National Institute of Economic and Social Research

NIESR's Response to the Spring Budget

Low-Key Budget Unlikely to Unlock Productivity Growth

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Economic and Social Research Council

Contents

Main Points

- This was a low-key budget that is unlikely to unlock the UK's growth and productivity problems

- The focus on arbitrary debt and deficit 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 regions

- While increasing real wages have improved conditions for many households in recent months, long-term economic prospects will remain weak – including the trend growth rate – without growth-enhancing fiscal policies such as a commitment to increasing public investment

- The further two per centage point cut in National Insurance Contributions (NICs) is regressive, with households in the lowest income decile set to gain 0.2 per cent of their annual disposable income whereas the top five decile gain 1.4 per cent of their annual disposable income

- Measures such as the NIC cut will not boost living standards significantly, which for the bottom 10 per cent of households are some 20 per cent lower relative to pre-pandemic levels

- The public service productivity plans, including the £3.4 billion investment in modernising NHS IT systems and the commitment to growth in 'day-to-day' public spending of one per cent in real terms, are moves in the right direction, but the budget lacks a plan for the longer-term funding of non-ringfenced departmental spending such as policing, the justice system and local government funding

- Local authorities are spending around 15 per cent of their budgets simply servicing their existing debt and without further support, or any reforms to regressive Council Tax, the provision of critical public services on which the most vulnerable people depend will be compromised

- The government's continued commitment to Levelling Up is welcome, including today's announcements of further funding and more devolution deals, but the scale is insufficient and the allocation has been too low and patchy to close the gap between the top performing and worst performing areas, which is at the heart of the 12 Levelling Up missions

Background

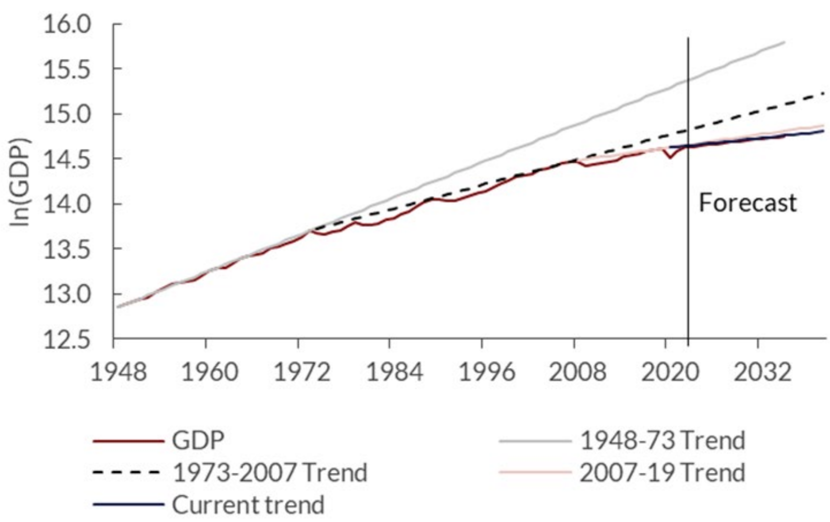
"Today's Spring Budget is taking place against a backdrop of low economic growth, as seen most notably by GDP per head being lower in the last quarter of 2023 than just before the pandemic (2019 Q4). While increasing real wages have improved conditions for many households in recent months, long-term economic prospects will remain weak without growth-enhancing fiscal policies, such as a commitment to increasing public investment. We therefore hope today's Budget focuses on the long-term, rather than pre-election giveaways."

— **Paula Bejarano Carbo (Economist)**

The Autumn Statement in November 2023 most notably saw cuts to different rates of National Insurance Contributions (NICs), an increase in the National Living Wage, the permanent extension of full expensing of investment, support granted to strategic manufacturing sectors, and raises in welfare and Local Housing Allowance rates. In our response to the Autumn Statement, we noted that some of these measures were steps in the right direction, but that more could have been done, and in a better value-for-money way. For example, we noted that the cuts to NICs are very costly 'back to work measures' (costing over £360,000 per person incentivised into work) and mostly benefit higher earners. At the same time, there is a desperate need to increase spending in infrastructure, education, skills, and healthcare – all of which contribute to productivity growth – that remains to be met.

The economic outlook for the United Kingdom has not changed much since November. In particular, today's Spring Budget is taking place against a background of GDP growth remaining near zero since early 2022. In our recent UK Economic Outlook, we projected that UK GDP growth will likely remain sluggish into the medium-term. Specifically, we forecast GDP to grow by 0.9 per cent in 2024 and at a similar rate throughout the rest of the forecast horizon. This outlook for economic growth is quite low by historical standards (Figure 1) and is lower than the OBR's medium-term forecast (Figure 2). This difference arises from various sources, including the OBR's forecast considering the effects of the Spring Budget measures on economic growth, as well as our differing views on key variables, such as productivity growth.

