figure 2.5. Public sector net debt since 1948–49: latest out-turns and March Budget forecast

Source: Office for Budget Responsibility, *Public Finances Databank*, October 2017 (http://budgetresponsibility.org.uk/data/); Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2017 (http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/).

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The larger-than-usual deficits that the UK has run since 2009–10, along with weak headline growth, have pushed up public sector net debt as a share of national income. This is shown in Figure 2.5. Prior to the financial crisis, public sector net debt was running just below 40% of national income (which at the time was the self-imposed ceiling on debt chosen by Gordon Brown when he was Chancellor). Public sector net debt has since doubled as a share of national income and is now approaching 90%. This is high by recent UK historical standards, although debt was larger before the mid 1960s. The March 2017 Budget forecasts are for debt to fall as a share of national income from 2018–19 onwards.

Of course, these fiscal aggregate forecasts are subject to change as the outlook for the public finances is always very uncertain. A very specific 'known unknown' at the moment is over what the impact of the UK leaving the EU will be on the UK economy and on the public finances. Box 2.2 sets out how the OBR's forecasts have changed as a result of the EU referendum result and how any future financial flows between the UK and the EU could affect the forecasts.

As well as comparing the UK's current debt and deficit levels on a historical basis (as we did in Figures 2.4 and 2.5), we can compare these levels with those of other advanced economies today. Appendix Table A.1 presents data from the IMF for 28 advanced economies for which data on both borrowing and debt are available. This shows that in 2016 the UK had a relatively high level of both borrowing and debt: out of the 28 countries, it had the seventh-largest deficit and the eighth-largest debt. The table also shows that it is common for the largest economies in the world (of these 28 countries, the UK had the fourth-largest economy in 2016) to have relatively larger deficits and debt. The obvious exceptions to this are Germany (which, for a large economy, had a relatively low level of deficit and debt) and Portugal and Greece (which, for relatively small advanced economies, had relatively large levels of deficit and debt).

Box 2.2. Brexit and the government's fiscal forecasts

The Office for Budget Responsibility downgraded its forecast for both the economy and the public finances in the November 2016 *Economic and Fiscal Outlook*, with part of this downgrade being explicitly attributed to the result of the EU referendum. This forecast was adopted by the Chancellor as the government's own. The OBR ascribed to Brexit: a downgrade to forecast investment growth and therefore future productivity growth; lower future net immigration than would otherwise have been the case; and greater inflation as a result of the depreciation of sterling that occurred after the referendum. The first two of these factors reduced forecast tax receipts, while higher inflation pushed up forecast spending on, for example, index-linked gilts. Overall, borrowing in 2020–21 was revised upwards by £15.2 billion as a direct result of the referendum result.[a] This is equivalent to almost £300 million per week. Furthermore, the investment-heavy composition of the short-term national income downgrade means the effect on the public finances could be worse in the long run – by around £3½ billion per year.[b]

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In addition to affecting the public finances via its impact on the economy, leaving the EU will also affect the fiscal transfers between the UK and the EU. The OBR's forecasts make no allowance for any 'divorce settlement' paid by the UK. Therefore, if such a payment were to be made, it would add to both borrowing and debt. However, the UK currently makes a financial contribution to the EU budget, which, net of the UK's rebate, is larger than the amount that the EU spends in the UK. The OBR assumes that all of the UK's contribution (net of the rebate) will be recycled into domestic spending. This was forecast to be worth £13.1 billion in 2020–21[c] (or approximately £250 million per week). If there were no ongoing payments from the UK to the EU, and none of the savings were recycled into domestic spending, then borrowing – and debt – would be revised downwards by this amount. This would offset most, but not all, of the downgrade to the public finances arising from the OBR's assessment of the impact of Brexit on the economy. But of that £13 billion gross contribution, around £5 billion is spent in the UK on, for example, agriculture subsidies, regional assistance and research grants.[d] Assuming this level of spending were to continue, the lower net contribution of roughly £8 billion would offset only around half of the fiscal loss the OBR, and government, believe would result from lower economic growth as a result of Brexit.

The actual impact of Brexit on the economy and the public finances remains highly uncertain. In part this reflects the difficulty of knowing the effect of any particular settlement, but it also reflects uncertainty over the form the settlement might take. So-called 'no deal' or 'hard' Brexit scenarios would likely have a much bigger negative effect over the next five years than that currently assumed by the OBR, with much more uncertainty around the outcome.

[a] Table B.1, page 249 of Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2016 (http://cdn.budgetresponsibility.org.uk/Nov2016EFO.pdf).
[b] C. Emmerson and T. Pope, 'Challenges for the UK public finances', in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2017* (https://www.ifs.org.uk/publications/8878).
[c] Table 4.16, page 127 of Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2017 (http://cdn.budgetresponsibility.org.uk/March2017EFO-231.pdf).
[d] Table 3.A, page 12 of HM Treasury, *European Union Finances 2016* (https://www.gov.uk/government/statistics/european-union-finances-2016).

2.2 The government's targets and plans

The government has committed itself to eliminating the headline budget deficit by the 'middle of the next decade'.[1] It also has three nearer-term fiscal targets, which are briefly described in Box 2.3.

The first fiscal target ('the fiscal mandate') specifies that the structural deficit in 2020–21 should be below 2% of national income. At the time of the March 2017 Budget, the Chancellor was on course to meet this target, although with relatively little room-to-manoeuvre given the degree of uncertainty around forecasting the deficit three years out. Figure 2.6 shows the path of both the deficit and the structural deficit since 2000–01 through to the end of the forecast horizon in 2021–22. From 2016–17 onwards, these are

[1] Conservative Manifesto, May 2017 (https://www.conservatives.com/manifesto).

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Box 2.3. The government's fiscal targets

Fiscal policy is currently constrained by one overarching objective and three shorter-term fiscal targets. The **fiscal objective** requires that the deficit be eliminated by the mid 2020s (previously a harder-to-meet 'as soon as possible in the next parliament').

The Chancellor's three fiscal targets are as follows:[a]

- The **fiscal mandate** requires that the structural deficit – that is, the portion of the deficit that is not thought to be explained by temporary strength or weakness in the economy – be below 2% of national income in 2020–21. On current forecasts, this means that the structural deficit must be below £45 billion in that year. The first estimate of whether or not this has actually been met will not be available until April 2021.
- The **supplementary target** requires that public sector net debt falls as a share of national income between 2019–20 and 2020–21. Again the first estimate of whether or not this has actually been met will not be available until April 2021.
- The **welfare cap** requires that spending on a specified set of welfare items not exceed, or be forecast to exceed, a certain cap. Most welfare items are included, though notable exceptions include the state pension and cyclical benefits such as jobseeker's allowance. The Charter for Budget Responsibility states that 'The OBR will assess spending against the welfare cap and margin at the first Budget or fiscal update of each new Parliament, coinciding with the incoming government's setting of a new cap'.[b] Therefore we can expect both the cap, and the OBR's assessment of compliance with that cap, to be announced in the November Budget.

[a] HM Treasury, *Charter for Budget Responsibility: Autumn 2016 Update*, November 2016 (https://www.gov.uk/government/publications/charter-for-budget-responsibility-autumn-2016-update).
[b] Paragraph 3.24, page 9 of HM Treasury, *Charter for Budget Responsibility: Autumn 2016 Update*.

very similar as the OBR judges that the UK economy has been operating at or around trend capacity. In other words, the OBR believes that the headline public finances are neither being flattered by the economy operating above its sustainable level nor being depressed due to the existence of spare capacity in the economy. If correct, this means that government cannot rely on above-trend growth over the next few years to help bring the deficit down; rather, if the deficit is to be reduced, then it would likely require a combination of tax rises and spending cuts (as a fraction of national income) to bring that about.

The forecast for 2020–21 was that there would be a headline deficit – and a structural deficit – of 0.9% of national income. This gave headroom relative to the 2% ceiling of 1.1% of national income. In other words, the structural deficit would need to turn out at least £26 billion greater than forecast in that year for the Chancellor's target to be breached. The errors in official forecasts for the structural deficit three years out suggest that, absent any further policy change, there would be about a 65% chance that the structural deficit will be below 2% of national income in 2020–21 and around a 35% chance that it will be greater than 2% of national income.

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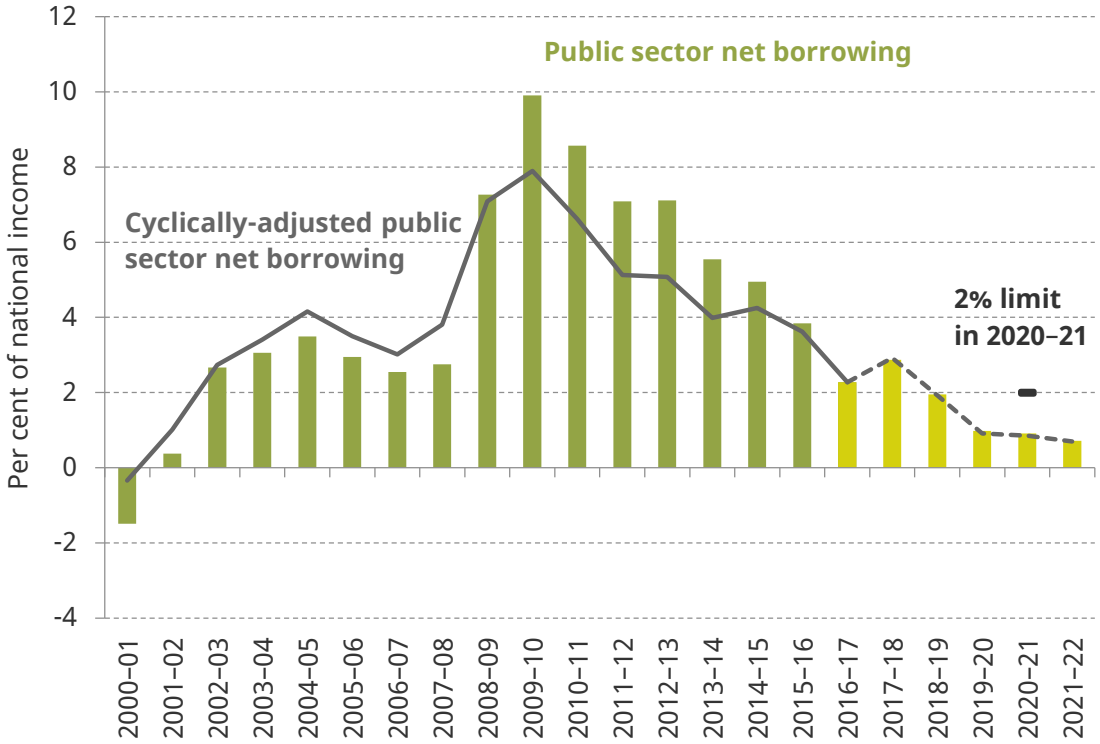
Figure 2.6. Public sector net borrowing since 2000–01, March Budget forecast



Source: Office for Budget Responsibility, *Public Finances Databank*, October 2017 (http://budgetresponsibility.org.uk/data/); Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2017 (http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/).

Figure 2.6 also shows that, more likely than not, further fiscal action beyond that already planned would be required for the government to meet its commitment to eliminate the headline deficit by the mid 2020s. While the deficit is forecast to fall reasonably sharply through to 2019–20, it is forecast to fall only slightly thereafter and to be running at 0.7% of national income in 2021–22. If these forecasts prove correct, then a steeper path of deficit reduction beyond March 2022 would be required than that seen in the previous two years if the deficit is to be eliminated around 2025. And any breach of the 2% limit on the structural deficit in 2020–21 would make this harder to attain.

The second fiscal target ('the supplementary target') requires that public sector net debt in 2020–21 is lower than it is in 2019–20. These types of targets are not sensible. While there are good reasons to want to reduce debt as a share of national income over the longer term, it is not the case that debt in 2020–21 should definitely be lower than it is in 2019–20. Furthermore, requiring that debt (as a share of national income) is lower in one year than in the previous one does little to constrain the longer-term debt path.

The forecasts imply that debt will fall as a share of national income in 2020–21. In part this is due to the expected timing of repayments of loans that have been made by the Bank of England to parts of the financial sector. As shown in Figure 2.7, debt would only be on course to fall slightly as a share of national income if these flows were ignored. A slowdown in the economy around the end of this decade could easily push debt up in 2020–21 and it would be far from clear that prompt policy action to prevent this from happening would be an appropriate response.

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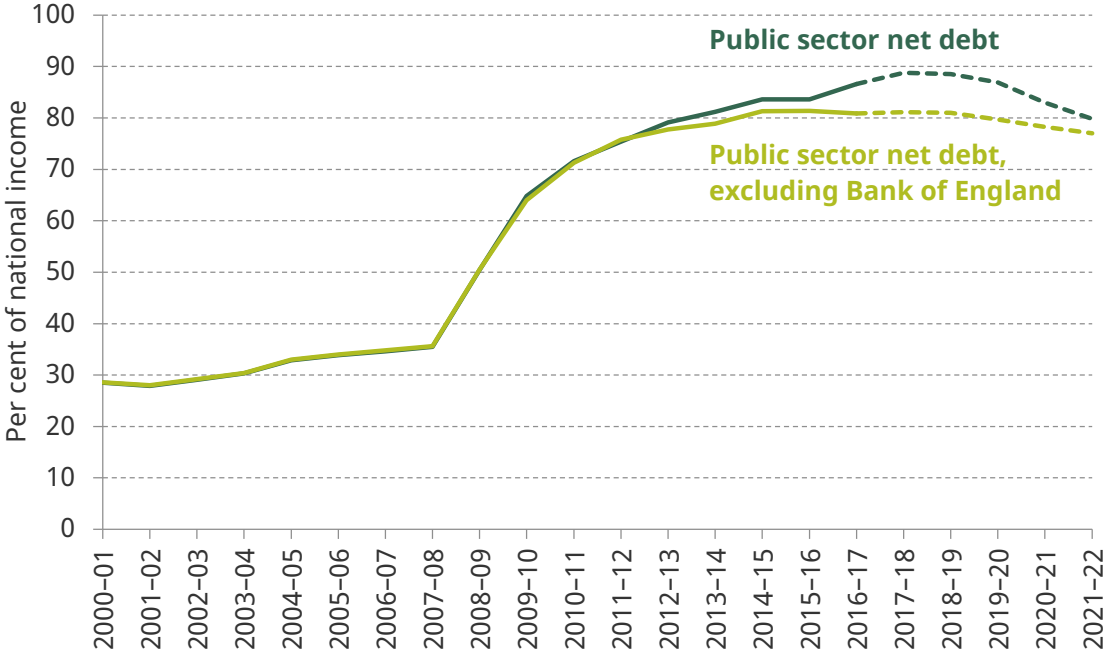
Figure 2.7. Public sector net debt since 2000–01, March Budget forecast



Source: Office for Budget Responsibility, *Public Finances Databank*, October 2017 (http://budgetresponsibility.org.uk/data/); Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2017 (http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/).

The third fiscal target ('the welfare cap') relates to spending on a specific set of welfare items. The cap is breached if spending exceeds, or is forecast to exceed, the cap. The November Budget will be the first fiscal event of this parliament, which is when the level of the cap (and the year in which it applies) is announced by the Treasury and is also the only time in this parliament that the OBR will get to make a formal assessment of whether or not the target is met. It would therefore be surprising if spending is forecast to exceed the cap, and the target be breached, as the Chancellor could always choose to set a higher cap, and this will be the last formal test of this target until the first fiscal update of the next parliament. These aspects render the welfare cap pointless, although presumably the OBR will continue to comment on progress towards the target in its biannual forecasts.

The March 2017 Budget deficit reduction plan

The March 2017 Budget plans implied that the government was on course to meet all three of its fiscal targets, although the OBR judged that it was not on course to meet its overarching objective to eliminate the deficit by the mid 2020s. It is also clear from Figure 2.6 that the forecast reduction in the deficit over the next five years was coming entirely from a reduction in the structural deficit. In other words, it was the result of fiscal policy action (and other underlying changes in the public finances) rather than a period in which particularly strong economic growth was forecast (as shown by the forecast path for national income per adult in Figure 2.1).

This section now turns to look at the drivers of the forecast reduction in the deficit over the next few years in more detail, as set out in Table 2.1. The top row shows the March 2017 Budget forecast for the headline deficit, falling from £58.3 billion in 2017–18 to £16.8 billion in 2021–22. The second row sets out the forecast reduction in the deficit

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Table 2.1. Consolidation plan, March 2017: change in deficit since 2017–18 (£ billion)

	2017–18	2018–19	2019–20	2020–21	2021–22
Forecast deficit	**58.3**	**40.8**	**21.4**	**20.6**	**16.8**
Forecast reduction in deficit since 2017–18		17.4	36.9	37.7	41.5
Of which:					
Underlying reduction in deficit		+2.3	+1.6	+2.9	–0.3
New measures		+15.2	+35.3	+34.7	+41.7
Of which:					
Discretionary tax rises		+8.5	+15.6	+17.0	+17.2
Discretionary tax cuts		–4.0	–6.4	–10.6	–10.9
Net discretionary tax rises		*+4.5*	*+9.2*	*+6.4*	*+6.2*
Net discretionary cuts to welfare spending		+4.1	+9.1	+10.9	+12.0
Impact from a real freeze to DEL (relative to constant share of GDP)		+6.3	+13.3	+21.3	+30.1
Additional impact from a real cut to DEL		+0.3	+3.7	–3.9	–6.6
DEL total (relative to constant share of GDP)		*+6.6*	*+17.0*	*+17.4*	*+23.5*

Note: Tax and welfare measures only count those measures announced since the coalition government took office in May 2010. DEL stands for departmental expenditure limits, and refers to OBR definitions (PSCE in RDEL and PSGI in CDEL) rather than Treasury ones. Numbers may not sum due to rounding.

