# SPENDING CHOICES AFTER 2015

## Pre-Budget Briefing

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March 2015

## SUMMARY


- The public finances are on track, and there may be some room for pre-election giveaways. These could amount to £3 billion - £5 billion, but potentially more, if the austerity set out in the Autumn Statement is relaxed.
- Tax cuts are looking likely. These could include increasing take-home pay by reducing income tax or national insurance contributions.
- But the margin for error on the OBR's economic forecasts are substantial, as they are highly sensitive to economic growth forecasts. It will be very uncertain as to whether any improvement in the public finances is temporary or permanent.
- And given the spending cuts to come in the next Parliament, it would be better to put any savings towards reducing these rather than reducing taxes.


## THE PUBLIC FINANCES ARE SHOWING IMPROVEMENT

The 2015 Budget will take place on the same day the OBR publishes its final Economic and Fiscal Outlook before the election, setting out its view on the health of the Government's finances.

In contrast to many of this Parliament's previous Budgets and Autumn Statements, the signs are looking promising:

- Borrowing is on track. In December, the OBR was expecting 2014-15 borrowing to fall by £6 billion compared to last year. So far, taking into account tax revenues and spending from April 2014 to January 2015, borrowing is already tracking at £6 billion lower. February's tax receipts will be important as they will include further self-assessment receipts – but the data on this will only be available two days after the Budget, on 20th March.[1]

- Debt interest payments are falling, despite the fact that debt is rising. Debt interest payments in January were 21% below what they were the same time last year. In December, the OBR revised down its forecast of debt interest payments due to lower than expected inflation. A similar revision could happen again. Last time the OBR revised its forecast of RPI downwards by between 0.2 and 1.1 percentage points, and the forecast drop in debt interest due to inflation was around £3 billion in 2014-15 and £4 billion in 2015-16. This time round, the OBR was expecting RPI to be 1.9% in the first three months of 2015.[2] The latest figures for January show RPI at 1.1%.

- The OBR December forecast was over-optimistic in its forecast of 2014 growth; it was expecting growth of 3%, which would then slow down to 2.4% in 2015. The latest outturn and economic forecasts suggest that instead, growth was slightly slower in 2014 (2.6%) but will then pick up in 2015, leaving overall economic health broadly unchanged.[3] This actually makes the borrowing figures look more promising – given that growth is a little lower than the OBR expected, but borrowing is falling, it may be that a little less borrowing is structural than previously thought. This would be good news, as it would mean that the OBR could conclude that any improvement in borrowing is permanent rather than temporary. However, as we set out in more detail below, there is substantial uncertainty in these calculations.

## THERE COULD BE POTENTIAL FOR GIVEAWAYS

So unlike many previous Budgets and Autumn Statements, the OBR could be in a position of revising up the health of the UK finances. This could mean that George Osborne has some room for some pre-election giveaways.

Other money could also be found. The Treasury has already published news that successful challenges by HMRC have brought in an extra £1.1 billion from businesses.[4] But the amount of money it is possible to recoup from anti-avoidance measures is notoriously hard to predict, and can take longer than expected to deliver savings.[5] Previously, the Chancellor has also been able to announce underspends by departments. For example, in the Autumn Statement, the expected underspend for 2014-15 was £2.5 billion. However, the OBR's view is that the size of any future underspends are likely to be much smaller, as departmental budgets become more squeezed.[6]

Overall then, George Osborne could have in the region of £3 billion to £5 billion from good news on borrowing and some additional savings from elsewhere.

There is also another way to generate some good news and apparent room for giveaways. The OBR's forecasts are based on Treasury's spending numbers – in the Autumn Statement, these were based on Coalition policy. They implied drastic cuts of 14% in departmental spending (17% cut in current day-to-day departmental spending), which would mean a £4 billion surplus by 2018-19 and a £23 billion surplus by 2019-20. On this basis, the OBR pointed out that Government spending would fall to its lowest level as a percentage of GDP since the 1930s. The plan went some way beyond simply "balancing the books", which is the goal that the Conservatives have said they would want to achieve in the next Parliament. And almost as soon as it was published, both the Conservatives and the Liberal Democrats effectively disowned the spending plans in the Autumn Statement, saying their deficit reduction targets involved less austerity. The Budget could be an opportunity to set out in more detail what this means.

The Chancellor could pencil in cuts of a less drastic nature (or indeed make tax cuts), reduce the planned surplus in the OBR forecasts and still be on course to meet targets for deficit reduction in the next Parliament. For example, he could use up the £4 billion surplus planned by 2018-19, or could postpone deficit reduction to 2019-20 and dip into the £23 billion surplus.

## WHAT COULD THE GIVEAWAYS BE?[7]

Income tax cuts look most likely. In his conference speech, David Cameron said a future Conservative government would want to cut income tax further, by increasing the threshold at which individuals start to pay income tax to £12,500.[8] He also set out an aim to raise the threshold for the 40p income tax rate to £50,000. There is potential room for the Chancellor to start on income tax cuts early, as a taster of what a Conservative Government would do. The Liberal Democrats are also in

favour of raising the personal allowance to £12,500 in the next Parliament, so of the two potential tax cuts, raising the Personal Allowance is the more likely option.[9]

The Personal Allowance is already planned to increase to £10,600 in April. Increasing it by an extra £100 would cost in the region of £500 million-£600 million. Taking it all the way to £12,500 immediately would be difficult to afford. But increasing it to £11,100 would cost around £3 billion.

