National Institute of Economic and Social Research

NIESR's Response to the Spring Budget

15 March 2023

Economic and Social Research Council

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Main Points

- The OBR have projected that the Chancellor will meet his fiscal targets for 2027-28. But, NIESR has long argued that this focus on arbitrary targets is not what should determine fiscal policy; rather we need a new framework where the emphasis is on improving outcomes for UK households and different policies are independently examined.

- The decision to go ahead with the rise in corporation tax from 19 per cent to 25 per cent will dampen GDP and hurt the supply side of the economy in the long run, though this is mitigated to a degree by the range of measures the government has announced to support business investment.

- The Chancellor announced increases in spending in some areas, but it was disappointing that he failed to address public-sector pay, or announce more public investment, at a time of falling output and high inflation.

- While three-quarters of UK households will see their disposable incomes increase in 2023-24 compared with 2022-23, the bottom half of the income distribution – some 14 million households – will have lower living standards than two years ago. Instead of a general subsidy to everyone, policy needs to be targeted at the half of the population who need it most; NIESR proposes to use a Variable Price Cap will achieve this.

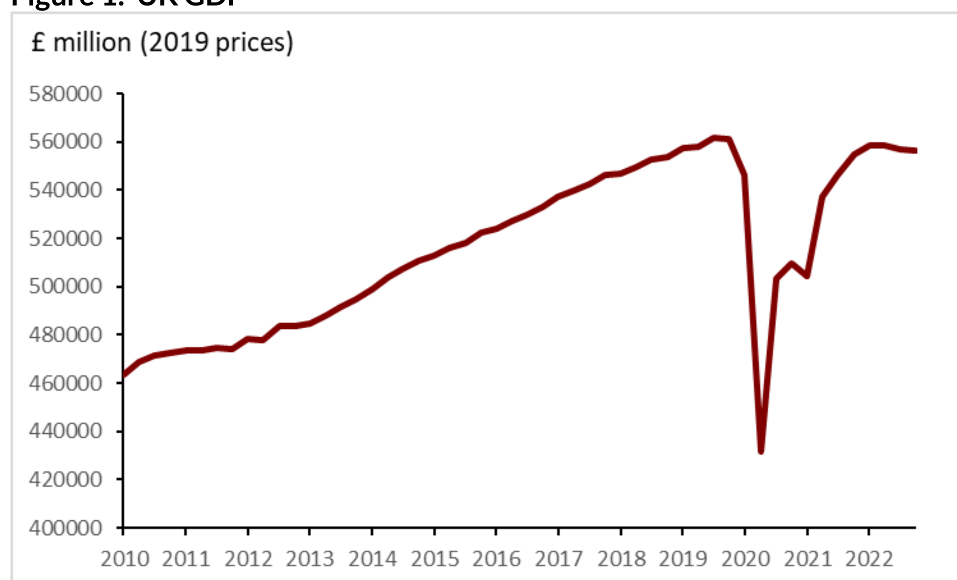
- The decision to pay childcare costs upfront in Universal Credit is a welcome move. However, we believe the Chancellor's announcement of more places on skills boot camps to encourage over-50s back to the workplace is unlikely to work as this group tend to be more concerned about health risks, job security, and a more tailored workplace balance.

- It's reassuring to see the government's commitment to Levelling Up and devolution deals though we worry that the government's Levelling Up policies will not benefit the whole country. While the policies will help cities, there is no evidence that city development will generate spill-overs to suburban, rural and coastal areas.

Background

Today's Spring Budget was set against an economic environment of sluggish growth and high inflation. Currently, we expect a contraction in GDP in the first quarter of 2023 of 0.1 per cent. Over 2023, we expect growth of only 0.2 per cent. Although the economy has improved since the Chancellor delivered his Autumn Statement in November, the longer-term outlook for the UK economy is still not good, with low productivity growth and labour supply issues. Figure 1 shows that UK GDP has still not returned to its pre-pandemic level and, even before then, growth had been slow (averaging only 2.0 per cent between 2010 and 2019). NIESR has long argued that a lack of both private and public investment has been a major contributor to poor UK productivity growth. Given this backdrop, we were looking to the Chancellor to use the budget as an opportunity to encourage private investment and increase public investment.