Source: Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2017 (http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/); Office for Budget Responsibility, *Policy Measures Database*, March 2017 (http://budgetresponsibility.org.uk/data/).

between each year and 2017–18. So in 2018–19 the deficit is forecast to have fallen by £17.4 billion from its 2017–18 level, while by 2021–22 it is forecast to have fallen by £41.5 billion from its 2017–18 level (i.e. £58.3 billion less £16.8 billion).

This forecast reduction in the deficit can be decomposed, roughly, into that which is explained by the estimated impact of policy decisions and a residual which, broadly, could be considered to be the underlying change in the public finances that would have occurred absent any measures. For policy measures, the table takes into account the estimated impact of all tax and benefit changes announced since the June 2010 Budget and the forecast change in departmental spending as a share of national income.

Policy measures are forecast to reduce the deficit in 2021–22, relative to 2017–18, by £41.7 billion, more than accounting for the total fall in the deficit over this period.

Of the £41.7 billion estimated impact of policy measures, £6.2 billion comes from the net effect of changes to the tax system, with the impact of large tax cuts (£10.9 billion) being more than offset by larger tax rises (£17.2 billion). Most of this impact is from measures that are already in place but which are forecast to have a larger impact on revenues in future years than in 2017–18. For example, the rise in the rate of dividend tax announced

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in the July 2015 Budget is forecast to reduce revenues by £0.9 billion in 2017–18 (as some of those affected brought forward their dividend income so as to pay tax prior to the increase taking effect) and to increase them by £2.0 billion in 2021–22, i.e. an estimated boost to revenues of £2.9 billion in 2021–22 relative to 2017–18. While the increase in council tax in England, earmarked for additional spending on adult social care, is forecast to raise £0.8 billion in 2017–18, this rises to £2.3 billion in 2021–22. But there are some tax increases – and tax cuts – that have been announced but are yet to take effect. The largest tax rise yet to come is a reduction in the dividend allowance (the annual amount of dividend income someone can receive before they are liable to pay tax on it) from £5,000 to £2,000 from April 2018, which is forecast to boost revenues in 2021–22 by £0.9 billion. The largest tax cut is the further reduction in the corporation tax rate from 19% to 17% by 2020–21, which comes at a long-run public finance cost of around £5 billion per year.

A slightly larger contribution to the reduction in the deficit forecast over the next four years comes from cuts to spending on benefits and tax credits. These are estimated to reduce spending by £4.1 billion in 2018–19, rising to £12.0 billion in 2021–22, relative to 2017–18. These are the result of the £12 billion cut to welfare spending announced following the 2015 general election, most of the impact of which is yet to be felt by households. They come on top of £29 billion of cuts implemented since 2010. The further cuts to welfare spending come from two further years (April 2018 and April 2019) of the freeze to the rates of most working-age benefits (which, based on the inflation forecast as of March, was expected to reduce spending by £0.8 billion in 2017–18 rising to £4.8 billion in 2019–20), plus the fact that many of the other cuts that came into effect in April 2016 did not affect the current entitlements of existing claimants but will make the social security system less generous over time. This includes the cut to employment & support allowance (negligible impact on spending in 2017–18, but a cut of £0.7 billion in 2021–22) and the two-child limit for means-tested benefits and tax credits (forecast to cut spending in 2017–18 by £0.3 billion rising to £1.4 billion in 2021–22).

The final contribution to the planned deficit reduction comes from a forecast cut to spending by government departments as a share of national income. This contributes a £6.6 billion fall in the deficit between 2017–18 and 2018–19, rising to a £23.5 billion fall in the deficit between 2017–18 and 2021–22. In the next two years, 2018–19 and 2019–20, this cut to spending as a share of national income comes from the fact that spending is being cut in real terms (while the economy is forecast to grow in real terms). In the final two years, 2020–21 and 2021–22, the cut to spending as a share of national income comes from the fact that while spending is forecast to grow relative to economy-wide inflation, it is forecast to grow less quickly than the economy. Over the four years as a whole, spending is forecast to increase by £6.6 billion in real terms, but would need to rise by £30.1 billion for it to remain constant as a share of national income.

The resulting planned path of total departmental expenditure limits (DEL), as a share of national income, is shown in Figure 2.8. The first two years of cuts under the coalition government, which were relatively sharp, were sufficient to return this component of spending to its pre-crisis share of national income. Since then, spending has been cut more gradually as a share of national income and, as implied by Table 2.1, this is forecast to continue through to 2021–22. Also shown in Figure 2.8 is the forecast path for resource DEL – that is, day-to-day (or non-investment) spending by central government departments – as a share of national income. Between 2009–10 and 2012–13, this fell less

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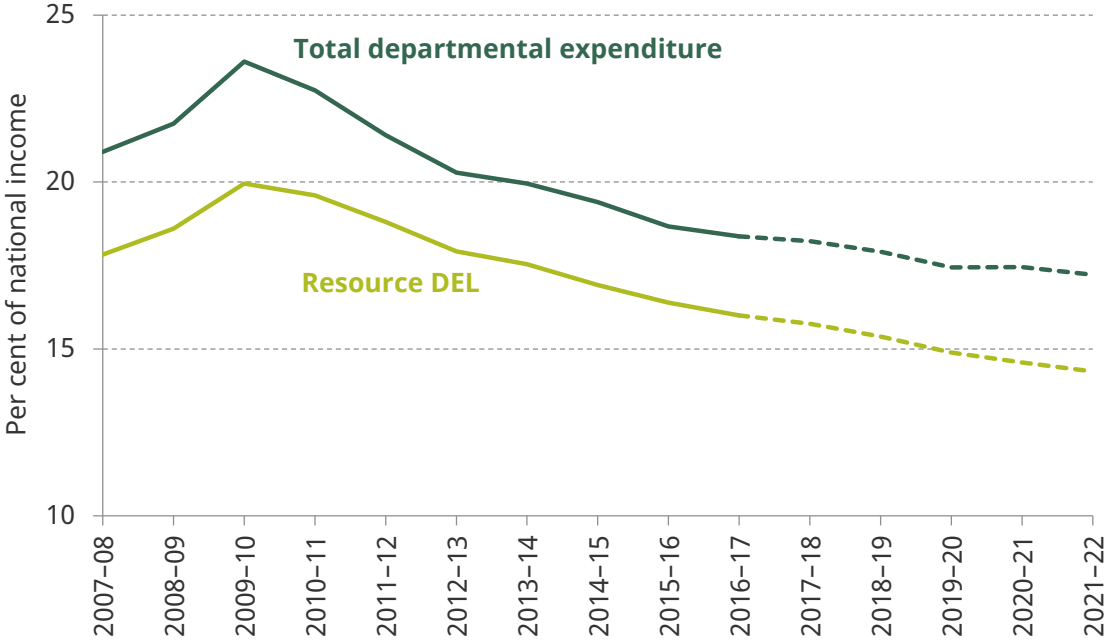
Figure 2.8. Departmental spending as a share of national income: March 2017 Budget forecast



Source: Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2017 (http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/).

sharply than total DEL as investment spending by departments (which is the gap between the two series in Figure 2.8) was cut back more sharply. Going forwards, there is a planned increase in investment spending, while resource DEL is forecast to continue being cut as a share of national income. This is a significant contributor to the forecast cut to day-to-day spending on public services, which is shown in Figure 2.3b (but which included spending on public services outside of central government – most notably that done by local authorities and devolved administrations), and implies that by 2021–22 it will reach its lowest share of national income since 2001–02.

Delivering these spending plans will not be straightforward. Not only is resource DEL due to fall as a share of national income, but also it is forecast to be cut in real terms (that is, relative to economy-wide inflation) in both 2018–19 and 2019–20, before being held fixed in real terms for a further two years. Overall, this implies a real-terms cut of 2% over the next four years. This comes after the period from 2010–11 to 2017–18, which (if the forecast for the current financial year is correct) will see this component of spending being cut by 8%. Over this period, the demands being placed on many public services are more likely to have increased than fallen. For example, the UK population is growing, and for many services – such as health and education – this will mean increased demand. As shown in Figure 2.9, resource DEL per capita is forecast to fall by 13% between 2010–11 and 2017–18 (an aggregate reduction of £46.0 billion) and to fall by a further 5% between 2017–18 and 2021–22 (an aggregate reduction of £15.3 billion in 2017–18 prices). (Further details of spending on the NHS over time can be found in Section 4.3.)

It is also the case that the cuts so far, and those planned, are not evenly shared across government departments. Over the period from 2010–11 to 2015–16, spending on the NHS and day-to-day spending on schools were protected from cuts while spending on overseas

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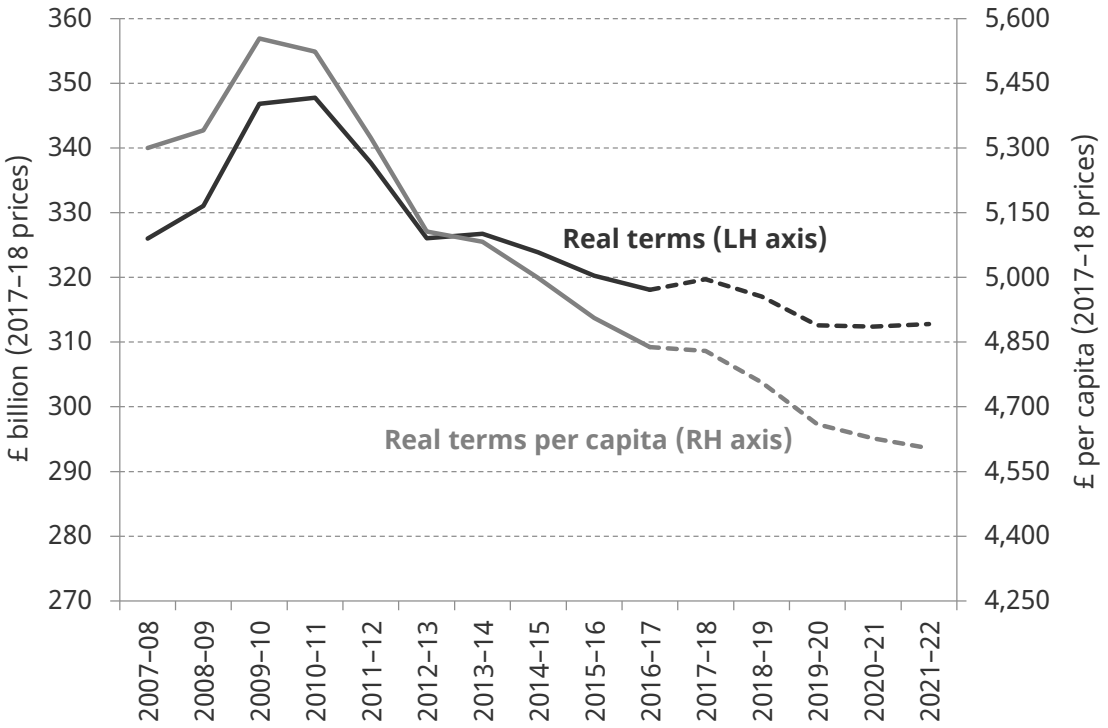
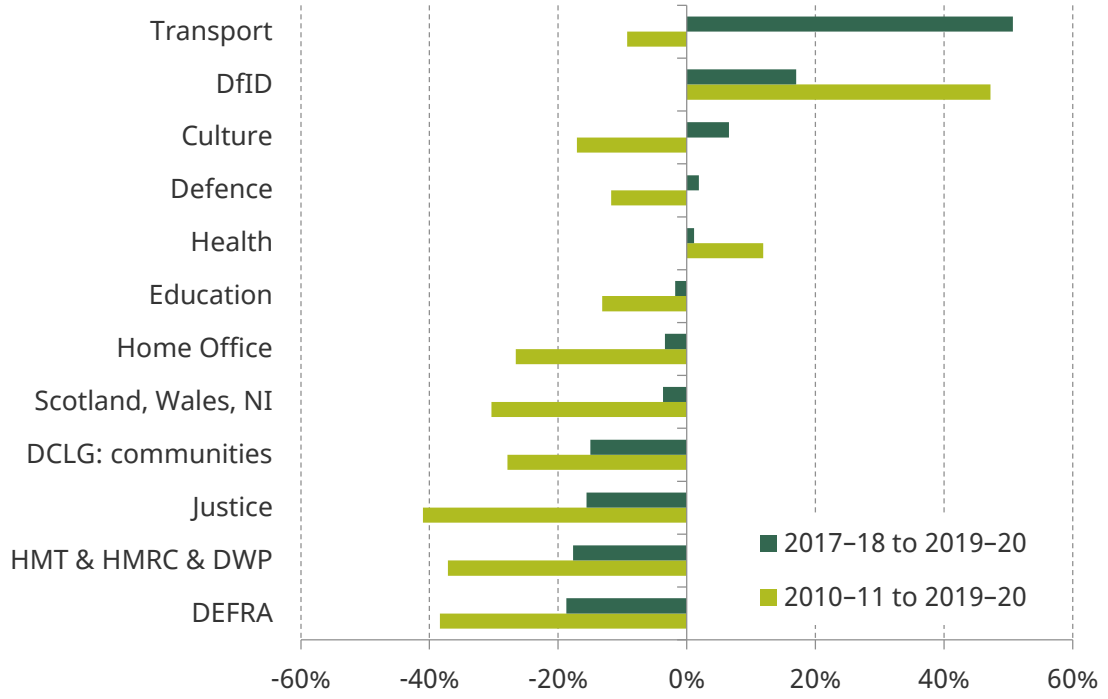
Figure 2.9. Resource DEL in real terms: March 2017 Budget forecast



Source: Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2017 (http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/).

Figure 2.10. Real-terms departmental budget changes, 2010–11 to 2019–20



Source: HM Treasury, *Public Expenditure Statistical Analyses*, July 2017 (https://www.gov.uk/government/collections/public-expenditure-statistical-analyses-pesa).

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aid was increased sharply to reach the legislated 0.7% of national income spending commitment. Since then, those areas of spending have remained relatively protected, with further protections added for spending on defence and police. Furthermore, capital-intensive departments – which tended to do less well in 2011–12 and 2012–13 as investment spending was cut sharply – will share the planned increase in capital spending (although areas such as transport will still see their day-to-day spending budgets cut). Over the next two years, particularly deep budget cuts are planned for the Ministry of Justice, the communities part of the Department for Communities and Local Government (DCLG), and the Department of the Environment, Food and Rural Affairs (DEFRA) – see Figure 2.10. This is despite these departments having already implemented relatively deep cuts over the last seven years. Furthermore, in the case of DEFRA, the spending settlement made in the Spending Review 2015 was made prior to the EU referendum and the resulting increase in demands that will follow for that department. (Further details on spending on prisons can be found in Section 4.3.)

Long-run pressures

The challenge of delivering a budget surplus by the middle of the next decade is made harder by the pressure on public spending from the ageing of the population. And even if a budget surplus is attained, population ageing and other cost factors are projected to put substantial pressure on public spending over the following decades.

The latest OBR projections, from January 2017, for total public spending (excluding spending on debt interest) over the next 50 years are shown in Table 2.2. Between 2019–20 (the last year for which detailed departmental spending plans have been set) and 2025–26, the projections suggest that demographic changes would place upwards pressure on spending worth 0.8% of national income (almost £17 billion in today's terms).

Table 2.2. Projected long-run total non-debt interest spending

	2019–20	**2025–26**	**2066–67**	***Increase to 2025–26***	***Increase to 2066–67***
Health	7.0	7.5	12.6	*+0.4*	*+5.6*
Long-term care	1.0	1.3	2.0	*+0.2*	*+1.0*
Education	4.0	4.0	3.8	*–0.1*	*–0.2*
State pensions	5.0	5.3	7.1	*+0.3*	*+2.0*
Pensioner benefits	0.8	0.8	0.9	*+0.0*	*+0.1*
Public service pensions	2.1	2.0	1.3	*–0.0*	*–0.8*
Other welfare benefits & credits	4.6	4.5	4.3	*–0.2*	*–0.4*
Other non-interest spending	11.4	11.5	11.8	*+0.1*	*+0.4*
Total non-interest spending	**36.0**	**36.8**	**43.8**	***+0.8***	***+7.8***

Note: Final two columns show projected increase in spending from 2019–20 to 2025–26 and 2066–67 respectively.

Source: Office for Budget Responsibility, *Fiscal Sustainability Report*, January 2017 (http://budgetresponsibility.org.uk/fsr/fiscal-sustainability-report-january-2017/).

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An ageing population beyond the mid 2020s is projected to continue to put upward pressure on public spending. The OBR's projections also allow for cost pressures within health to run ahead of economy-wide inflation, as they have done in the past. This adds considerably to the projected upwards pressure on public spending. As shown in Table 2.2, the latest projections have total non-interest spending increasing by 7.8% of national income between 2019–20 and 2066–67 (almost £160 billion in today's terms), with 5.6% of national income of this coming from health spending pressures. Spending on long-term care and on state pensions are also projected to increase, while spending on public service pensions and working-age benefits are projected to fall.

