Autumn Budget 2017:
An IEA Briefing

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Summary

- **The Chancellor should resist the siren calls to ramp up spending and focus instead on reducing the burden of tax and regulation. That would be a truly 'bold Budget'.**
- The economy has weathered the initial shock of the Brexit vote much better than most had expected. Unemployment has continued to fall and inflation should peak soon, easing the pressure on real incomes. There is therefore no need for a fiscal boost.
- What's more, the public finances remain in poor shape. There is only room for some small increases in spending on priority areas, partly funded by savings on contributions to the EU. Even on current plans, it will be at least a quarter of a century since the government last balanced the books.
- This Budget will also have to take account of more pessimistic assumptions about future productivity, made by the Office for Budget Responsibility. As it happens, the OBR may be chucking in the towel just as productivity is about to recover. But if the OBR is right, an extended period of lower growth will reduce the fiscal wiggle room even further.
- The Chancellor should ignore the temptation to address intergenerational inequality with gimmicks, such as tax breaks for younger people or a temporary cut in stamp duty for first-time buyers. Instead, the playing field should be levelled by tackling underlying problems that mainly affect the young, including the lack of housing supply, and by withdrawing subsidies which mainly benefit the elderly regardless of need.
- The Chancellor should also resist the calls to boost productivity with a splurge of public investment. Rather he should focus on measures that free up the economy without spending enormous amounts of other people's money, such as liberalising planning laws to facilitate housebuilding and devolving more fiscal powers to the regions.
- And while there may be little margin for additional tax cuts now, he should announce a fundamental review of taxes on property – including stamp duty – with the aim of dramatically simplifying the system.
- On Brexit, the Chancellor should emphasise the opportunities rather than just dwell on the risks. These opportunities include the scope to reduce trade barriers with the rest of the world and review regulations at home.

1. Introduction

On Wednesday 22nd November the Chancellor, Philip Hammond, will present the first Budget following the general election. The Spring Budget has been downgraded to a statement responding to the latest forecasts from the independent Office for Budget Responsibility (OBR). From now on the Autumn Budget will therefore be the only 'fiscal event' each year.

This is a welcome improvement. Nonetheless, even just one major set piece a year provides too many opportunities for the Chancellor to tweak policy. This almost invariably leads to a ratcheting up of public spending and further complication of the tax system. In the long run, there is a case for downgrading the importance of the Autumn Budget too.

However, this will have to wait until a better system of taxation and spending is in place. This briefing therefore focuses on the key issues in this year's Autumn Budget, while also putting down some markers for the future.

2. The economic backdrop

As usual, the Chancellor will have to take the economic and fiscal forecasts of the OBR as given. But he would be right to be positive about the outlook, despite the persistence of 'Project Fear' since the vote to leave the EU.

Admittedly, the economy has grown more slowly than it would otherwise have done. The fall in the pound has lifted inflation to 3%, adding to the squeeze on real wages. Uncertainty about the outcome of the negotiations with the EU has also held back business investment.

Nonetheless, quarterly growth in GDP has still averaged 0.4% in the five quarters after the EU referendum, which is only slightly slower than the pace in the five quarters before the vote. Indeed, growth is currently on track to be stronger in the second half of 2017 than the first.

What's more, at least one headwind should fade next year – as real wages recover. The pound has now been relatively stable (on a trade-weighted basis) for the last 12 months, so price inflation should fall back. In the meantime, the labour market has continued to tighten and pay pressures in the private sector are picking up again. A combination of lower inflation and faster growth in nominal wages should therefore boost consumer purchasing power.

There are two other big unknowns. The first, of course, is the nature of the UK's departure from the EU. In particular, the outlook for investment will largely depend on the progress of the talks in Brussels. If (perhaps a big if) there is some clarity soon, a recovery in business confidence should encourage firms to ramp up their spending once more.

The second unknown is the longer-term outlook for productivity (output per hour worked). The OBR, like most forecasters, has consistently been too optimistic about productivity since the financial crisis. But it has now signaled that it will be revising its projections down. This in turn would imply both a lower profile for economic growth and a worse outlook for the public finances, with government spending expected to be higher and tax revenues lower.