Figure 1: UK GDP

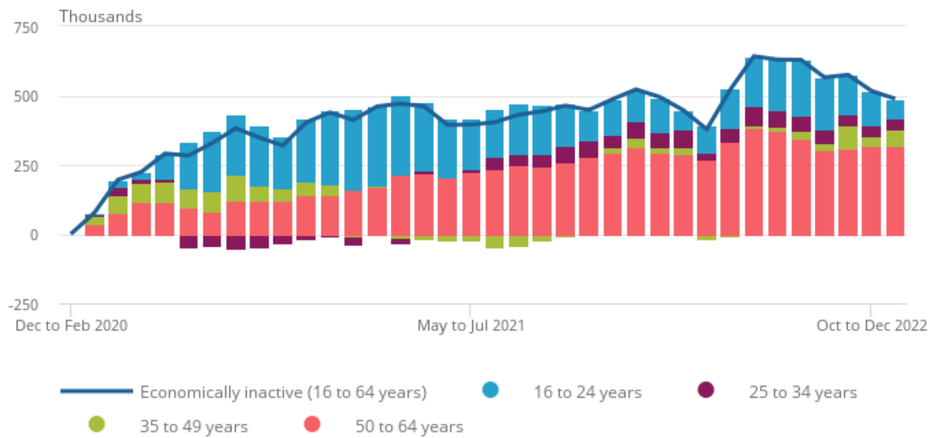


Source: ONS

The other major development in the UK economy since the pandemic has been the marked fall in labour force participation. As can be seen in the figure below (from the latest ONS labour market data release that came out on 13 March), economic inactivity has risen by 488,000 since the three months to February 2020. This was driven initially by people aged between 16 and 24, but now predominantly reflects a rise in inactivity among people aged between 50 and 64, who account for 320,000. Given this backdrop, the Chancellor flagged ahead of time that this would be a 'back-to-work' budget that would seek to improve incentives for people to join and/or remain part of the labour force.

Figure 6: The decrease in economic inactivity during the latest three-month period was driven by those aged 16 to 24 years

UK economic inactivity by age, people aged 16 to 64 years, seasonally adjusted, cumulative change from December 2019 to February 2020, for each period up to November 2022 to January 2023



Source: Labour Force Survey from the Office for National Statistics

The rest of this note assesses the degree to which the Chancellor was able to address these issues. We note up front, however, the need for a new fiscal framework.

Fiscal Space

"The Chancellor announced that he would meet his fiscal targets for 2027-28 by £6.5 billion in the case of the debt target and £39.2 billion in the case of the deficit target. But this focus on arbitrary targets is not what should determine fiscal policy; rather we need a new framework where the emphasis is on improving outcomes for UK households and different policies are independently examined."

— Stephen Millard (Deputy Director for Macroeconomic Modelling and Forecasting)

- In the Autumn Statement in November, Jeremy Hunt announced new fiscal targets:
  - To get borrowing below 3 per cent of GDP in five years' time (currently 2027-28)
  - For underlying debt to be falling in five years' time (currently 2027-28)
- NIESR has long argued that fiscal policy should concentrate on improving the welfare of UK households and should not be set purely to satisfy such targets which are, essentially, arbitrary.
- That said, the OBR – in their Economic and Fiscal Outlook – have calculated that, after today's budget, the Chancellor will achieve these targets with £39.2 billion (1.3 per cent of GDP) and £6.5 billion (0.2 per cent of GDP) to spare, respectively.
- These forecasts, though, are based on assumptions about output growth and inflation over the coming five years. In particular, the OBR assume nominal GDP growth of 26.2 per cent over this period; this compares with NIESR's forecast of 39.4 per cent growth in nominal GDP between now and 2027-28. As a result, we think that the Chancellor has more fiscal space than calculated by the OBR (Tables A and B).
- The greater amount of fiscal space is a direct result of the implicit 'inflation tax' on government bond holders, given our belief that inflation will be higher for longer than expected by the OBR (Figure 2).