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3. Developments since March

Key findings

Strong receipts since the Budget imply lower borrowing.	Borrowing in 2016–17 (at £45.7 billion) now appears to have been £6 billion lower than the March forecast, and growth in receipts since has outstripped expectations across a number of tax bases. This welcome news points towards lower borrowing this year (of around £51 billion, £7 billion lower than the March forecast) and beyond.
Policy changes announced since the Budget add slightly to borrowing in the current parliament.	Policy giveaways announced since March – on self-employed NICs and spending in Northern Ireland – combine to increase borrowing a little over the next few years. Making student loan repayment terms in England substantially more generous will push up borrowing, but not until the first post-2012 loans are written off in the 2040s.
Lower productivity growth and more rapid interest rate rises would mean higher borrowing.	The OBR has indicated that it is likely to downgrade forecast productivity growth, which it has consistently overestimated since 2010. This would depress forecast receipts. Market expectations now imply interest rates rising more quickly, which will push up forecast debt interest spending.
Any substantial productivity downgrade would dwarf other factors and lead to higher medium-term borrowing.	If future productivity growth is downgraded halfway towards that seen over the last seven years, then – after accounting for recent receipts growth and the giveaways announced since the last Budget – the deficit in 2021–22 could be around £36 billion. This would be almost £20 billion higher than the £17 billion forecast by the OBR back in March.

The landscape facing the Chancellor is much changed since March. We have six more months of economic and public finance data, including revised market expectations about the Monetary Policy Committee's future actions on the base rate. There have also been new policy announcements, beginning a week after the Budget with the cancellation of the planned rise in the rate of National Insurance contributions (NICs) levied on the self-

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employed. Perhaps most significantly, there has been a general election leading to the Conservatives entering into a 'confidence and supply' arrangement with the DUP.

In this chapter, we lay out how these factors have changed since the last forecast in March and how they are likely to affect the public finances. We also consider risks to this public finance forecast, and especially the risk that productivity growth, which has been terrible over the last seven years, continues to disappoint over the next five.

3.1 Changes in the economy and the underlying public finances

Real economic growth

The single most important factor determining the health of the public finances is economic growth. Weak economic performance is the main reason why plans to reduce the deficit have been consistently delayed since 2010. Tax revenues tend to be lower when national income is lower.

The OBR estimates that about half of any downwards revision to trend national income is typically translated into increased government borrowing. So, for example, if national income is 1% – or £20 billion – lower than expected, then the deficit will be about £10 billion higher than expected.[2]

Growth so far in 2017 is estimated to have disappointed relative to the OBR's March forecast. Based on the latest out-turns, the size of the real economy in the second quarter of this year was only 0.5% higher than the final quarter of 2016, whereas in March the OBR expected the economy would be 0.9% larger. Figure 3.1 shows how the Bank of England's assessment of the economy has changed since February (when its forecast for the path of the economy was similar to the OBR's March forecast) as a result. Growth in 2017 and the first half of 2018 have been slightly downgraded, with marginally higher growth subsequently. The overall effect implies that the Bank of England now expects the economy to be slightly smaller in 2020 than it thought back in February.

While the forecast has been downgraded, relative to the uncertainty in the forecast the change is very slight indeed and the scale of the revision is not of a surprising magnitude. While in February the Bank expected annual growth up to 2018Q4 to be 1.7%, it thought there was an 18% chance that the economy would actually contract in that year and a 9% chance that it would grow at a rate of over 4%. For comparison, the Bank of England downgraded its forecast for the size of the economy in 2019 by more than 2% between May and November 2016 (following the EU referendum). Between February 2017 and August 2017, 2020 real GDP was downgraded by 0.3%.

Figure 3.2 shows how the outlook for growth implied by the average of the other independent macroeconomic forecasters surveyed by the Treasury has changed. The independent forecasters were, on average, more pessimistic than the OBR earlier in the year. Despite this, six out of the nine independent forecasters considered have downgraded their medium-term growth forecasts since then. There is still substantial

[2] See paragraph 5.48 of Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2016 (http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2016/).

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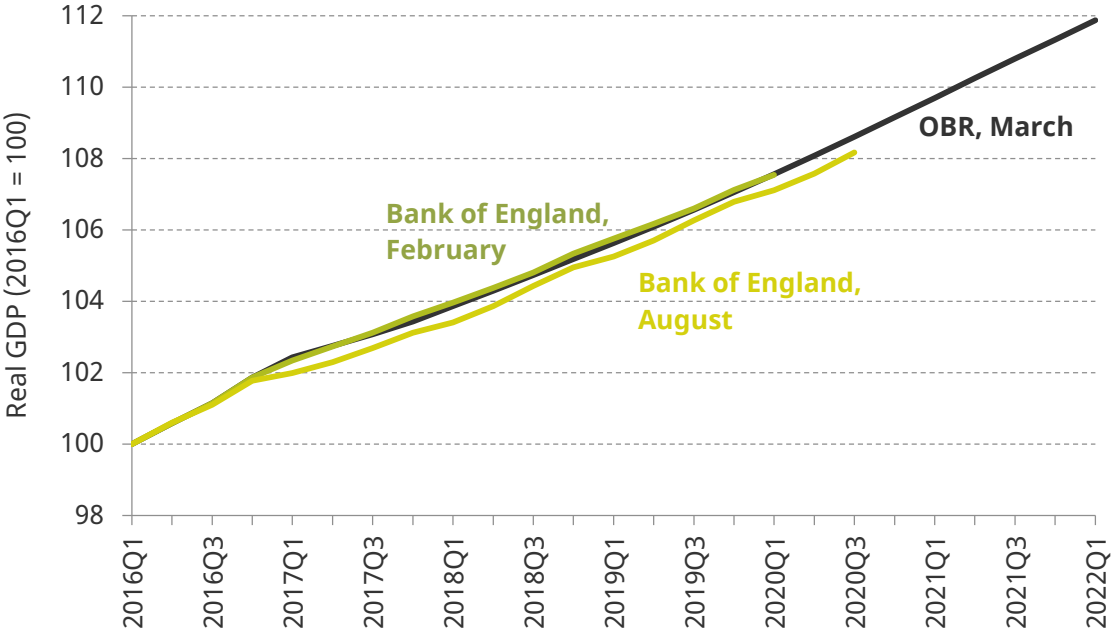
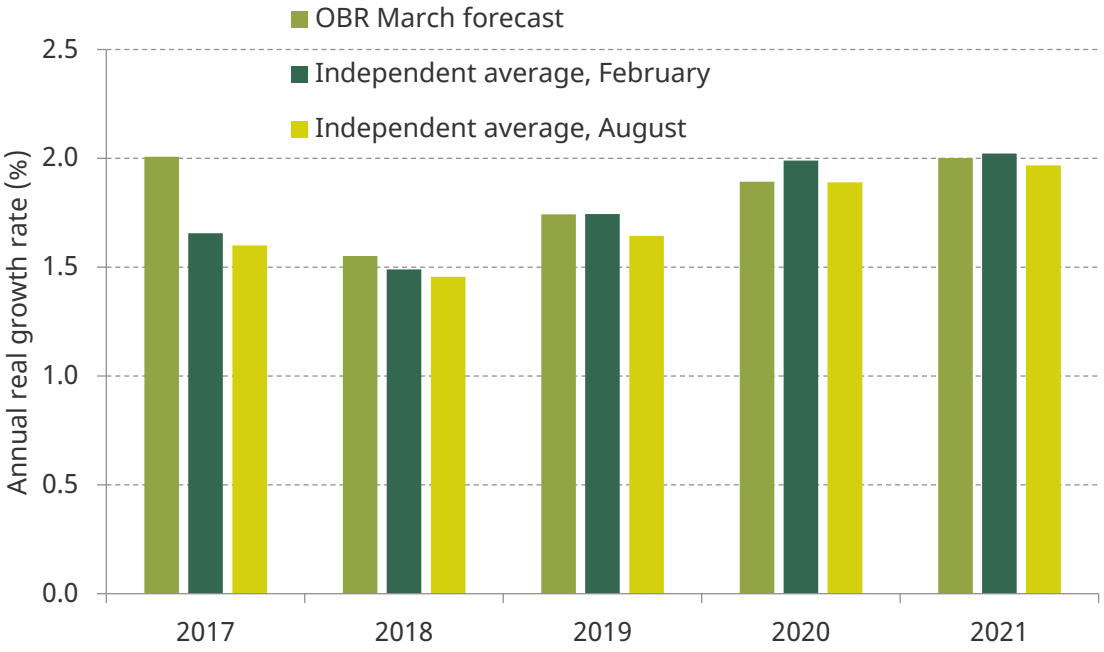
Figure 3.1. OBR and Bank of England real GDP forecasts (2016Q1 = 100)



Source: Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2017 (http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/); Bank of England, *Inflation Report*, February 2017 and August 2017 (http://www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx).

Figure 3.2. Average of independent real GDP growth forecasts



Note: Includes forecasts from all forecasters that provided the Treasury with a GDP forecast in both February and August. These are Citigroup, Commerzbank, Daiwa, ING, NatWest, Beacon, Experian, National Institute of Economic and Social Research, and Oxford Economics.

Source: Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2017 (http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/); HM Treasury, *Forecasts of the UK Economy*, February and August 2017 (https://www.gov.uk/government/collections/data-forecasts).

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disagreement among these independent forecasters, reflecting forecast uncertainty – 2018 growth forecasts range from 0.9% to 2.1%.

If the OBR were to downgrade its forecast in line with the Bank of England (up to 2019, when the Bank's February forecast ended) and the average of independent forecasters (from 2020 onwards), the forecast real size of the economy in each of these years would only be slightly below the forecast in March (0.4% smaller by 2021). This modest movement in national income would still affect the public finances, leading to higher borrowing of around £5 billion in 2021–22. The precise effect on the public finances would depend on changes to the composition of national income. For example, if the downwards revision were predominately about weaker investment or export growth, then the public finance impact would be more benign than if it were about weaker consumption growth, since the latter is more heavily taxed. Compositional changes within sources of income also matter. Most obviously, if household income growth were to be revised down, then if this were to come more through weaker average earnings growth than through weaker employment, this less tax-rich mix of growth would exacerbate the extent to which receipts were revised down.

However, it appears likely that the OBR will downgrade its growth forecast by more than the average of independent forecasters this autumn. Since the OBR began forecasting in 2010, it has consistently overestimated productivity growth. Figure 3.3 shows successive forecasts for output per hour worked. Since 2010, the OBR has expected productivity to return to a growth rate of around 2% per year, and yet output per hour has increased by less than 3% in total over the seven years since 2010. Looking at Figure 3.4, these forecasts are perhaps understandable. Over the 35 years leading up to the financial crisis, output per hour grew at an average of over 2% per year, and always returned to that growth rate (or better) quickly after periods of weak productivity performance. However, since 2008 productivity growth has been terrible, growing at only 0.1% per year. Even ignoring two years of negative growth in output per hour in 2008 and 2009, the average growth rate over the past seven years has been only 0.4%. Such a period of low productivity growth is unprecedented in the UK in recent times: data from the Bank of England suggest that the last time output per hour grew so slowly over a six-year period prior to the recent financial crisis and associated recession was the six years from 1942 to 1948. The period from 2007 to 2016 was the first time that output per hour barely increased over a nine-year period since comparable data begin in 1856.[3]

When launching its latest *Forecast Evaluation Report* on 10 October 2017, the Chairman of the OBR, Robert Chote, said, 'for now we are minded to revise down potential productivity growth significantly' in November.[4] The March forecast implied average potential productivity growth of 1.6% per year from 2016–17 to 2021–22. However, productivity growth so far in 2017 has been negative, and 2016 productivity growth has also been revised down since the Budget, making such a path going forwards appear unduly optimistic. Productivity growth is the primary driver of economic growth, and so a downgrade to the productivity growth forecast would substantially affect national income, and therefore the public finances. It would, most likely, also lead to a weaker outlook for wage growth affecting the finances of working households. Slightly offsetting this, Robert

[3] Source: Bank of England, *A Millennium of Macroeconomic Data* (http://www.bankofengland.co.uk/research/Pages/datasets/default.aspx).

[4] See http://budgetresponsibility.org.uk/chairmans-presentation-latest-forecast-evaluation-report/.

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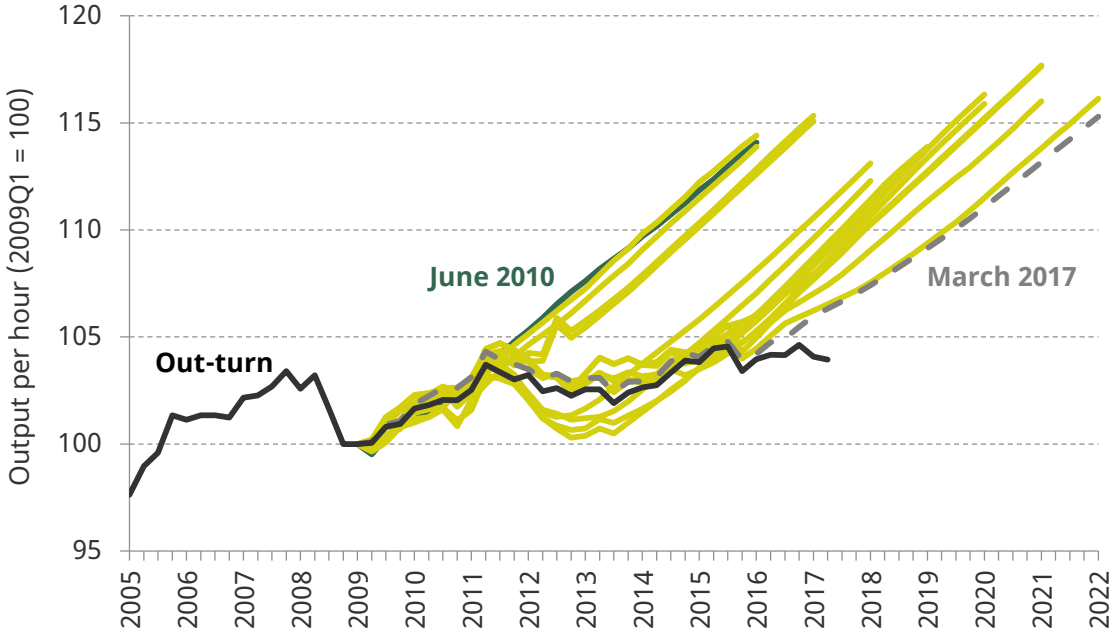
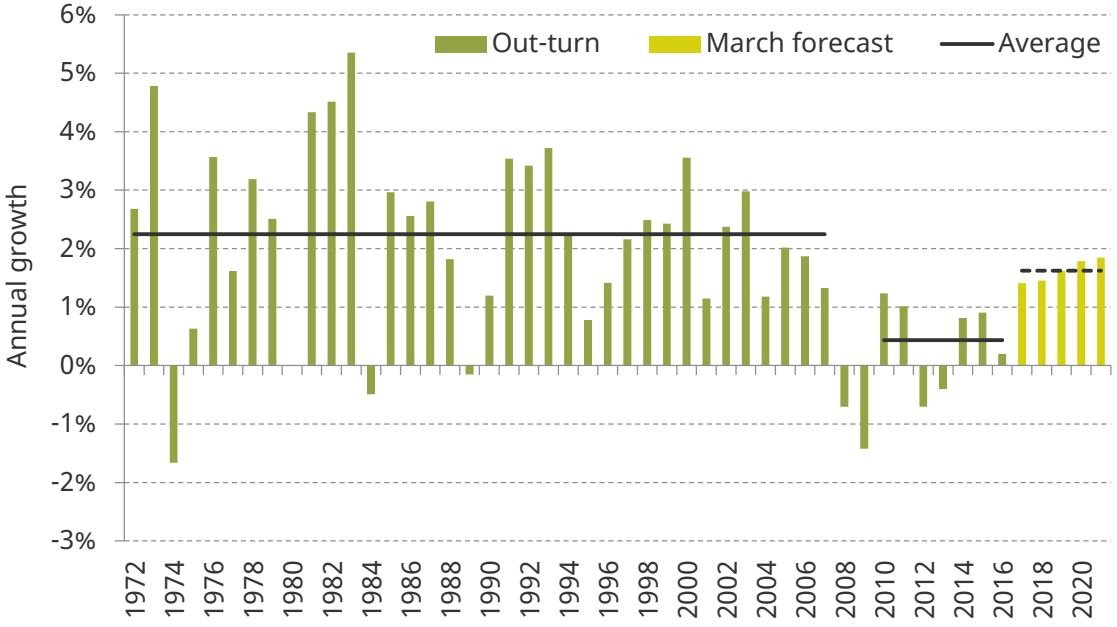
Figure 3.3. Successive forecasts for productivity



Source: Office for Budget Responsibility, *Forecast Evaluation Report*, October 2017 (http://budgetresponsibility.org.uk/fer/forecast-evaluation-report-october-2017/).

Figure 3.4. Output per hour annual growth since 1972



Note: Black lines refer to average growth rates in the relevant periods (1972–2007, 2010–2016, 2017–2021).

Source: Office for National Statistics series LZVB; Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2017 (http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/).

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Chote also noted, reflecting on stronger-than-expected growth in hours worked and employment, 'we will need to take these trends into account … too'.

While since February the Bank has downgraded its forecast for productivity growth in 2017 (from 1½% to ½%), it has upgraded its forecast for productivity growth in 2018 and 2019 (from 1¼% to 1½%). If the OBR were instead to downgrade forecast productivity growth substantially, therefore, the medium-term real GDP growth forecast in the November 2017 Budget could potentially be much lower than the Bank of England's most recent forecast.