Figure 1: UK GDP growth trends



Source: ONS, NIESR calculations

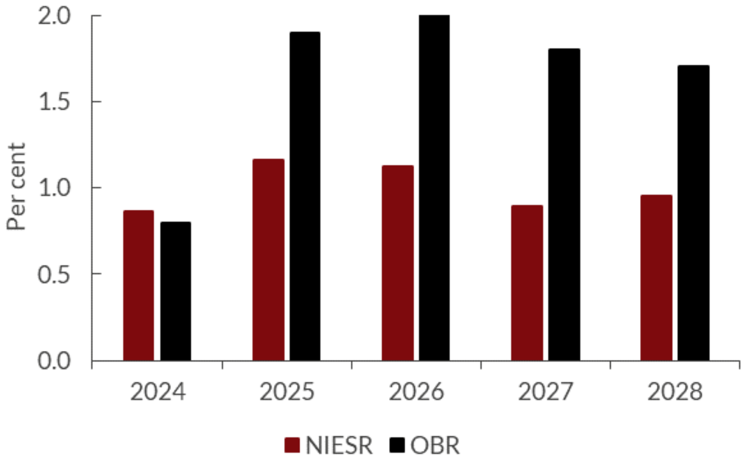
While trends in prices and wages resulting in increased real wages have improved conditions for many households in recent months, long-term economic prospects will remain weak without growth-enhancing fiscal policies, such as a commitment to increasing public investment.

Despite the tax changes announced today, UK households are still facing historically high taxation as a share of GDP. That this is the case at the same time as public services are on the brink of collapse is extremely worrying. One reason why this may be is that our public sector capital stock (e.g., infrastructure) has been below its optimum level for some time, which would reduce the quality of our public services and put an unsustainable burden on the public-sector labour force to keep them afloat.

The systematic running down of the public capital stock can be seen in the healthcare sector, for example, where insufficient infrastructure investment has led to a decrease in the number of usable beds in hospitals and a reduction in the quality or condition of the NHS estate, both of which have likely contributed to treatment backlogs (Warner and Zaranko 2022). Until we reverse the under-investment trend, budgetary increases will continue to be partially offset by a need to simply 'patch up' struggling public services.

Consequently, NIESR have been advocating for some time now the need for the government to increase public investment – which research suggests has a higher return in terms of economic growth than tax cuts or other short-term spending boosts. (See, for example, Ramey 2020).

Figure 2: Annual GDP growth forecast comparison



Source: OBR, NIESR

Fiscal Space

"The Chancellor announced that he would meet his fiscal target for the debt to GDP ratio in 2028-29 to be falling by £8.9 billion. 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, the Chancellor confirmed that his fiscal targets remain:

- Public-sector borrowing needs to be below three per cent of GDP in five years' time (i.e., the 2028-29 fiscal year)
- Public-sector debt needs to be falling as a percentage of GDP in five years' time (i.e., over the 2028-29 fiscal year)

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. We set out our view of a what a better fiscal framework might look like in Designing a New Fiscal Framework: Understanding and Confronting Uncertainty. Broadly, such a framework would require the Chancellor to follow a structured timetable for fiscal events (without leaking the budget through the media ahead of time!), require the OBR to publish pre-fiscal event reports and the Chancellor to produce economic risk assessments based on scenario analyses, create a body of independent experts, and guarantee a fiscal strategy that works for all by bringing distributional concerns, productivity, well-being, ecological sustainability and consistency across the UK regions to the forefront.

That said, it is worth considering how much 'fiscal space' the Chancellor has relative to his announced targets. In their latest Economic and Fiscal Outlook, the OBR calculated that, after today's announcements, the Chancellor will achieve his debt target with £8.9 billion of headroom – roughly in line with NIESR's UK Economic Outlook (Winter 2024) forecast – while the deficit to GDP ratio in 2028-29 will equal 1.25 per cent of GDP (Table A). This is much smaller than the £26.1 billion average Chancellors have set aside against their fiscal rules since 2010 and, as a result, the OBR estimate that there is a 46 per cent probability that the government will miss its target. Lower inflation and interest rates than expected in November have improved the fiscal position by around £20 billion over the next two years, though leaving the projected deficit in 2028-29 more or less unchanged, while the higher net migration and lower participation rates that we have seen since November roughly balance each other out. Against this slight improvement in the fiscal position, the tax cuts announced in the Budget, in particular the two-percentage point cut in employee National Insurance Contributions, will increase borrowing by around £8 billion a year. We discuss the possible effects of these tax cuts later in this document.