Table A: OBR forecast (March 2023)

	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
Government Spending (£ billion)	1040	1172	1189	1189	1214	1247	1280
Taxes (£ billion)	917	1020	1058	1104	1137	1184	1230
Interest (£ billion)	49	103	75	61	65	77	82
Deficit (£ billion)	123	152	131	85	77	63	50
Debt (£ billion)	2054	2250	2421	2545	2649	2750	2840
Implied interest rate (per cent)	5.02	3.34	2.54	2.56	2.92	3.00	
Bond rate (per cent)	1.06	3.05	3.28	3.32	3.4	3.51	3.64
Implied tax rate (per cent)	39.22	40.73	41.12	41.36	41.21	41.54	41.69
GDP (£ billion)	2338	2504	2573	2669	2759	2850	2950
GDP (centred end March £ billion)	2448	2531	2621	2717	2801	2900	3002
Deficit to GDP ratio (per cent)	**5.26**	**6.07**	**5.09**	**3.18**	**2.79**	**2.21**	**1.69**
Debt to GDP Ratio (per cent)	**83.91**	**88.90**	**92.37**	**93.67**	**94.57**	**94.83**	**94.60**

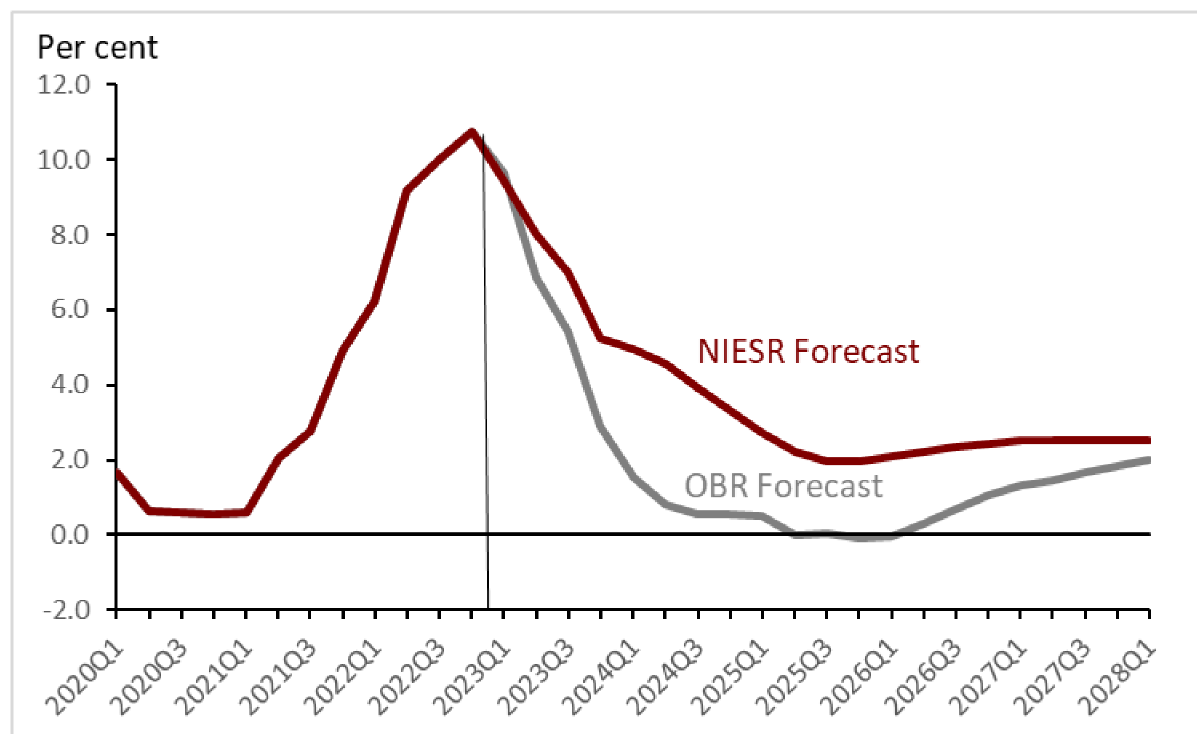
Source: OBR Economic and Fiscal Outlook, March 2023