To illustrate the sensitivity of the borrowing forecast to alternative assumptions about productivity growth, we consider the effect of three different productivity scenarios. In a 'moderate' scenario, we assume that growth is downgraded in line with the Bank of England's forecast up to 2019 and the average of independent forecasts beyond that. We also consider the implications of a substantial productivity downgrade. In our 'very poor' productivity growth scenario, we assume that productivity growth over the next five years is as bad as it has been for the last seven. This would imply average productivity growth of only 0.4% per year. In our 'weak' productivity growth scenario, we consider the effect of productivity growth being halfway between the OBR's March forecast and the average of the past seven years. While this would still be a large downgrade to productivity growth, it would imply an average growth rate of 1.0%, substantially higher than that over the last

Table 3.1. Average growth rates under different scenarios

Average growth rate, 2016–17 to 2021–22	March forecast	'Moderate' productivity growth	'Weak' productivity growth	'Very poor' productivity growth
GDP	1.8%	1.7%	1.3% (down 0.5 ppts on March)	0.7% (down 1.1 ppts on March)
Of which:				
Output per hour	1.6%	N/A	1.0% (down 0.6 ppts on March)	0.4% (down 1.2 ppts on March)
Population	0.6%	N/A	0.6% (unchanged)	0.6% (unchanged)
Employment	–0.1%	N/A	–0.1% (up 0.05 ppts on March)	–0.1% (up 0.05 ppts on March)
Average hours	–0.2%	N/A	–0.2% (up 0.05 ppts on March)	–0.2% (up 0.05 ppts on March)

Note: GDP growth is actual GDP growth. The individual components reflect potential growth. The difference between them reflects the cyclical component of GDP, though the OBR's March forecast was that this difference was small. In the 'moderate' scenario, growth is downgraded according to forecast changes by the Bank of England and independent forecasters, and so we do not have a decomposition of growth into components.

Source: Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2017 (http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/); HM Treasury, *Forecasts of the UK Economy*, February and August 2017 (https://www.gov.uk/government/collections/data-forecasts); Bank of England, *Inflation Report,* February 2017 and August 2017 (http://www.bankofengland.co.uk/publications/Pages/inflationreport/default.aspx).

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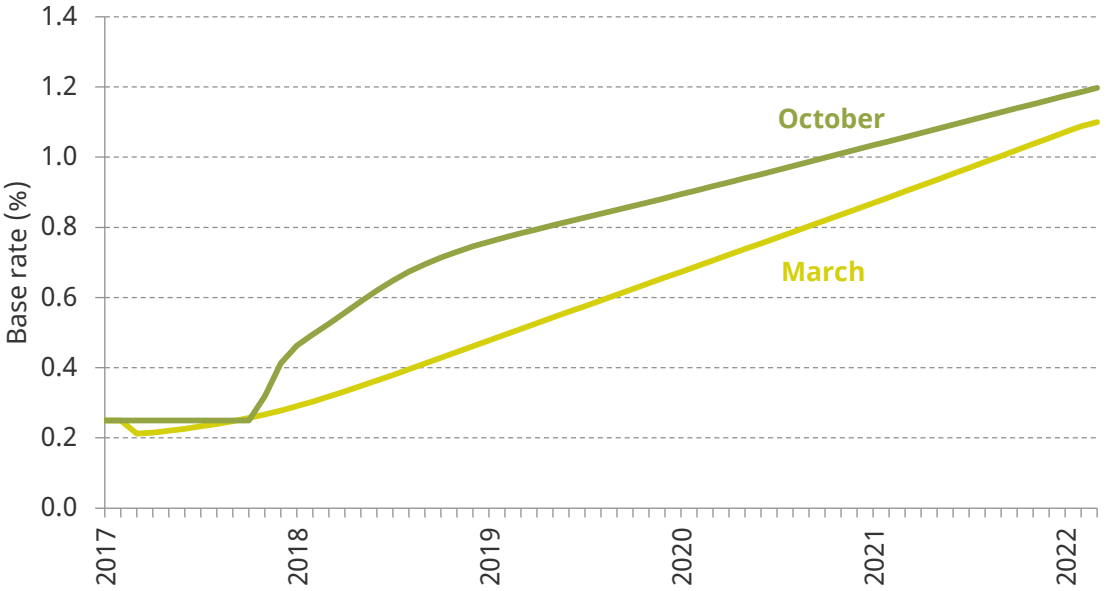
seven years. In each of the last two scenarios, we also adjust upwards the hours and employment forecasts, such that these two factors combine to increase economic growth by 0.1% per year relative to the OBR's March forecast. These scenarios, and the March forecast, are illustrated in Table 3.1, while the implications for borrowing are presented in Section 3.3.

Debt interest spending

The UK government currently spends around 2% of national income servicing its national debt (as shown in Figure 2.3a), which stands at 89% of national income (as shown in Figure 2.5). Much of that debt is in the form of bonds with long maturities, which means that a change in gilt rates (the interest rate on government debt) will only affect the cost of new gilt issuance and does not immediately lead to large increases in the cost of servicing the national debt. However, the amount of debt interest paid by the public sector is sensitive in the short term to the base rate set by the Bank of England's Monetary Policy Committee (MPC).

Ordinarily, public sector interest rate payments would only depend on the base rate indirectly (i.e. because increases in the base rate will typically be associated with increases in gilt rates). However, the Bank of England's Asset Purchase Facility (APF) currently holds UK government gilts with a face value of £435 billion as a result of the purchases made under its programme of quantitative easing. The cost of financing these purchases is scored in the public finances as being the Bank of England base rate. Since the base rate is currently at such a low level, this means that the public finances are temporarily flattered. It also means that public sector interest payments will increase when the base rate increases. This increase is likely to be particularly sharp – for example, an increase in the base rate from its current low of 0.25% to just 0.5% would instantly double the measured cost of financing the gilt purchases held in the APF (from £1.1 billion per year to

Figure 3.5. Market expectations of Bank Rate



Source: Bank of England Overnight Index Swap Yield curve data (http://www.bankofengland.co.uk/statistics/pages/yieldcurve/default.aspx).

£2.2 billion). This exposure of the UK public finances to changes in short-term interest rates is documented in one of the ICAEW chapters in the February 2017 IFS Green Budget.[5]

Since March, market expectations over the base rate have changed significantly (see Figure 3.5). The Monetary Policy Committee is now expected to increase interest rates sooner than previously thought, which as explained above has short-term consequences for the UK public finances. As the figure shows, the difference between expectations now and in March is in the near term – the MPC is expected to increase interest rates more quickly, but not necessarily to a higher medium-term level. As a result, the cost to the public finances of this change would diminish over time. Interest costs in 2018–19 would be around £1.5 billion higher, but costs in 2021–22 would be only £0.7 billion higher, than the March forecast. Since the OBR uses market expectations for the base rate to produce its forecast for the public finances, we can expect a revision to forecast debt interest spending along these lines in the November Budget.

Developments in the public finances

Despite economic growth this year disappointing relative to the OBR's March forecast, borrowing in the year to date has been lower than expected. Furthermore, while the first estimates of borrowing in 2016–17 suggested that it was very close to the OBR's March forecast (£0.3 billion higher), it has subsequently been revised down. The latest estimates suggest that borrowing in 2016–17 was around £6 billion lower than the OBR expected back in March. Following on from this, borrowing this year appears to be running below the March forecast mostly due to stronger performance of tax receipts. While part of this is driven by timing effects – in particular, that self-assessment revenues, which largely materialise around late January, are set to be much lower than last year (when receipts were temporarily flattered[6]) – even taking this into account the in-year public finances are healthier than we might have expected given the OBR's forecast.

Figure 3.6 shows that the better-than-expected receipts performance so far this year is spread across many of the main taxes. Of these changes, the OBR notes that the PAYE and NICs performance may be attributable to particularly weak pay performance in the first half of 2016–17, and therefore the improvement relative to last year may unwind a little towards the end of the year.[7] However, we might reasonably expect around half of this difference, and the remaining improvements, to persist. If this were to be the case, the effect would be to reduce borrowing in 2017–18 by almost £6 billion relative to the March forecast. Furthermore, spending on tax credits is lower than expected (possibly saving £2 billion over the year as a whole), while larger-than-expected EU budget underspends mean those transfers are likely to be £¾ billion lower than expected in March.

[5] See R. Campbell and M. Wheatcroft, 'ICAEW: debt', in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2017* (https://www.ifs.org.uk/publications/8825).

[6] The announcement in the Summer 2015 Budget to increase the rate of dividend tax from April 2016 led to some high-wealth individuals bringing forward dividend income into 2015–16. This inflates revenues received in January 2017 but will depress them in later years. It appears this happened to a greater extent than was initially factored into the forecasts by the OBR.

[7] Paragraph 6 of Office for Budget Responsibility, 'Commentary on the public sector finances release: August 2017', September 2017 (http://budgetresponsibility.org.uk/docs/dlm_uploads/Sep-2017-Commentary-on-the-Public-Sector-Finances.pdf).

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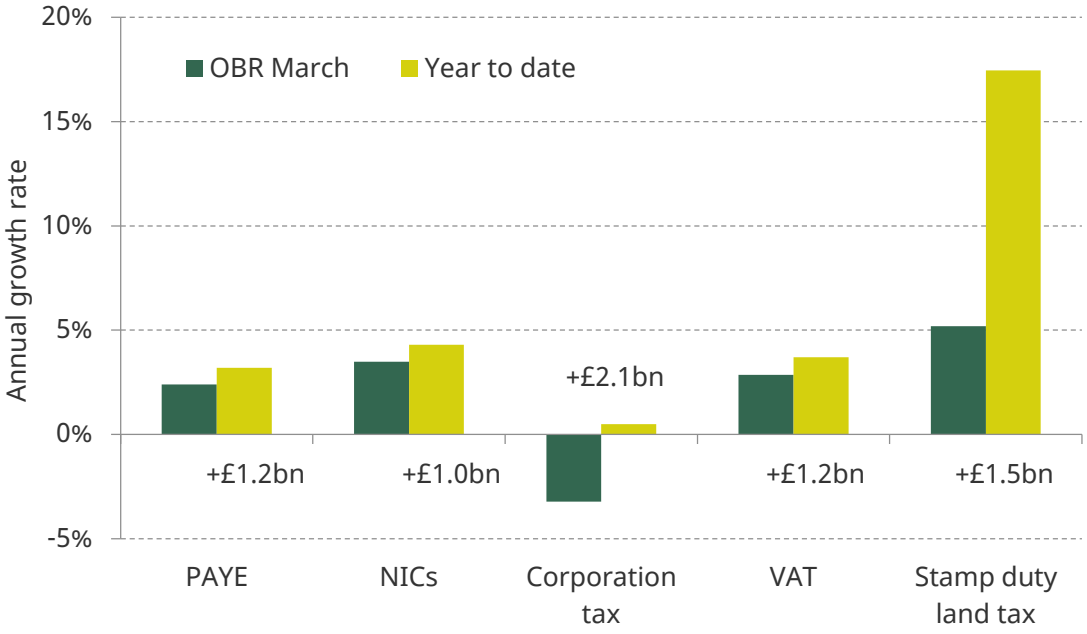
Figure 3.6. Growth in tax receipts: OBR March forecast for the year as a whole and the year to date



Note: OBR March growth rate based on March nominal forecast and the most recent out-turns. The numbers refer to the additional revenue that would be received if the improvement for the year to date were to persist for the year as a whole.

Source: Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2017 (http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2017/); Office for National Statistics *Public Sector Finances, UK: September 2017* (https://www.ons.gov.uk/economy/governmentpublicsectorandtaxes/publicsectorfinance/bulletins/publicsectorfinances/september2017).

That this continued stronger-than-expected growth in receipts has arisen despite the economy performing more poorly than anticipated suggests an even greater underlying improvement in the public finances. Ordinarily, the weaker-than-expected economic growth thus far would be expected to depress receipts, by around £2½ billion. This suggests a true underlying improvement in the public finances of £11 billion (i.e. £6 billion from higher receipts, £2¾ billion from lower spending and an additional £2½ billion reflecting weaker growth). In our calculations below, we assume that this persists (with the exception of lower EU transfers) for the remainder of the forecast period, rather than assuming it is an effect that would only be felt in 2017–18 or one that would fade thereafter.

In our analysis, we have not taken account of modest deviations to oil and stock prices relative to the OBR's March forecast, or of changes to the outlook for household inflation forecasts, all of which would affect the forecast by less than £0.5 billion per year. (Normally, the fact that inflation in September 2017, as measured by the Consumer Prices Index (CPI), turned out higher than forecast would be expected to feed into greater spending on working-age benefits. However, the current government policy of freezing most rates of working-age benefits considerably limits this impact.) Of course, there are other factors that may prove important for the Budget forecast. In particular, the GDP deflator – a measure of economy-wide prices – determines the nominal (£ billion) size of a real economy of a given size. As the nominal size of the economy is the most important

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thing for the public finances, a downgrade (upgrade) to the GDP deflator could considerably worsen (improve) the borrowing forecast. In Section 3.3, we lay out the implications of these developments for the public finances, including the sensitivity of the borrowing forecast to alternative assumptions over productivity growth.

In the next section, we briefly lay out policy changes since March and their (relatively minor) public finance implications, before considering the path of borrowing, structural borrowing and debt under different scenarios for productivity growth in Section 3.3.

3.2 Policy developments

The previous section presented ways in which the Budget forecast for the public finances is likely to be revised in light of developments since March. Undoubtedly, the Budget will contain policy measures that affect government borrowing over the next few years. In Chapter 4, we consider possible policy options that the Chancellor could be considering. However, there are also several policy changes that have already been announced since March which (to differing degrees) will affect the public finances, as summarised in Table 3.2 and discussed below.

Table 3.2. Policies announced since March Budget

Policy	Notes on cost
Self-employed NICs	Reversal costs £0.5 billion per year.
Confidence and supply arrangement	£450 million per year for two years. Potentially additional outgoings if parliament continues beyond two years.
Making Tax Digital	Short-run increase to borrowing of £0.3–£0.4 billion per year.
Student loans	Long-run cost of £2.0 billion for the 2017 cohort of students. Little effect on public sector net borrowing in near term; higher government debt in short and long run.
Help to Buy	£10 billion over five years. No effect on public sector net borrowing in near term; higher debt in short run.

Self-employed NICs

The most immediate policy change since the March Budget came only a week later, when the government U-turned on a Budget measure to increase the rate of Class 4 (self-employed) National Insurance contributions. The measure would only have partly closed the very large – and unfair – gap in the taxation of employees and the self-employed.[8] However, it proved unpopular and controversial given the Conservatives' 2015 general election manifesto commitment to no increases in VAT, income tax or National Insurance. In his letter to the Chair of the Treasury Select Committee announcing the U-turn, the Chancellor wrote that 'the Government continues to believe that this is the right approach' and that this reversal would 'be funded by measures to be announced in the

[8] S. Adam, H. Miller and T. Pope, 'Tax, legal form and the gig economy', in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2017* (https://www.ifs.org.uk/publications/8825).

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Autumn Budget'.[9] This measure was forecast to raise around £500 million a year from 2018–19, and so the reversal adds the same amount to the borrowing forecast.

Confidence and supply deal

In reaching a 'confidence and supply' arrangement with the DUP in June, the government committed to spending an extra £450 million per year for two years in Northern Ireland. The bulk of these funds were set to be spent on infrastructure (£275 million per year) and health and education (£150 million per year). These are additional expenditures on top of March plans. The confidence and supply agreement 'will remain in place for the length of the Parliament',[10] so it would not be surprising if further funds were to be made available if the current parliament runs for more than two years.

Delays to 'Making Tax Digital'

In the Autumn Statement of 2015, the government announced its intention to change radically the ways in which businesses pay tax to HMRC, allowing taxes to be paid in 'real time' rather than annually. However, this would require businesses to provide some information to HMRC in real time as well, and the timeline has been delayed. Originally, the system was intended to be fully in place by 2020. However, the measure was withdrawn from a pared-down Finance Act earlier this year (due to the announcement of the general election) and in July the government announced that only businesses above the VAT threshold need keep records from 2019 – and only for VAT purposes – and other businesses would not need to provide information for other taxes until at least 2020.[11]

The measure is expected to raise around £1 billion per year from 2021–22 onwards,[12] so delays in its implementation have short-run consequences for the public finances. Pushing back the reform by one year would increase borrowing by £300 million in 2019–20 and 2020–21 and by £400 million in 2021–22.

Announced changes to student loans

On the eve of the Conservative party conference, the Prime Minister Theresa May announced changes to the system of financing universities in England. The fee cap will be frozen in cash terms at £9,250 and for those who started university from 2012 onwards the repayment threshold – the annual income an individual has to have before making student loan repayments – will increase from £21,000 to £25,000.

The first of these changes is a cut to the funding of English universities. Since very few students are projected to pay off their full student loans, the gains from this will largely accrue to the exchequer rather than to the graduates in future. Universities will receive an estimated £0.3 billion less for the group of students who have just begun university over

[9] Philip Hammond's letter to the Chair of the Treasury Select Committee, 15 March 2017 (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/600036/Chancellor_letter_to_Chairman_TSC.pdf).

[10] *Confidence and Supply Agreement between the Conservative and Unionist Party and the Democratic and Unionist Party* and *UK Government Financial Support for Northern Ireland* (https://www.gov.uk/government/publications/conservative-and-dup-agreement-and-uk-government-financial-support-for-northern-ireland).

[11] See https://www.gov.uk/government/news/next-steps-on-the-finance-bill-and-making-tax-digital.