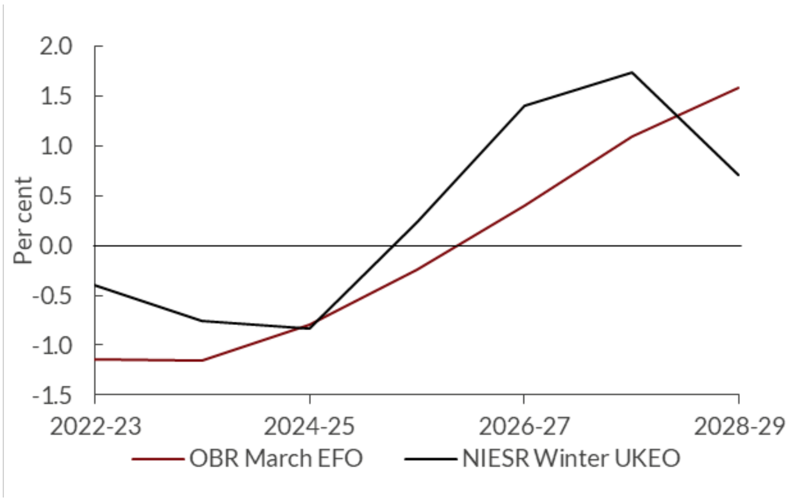
But even the small amount of fiscal headroom the Chancellor has left himself is based on a tightening of fiscal policy resulting from the continued freezing of income tax thresholds. As a result, the OBR forecast the share of taxes in GDP to rise to 37.1 per cent in 2028-29, higher than at any point since 1948 and the primary fiscal balance moves from a deficit of around one per cent of GDP to a surplus of around 1.5 per cent of GDP (Figure 2). It is not clear that an incoming government would feel itself bound by the tax and spending plans in the current budget – indeed it is likely that a comprehensive spending review will follow the election – rendering any discussion of fiscal space moot.

Table A: OBR forecast (March 2024)

	2022-23	2023-24	2024-25	2025-26	2026-27	2027-28	2028-29
Government Spending (£ billion)	1157	1216	1226	1252	1290	1323	1362
Taxes (£ billion)	1029	1102	1139	1174	1222	1272	1322
Interest (£ billion)	99	82	65	71	80	85	91
Deficit (£ billion)	128	114	87	78	68	51	40
Debt (£ billion)	2540	2691	2793	2820	2903	2995	3078
GDP (£ billion)	2553	2731	2786	2875	2985	3094	3207
GDP (centred end March £ billion)	2653	2757	2827	2927	3040	3151	3264
Deficit to GDP ratio (per cent)	**5.01**	**4.17**	**3.12**	**2.71**	**2.28**	**1.65**	**1.25**
Debt to GDP ratio (per cent)	**95.74**	**97.61**	**98.80**	**96.34**	**95.49**	**95.05**	**94.30**

Source: OBR *Economic and Fiscal Outlook*.

Figure 3: Public-sector primary balance



Source: OBR *Economic and Fiscal Outlook* and NIESR *UK Economic Outlook* (Winter 2024).

Tax Changes

"The Chancellor has stressed the need to bring down taxes in a 'responsible' way to boost growth. However, further cuts in National Insurance Contributions are short-sighted and only modestly improve economic outcomes. Remaining fiscal space should have instead been directed towards sustaining higher public investment."

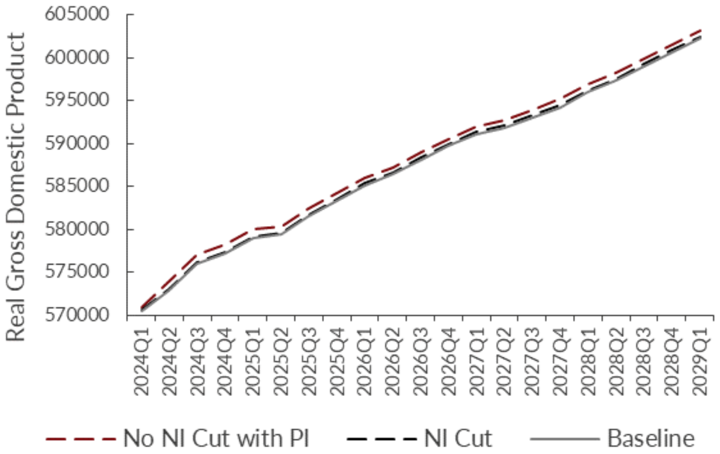
— **Benjamin Caswell (Senior Economist)**

With inflation falling, public sector net debt at 96.5 per cent of GDP, and an economy that was in a technical recession in the second half of last year, the Chancellor faces tough fiscal choices heading into this election year. The tax burden currently stands at 37 per cent of GDP, higher than at any time since the 1950s, and the Chancellor has stressed the need to bring down taxes in a 'responsible' way in order to boost growth.