Table B: NIESR forecast (February 2023)

	2021-22	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28
Government Spending (£ billion)	1047	1182	1199	1180	1199	1240	1271
Taxes (£ billion)	912	1030	1148	1204	1239	1284	1339
Interest (£ billion)	49	109	67	83	83	83	84
Deficit (£ billion)	135	152	51	-24	-40	-44	-68
Debt (£ billion)	2054	2315	2434	2493	2535	2575	2591
Implied interest rate (per cent)	4.58						
Bond rate (per cent)	0.96	2.91	3.43	3.32	3.29	3.28	3.27
Implied tax rate (per cent)							
GDP (£ billion)	2339	2558	2756	2888	2996	3121	3261
GDP (centred end March £ billion)	2426	2653	2810	2928	3040	3172	3312
Deficit to GDP ratio (per cent)	5.75	5.96	1.84	-0.85	-1.34	-1.41	-2.09
Debt to GDP Ratio (per cent)	84.67	87.28	86.61	85.13	83.40	81.17	78.22

Notes: We have assumed government spending in line with the OBR forecast; in practice, you would expect a proportion of government spending to be higher than the OBR forecast given our higher inflation forecast. As such, the available fiscal headroom in Table B should be seen as an upper limit. However, as emphasised in our Pre-Budget Analysis, the main takeaway is that if inflation comes in line with our forecast, then the implicit 'inflation tax' means that the Chancellor will have significantly more fiscal headroom than implied by the OBR forecast.

Figure 2: CPI inflation forecasts



Tax Changes

"The decision to go ahead with the rise in corporation tax from 19 per cent to 25 per cent will dampen GDP and hurt the supply side of the economy in the long run. The range of measures the government has announced to support business investment will help mitigate this, but it remains to be seen as to whether this will be enough, especially as the time horizon for these measures may not be long enough to provide long term certainty."

- Ed Cornforth (Associate Economist)

- We simulated the effects of the rise in the corporation tax rate from 19 to 25 per cent using our global econometric model, NiGEM. We found that this tax increase, by itself, could decrease annual average GDP growth by 0.84 per cent over the next 10 years, as shown in Figure 3.
- Corporation tax changes can be disruptive in the short run through the demand side, hitting business investment, employment, and consumption. As the economy evolves, supply-side depletion through reduced business investment leads to a permanent decrease in the capital stock and therefore a permanently lower level of output capacity and GDP.
- However, the Chancellor's announcement of investment support, which includes full capital expensing over the next three years. This is claimed to reduce costs by £9 billion per year, with the OBR estimating that full capital expensing could increase investment by 3% at its peak. Whether this is enough support for the economy remains to be seen, especially since a three-year policy leaves uncertainty beyond that horizon, which may dampen future investment.
- Figure 4 shows the amount of Corporation tax that was paid by sectors in the financial year of 2020-2021. The chart shows that the Financial and Insurance sector paid the most at £11.8 billion. If the rate had been 25 per cent, the extra amount raised from the Financial and Insurance sector would have been £3.7 billion, all other things being equal.
- There was no change announced to the Personal Allowance or other income tax thresholds, which means that there is extra income for government as wage increases push households into higher tax bands.