3. The fiscal position

These revisions would come at a time when the fiscal position is already poor. The good news is that public sector net borrowing (the annual budget deficit) has fallen from a peak of just under 10% of GDP in 2009-10 to less than 3%, taking it back to pre-crisis levels. However, the job is far from done. Consider the following:

i. The years of huge deficits have more than doubled the stock of government debt, which now stands at around £1.8 trillion (equivalent to 87% of the value of the goods and services produced in the UK economy each year);

ii. In its latest forecast, the OBR expected the government to spend a whopping £41.5 billion on debt interest payments in 2017-18 (actually £55.8 billion of gross payments, before netting off £14.3 billion paid on gilts held by the Bank of England). This is about the same as the UK's entire defence budget, or half what the government spends on education. Interest rates are now rising too;

iii. Government spending has fallen back to pre-crisis levels as a share of GDP, but this is due to the recovery in the rest of the economy rather than substantial cuts in the public sector. Indeed, the government is still spending roughly as much today as it was in 2010, in terms of billions of pounds, even allowing for the impact of inflation;

iv. The ageing of the population will put growing pressure on the public finances, including the bills for pensions and for long-term social care. Current benefits and perks will therefore be increasingly unaffordable;

v. Moody's decision to downgrade the UK's credit rating further (announced on 22nd September) underlines the risks.

Despite all this, the Conservative Manifesto for the 2017 election merely committed the government to 'continue with the fiscal rules announced by the chancellor in the autumn statement last year, which will guide us to a balanced budget by the middle of the next decade'. Even if this unambitious target is met, it would be a quarter of a century since the government last ran a surplus.

Some would argue that fiscal discipline could be maintained by financing increased spending from higher taxes. However, the burden of taxation has been creeping higher since the mid-1990s. Even on the most favourable measure, taxes now account for around 34% of national income. This figure has only been matched in two years since the 1950s – in 1969/70 and in 1981/82 (when it was flattered by North Sea oil revenues) – but on both those occasions it quickly fell back again.

In contrast, the tax take is now projected to continue rising over the next few years. As a result, UK taxpayers are already facing a burden which is unprecedented in the post-war period. The government should be looking to ease this burden, not add to it.

4. Is there any money to spend?

Overall, then, the resilience of the economy and the poor state of the public finances mean that the government should be looking to tighten fiscal discipline, rather than abandon it. Nonetheless, the Chancellor is under intense political pressure to loosen control of public spending, even at the cost of higher taxes.

As it happens, he probably does have a small amount of money to play with:

i. The recent monthly borrowing numbers have been better than the OBR forecast back in March, suggesting that the deficit for this year could be around £10 billion lower than expected;

ii. The forecasts in the previous Budget also built in a large margin to ensure that the target[1] of cutting the structural deficit to less than 2% of GDP in 2020-21 would be met comfortably;

iii. Finally, the OBR has assumed that payments to the EU budget will be recycled into extra domestic spending from 2019-20 (starting with £12.7 billion in that year). Ideally, this money should be used to cut taxes or repay debt, but the Chancellor could be forgiven for allocating some to the NHS.

Overall, this might now allow a few extra billion each for priorities such as health, social care and housebuilding. In general, though, the government should do the bare minimum – and find offsetting savings.

5. Public sector pay

It looks inevitable that the public sector pay cap will be lifted for some workers.

In support of this, there is some evidence that there is no longer any significant gap in pay between the private and public sectors when individual jobs are compared on a like-for-like basis. However, it is hard to argue that public sector workers as a group are particularly disadvantaged. Indeed, average public sector pay remains higher than in the private sector, even without taking account of more generous pension arrangements.

This means that higher pay awards should only be given in those areas where there is unambiguous evidence of difficulties in recruiting and retaining staff. This decision should also be depoliticised as far as possible, based on advice from independent review bodies. What's more, there should be scope for saving money at the same time. Examples include ending national pay setting to allow greater flexibility, from the regional level down to individual employers, and addressing the differences that still exist in pension funding and provision.