Subsequently, building on the cut in National Insurance Contributions (NICs) in the Autumn statement, the Chancellor has implemented a further two percentage point cut in the main rate of NICs paid by employees. The OBR estimate the two percentage point cut in NICs announced today to reduce tax receipts by £10.5 billion a year.

Simulations from our global econometric model, NiGEM, indicate that this additional two percentage point cut could raise GDP by a modest 0.05 percent over the next five years through a slight rise in employment. We instead believe that if this fiscal headroom must be utilised it would be better directed at sustained public investment. As shown in Figure 3, we simulate a counter-factual of where the further two percentage point cut in national insurance (NI) does not take place and instead, the 9.8 billion is instead diverted into public investment (PI). Our findings suggest that if funds from the national insurance cut were instead diverted towards public investment, over a five-year horizon, GDP would instead be 0.17 per cent above baseline relative to 0.05 per cent.

Figure 4: Real GDP – Spring Budget's National Insurance Cut compared to a counterfactual increase in public investment



Source: NIESR Calculations, NiGEM

Importantly, these cuts will have to be paid for by future tax increases. The current fiscal rules state that the public debt-to-GDP ratio must be falling at the end of a rolling five-year horizon. While current tax and spending plans do just meet this target, for most of that five-year period, fiscal policy will be set by the winners of the upcoming election. Therefore, constraints on fiscal choice will not bind this year in the typical sense. In principle, this allows the Chancellor a considerable degree of flexibility in ‘frontloading’ tax cuts without having to overly worry about consequences.

In addition to the NICs cut, the Chancellor has announced the scrapping of the 'non-dom' tax status, which impacts individuals who live in the United Kingdom but whose principal home for tax purposes is elsewhere. Removal of this ‘non-dom’ status is set to raise £2.6 billion by 2028-29, according to the OBR. This would be a welcome measure as it partially offsets the cost of the cumulative NICs cuts over the past six months and is a tax which is borne by the broadest shoulders.

Lastly, the Chancellor has decided to extend the 5p cut in fuel duty for a further 12 months. This continues to exert additional downward pressure on fuel prices at the pump by six per cent, at a potential cost of £5 billion in tax revenue. This will continue to contribute to keep fuel prices lower than they otherwise might have been, but it is also acts as an implicit subsidy in favour of non-renewables. While this undoubtedly is welcome by motorists, it further constrains already limited fiscal headroom and runs counter to the government’s legal mandate of net zero by 2050.

Spending Changes

"Against the backdrop of an economy that has been experiencing flatlining productivity since the 2000s, the Chancellor's announced public service productivity plans, including the £3.4 billion investment in modernising NHS IT systems, and the commitment to growth in 'day-to-day' public spending of one per cent in real terms are moves in the right direction. However, NIESR still feels a need for sustained public investment spending and policies that look beyond the short term and focus on long-term growth – something the United Kingdom crucially needs."

— **Hailey Low (Associate Economist)**

In today's Spring Budget, the Chancellor announced several spending changes, including £6 billion in extra funding to NHS – £3.4 billion allocated to improve "outdated" systems and £2.5 billion to healthcare service provision – £26 million to creative industries, up to £120 million for the Green Industries Growth Accelerator fund, £270 million to advanced manufacturing industries and £230 million to public safety services. Amongst the spending measures, the extra NHS funding, although much overdue, will be greatly appreciated. However, the NHS and the social care system cannot be fixed with a temporary funding boost but require sustained investment to return them to adequate levels of service.

We welcome the Chancellor's commitment to increasing public spending by one per cent annually in real terms. However, more clarity is needed on how the government will allocate this spending. Public services across the board are buckling under pressure after prolonged underinvestment. With spending increases pencilled in for health, defence, and childcare, other public services will inevitably need to be cut. This creates serious problems for the next government, where they will face stark choices between steep cuts to already frail public services or more tax rises amidst limited fiscal headroom.

We would question the government's lack of commitment towards public investment which is falling as a percentage of GDP over each of the next five years. NIESR has long argued for the need to increase public investment as a percentage of GDP. The United Kingdom has one of the lowest public investment to GDP ratios among advanced economies and the need to improve infrastructure, education, skills, and healthcare is becoming ever more apparent. Indeed, lack of investment in all of these has likely contributed to sluggish productivity growth in the United Kingdom since the global financial crisis.