Figure 3: NiGEM simulation of a rise in the corporation tax rate

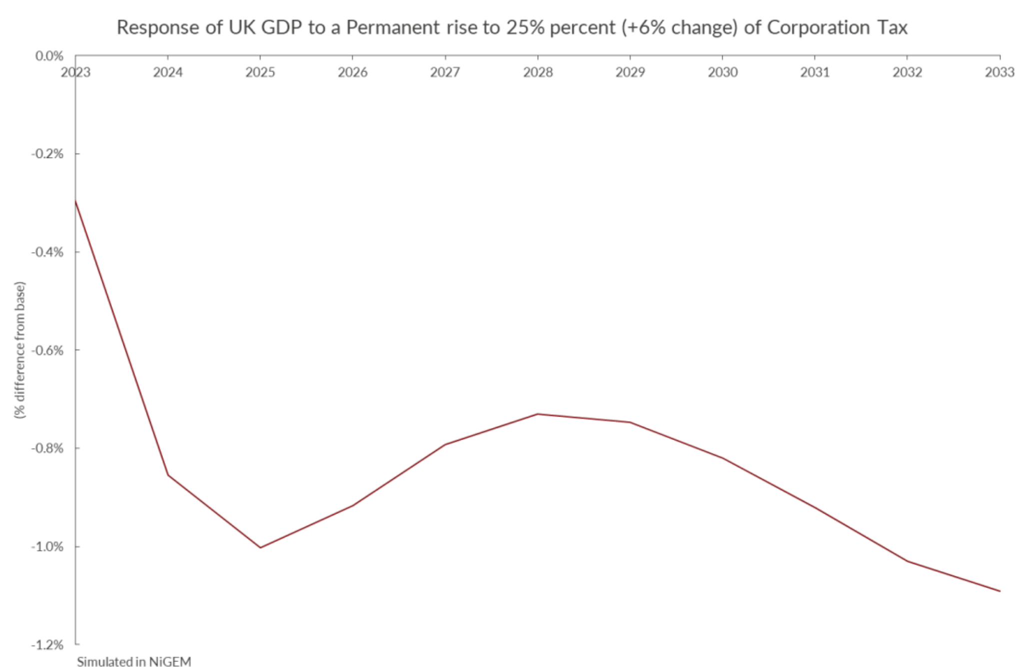


Figure 4: Corporation tax paid by sector in 2020-21

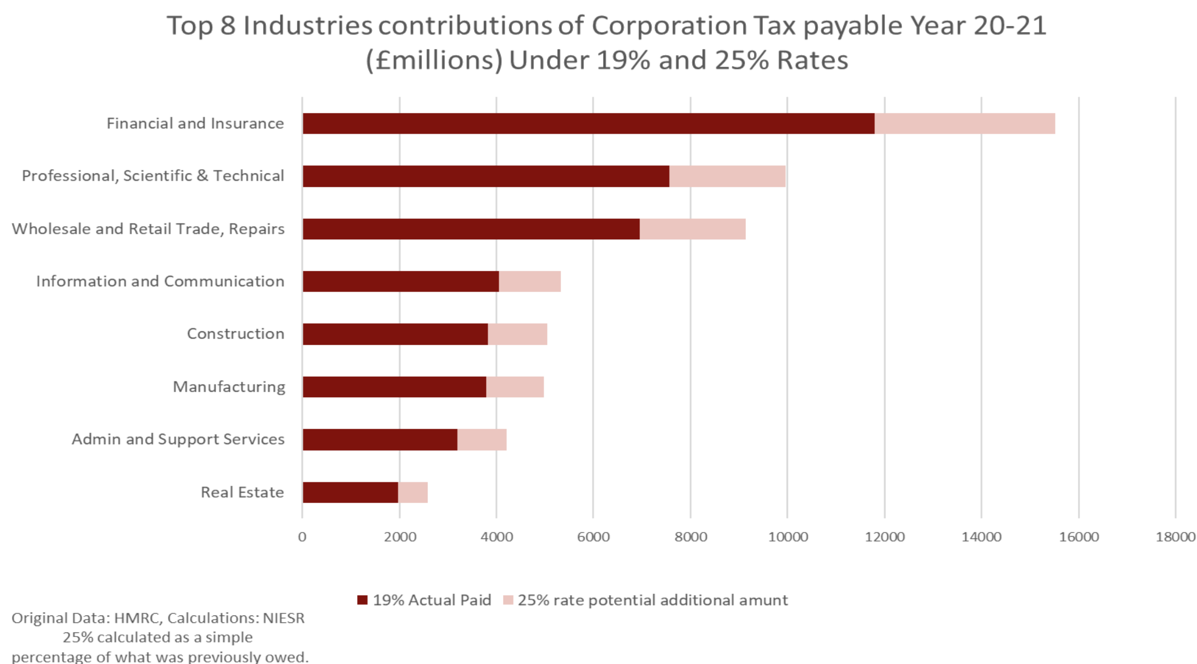


Table C: Personal Allowance 2019-2023

Year	2022 to 2023	2021 to 2022	2020 to 2021	2019 to 2020
Personal Allowance	£12,570	£12,570	£12,500	£12,500
Personal Allowance (If grown with CPIH from 2019)	£14,200.30	£13,160.62	£12,839.63	£12,712.50
Difference in Tax Paid.	£326.06	£118.12	£67.92	£42.50

Spending Changes

"The Chancellor announced several spending commitments for key segments of the economy against a backdrop of tight public finances. While the strategic move to fortify national security by increasing defence spending is welcome, we are disappointed that the Chancellor failed to address public-sector pay, or announce more public investment, at a time of falling output and high inflation."