The public sector is also a major payer of the National Living Wage. Rather than engage in a political bidding war, the government should heed the warnings (including from the OBR) about the potential cost to jobs from rising labour costs and listen to the advice of the independent Low Pay Commission.

1 The government's overriding fiscal objective is to eliminate the deficit by the mid-2020s. In addition, there is a 'fiscal mandate' that the structural deficit (i.e. adjusted for the economic cycle) should be less than 2% of GDP in 2020-21, and a 'supplementary target' that net debt should fall as a share of GDP between 2019-20 and 2020-21. Finally, aggregate spending on most welfare is subject to a cap which is due to be lifted in 2020-21.

6. Students

The Prime Minister has already announced a temporary freeze in the cap on tuition fees (in England) at £9,250 and an increase in the income threshold at which students are expected to start to repay their loans. These will presumably be confirmed in the Budget.

Another possible measure would be to link the interest rates on student loans to the CPI (or CPIH) measure of inflation, which is generally lower than the RPI. This is a long-overdue change anyway, given the doubts over the quality of the RPI data. It could also be extended to other cases, such as business rates, where government charges are tied to an official inflation index[2].

However, the government should stop there. As it is students that benefit the most from their education, they should continue to bear the bulk of the costs and risks. There is also no good reason for government intervention to skew the financial incentives towards one type of degree (or university) rather than another.

7. Other measures to help younger people

Indeed, the Chancellor should ignore the temptation to address intergenerational inequality by introducing expensive new subsidies for young people.

For example, it has been suggested that young people should be helped with tax breaks such as lower national insurance contributions for those in their 20s and 30s. There are precedents for applying different tax rates for different ages – for example, you do not pay National Insurance after you reach State Pension age, unless you are self-employed and paying Class 4 contributions. And there are many other ways in which the tax system discriminates – for example, between married and single people.

But it is not obvious that merely being ‘young’ is a good basis for paying less tax. Why should a City trader in their 20s pay less tax on the same income than an NHS consultant in their 50s? This measure would also be unfair to women who might take a career break to raise children then return to paid employment in later life.

Another proposal is to introduce a temporary cut in stamp duty for first-time buyers. But this is also likely to backfire, either by pushing up prices for everybody or by subsidising first-time buyers only at the expense of those buying for the second time. The latter includes young families, who are not obviously any less worthy of support.

A one-off subsidy for first purchases might also encourage some people to buy now when they would actually do better to wait for affordability to improve.

Overall, then, to the extent that some young people do face particular problems – such as high housing costs or student debt – these problems should be tackled directly rather than via the tax system. Above all, the solution to high house prices is more supply, not additional subsidies to inflate demand. And if a young person has a relatively low income, they will pay less tax anyway.

2 Where this might result in an undesirable shortfall in revenues, the gap could be closed by adding an additional mark up to the CPI measure (so RPI is replaced by CPI + x%, where x% adjusts for the likely difference between the two measures). The government should also start to issue inflation-linked bonds indexed to the CPI.

8. Leveling the playing field by reducing subsidies for the elderly

The desire to help students partly comes from the pressure to address intergenerational inequality. But this could also be achieved by better targeting of welfare spending on the elderly on the basis of genuine need rather than age alone.

Clearly this a political minefield. The government will need to build a consensus for changes, but a sensible package would include some or all of the following:

i. Ending, or at least means-testing, pensioner benefits such as free bus passes and the winter fuel allowance;

ii. Replacing the triple-lock on state pensions with a single link to CPI inflation, which would be sufficient to achieve the most important aim of protecting their value in real terms;

iii. Requiring elderly people to make larger contributions to the cost of their social care (including by greater use of private insurance);

iv. Closing National Savings products with market-leading rates, which are simply a subsidy for the relatively wealthy;

v. Scaling back tax breaks that disproportionately help older people, including generous tax reliefs for private pension contributions and the exemption of primary residences from capital gains tax. The former will almost certainly feature in this Budget, while the latter might be considered as part of a wider review of property taxation.