Alternatively the Chancellor could increase workers' take-home pay by raising the threshold at which employees pay National Insurance, currently £7,956 a year. Raising this to the same threshold at which workers start to pay income tax (£10,600 a year) would cost between £6 billion and £7 billion.

Other options could include reducing VAT from 20% to 19% (cost of £5.5 billion); reducing Class 1 National Insurance rates for employees by 1 percentage point (cost of just under £4 billion); reducing alcohol and tobacco duties by 10% (cost of just over £1 billion).

## ARE GIVEAWAYS AFFORDABLE?

However, giveaways today might be better spent on reducing the amount of austerity required in the next Parliament. Public spending is set to see substantial cuts by 2019-20. The Conservatives have set out an aim to save £12 billion from welfare. This is looking extremely difficult. As we set out in *Commitment Issues*, protecting pension spending means that other welfare payments – including housing benefits, tax credits, disability living allowance and incapacity benefit, would need to take average cuts of 9% in real terms.

As we also set out in *Commitment Issues*, spending commitments are already being made across a range of areas, including capital spending, overseas aid, education, health and pensioner benefits. That means that around half of spending in the next Parliament may be off the table for savings when the next Spending Review begins, making it very difficult to find the necessary amount of savings, particularly when departmental spending has already seen substantial cuts since 2010. Cuts in day-to-day (non-capital) spending could be particularly severe. For example, under the Autumn Statement plans, day-to-day departmental spending is set to fall by 17%; but protecting health, education and international development would increase the average cut that all other departments had to take to 39%. If there is room in the Budget, then money could be put towards reducing the size of the cut in the next Parliament.

Reducing the cut in the next Parliament would also be a way of avoiding the criticism that by 2020, spending will be reduced to 1930s levels as a proportion of GDP. Increasing planned spending in 2019-20 by around £15 billion would leave total spending as a proportion of GDP at 1999 levels.

Finally, there is a growing issue about who pays tax. As we set out in *Taxing Matters*, we are seeing a narrowing of the tax base. Big increases in the Personal Allowance and national insurance thresholds since 2010 have led to fewer people paying income tax and national insurance. In the short term, tax giveaways such as increases in the Personal Allowance reduce revenues that could be used to cut the deficit. In the longer term, a small tax base may lead to volatile and uncertain tax revenues, with the risk of a large fall in revenues in the event of another economic downturn.

## THE MARGIN OF ERROR ON DEFICIT REDUCATION FORECAST IS IN THE 10S OF BILLIONS

But more fundamentally, debate about how to spend a few billion here or there and still meet deficit targets is a case of spurious accuracy. As we set out in *A Deficit of Growth*, the main uncertainty is

how productivity growth will play out in the next Parliament. This is one of the substantial uncertainties in the OBR forecast. There is little consensus among the experts on the underlying health of the economy and therefore the likelihood of strong economic growth in the next few years.

As shown in *A Deficit of Growth*, the OBR's December forecast assumes that UK productivity growth picks up from the trend seen since 2008. If, instead, we saw a continuation of the trend since 2008, cuts of around £90 billion would be needed to run a surplus by 2018-19. In contrast, if we saw productivity return to trends last seen in the early 1970s or 1980s, no further cuts would be needed beyond 2015-16. These are extremes. But even a relatively small difference in the state of the underlying health of the economy could result in a permanent improvement in the state of the finances.

## PRUDENT V POLITICAL

If there is some extra room in this year's Budget and the aim is to reduce the deficit, then the prudent option would be to put any savings towards reducing future spending cuts. The economic forecasts are so uncertain that it will be very difficult to know whether any improvement is temporary or not. If there is a political desire to increase spending, it would be best to increase growth-friendly spending that will improve living standards and boost the long-term health of economy and finances, as set out in *Investing for Growth*. Cuts in income tax now would suggest that the aim is a smaller state, not deficit reduction.

## ABOUT THE AUTHOR

**Nida Broughton** is Chief Economist at the SMF, where she leads research on growth, skills policy, entrepreneurship and analysis of public spending. Nida also has expertise in a range of public policy areas including education, housing and consumer markets.

Nida regularly appears in the media including Sky News, BBC Newsnight, BBC Radio 4 Today, BBC News and LBC, where she is known for providing rigorous and balanced economic and policy analysis. She has also written for titles including City AM, New Statesman, Public Finance and The Independent.

## ENDNOTES

[1] OBR Commentary Feb 2015
[2] OBR Economic and Fiscal Outlook Dec 2014, Chart 3.22. RPI is used as the basis for Government index-linked gilts.
[3] OBR Economic and Fiscal Outlook Dec 2014; ONS Second estimate of GDP Q4 2014; HM Treasury Independent Forecasts Feb 2015
[4] HMRC Press Release https://www.gov.uk/government/news/multinationals-face-11-billion-in-extra-tax-after-hmrc-challenges-transfer-pricing
[5] OBR Economic and Fiscal Outlook Dec 2014, Box 4.2
[6] OBR Economic and Fiscal Outlook Dec 2014
[7] Estimates are based on HMRC, Direct effects of illustrative tax changes
[8] David Cameron speech to Conservative Party, http://press.conservatives.com/post/98882674910/david-cameron-speech-to-conservative-party
[9] http://www.libdems.org.uk/fair-taxes-for-everyone