— Hailey Low (Associate Economist)

- In an environment where geopolitical uncertainty and threats are at a high, announcing the goal of increasing defence spending from 2 per cent to 2.5 per cent of GDP together with the specific extra £11 billion defence stimulus over the next 5 years to fortify the UK's defence capabilities is a strategic and welcome move. However, more clarity is needed as to when the goal of 2.5 per cent of GDP would be achieved.

- **However, it is disappointing that the Chancellor failed to make an announcement on public sector wages.** This will come as a major blow to public sector workers who continue to see a huge disparity between their wages and that of their private sector counterpart, but more importantly, continue to see real cuts in their wages. This decision leaves those providing public services to choose between large real pay cuts or cutting back on front-line duties or both. The Chancellor should also be cognizant of the potential output losses across the economy if industrial strife were to be escalated or we were to see an exodus of skilled public-sector workers to the private sector.

- We would question the government's lack of commitment to public investment spending. Public sector net investment nudges up to around 2 per cent of GDP over the forecast horizon, which is welcome given the recent average of 1 per cent of GDP. But this is still not enough to make up for historic shortfalls, which would imply some 3 per cent of GDP or so and represents a fall in public investment relative to the Autumn Statement.

- The government has decided to keep the EPG threshold at £2,500, reversing its decision to raise it to £3,000 from April. Current forecasts suggest the price cap should fall below £2,500 from July 2023, meaning the government will be spending much less on energy support throughout 2023 than was anticipated in November.

Increasing Participation

"We recognise the efforts of the Chancellor to discourage early retirement by easing the tax allowances surrounding pensions. While there are good reasons to increase pension allowances, the effect on labour force participation might be minimal. We believe that a more targeted approach might be more impactful."

"The decision to pay childcare costs upfront in Universal Credit is a welcome move in the Chancellor's Budget today. The move will act to remove any potential cash flow barriers to those joining the workforce. However, we believe the Chancellor's announcement of more places on skills boot camps to encourage over-50s back to the workplace is ill-judged and misinformed. Those in the over-50s category are more concerned about health risks, job security, and a more tailored workplace balance".

— Hailey Low (Associate Economist)

- The Chancellor's decision to abolish lifetime allowances on pensions is a step in the right direction; however, it might not be sufficient to tempt over-50s back to work as the tax-free limit on pensions savings represents only a small part of the reason why people are retiring early.

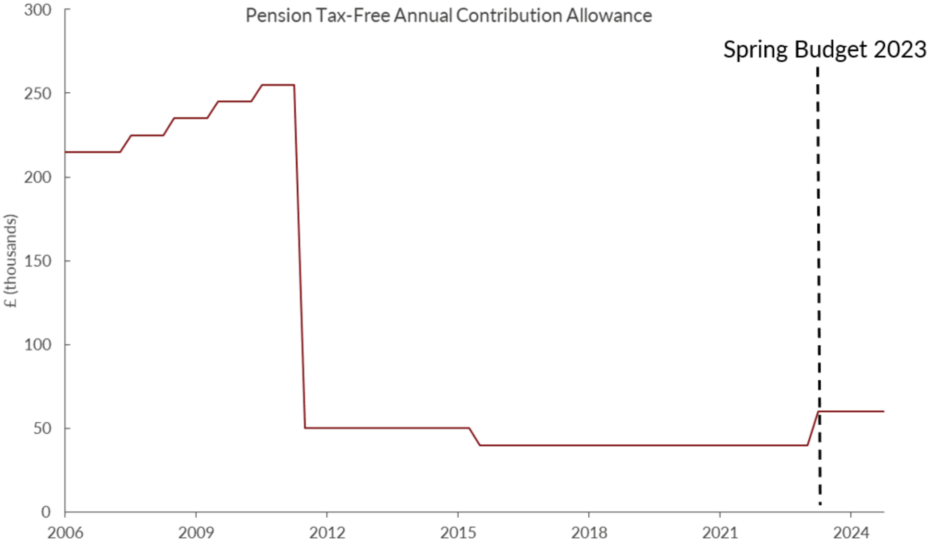
- The Chancellor announced two new changes to pension schemes: first, he lifted the cap on tax-free annual pension contributions, which has been frozen for nine years, from £40,000 to £60,000; second, he abolished the lifetime allowance. While we recognise the efforts of the Chancellor to discourage early retirement, the approach taken might not have the desired effect. A better targeted approach might be more impactful. For example, adjustments directly to the NHS pension scheme might do more to encourage doctors to remain in the workforce longer.