9. Tax reform and simplification

While there may be little margin for additional tax cuts now, the Chancellor should press ahead with promised increases in the personal allowance and reductions in corporation tax.

But there are also some specific weaknesses in the tax system that should be addressed soon. In particular, stamp duty on house purchases is extraordinarily inefficient, reduces labour market mobility and discourages homeowners from upgrading their property or downsizing.

Abolition of stamp duty on residential properties would be likely to cost at least £10 billion a year (HMRC data show this tax raised £9.4 billion in the 12 months to September). This is therefore probably not a runner for this Budget. However, the government should announce a fundamental review of property taxation to include capital gains tax, inheritance tax, council tax and business rates, as well as stamp duty. These could gradually be replaced by some simpler form of property or land tax, phased in, if necessary, over five to ten years.

In the meantime, unfortunately, reports suggest that the Chancellor is considering further tax increases in this Budget – including raising duties on diesel fuel and lowering the threshold above which small businesses must register for VAT. These proposals might have some merits, but would add disproportionately to the burden of tax and regulation.

10. Investment and productivity

The Chancellor should also resist the calls to boost productivity with a splurge of public investment. Rather he should focus on measures that free up the economy without spending enormous amounts of other people's money, such as liberalising planning laws to facilitate housebuilding and devolving more fiscal powers to the regions.

The UK's relatively poor performance on real wages and on productivity is often linked to a low level of investment. But it would be a mistake to conclude that the only way to boost real wages or solve the productivity puzzle is to increase investment by, or directed by, the state. In fact, there are many public sector projects that should be scrapped – starting with HS2.

For a start, the weakness of real wages can also be explained by a series of one-off or temporary factors since 2010, including hikes in VAT, compositional shifts in the labour market, the public-sector wage freeze, large scale migration from the EU and, most recently, the fall in the pound. Crucially, all these pressures have now ended, or will do so soon, while the labour market has continued to tighten. As a result, real wages should recover of their own accord.

In the meantime, UK's productivity performance has not been as bad as the headlines suggest. In part it is simply the flipside of rapid growth in employment (a good thing) as a result of the UK's relatively flexible labour market. As the pool of spare labour dries up, firms will naturally prioritise gains in productivity once more. The deterioration has also been concentrated in a handful of sectors, including financial services and energy, where increased government intervention is already part of the problem.

Similarly, the low levels of investment in the UK compared to other countries partly reflects the relatively high share of services in the UK economy – again, not obviously a bad thing.

Two other developments in the pipeline should also help to raise productivity with no further action from the Chancellor. One is the return of interest rates towards more normal levels, increasing the incentive for banks to lend and encouraging the reallocation of resources to more productive uses.

The other is an easing of uncertainty about the impact of Brexit, which should encourage companies (especially those sitting on ample cash reserves) to look again at new investment projects.

The upshot is, despite the OBR's more gloomy view of the outlook for productivity, now may actually be precisely the wrong time to indulge in a splurge in public investment.

The Chancellor should also be wary of calls to redefine the budget deficit target to exclude capital spending. In principle, it does make economic sense to view capital spending differently from current spending, because the assets created can be self-financing. But in practice, there is a risk that capital spending is then subject to less rigorous scrutiny, even though the government's track record in this area is poor.

11. Brexit

Last but not least, the Chancellor should talk up the benefits of Brexit and not just the risks. For now, the EU Withdrawal Bill will simply translate existing EU regulations into UK law. But these regulations should be reviewed at the earliest opportunity to gauge whether they are still suitable, putting the interests of consumers first.

He should also emphasise the scope to reduce trade barriers with the rest of the world. He should be ready to cut or eliminate tariffs on imports at the earliest opportunity, providing an immediate boost to real incomes. And increased trade with developing countries should allow a reduction in government spending on overseas aid.

12. Conclusion

The economy has performed better than most had expected and there is no need for a major fiscal stimulus either to boost demand or raise productivity. The Chancellor should therefore resist the siren calls to ramp up public spending and focus instead on reducing the burden of tax and regulation, allowing the economy to make the most of the opportunities presented by Brexit. That would indeed be a truly ‘bold Budget’.

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