[12] Paragraph 5.89 of Office for Budget Responsibility, *Fiscal Risks Report*, July 2017 (http://budgetresponsibility.org.uk/frr/fiscal-risk-report-july-2017/).

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the course of their degree. While this is a small change in the short term, a permanent freeze in fees would result in a large erosion of university funding in the long run.

Assuming the fee freeze is not continued beyond the near term, the change to the repayment threshold is far more significant as it means that most students will now pay off a smaller amount of their loan debt before it is written off 30 years after graduation. The change is estimated to cost the government £2.3 billion a year of lost revenue from lower fee repayments in the long run, as it will now be writing off 45% of student loan debt, up from 31% in the absence of these reforms.[13]

It is clear that these changes will increase taxpayer support for those studying in English universities and therefore will weaken the public finances. In terms of government debt, the freeze to the tuition fee cap will reduce the amount lent out, but this impact will be more than counteracted by the increase in the repayment threshold reducing tuition fee repayments and therefore pushing up debt. In terms of public sector net borrowing, in the near term, greater outstanding tuition fee debt may in turn actually very slightly increase the accrued interest scored in the public finances (despite the fact that much of this additional debt will never be repaid). The far more significant impact on borrowing comes from the increase in the repayment threshold leading to lower tuition fee repayments by graduates, and ultimately a greater share of total loan value being written off. This will increase borrowing, but not until these loans are written off, which will not start to happen until April 2046 (i.e. 30 years after those who started university in 2012 will have graduated).

Expansion of Help to Buy

The government 'Help to Buy' scheme provides loans to some first-time buyers purchasing newly built homes, and requires a deposit of only 5%. The government provides an equity loan of 20%, reclaiming its stake when the house is sold. In his conference speech, the Chancellor announced that he would provide a further £10 billion of funding for the scheme, which is set to continue until 2021. This was in response to 'higher take-up than expected' so far. The extra funds provide loans that the government expects to reclaim, and therefore in the near term public sector net borrowing is unaffected. Should less (or more) subsequently be repaid when the house is sold, this would increase (or reduce) borrowing at that point. However, as with changes to the student loan system, this policy will affect government cash flows, increasing national debt in the short run when the loans are made and subsequently reducing it when houses are sold and the loans are repaid.

3.3 Implications for the public finances

Table 3.3 and Figure 3.7 show how alternative assumptions about changes to the growth forecasts and market expectations of the Bank of England base rate, as well as the underlying strength of the public finances and policy changes announced so far, are likely to affect the outlook for borrowing. In the 'moderate' scenario, where growth is downgraded in line with the Bank of England and independent forecasts, there is a slight improvement in the borrowing forecast. It would certainly be a very modest forecast

[13] For more information on these changes, see C. Belfield, J. Britton and L. van der Erve, 'Higher education finance reform: raising the repayment threshold to £25,000 and freezing the fee cap at £9,250', IFS Briefing Note no. 217, October 2017 (https://www.ifs.org.uk/publications/9964).

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Table 3.3. Borrowing under different real growth scenarios (£ billion)

	2017–18	2018–19	2019–20	2020–21	2021–22
OBR March borrowing forecast	**58.3**	**40.8**	**21.4**	**20.6**	**16.8**
'Moderate' total change	–6.9	–4.9	–5.3	–5.5	–5.4
Of which:					
Total underlying change	–6.9	–5.7	–6.7	–6.4	–6.3
Of which:					
Real growth downgrade	+3.7	+3.4	+2.9	+4.0	+4.8
Higher base rate expectation	+0.4	+1.5	+1.3	+1.1	+0.7
Underlying improvement	–11.0	–10.6	–10.9	–11.4	–11.8
Total policy change	0.0	+0.8	+1.4	+0.9	+0.9
'Moderate' borrowing forecast	**51.3**	**35.9**	**16.0**	**15.1**	**11.4**
'Weak' total change	–6.9	+0.2	+6.1	+12.0	+19.1
Of which:					
Total underlying change	–6.9	–0.6	+4.8	+11.1	+18.1
Of which:					
Real growth downgrade	+3.7	+8.5	+14.4	+21.5	+29.3
Higher base rate expectation	+0.4	+1.5	+1.3	+1.1	+0.7
Underlying improvement	–11.0	–10.6	–10.9	–11.4	–11.8
Total policy change	0.0	+0.8	+1.4	+0.9	+0.9
'Weak' borrowing forecast	**51.3**	**41.0**	**27.5**	**32.6**	**35.8**
'Very poor' total change	–6.9	+10.7	+23.4	+37.4	+53.1
Of which:					
Total underlying change	–6.9	+9.9	+22.0	+36.5	+52.2
Of which:					
Real growth downgrade	+3.7	+19.0	+31.7	+46.9	+63.4
Higher base rate expectation	+0.4	+1.5	+1.3	+1.1	+0.7
Underlying improvement	–11.0	–10.6	–10.9	–11.4	–11.8
Total policy change	0.0	+0.8	+1.4	+0.9	+0.9
'Very poor' borrowing forecast	**51.3**	**51.5**	**44.8**	**58.0**	**69.9**

Note: 'Moderate', 'weak' and 'very poor' refer to alternative productivity scenarios set out in Table 3.1. Assumes base rate following market expectations, and receipts and spending improvements so far this year persisting over the period.

Source: See Figures 3.1, 3.2 and 3.5; authors' calculations.

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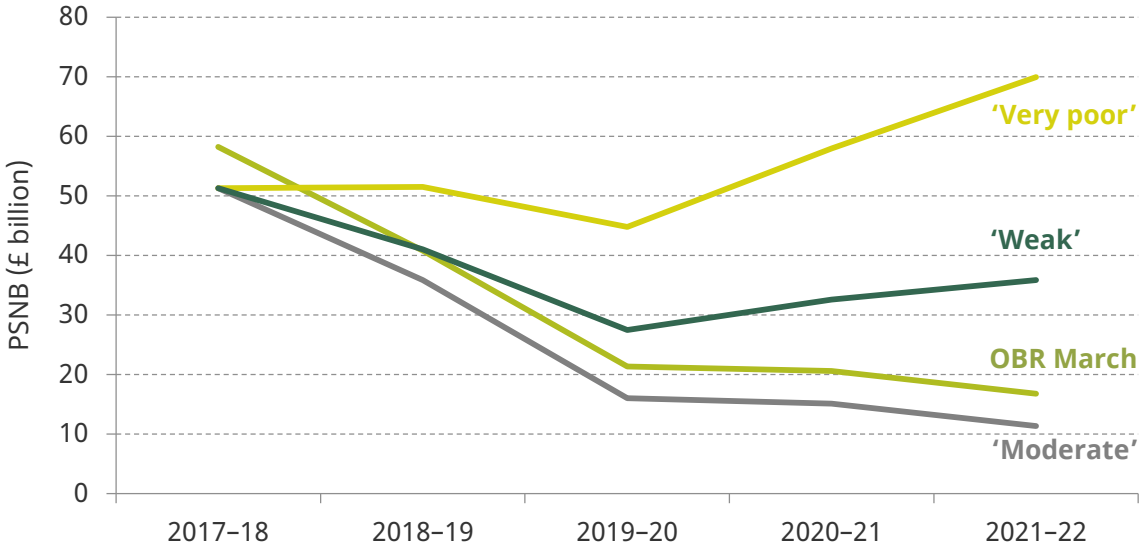
change by historical standards, especially in the medium term (Table 3.4 shows the average absolute underlying change in Autumn forecasts from the previous forecast since 2010). A weaker economy, a higher Bank of England base rate and some policy giveaways are outweighed by stronger receipts in recent months, which we assume will persist beyond this year.

Even this 'moderate' scenario is subject to risks. If the underlying improvement in the public finances is judged to be temporary rather than permanent, then the effects of weaker growth, higher interest rates and policy giveaways would lead to a modest increase, rather than fall, in the borrowing forecast. Even if this were to be the case, the changes to the forecast would be small, however, and would not lead to a public finance outlook that was qualitatively different from that in March. A small improvement or worsening in the borrowing forecast would both portray more or less the same message – the assessment of the public finances in March, and the challenges described in Chapter 2, would remain.

Figure 3.7. Public sector net borrowing under different growth scenarios



Note: Assumes interest rate market expectations, policy changes and the underlying improvement in the public finances from Table 3.3. Scenarios reflect those in Table 3.1.

Source: See Figures 3.1, 3.2 and 3.5; authors' calculations.

Table 3.4. Average absolute underlying change in Autumn forecasts (from previous forecast) since 2010 in different years of the forecast (£ billion)

Year 1 (in-year)	Year 2	Year 3	Year 4	Year 5
5.0	10.9	14.9	15.9	16.5

Note: Change in forecast before taking policy measures into account. Year 1 refers to the fiscal year in which the forecast was made (i.e. for the November 2010 forecast, Year 1 is 2010–11). Covers all Autumn Statements 2010 to 2016.

Source: Office for Budget Responsibility, *Historical Official Forecasts Database*, September 2017 (http://budgetresponsibility.org.uk/data/).

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The picture for borrowing is very different in the 'weak' and 'very poor' productivity growth scenarios. If productivity growth were as weak as it has been for the last seven years (the 'very poor' productivity scenario), borrowing would increase to almost £70 billion a year by the end of the forecast horizon. This would be the single largest March-to-November forecast revision by the OBR, though forecasts have differed from the eventual out-turn by large amounts before (in June 2010, the forecast for borrowing in 2015–16 was more than £50 billion lower than the actual out-turn). Even if productivity were to be halfway between the OBR's March forecast and the average of the last seven years (the 'weak' scenario), absent further policy action the deficit would be approaching £40 billion, and rising, by the early 2020s. While it would be a larger-than-average forecast revision if the OBR were to downgrade the forecast in line with the 'weak' scenario, it would not be unprecedented. For example, it would be a smaller downwards revision than in the Autumn Statements of 2011 and 2012.

Table 3.3 and Figure 3.7 may even understate the increase in borrowing occurring under the two bad productivity scenarios we consider. In the 'weak' scenario, trend growth is on average 0.5 percentage points per year lower than in the March forecast (see Table 3.1). However, more of that growth is set to come through employment and hours growth, rather than output per hour. This mix of growth would be relatively unfavourable for the public finances. Having a greater number of lower-wage employees attracts less extra income tax than the equivalent increase in earnings through higher wages across the board. As a result, we might expect borrowing to be higher than shown under such a scenario.

Figure 3.8 shows the implications of these scenarios for structural borrowing. Weaker productivity growth would mean that trend growth would be lower (i.e. low growth would not be a temporary weakness from which we would expect the economy to recover), so higher borrowing would also translate into a higher structural deficit. In our 'very poor' productivity scenario, structural borrowing could be expected to increase to over 3% of national income by the early 2020s, and hence the fiscal mandate – the target to reduce the structural deficit below 2% of national income in 2020–21 – would be missed unless an additional fiscal tightening of almost £15 billion were implemented. In the 'weak' productivity scenario, the fiscal mandate would still be met, but with only £13 billion of headroom to absorb any further unpleasant public finance news. This would be only 50% of the headroom that the government had just nine months ago in March, and another negative public finance shock could easily lead to the target being missed (or additional fiscal tightening being required if the target were to be met). Based on previous forecast errors, there would be a 40% chance that the target would be missed if the forecast were revised in this way. Of course, it is also possible that the economy, or the public finances, could turn out better than expected, in which case this headroom could prove more than sufficient.

Even if structural borrowing were to remain below the 2% cap in 2020–21, a higher deficit towards the end of the forecast period would make achieving the government's fiscal objective of eliminating the deficit by the mid 2020s more difficult. If no additional policy action were to be taken before April 2022, an average tightening of over 0.5% of national income per year would be required to achieve a surplus by April 2025. As we noted in Chapter 2, even on current plans (and, by extension, in the 'moderate' scenario), the pace of consolidation would need to accelerate beyond 2021–22. If the 'very poor' productivity

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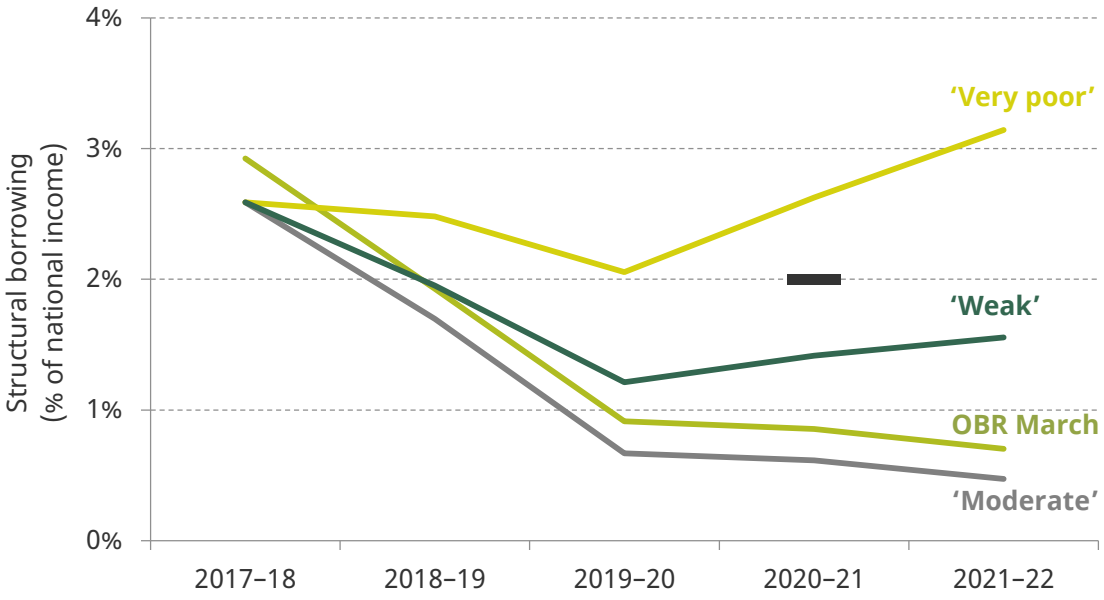
scenario were to materialise, the prospect of eliminating the deficit by the mid 2020s would seem even more unlikely.

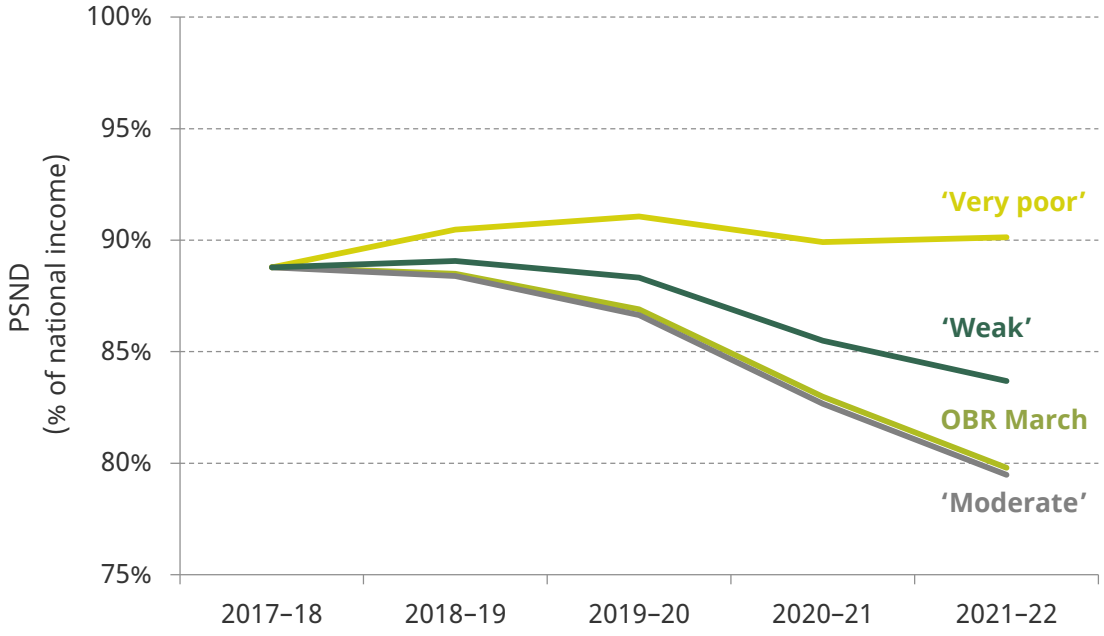
Higher borrowing and slower national income growth also have implications for debt. Figure 3.9 shows that, as a share of national income, the 'moderate' scenario is more or less indistinguishable from the March forecast. However, a combination of higher borrowing and weaker growth means the debt burden is almost certain to be higher if productivity growth is weaker. Under both our alternative scenarios, debt would rise

Figure 3.8. Structural borrowing under different growth scenarios



Note and source: See Figure 3.7.

Figure 3.9. Public sector net debt under different growth scenarios



Note and source: See Figure 3.7.

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rather than fall as a share of national income in 2018–19. By 2021–22, in the absence of further policy measures, debt would be almost 4% of national income higher if productivity growth were halfway between the March forecast and the average of the past seven years ('weak'), and more than 10% of national income higher if productivity growth does no better than in the last seven years ('very poor'). Notably, even with 'very poor' productivity growth, the supplementary target (that debt should fall as a share of national income between 2019–20 and 2020–21) would still be met due to repayments of Bank of England loans to the financial sector. This emphasises the ineffectiveness and oddity of the target – the Chancellor would be compliant with the target despite the fiscal mandate being missed by almost £15 billion and despite debt being above 90% of national income and rising in the next year.