- These changes, however well intentioned, seem to represent a tax break for high income earners. The tax relaxation therefore impacts the workforce disproportionately as it does very little for basic rate taxpayers or provide any incentives for those not currently saving into a pension.

- The increase in the annual pension allowance might instead be a double-edged sword as it enables these professionals to reach their targeted savings levels faster and retire earlier than they otherwise would without this increase. Ultimately, the change risks more people leaving the workforce earlier than expected while only benefitting high-income earners rather than most of the workforce.

- We welcome the Chancellor's £4 billion expansion of free childcare for one- and two-year olds as an attempt to help people into work and stimulate growth in the economy. Childcare costs in the UK have been a major deterrent for parents joining the workforce; therefore, the move to help reduce them further is a positive step in breaking down barriers to entering the workforce.

Figure 5: Annual tax-free allowance for pension savings



Household Finance and Support for Households: The EPG

"While three-quarters of UK households will see their disposable incomes increase in 2023-24 compared with 2022-23, the bottom half of the income distribution – some 14 million households – will have lower living standards than two years ago. Instead of a general subsidy to everyone, policy needs to be targeted at the half of the population who need it most. That is why we have long argued for a Variable Price Cap for energy whereby the price per unit increases with usage. This, combined with a Social Tariff Discount as proposed by the government, would help the hardest hit households while also incentivising energy saving for the higher-income households who tend to use more energy. An opt-in Social Tariff could be brought in this year to provide targeted support."

— Max Mosley (Economist)

- **The Chancellor's decision to hold the EPG at £2,500 for three months and maintain the 5p fuel duty cut will not worsen the situation for the lowest-income households**: the bottom half of the income distribution will see energy bills reduced between £800 and £1,000 (worth between 1.2 per cent and 6.2 per cent of their disposable income) compared with the previously announced rise in the EPG to £3,000.

- **The decision to bring prepayment energy metre charges in line with direct debit charges is welcome news for some of the poorest households up and down the country**. But many low-income households will still pay more than 10 per cent of their disposable incomes on energy.