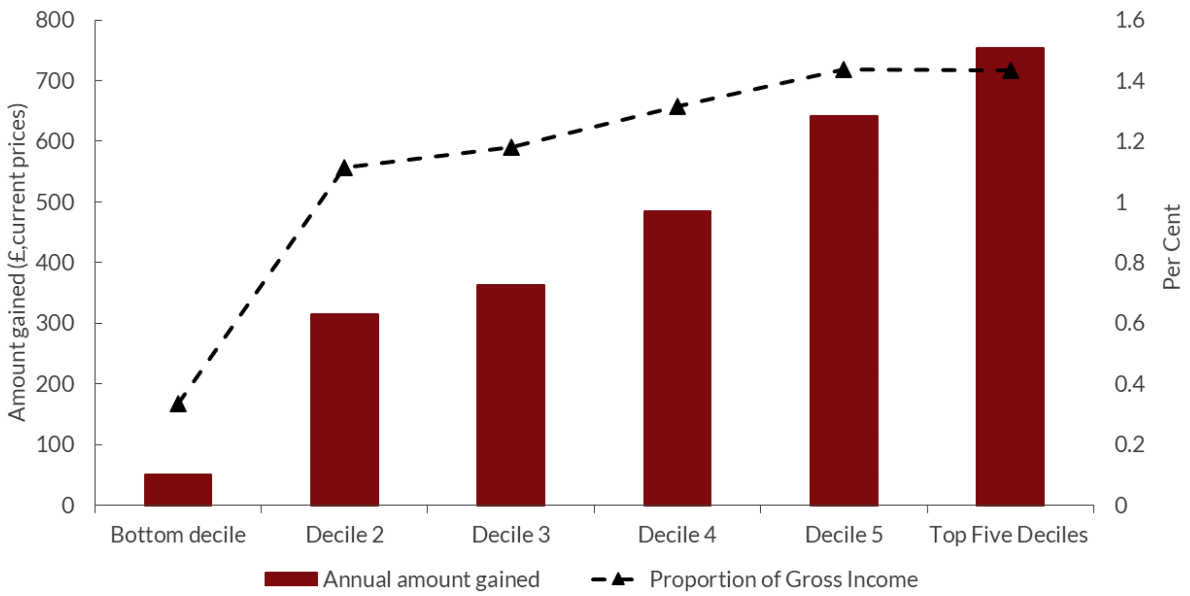
Household Finances and Living Standards

"The living standards for low-income households that have been hit hardest by shocks such as Covid-19 and the spike in inflation are rising slowly this year, but they remain well below pre-pandemic levels. The lowest income decile remains around 20 per cent below pre-Covid levels with an income shortfall of some £4,600 per year. While the two per cent cut to National Insurance Contributions gives households more cash in hand across income deciles, it is a regressive measure. Households in the lowest income decile are set to gain 0.2 per cent of their annual income whereas the top five decile gain 1.4 per cent of their annual income. At a time where there is a desperate need to increase spending on infrastructure, education and health which benefit the living standards for all, short-term measures such as the NIC cut won't boost living standards in the long-term."

— **Robyn Smith (Assistant Economist)**

The decision to cut the main rate of employee National Insurance Contributions (ICS) by a further two per cent will increase the disposable income of an average household by about £450 per year. Things look very different when considering the variation across income deciles. Figure 5 shows that the bottom deciles stand to gain an extra £50 per year, which amounts to 0.3 per cent of their annual gross income. This contrasts with the top income deciles, standing to gain around 1.4 per of their annual gross income. Further cuts to NICs gives households a small boost to their disposable income but doesn't answer the question of how we can boost investment into services such as health, infrastructure and education which can benefit the living standards for all.

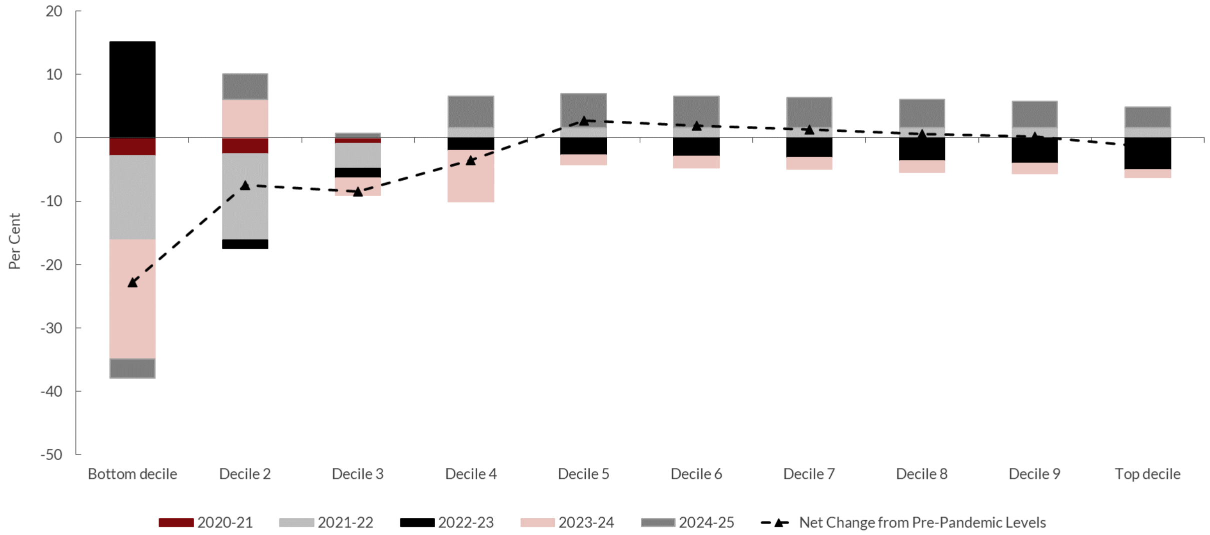
Figure 5: The impact of the two per cent cut in NICs across income deciles