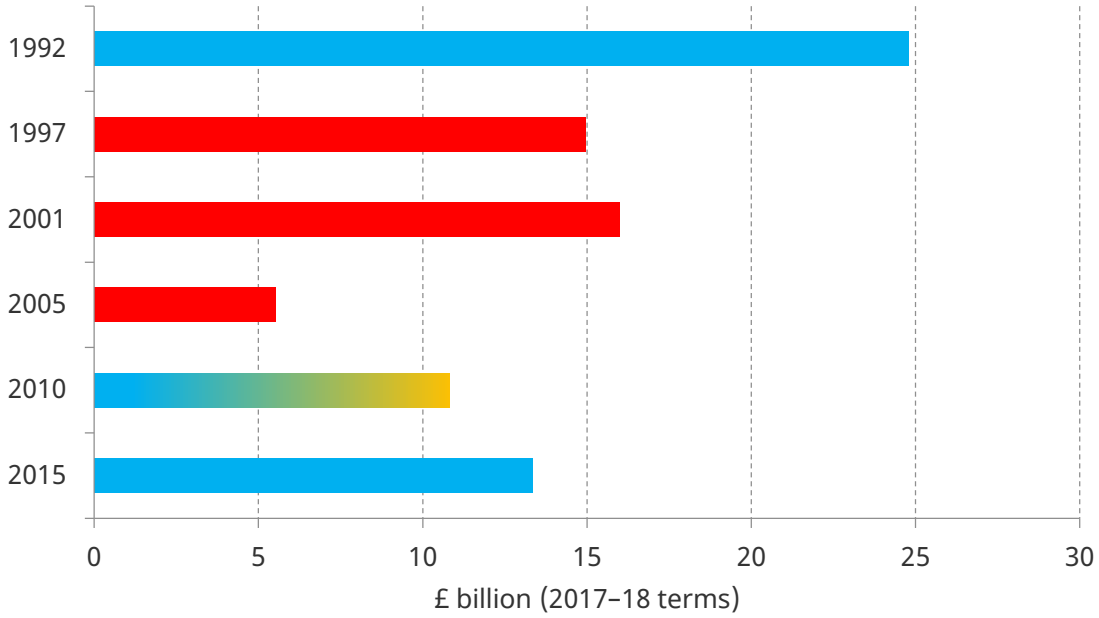
3.4 Lessons from recent history

In Chapter 4, we consider policy options for the Budget in specific areas. However, before we delve into specifics, it is worth considering what we can learn about the Chancellor's likely response to a new forecast, given what recent Chancellors have tended to do in the first Budget of a parliament and how they have tended to react to situations where the outlook for the public finances has worsened.

General election

The most significant political development since March was the snap general election held in June. If recent history is any guide, we might expect a tax rise to be on the way. In the year following the last six general elections, measures that equate to a net tax rise have

Figure 3.10. Long-run net tax rise from measures announced in the year following elections, 2017–18 terms



Note: Colour of bar refers to party or parties in government after the election. All figures based on the cost of the measure in the final year on the scorecard.

Source: Office for Budget Responsibility, *Policy Measures Database* (http://budgetresponsibility.org.uk/data/).

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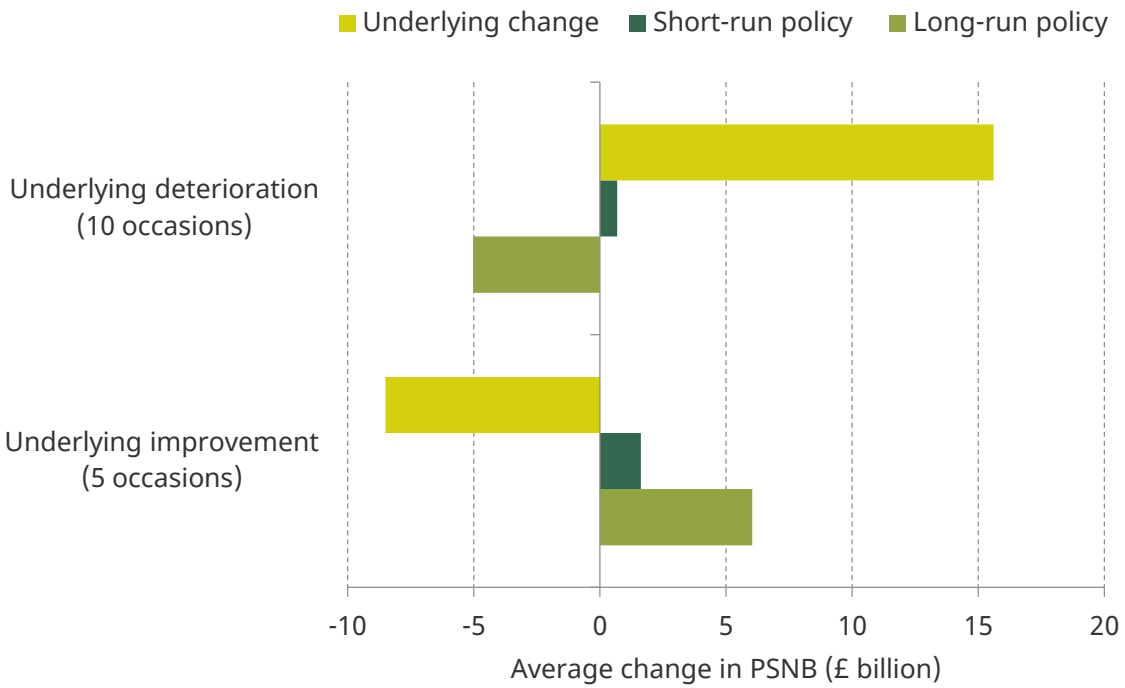
been announced (see Figure 3.10). This has been true for Conservative, Labour and coalition governments: indeed, the largest increase was the last time a Conservative government was re-elected, in 1992. While there were no notable tax rises proposed in the Conservative manifesto, many of these previous tax rises were also not part of the parties' election manifestos. Of course, these data do not cover fiscal events of any minority governments, and parliamentary arithmetic may therefore make significant tax rises much more unlikely this time around.

Changes in the public finance outlook

Since 2010, substantial revisions to the economic forecast, and therefore the public finance outlook, have been frequent. Overall, these changes have unfortunately been more likely to worsen the public finance forecast, rather than improve it – not least because productivity growth has continued to disappoint. Figure 3.11 shows the average change in the long-run underlying borrowing forecast over this period, split by when those changes have led to an underlying deterioration (increase in borrowing) and underlying improvement (reduction in borrowing).

Broadly, there are two consistent approaches to these public finance shocks that a Chancellor could reasonably adopt. First, she could decide that borrowing forecasts are

Figure 3.11. Average annual change in public sector net borrowing forecasts when underlying public finances deteriorate or improve



Note: Negative number indicates reduction in the borrowing forecast since the previous one. Underlying change is change before policy costs, and refers to the change in the final year of the forecast. Short-run policy shows the average impact of policy measures over the first two full fiscal years after the fiscal event. Long-run policy refers to the impact of policy measures in the final year of the forecast. A fiscal event qualifies as an underlying deterioration (improvement) if, absent policy measures, the final-year forecast for borrowing would have increased (fallen).

Source: Office for Budget Responsibility, *Historical Official Forecasts Database* (http://budgetresponsibility.org.uk/data/).

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quite volatile, and that a change of the opposite sign and a similar magnitude could emerge in the future. In that case, a change in either direction does not affect the correct policy path and we would not expect her to change policy systematically if the borrowing forecast improved or worsened. The alternative approach would be to view a fall (increase) in the borrowing forecast as a clear indication that the public finances are stronger (weaker), allowing a Chancellor to perform a fiscal loosening (tightening).

Importantly, both of the approaches outlined above imply a symmetric treatment of positive and negative public finance shocks. However, this is not what we observe in Figure 3.11, which covers the period since Mr Osborne entered Number 11 in 2010. Regardless of changes to the underlying public finances, on average fiscal policy is loosened in the first two years of the forecast period ('short-run policy'). When the underlying public finances improve, the Chancellor has spent the majority of this improvement on giveaways, whereas policy has played a more limited counterbalancing role when the forecast has deteriorated. In some cases – for example, Mr Hammond's first fiscal event, last November – the Chancellor has simply accepted a higher level of medium-term borrowing rather than using policy to offset the deterioration at all.

Given these trends, we might expect a small giveaway in the short term regardless of how the underlying forecast for the economy changes. If low productivity growth were to result in a higher borrowing forecast (as in our 'weak' and 'very poor' scenarios), we might expect some, but only a minority, of this revision to be offset by a medium-term tightening. If, on the other hand, there is a small underlying improvement (as in our 'moderate' scenario), we might expect this to fund medium-term giveaways of a similar magnitude.

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4. Policy options for the Budget

Key findings

A weaker medium-term position would necessitate further tax rises or spending cuts at some point.	Significant additional fiscal tightening in the Budget may be unlikely. If further tax-raising measures do follow at some point, then the Chancellor (or his successor) could do worse than increase rates of income tax or National Insurance.
At least in the near term, tax changes are likely to be more modest.	The Conservative manifesto commitment to increase the income tax personal allowance and higher-rate threshold to £12,500 and £50,000 respectively would now only cost an additional £1.1 billion. Other traditional measures include a further freeze to fuel duty rates (costing £750 million) and some revenue raised from 'anti-avoidance' measures.
Will the Chancellor choose to boost public spending too?	The freeze to most working-age benefits has two more years to run and rising inflation has made it harsher. The government could ease off on this. Another option would be to reduce the waiting time before payments of universal credit are received. Any relaxation of the public sector pay cap might require additional funding for public services across the board. A more targeted approach could see more spending for services under most pressure. Both the NHS and prisons show signs of strain.

In recent months, the government has faced calls to loosen policy in a number of areas. But if the fiscal forecast has worsened since March, the Chancellor would not be able to offer a net giveaway in the Budget without having a higher borrowing path than set out eight months ago. As he had to in March, the Chancellor must balance the costs of having higher debt, the needs of the economy, strains on public services and other pressures. Further complicating matters, any measure – and this is especially the case for any proposed takeaways – must be able to pass in a vote in parliament, which potentially further constrains the Chancellor by more than most of his predecessors. This chapter considers policy options that the Chancellor may be considering in the areas of tax policy, welfare spending and public service spending.

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4.1 Options on tax

Given the likely deterioration in the outlook for the public finance forecast, as laid out in Chapter 3, announcing medium-term tax rises would be one option for the Chancellor. When seeking ways to increase tax, the most obvious places to look are the three main taxes – income tax, National Insurance contributions and VAT – which together account for 60% of government revenues. (Below, we also consider an increase to the rate of corporation tax, which is the fourth-biggest revenue raiser.) While the Conservative manifesto stated that 'we will not increase the level of Value Added Tax', a 1 percentage point increase in all income tax rates, or all employee and self-employed NICs rates, would each raise around £5½ billion.[14] And either would do so in a progressive manner, i.e. the takeaway would, on average, represent a larger share of the incomes of higher-income households than of lower-income households. There would be some important differences between increasing income tax and NICs. Increasing income tax, rather than NICs, would mean a tax increase for pensioners and others reliant on unearned income, as well as for those with labour market earnings. While the basic or higher rates of income tax have not been increased since the 1970s, increases in the rates of National Insurance have been implemented by Conservative (early 1990s), Labour (early 2000s) and coalition (early 2010s) governments, so on that basis perhaps an increase in the early 2020s is not so implausible.

In practice, these options appear politically infeasible, but if the government did require extra revenue then increases in the rates of income tax, or the rates of employee and self-employed NICs, would not be a particularly bad way to do it. It would certainly have a better underpinning rationale than many of the more obscure changes that have been used by recent Chancellors to boost revenues. These include large increases in the rates of insurance premium tax (George Osborne) or stamp duty land tax (Gordon Brown) or reductions in the generosity of pension tax relief for those on higher incomes (Alistair Darling and George Osborne). In what follows, we examine what might be considered possible tax changes, many of which are giveaways rather than takeaways.

Conservative manifesto commitments on income tax

The Conservative manifestos for both the 2015 and 2017 general elections contained the commitment to increase the personal allowance (the amount of income an individual can receive each year before paying income tax) to £12,500 and the higher-rate threshold (the income level at which an individual enters the 40% marginal rate band) to £50,000 by 2020.[15] The DUP manifesto also proposed increases in the income tax personal allowance. This pledge is on top of large increases in the personal allowance since 2010. If the personal allowance had been uprated in line with the CPI since 2010 (the default), it would now be £7,525, whereas it is £11,500 today. Partly as a result of this, less than 60% of UK adults now pay any income tax at all; the 40% of adults who do not pay income tax – because their incomes are too low – would not benefit from further increases in the personal allowance.

[14] HM Revenue & Customs, 'Direct effects of illustrative tax changes', April 2017 (https://www.gov.uk/government/statistics/direct-effects-of-illustrative-tax-changes).

[15] In the 2015 manifesto, the commitment was officially to reach these levels by 'the end of the parliament', which may at the time have been expected to be May 2020 but turned out to be June 2017.

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Changes to the personal allowance and higher-rate threshold since 2010 have been expensive (representing a tax giveaway of £12 billion in 2017–18). But higher inflation as a result of sterling's depreciation in the aftermath of last June's referendum means that meeting the manifesto pledge is now estimated to cost only £1.1 billion. Of this, the cost of increasing the personal allowance is only £0.5 billion. Given that this is a long-standing Conservative Party pledge that would presumably be well received by the DUP, and it is now a relatively small giveaway, we might expect this policy to be formally announced in one of the Budgets in this parliament.

Anti-avoidance measures

It is rare for a fiscal event to occur without at least some revenue being raised through 'avoidance and evasion' measures. In principle, these measures are designed to reduce opportunities for individuals to reduce their tax bill in ways the original rules did not intend. In some cases, however, they amount to a genuine restriction of the tax base (i.e. previously permitted and intended avenues that would reduce tax payments are shut off). More than a hundred 'anti-avoidance and operational' measures announced since June 2010 (the first fiscal event of the coalition government) were together forecast to raise over £10 billion in additional revenue in 2017–18.[16]

It would therefore not be surprising if the Chancellor were to attempt to raise revenue from further anti-avoidance measures this November. If he does, however, he should not necessarily count on the measures raising the amounts that appear on the scorecard. These costings are often given a 'highly uncertain' rating by the OBR, and they frequently raise a significantly different amount from what was expected. A comparison of the forecast yield with how much is estimated to have actually been raised subsequently suggests that while, for any individual measure, the yield is as likely to be understated as it is to be overstated, the measures expected to raise the most money have systematically raised less than hoped.[17] As a result, the OBR judges that anti-avoidance measures have raised less than expected on average – there is a risk this trend may continue for any measures announced this time.

Fuel duties

The default assumption embedded in the public finances is that fuel duties will be uprated in line with the Retail Prices Index (RPI) each April. Despite this, the rise has been cancelled in each of the last six years and duties have been fixed in nominal terms since April 2011. Revenues this year are £5.4 billion less than they would have been had duties been uprated in line with the RPI each year. If next April's increase were to be cancelled as well, this would cost an additional £¾ billion a year. The prospect that fuel duties will actually increase in line with the RPI appears very slim indeed, and this eroding source of important tax revenue is an increasing issue for the public finances.

It is well known that the RPI is a discredited inflation measure that typically overstates household inflation. However, while this may mean that RPI indexation is excessive, it is certainly not the case that an indefinite nominal freeze is the appropriate response.

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[16] Office for Budget Responsibility *Fiscal Risks Report*, July 2017 (http://budgetresponsibility.org.uk/frr/fiscal-risk-report-july-2017/).

[17] S. Johal, 'Evaluation of HMRC anti-avoidance and operational measures', OBR Working Paper no. 11, September 2017 (http://budgetresponsibility.org.uk/download/working-paper-no-11-evaluation-hmrc-anti-avoidance-operational-measures/).

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Furthermore, announcing yet another one-year freeze every year adds unnecessary uncertainty into the tax system. One option would be to move to CPI indexation – this is the measure of household inflation now used to uprate most parameters in the tax system. In addition, moving to monthly rather than annual indexation would mean that rates increased more gradually, which might reduce political pressure to implement ad-hoc nominal freezes. While CPI indexation of fuel duties would represent a tax cut relative to the current supposed policy of RPI indexation (£1.0 billion by 2021–22), moving to CPI indexation would arguably actually strengthen the public finances given that, in reality, current policy is closer to announcing a one-year freeze in rates every year (costing £2.6 billion by 2021–22 relative to RPI indexation).

Given recent evidence on emissions from diesel vehicles, there is also a case for setting a higher rate of fuel duty on diesel than on petrol. Indexing diesel duty and not petrol duty would cost £¼ billion this year (rather than £¾ billion). A revenue-neutral change with a freeze in petrol duty would mean increasing diesel duty by 4.9%. However, more than half of diesel consumption is accounted for by vans, heavy goods vehicles, buses and coaches (compared with only a small minority of petrol consumption), so increasing diesel duty more quickly than petrol duty would represent an increase in business cost pressures.

Planned corporation tax cuts

The largest tax cuts planned over the next five years are further cuts to the corporation tax rate (from 19% today to 17% in April 2020). This measure has an annual cost of £5 billion in today's terms. One option for raising revenue is to cancel this future tax cut (though this would still require a vote in parliament to be passed). Doing this would raise more revenue, though it would be expected to lead to less investment taking place in the UK over the longer term. However, even leaving the rate at 19%, the UK would have the lowest headline corporate tax rate in the G20 and, although this is somewhat offset by a relatively broader tax base, it still has one of the most generous corporate tax systems among advanced economies on more comprehensive measures.[18]

A concern is that reversing the planned cuts might send a signal to the business community of a different government attitude towards business compared with the previous Chancellor's approach. And the timing may be inopportune, given uncertainty over the path of Brexit negotiations in the coming months and years. Commitment to the planned policy was also reiterated in the Conservative manifesto.