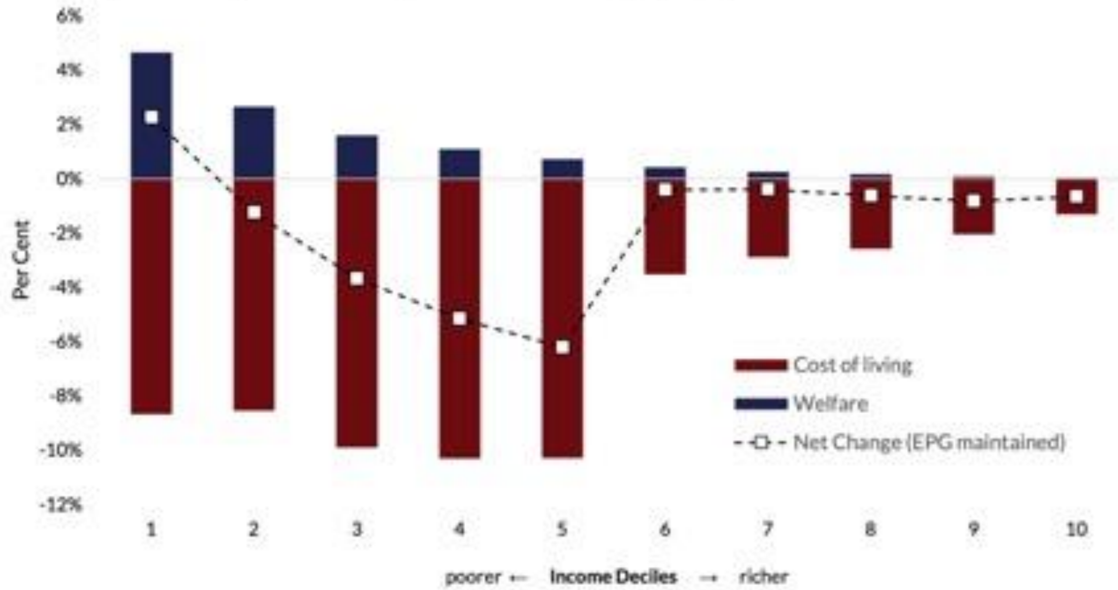
- **We think that the Chancellor could have been more ambitious by introducing a combination of a Social Tariff and Variable Price Cap:** a Social Tariff, which would work by applying a discount to households which energy companies identify as poor or vulnerable, would be the most effective tool in lowering the bills of the poorest. A Variable Price Cap would raise the cost of energy with its usage for all other households, which would lower the bills for the lower-income households who tend to use the least amount of energy and raise it for the higher-income households who tend to use the most. This could be cost-neutral and would still incentivise lower energy demand.

- **The costs of leaving the fuel duty cut in place and not uprating fuel duty in line with inflation are around £6 billion:** this would cut petrol and diesel bills by about £100 per year but is a regressive measure that will benefit higher-income households disproportionately.

- **Living standards will continue to remain below the level in 2021-22**; the OBR are now predicting a decline of approximately 5 per cent. We have long argued that the key question is the distributional impact. Lower-income households will take a greater hit, not least with the indirect tax increase resulting from the government's freezing of the income tax thresholds, which will add about £500 to the tax bill of low-income households. On this problem of fiscal drag, the OBR says that up to 3.2 million people will become new

taxpayers and 2.1 million will be pulled into the 40 per cent band. These stealth tax increases are a further hit on already strained household finances.

Figure 6: Changes in living standards since 2021-22



Implications for Levelling Up

"It's reassuring to see the government's commitment to Levelling Up and devolution deals. But besides the lack of scale in public investment, the fundamental problem with the government's Levelling Up policies is that it will not benefit the whole country. While it will help cities, there is no evidence that city development will generate the spill-overs to suburban, rural and coastal areas. Thriving cities are a vital part of national renewal but that will require institutions and a much greater transfer of powers and resources from the centre to lower levels – coupled with higher state capacity in Whitehall to implement an ambitious industrial policy."

— Adrian Pabst (Deputy Director for Public Policy)

- Plans to create 12 investment zones – eight in England, four in the three devolved nations – clustered around universities provide greater certainty for companies to invest, but they lack institutions to disseminate R&D and sufficient public funding to unlock greater business investment; coupled with the three-year limit on full capital expensing and the abolition of Local Enterprise Partnerships (LEPs), this adds to the short-term outlook and the constant churn in policy making.

- The Chancellor's announcements for several regeneration projects and Levelling Up partnerships underline the government's general commitment to regional regeneration, as does the planned transfer of further fiscal powers to mayors and combined authorities such as Greater Manchester Combined Authority; while these plans are welcome, there was little detail about which decision-making powers and resources would be devolved.

- The creation of Levelling Up Partnerships will enable 20 places across the country to access a fund of £400 million, which will involve community organisations and residents in setting their priorities – all a step in the right direction of strengthening civil society participation and the attempt to boost civic cohesion; as with the separate sixteen regeneration programmes totalling £200 million, it adds to the sense that Levelling Up funding streams remain fragmented and that local or regional authorities will spend precious time and resources trying to access these underspent funds.