Source: NIESR Calculations, LINDA

The extension of the Household Support Fund by six months is welcome news for the bottom decile. However, living standards as measured by Real Household Disposable Income (RDHI) remain below pre-pandemic levels for the bottom four income deciles (that is, people earning up to about £34,000 per year). The bottom income decile remains just over 20 per cent below pre-pandemic levels. Figure 6 shows how living standards have changed each year since 2019 with respect to pre-pandemic levels. The breakdown by year shows that the years of high inflation had a disproportionately adverse effect on the bottom income decile last year. This was the case despite positive effects from the Cost-of-Living payments (up to £900) and the near ten per cent increase in the National Living Wage (NLW) and the National Minimum Wage (NMW). Figure 6 also shows the clear heterogenous nature of living standards across income deciles over the last five years.

Figure 6: The change in Living Standards (RDHI) across income deciles over the past five years relative to pre-pandemic levels (2019-20)

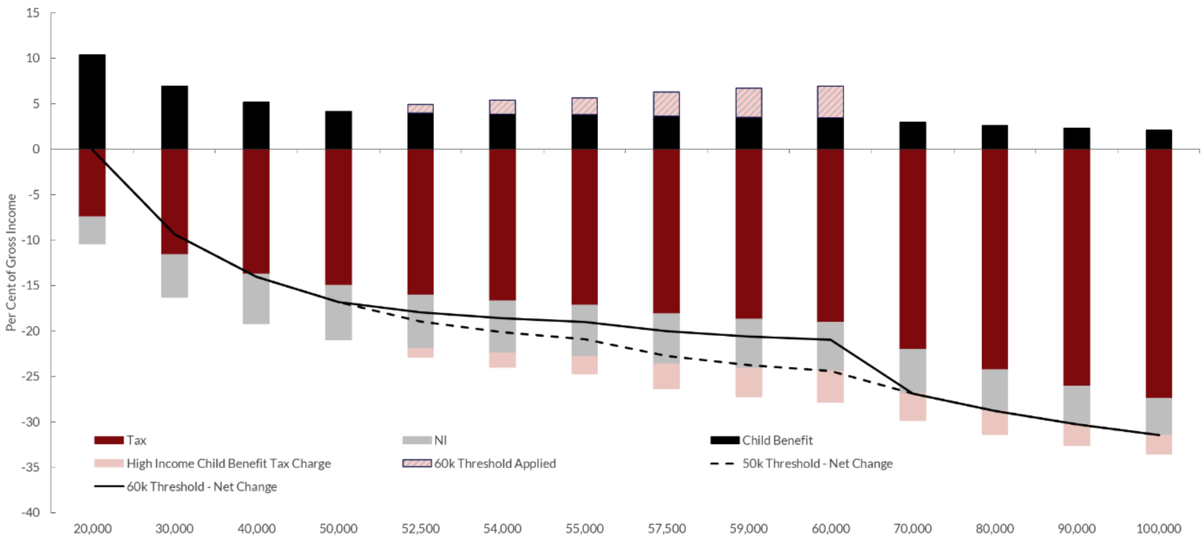


Note: 2020-21 is the annual year rather than the fiscal year.

Source: NIESR Calculations

The increase in the High-Income Child Benefit threshold from £50,000 to £60,000 is the right decision as it will help the "squeezed middle" who previously opted out. Households where the highest earner's salary is between £50,000 and £60,000 now stand to gain two per cent of their gross annual income (Figure 7).

Figure 7: The effect of changing the High-Income Child Threshold from 50k to 60k across income distributions



Source: NIESR Calculations, LINDA

Another addition to the list of ISAs that are currently available, the introduction of the British ISA with an annual limit of £5,000 that brings the annual lifetime ISA allowance to £25,000 is welcome, as it encourages investment into UK equity. However, this is a policy for high-income deciles and does not address the issue that more than 11 million people do not have savings of £1,000 for a rainy day, let alone £25,000.