4.2 Options on welfare spending

In Chapter 2, we showed that welfare measures in the pipeline are forecast to cut spending by a further £12 billion in 2021–22 (relative to their impact on spending in 2017–18). These measures are targeted at working-age benefits and are an important driver of spending on working-age benefits being forecast to fall in 2021–22 to its lowest share of national income since 2000–01.

In large part, these cuts arise from reforms already in place that will gradually apply to more claimants. For example, those already in receipt of means-tested benefits who have

[18] See M. Devereux, K. Habu, S. Lepoev and G. Maffini, 'G20 corporation tax ranking', Oxford University Centre for Business Taxation, Policy Paper, March 2016 (https://www.sbs.ox.ac.uk/faculty-research/tax/publications/policy-papers).

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a third or subsequent child will not receive additional means-tested benefit payments in respect of the third and subsequent children, while those who move onto universal credit (UC) from November 2018 with more than two children will receive support based on them having two children. More generally, the cuts to the work allowance announced in the Summer 2015 Budget mean that entitlements to UC are, on average, lower than entitlements under the system it is replacing, though those transitioning onto UC from tax credits will not see immediate cash-terms cuts to their benefits: the less generous system will only immediately apply to new claimants.

Issues surrounding universal credit roll-out

Universal credit is in the process of being gradually rolled out across the country. As of 14 September 2017, there were 610,000 claimants of UC.[19] This represents 8% of the expected final caseload, with this figure forecast to rise to 13% of the expected final caseload by March 2018.[20] Even this additional roll-out over the remainder of 2017–18 still leaves UC far behind the initial plan: even as recently as March 2013, the Department for Work & Pensions (DWP) was planning on it being nearly fully rolled out by this stage, with over 7 million claimants.[21]

The recent further roll-out of UC has led to renewed attention being paid to the time that often elapses before a new claimant receives their first benefit payment. Universal credit entitlement is based on income over a monthly assessment period, and UC is paid in arrears. The stated motivation for this is that it mimics the situation for someone in paid work being paid monthly. Of course, while most employees are paid monthly, there are many who are not, especially among the lower-paid population most affected by UC. And people starting employment midway through their employer's pay period would typically not have to wait a full month before being paid. However, while waiting for their first UC payment, individuals can request an advance payment of up to 50% of their standard award, which, if made, will then subsequently be deducted from future payments.

With some exceptions, unemployed claimants who are expected to be actively seeking work must serve a seven-day waiting period before their assessment period begins. This means it can be six weeks before a claimant receives their first payment. This could be delayed even further if incomplete information is provided or mistakes are made – either by the claimant or by the DWP – during the claims process. Currently, 76% of new claimants receive a full payment on time, leaving almost a quarter who do not receive their first entitlement in full when they should – though the share of new claimants receiving full payments on time has been increasing steadily over time.[22]

One straightforward way in which the government could reduce the time before a first payment is received, albeit only slightly, would be to reduce the seven-day waiting period. For example, this could be cut back to the three days that previously existed under jobseeker's allowance. Earlier this year, the outgoing Minister of State for Welfare Reform, Lord Freud, said in oral evidence to the Work and Pensions Select Committee, 'I think

[19] Department for Work & Pensions, *Universal Credit Statistics: Data to 14 September 2017*, (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/652897/universal-credit-statistics-to-14-sept-2017.pdf).

[20] See https://www.gov.uk/government/news/next-phase-in-rollout-of-universal-credit-confirmed.

[21] See chart 4.7, page 155 of Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2016 (http://cdn.budgetresponsibility.org.uk/Nov2016EFO.pdf).

[22] See https://www.gov.uk/government/statistics/universal-credit-payment-timeliness-january-to-june-2017.

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waiting days does not help in the introduction of Universal Credit'.[23] Moving back to a system of three waiting days, as well as a similar change being made to employment & support allowance, would cost the government an estimated £0.3 billion per year.[24]

The benefits freeze

The largest single welfare cut announced since 2015 is the four-year freeze to the rates of most working-age benefits from 2016–17 to 2019–20. When the measure was announced in July 2015, it was expected to reduce spending by £3.4 billion in today's terms. Since then, inflation has been running higher than expected – something that is expected to continue over the next couple of years. As a result, this benefit freeze is now expected to cut spending by £4.6 billion – an increase in the size of the saving to government of over a third. Of course, this increased real cut to benefit spending is equally a cut to the benefit incomes of households. In July 2015, the measure was expected to reduce the real value of benefits by a little less than 5%. It is now expected to reduce them by 7%.[25]

This change illustrates a problem with setting benefit rates in cash terms many years in advance – unexpected movements in inflation will cause the generosity of the benefits to differ from what the government intended. It also means that any risk from changes to inflation forecasts is borne by households rather than the government. Given that the policy now represents a larger real-terms cut than intended, the government could choose to reverse the policy to some extent, either by stopping the freeze one year early or increasing the cap from zero to, say, a 1% increase over the final two years. Either of these policies would, on current forecasts, mean that the overall generosity of the system was reduced by a similar amount to what was expected in July 2015. Of course, these policies would still be sensitive to inflation turning out differently from forecast. Or the government could decide to end the freeze now and return to inflation indexation of benefit rates from next April, though this would increase spending in 2019–20 by £4 billion.

4.3 Options on public service spending

The planned paths for government day-to-day and investment spending were set out in Chapter 2. While investment is set to increase slightly as a share of national income over the next few years, the plans for the day-to-day spending of government departments certainly do not look easy to deliver. They follow five years of extremely tight settlements, making further spending restraint even more difficult to achieve. While these settlements may be placing pressure on many areas of public service provision, three particular areas where there is quantitative evidence indicating pressure are public sector pay, the NHS and prisons.

[23] Oral evidence, 7 February 2017 (http://data.parliament.uk/writtenevidence/committeeevidence.svc/evidencedocument/work-and-pensions-committee/universal-credit-update/oral/46960.html).

[24] See table 3 of HM Treasury, *Spending Round 2013*, June 2013 (https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/209036/spending-round-2013-complete.pdf).

[25] A. Hood and T. Waters, 'Higher inflation means more pain for households from the benefits freeze, less gain from £12,500 personal allowance', IFS Observation, October 2017 (https://www.ifs.org.uk/publications/9993).

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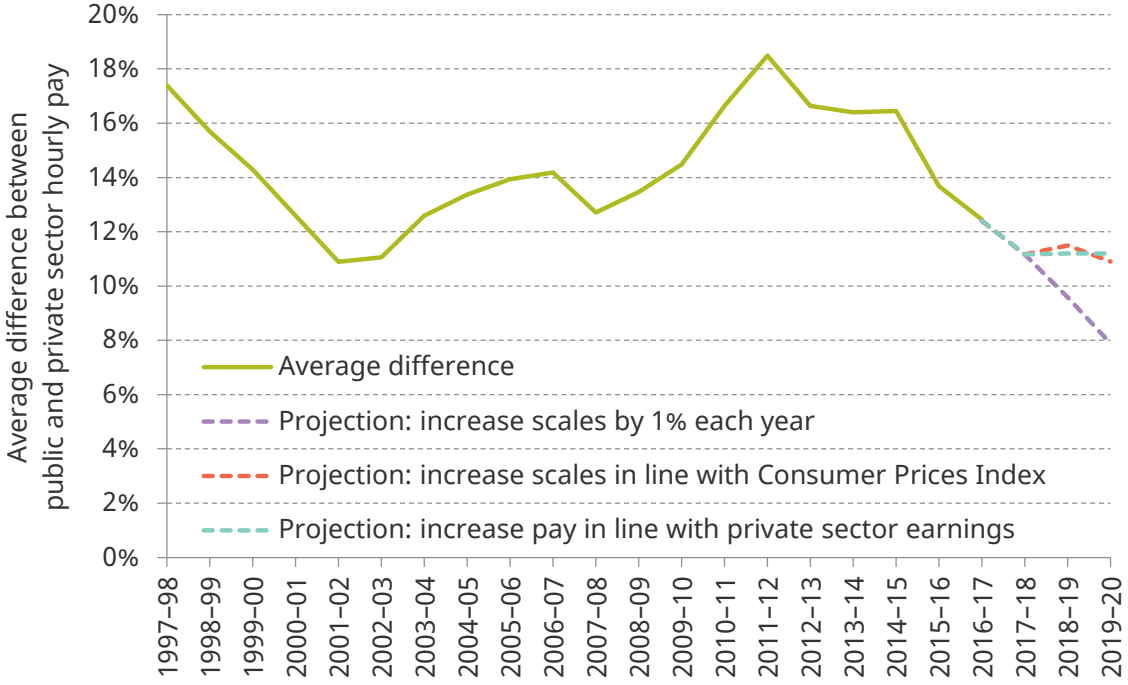
Public sector pay

Figure 4.1 shows the average hourly pay difference between the public and private sectors since 1997. Public sector workers are paid more, on average, than private sector workers. In part, this results from the fact that public sector jobs and workers are different from those in the private sector: for example, on average, they have higher levels of education. One relevant comparison is therefore the size of the pay differential over time. If the pay differential is relatively higher (lower), it is likely to be relatively easier (harder) for the public sector to recruit and retain high-quality motivated staff. As the figure shows, the gap in hourly pay increased during the recession as real wages fell in the private sector but were initially protected in the public sector. Public sector pay policy over the period 2011–12 to 2014–15 reduced the differential, and in 2016–17 the difference had more or less returned to its pre-crisis level. The gap after adjusting for observed differences (such as age and education) has also returned to its pre-crisis level.

We are currently two years into the four-year public sector pay cap, which limits the pay increase for a given position (of a given seniority) to 1% per year. This followed a pay freeze for all but the lowest-paid grades between 2011 and 2013. Continuing with the cap for a further two years, as planned, would see public sector pay continue to fall in real terms. Furthermore, on the March 2017 forecasts of private sector wage growth, public sector pay would also fall to its lowest level relative to its private counterpart for at least the last 20 years. If this policy were to be maintained, there is clearly a risk that difficulties recruiting and retaining staff would worsen. On the other hand, increasing pay scales in line with either the Consumer Prices Index or private sector earnings would maintain the differential at around its current level.

Figure 4.1. Difference between average public and private sector hourly pay, including projections under different scenarios



Note: A positive difference means that public sector pay is higher than private sector pay on average.

Source: J. Cribb, 'Public sector pay: still time for restraint?', IFS Briefing Note no. 216, September 2017 (https://www.ifs.org.uk/publications/9805).

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Since the general election, the government has already decided to lift the cap for prison staff (awarding a 1.7% pay rise) at relatively little cost since prison staff are only a small group of public sector workers (in addition, police officers are to get the standard 1% uplift plus, for one year only (at least for now), an additional payment of 1%). However, if the cap were to be lifted more widely, the policy could quickly become expensive. If the 1.7% pay rise were to be implemented for two years across the public sector, spending on pay would be around £2.6 billion per year higher. Increasing in line with inflation for the next two years would cost more than £6 billion in 2019–20 compared with keeping to the 1% cap.

These costs are far from evenly distributed across departments. Inflation-linked increases for two years would cost the NHS an estimated £2 billion, while the cost would be similar for the Department of Education. This represents a much larger share of the education budget than the health budget (2.8% as opposed to 1.5%), but the higher wage costs for the NHS would account for almost all of the planned funding increase between now and 2019–20. If the pay cap were to be lifted but departmental settlements were to remain the same, the extra wage costs would have to be found from elsewhere in the budget (or departments might be forced to employ fewer people). For example, in the NHS it may well be that the existing budget settlement would only allow a 1% pay rise and therefore, absent additional funds being made available, lifting the cap may be of limited use. If, on the other hand, the increases were fully reflected in departmental settlements, the measure would add substantially to public spending and therefore to borrowing.

NHS funding and performance

Based purely on Figure 2.10, it might be surprising that health is one of the areas that are showing signs of struggling. Compared with other departments, the Department of Health (DH) has had reasonably generous settlements since 2010. However, the challenges become far clearer when put in their historical context. While real spending per head is greater than it was in 2009–10, the increases over this period have been far lower than the NHS has ever enjoyed before (Figure 4.2). Furthermore, this tight settlement looks set to continue over the next five years.

Figure 4.3 shows that despite modest funding increases, the NHS is doing more, potentially implying efficiency gains. While real per-capita spending has increased only slightly, the amount of activity the NHS is doing per capita – indicators of which have been collated by the King's Fund – have increased far more quickly. A 3% per-capita funding increase – though this includes slightly larger increases for NHS front-line services – compares with more than 15% more elective admissions and outpatient attendances per capita. This increase in activity is driven both by an ageing population – on average, older people use more healthcare than younger people – and technological developments which mean that the NHS is able to treat more diagnoses than it could before.

Despite the fact that the NHS has been able to perform more activity with small real-terms spending increases, some potential measures of NHS performance are deteriorating, suggesting that quality is slipping. For example, the high-profile government target that 95% of A&E patients must wait a maximum of four hours is not being met nationally, and the proportion being seen in four hours appears to be moving further away from the

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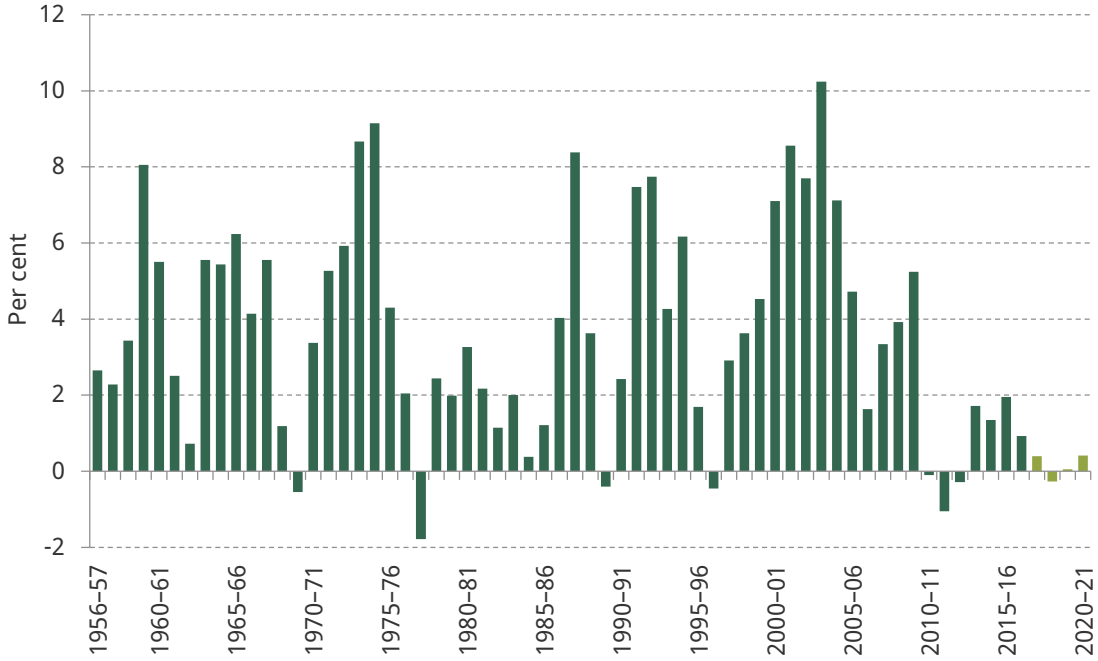
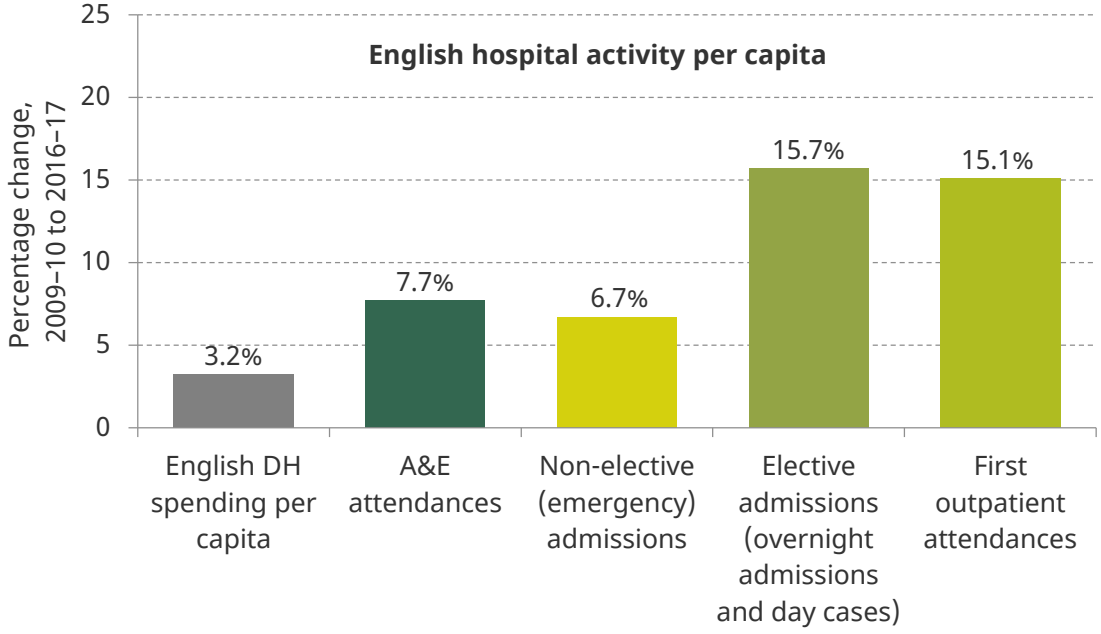
Figure 4.2. Annual real change in per-capita UK NHS spending



Note: Forecasts estimated based on planned spending in England from PESA 2017 and Spending Review 2015.