The degree of under-saving in the United Kingdom is something that should be given more attention, whether it is saving into a pension, an easy access account or an ISA. In periods of high inflation, the gap is widening between the top and bottom income deciles as people on high incomes have savings that yield higher returns with the increase in interest rates.

Implications for Levelling Up and Local Authorities

"The government's continued commitment to Levelling Up is welcome, and today's announcements of further funding and more devolution deals are a step in the right direction. But the allocation of funds has been slow and patchy. Infrastructure projects have largely privileged more prosperous regions of the country. Recent allocations focusing on the North West and for the Stormont settlement look to redress some of the imbalance, but are relatively small. Indeed, the current scale of investment is insufficient to close the gap between the top performing and worst performing areas, which is at the heart of the 12 Levelling Up missions. More targeted investment in affordable housing, transport and devolved powers in the area of skills are urgently needed to boost productivity and raise growth in the struggling regions and localities across the UK."

— **Arnab Bhattacharjee (Research Lead, Regional Modelling) and Adrian Pabst (Deputy Director for Public Policy)**

"Local authorities are spending around 15 per cent of their budgets simply servicing their existing debt, adding further strain to already unsustainable finances; it is disappointing that the Chancellor announced no new measures to address this. Without further support, or any reforms to regressive council tax, the provision of critical public services on which the most vulnerable people depend will be compromised."

— **Max Mosley (Senior Economist)**

The announcements on Levelling Up in today's Budget include further funding and greater devolved powers, including:

- A new trail blazer for the North East worth about £100 million
- Further powers to Buckinghamshire, Warwickshire and Surrey
- An extension of the Towns Fund benefitting 20 further towns worth about £200 million
- More funding for Scotland, Wales and Northern Ireland: the Scottish Government will receive about £300 million, the Welsh government £100 million and the Northern Irish executive a further £100 million
- Greater investment in the science sector in Cambridge and the promise to make the UK "the next Silicon Valley"
- £160 million towards land acquisition for the planned Wylfa nuclear power station in Wales

However, progress on implementation of Levelling Up projects has been very slow and delayed. There does not seem to be a clear strategy either for allocation of funds, efficient use or indeed projections of their impact on Levelling Up. Without this, there is a growing gap between Levelling Up ambitions and actual progress.

Levelling Up and its associated programmes were promised as urgent policy means to boost investment, raise productivity and regenerate devolved nations and English regions. In late 2023, the government allocated its final tranche of £1 billion in the lifetime of this parliament as Round 3 of the Levelling Up allocations. The allocations were largely concentrated on the devolved nations of Scotland and Wales as well as Yorkshire and the Humber. This followed a £2.1 billion allocation in Round 2, with the largest concentration in the North West and £1.7 billion in Round 1 distributed somewhat more evenly across the country, but with somewhat larger shares for the

North West and Scotland. The intent is perhaps evident in the £4.8 billion allocation in total, even if the ambitions have not always matched up with the outcomes.

Indeed, progress on Levelling Up and its associated programmes has been stuttering. Less than a fifth of projects allocated funding under the flagship Towns Fund are completed, and only about half are expected to be completed by the end of the year. Nearly £2 billion of the proposed allocation for housing was returned to the Chancellor because of poor uptake. Councils and local authorities are financially constrained and little progress on utilisation of Levelling Up funds has been made. An important component of the transport outlay – the northern leg of HS2 – was scrapped after persistent cost and time overruns. It is difficult to find much evidence of planning logic behind regional variations in allocation, though this has improved somewhat over time. The projects themselves are driven largely by Westminster and Whitehall with little involvement or agency from local governments.