Source: Nominal health spending data from Office of Health Economics (1971–72 to 1990–91) and HM Treasury *Public Expenditure Statistical Analyses* (1991–92 to 2016–17). Real spending refers to 2017–18 prices, using the GDP deflator from the OBR in March 2017. UK population data available on an annual basis (but not financial year) from the Office for National Statistics (ONS) mid-year population estimates, June 2017 release (https://www.ons.gov.uk/peoplepopulationandcommunity/populationandmigration/populationestimates/timeseries/ukpop/pop).

Figure 4.3. Increase in NHS spending and activity per capita between 2009–10 and 2016–17, England



Source: Spending per capita from HM Treasury *Public Expenditure Statistical Analyses*; NHS per-capita activity data from the King's Fund (https://www.kingsfund.org.uk/projects/nhs-in-a-nutshell/hospital-activity) using data from NHS England.

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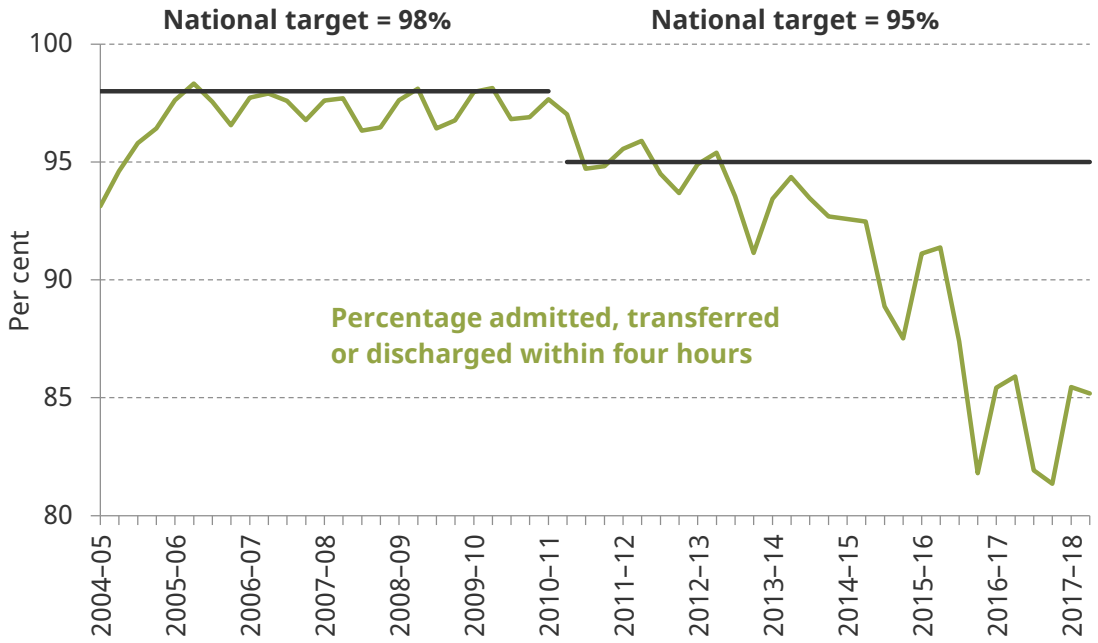
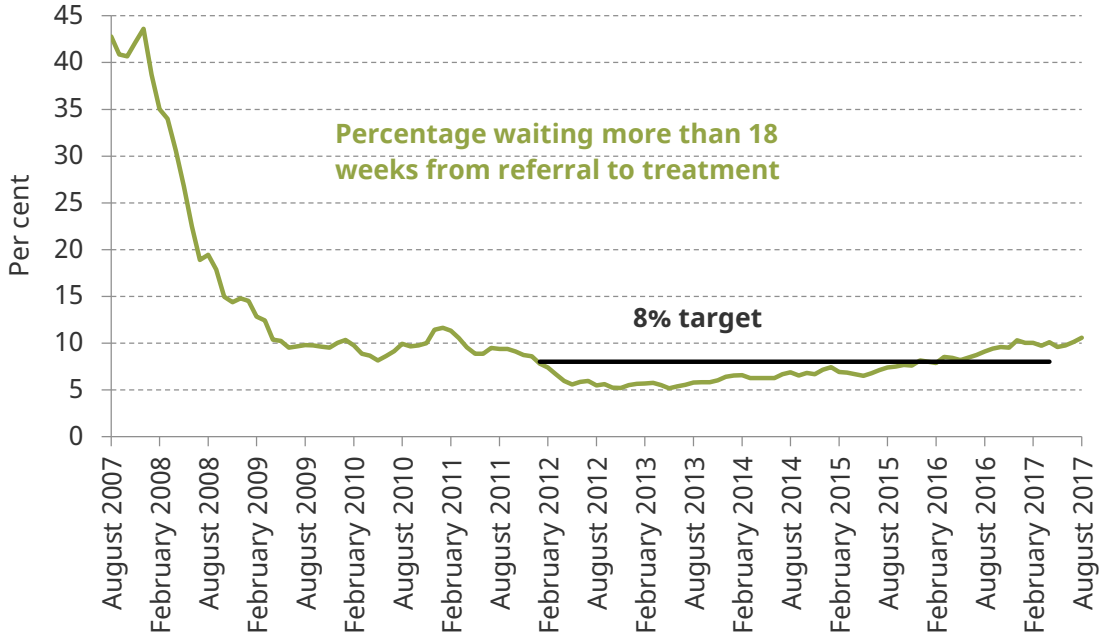
Figure 4.4. A&E patients in England increasingly likely to wait more than four hours



Note: Shows the figure for type 1 (major) units, which cover major hospitals.

Source: NHS England, A&E attendances and emergency admissions, October 2017 (https://www.england.nhs.uk/statistics/wp-content/uploads/sites/2/2017/06/Quarterly-timeseries-September-2017-hubjg.xls).

Figure 4.5. Target being missed for 18-week wait between referral and treatment in England



Source: NHS England, consultant-led referral to treatment (RTT) waiting times (https://www.england.nhs.uk/statistics/wp-content/uploads/sites/2/2017/06/RTT-Overview-Timeseries-Aug17-XLS-86K-58115.xls).

target (Figure 4.4). In the light of this pressure, the Health Secretary Jeremy Hunt has indicated that he believes the target should be revised to apply only to urgent cases.[26]

Another government target requires that fewer than 8% of people wait more than 18 weeks between referral and the beginning of their treatment. This target is also now being missed, with the proportion waiting more than 18 weeks up at 10% (Figure 4.5). Given this pressure, it seems that this target has been dropped.[27] On this and many other NHS targets, a sense of perspective is important, however. While the proportion waiting beyond the target time has risen substantially since 2012, it is still an extremely long way below the proportions seen in 2007 and 2008 before the target was instituted.

Although in many ways the funding of health and social care are separate, there are important links between the NHS and the provision of publicly funded social care (which is mostly funded by local authorities). While protected relative to spending on most other local government services, social care spending has seen real-terms cuts over the last few years, despite facing many similar demographic pressures to the NHS.[28] A social care Green Paper – promised 'later this year' in the March Budget – is expected to lay out a long-term strategy for funding and system design. For the period up to 2019–20, spending on adult social care in England could actually increase reasonably substantially, at least on average, if councils fully use their new powers to increase council tax to boost spending in this area (and spend ring-fenced money on social care rather than on other services).[29]

Prison funding and performance

One of the areas that have faced relatively large spending cuts since 2010 is the prison service, with spending cut in real terms by 22% between 2009–10 and 2016–17. Large cuts thus far are set to be followed by a tight settlement for the next two years. In last year's Autumn Statement, the financial pressure in this area was eased slightly in order to recruit more prison staff. Aside from the temporary uplift to police officer pay, this is also the only area – at least so far – where the public sector pay cap has been lifted. These provisions indicate that the government is aware that prisons are struggling to maintain service provision amidst large cuts since 2010 – and they are an area where Mr Hammond has already shown he is prepared to provide additional funding.

Data compiled by the Institute for Government in its *Performance Tracker* emphasise the challenges facing the prison service. Figure 4.6 shows that while the prisoner population has only increased by 3% since 2009, spending and staffing have both fallen substantially. Assaults on staff and prisoners, as well as prisoner self-harm, have increased since around 2012 and are on alarmingly steep upwards trajectories. In the light of the scale of these trends, the Chancellor might decide that more cash is needed for this area in particular.

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[26] https://www.theguardian.com/society/2017/jan/09/labour-party-jeremy-hunt-nhs-waiting-time.

[27] https://www.theguardian.com/society/2017/mar/31/nhs-surgery-target-operations-cancelled-simon-stevens.

[28] For more details on the path of social care spending, and the relationship between social care and the NHS, see D. Luchinskaya, P. Simpson and G. Stoye, 'UK health and social care spending', in C. Emmerson, P. Johnson and R. Joyce (eds), *The IFS Green Budget: February 2017* (https://www.ifs.org.uk/publications/8879). Details of the spending trade-offs made by local authorities under austerity can be found in D. Innes and G. Tetlow, 'Delivering fiscal squeeze by cutting local government spending', *Fiscal Studies*, 2015, vol. 36, pp. 303–25 (https://www.ifs.org.uk/publications/8033).

[29] P. Simpson, 'Adult social care spending in England', presentation at IFS Budget briefing, March 2017 (https://www.ifs.org.uk/uploads/budgets/budget2017/budget2017_ps.pdf).

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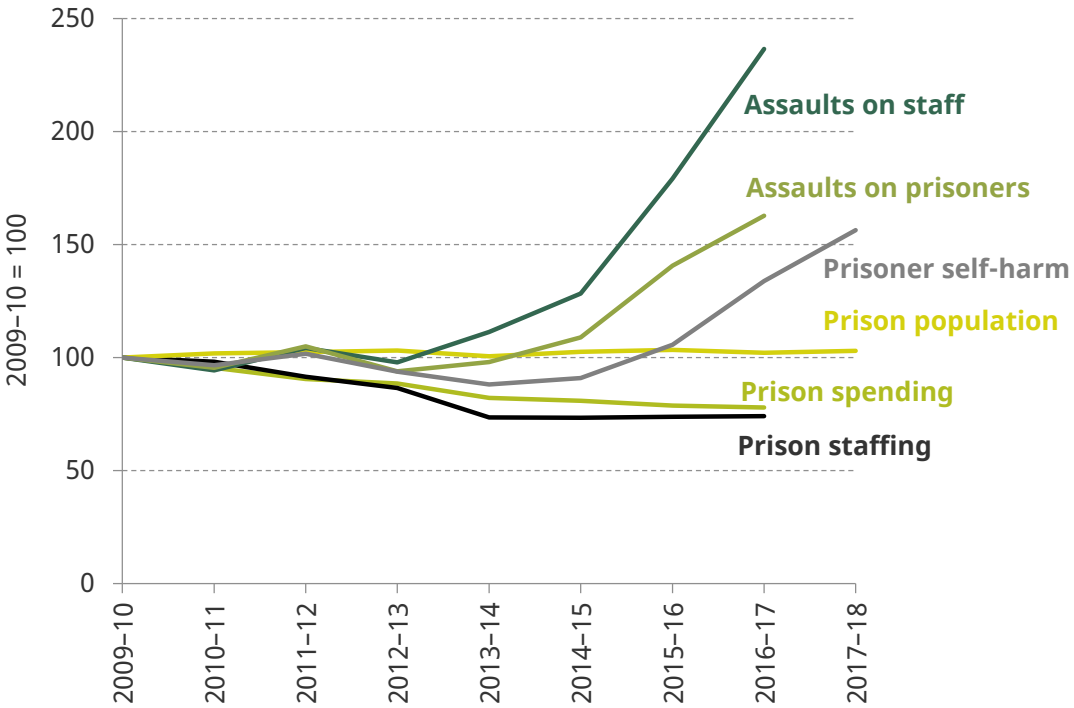
Figure 4.6. Prison spending and staff cut, but assaults on staff, assaults on prisoners and prisoner self-harm have grown much faster than the prison population



Note: All figures relative to 2009–10 levels. Spending, staffing and assaults are based on financial years; prison populations are from each June; self-harm figures are based on calendar year (e.g. the 2009–10 figure is the 2009 measure).

Source: Institute for Government, *Performance Tracker: Prisons*, Autumn 2017 (https://www.instituteforgovernment.org.uk/publication/performance-tracker-autumn-2017/law-and-order/prisons).

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5. So what's a Chancellor to do?

The first Budget of a new parliament is often the best chance a Chancellor has to set out her stall. She can raise taxes if need be, set an agenda for the next five years, and set in train economic and fiscal reforms. Mr Hammond, though, has been dealt a very tricky hand indeed. The political arithmetic makes any significant tax increase look very hard to deliver. It looks like he will face a substantial deterioration in the projected state of the public finances. He will know that seven years of 'austerity' have left many public services in a fragile state. And, in the known unknowns surrounding both the shape and impact of Brexit, he faces even greater than usual levels of economic uncertainty.

While borrowing came in £6 billion below expectations last year, and looks like doing so by a similar margin again this year, expected rises in interest rates and, in particular, lower forecast productivity growth are likely to mean a significantly worsened fiscal forecast at the November Budget. So long as the productivity downgrade is not so extreme as to see the terrible growth over the last seven years as the new norm, the Chancellor is likely to remain on course to comply with his fiscal targets – albeit with much reduced headroom compared with just eight months ago. When faced with similar changes in forecasts, his predecessor tended to offer small giveaways in the short term, with a medium-term takeaway offsetting only a relatively small proportion of the overall downgrade. Mr Hammond may not deviate far from that practice. The chances that he will announce a significant tightening to offset fully the worsening fiscal outlook seem very small.

In fact, the public discussion of policy options in the lead-up to the budget has principally concerned possible giveaways – reflected in the title of this publication, 'Options for easing the squeeze'. Obviously, any additional spending would, if unmatched by tax rises, worsen the fiscal outlook further. But while the political scope for significant tax rises looks limited, the pressure for spending increases is substantial.

Public sector workers, the NHS, the prison service, schools and working-age benefit recipients, among others, would like more money. Yet after seven years of 'austerity', public spending is no lower now as a fraction of national income than it was in 2008, after 11 years of Labour government. It would take quite a reversal in policy for Mr Hammond to find money for all of these areas. Choosing between them will be tough.

Even if he does find some money, unless it did represent a very big change of direction, it won't mean 'the end of austerity'. Tight spending settlements, net tax rises and cuts to working-age benefits are all putting significant downward pressure on borrowing over the next two years in particular.

Mr Hammond is likely still to be on course to meet his target of a structural deficit of no more than 2% of national income by 2020–21, if only just. But it looks increasingly unlikely that the ever-receding target to get rid of the deficit altogether will be achieved by the mid 2020s, which is when that is currently supposed to happen. Of course, it is possible that the economy, or the public finances, will perform much better than expected. But given all the current pressures and uncertainties – and the policy action that these might require – it is perhaps time to admit that a firm commitment to running a budget surplus from the mid 2020s onwards is no longer sensible.

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Appendix

Table A.1. 2016 deficit and debt in 28 advanced economies

Country (ranked by GDP from largest to smallest)	Deficit		Debt	
	% GDP	Rank	% GDP	Rank
United States	4.1	3	82.2	6
Japan	5.2	1	127.9	2
Germany	–0.1	24	45.4	14
United Kingdom	**3.3**	**7**	**80.5**	**8**
France	3.3	6	89.2	5
Italy	2.5	12	113.8	4
Canada	2.5	11	26.9	20
Korea	–0.8	26	36.8	16
Australia	2.9	9	19.7	22
Spain	4.5	2	81.4	7
Netherlands	1.1	17	34.8	17
Switzerland	0.3	22	23.6	21
Taiwan	1.6	14	33.9	18
Sweden	0.4	20	–18.0	26
Belgium	2.7	10	62.0	11
Austria	1.6	15	58.5	12
Norway	–3.0	27	–274.4	28
Israel	3.4	4	62.7	10
Ireland	0.7	19	63.8	9
Denmark	0.9	18	7.3	23
Finland	2.4	13	–47.1	27
Portugal	3.0	8	121.9	3
Greece	3.4	5	176.6[a]	1
New Zealand	0.4	21	6.7	24
Lithuania	0.3	23	39.2	15
Latvia	1.2	16	32.3	19
Estonia	–0.2	25	–1.6	25
Iceland	–14.7	28	45.5	13

[a] Figure for net debt in Greece refers to 2015.

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Note: Countries ranked by the size of their economy in 2016 (in dollars) from the largest at the top to the smallest at the bottom. Measures are general government net deficit and general government net debt. These are similar to, but differ slightly from, the public sector measures typically used in the UK and quoted elsewhere in the chapter.

Source: International Monetary Fund, *World Economic Outlook Database*, October 2017 (http://www.imf.org/en/Publications/WEO/Issues/2017/09/19/world-economic-outlook-october-2017). Data on net debt for Greece taken from April 2016 database.

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