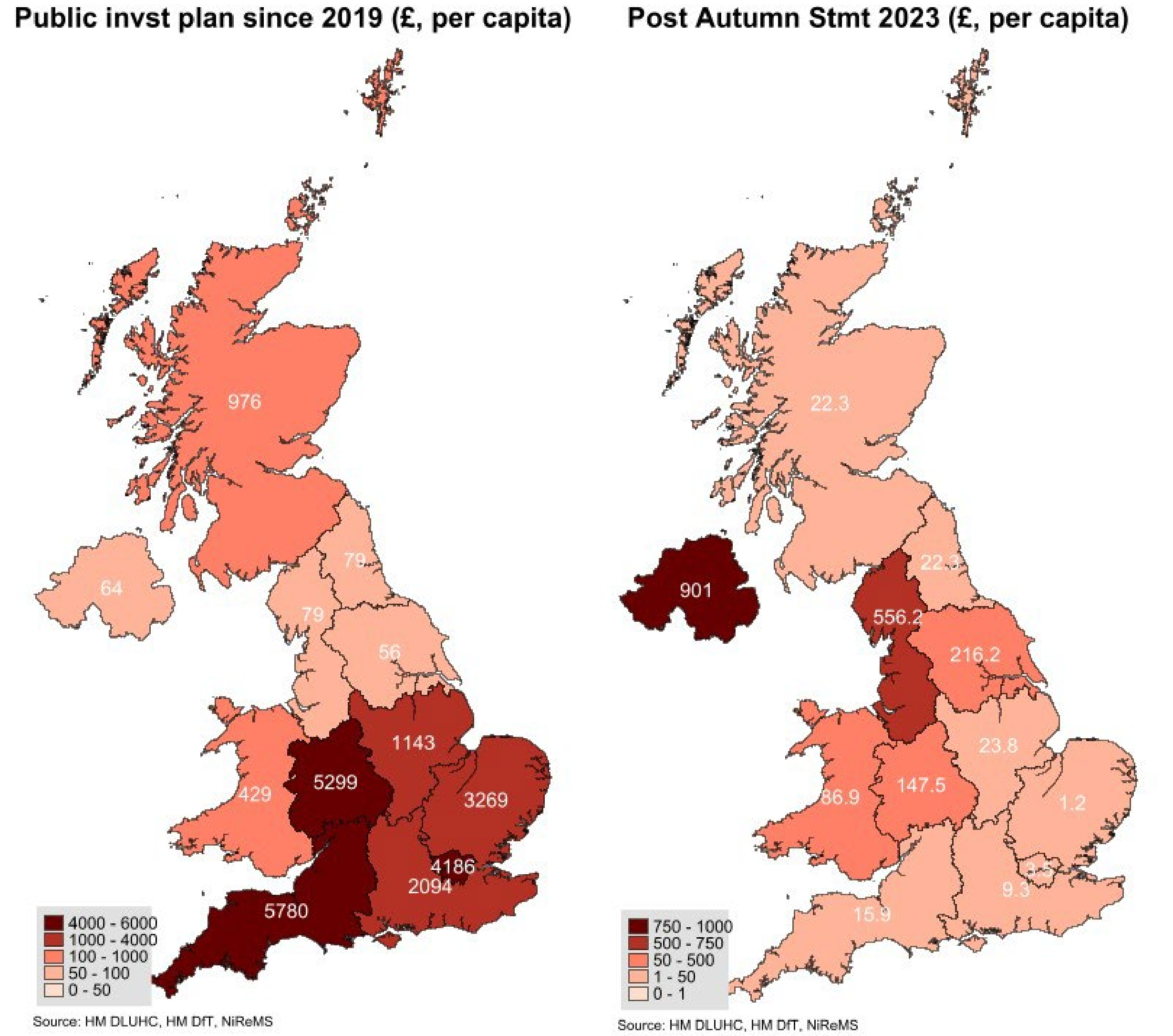
Further, Levelling Up funds are but a small proportion of public investments, the bulk of which relate to large infrastructure projects. These infrastructure investments have the best potential to crowd in private investments, create better jobs aligned with skills and drive genuine regional regeneration. As the map on the left of Figure 8 shows, over the lifetime of the current Parliament until the Chancellor's Autumn Statement 2023, regional allocation of public investments (including Levelling Up funds) in per capita terms has been concentrated on relatively well-to-do regions and therefore hardly been conducive to strengthening places and communities and Levelling Up opportunities across the country.

Since then, we saw allocation for Round 3 of the Levelling Up funds as well as three major announcements in the first quarter of 2024. First, the government announced a £3.3 billion funding package to Northern Ireland as the administration in Stormont was restored, only about half of which are available for public investments (the remaining will go towards stabilising public finances and meeting public sector pay settlements). This is a substantial outlay, particularly relative to population size, but arguably this compensates partly for the absence of effective power-sharing and public investments over the past three years. Second, the Secretary of State for Levelling Up, Housing and Communities announced just last week an additional £208 million investment in the North to transform towns and cities, the bulk of the allocation (£140 million) going to the North West. Third, £4.7 billion funding from the scrapped HS2 northern leg is now being redirected into a local transport fund for the North.

Moreover, there are almost no announcements on public investments in the Budget, except for land acquisition for the planned Wylfa nuclear site in Wales. This is disappointing because it is public investment that provides the best opportunity for Levelling Up, across regions and across the income distribution. Late announcements of additional allocations to the North and to Northern Ireland attempt to redress this balance somewhat, but also small and ineffective relative to the past. The regional allocation of the above initiatives (together with the Midlands Railway Hub) in shown on the right panel of Figure 8.

These initiatives show some ambition, though perhaps more a need for pre-election headlines. A clear plan is lacking or, at the very least, not debated and disclosed sufficiently. The purpose of regional policy is to reduce uncertainty and create the best conditions for business and local government to work for communities. There is still little sign of an effective joined-up approach along these dimensions.

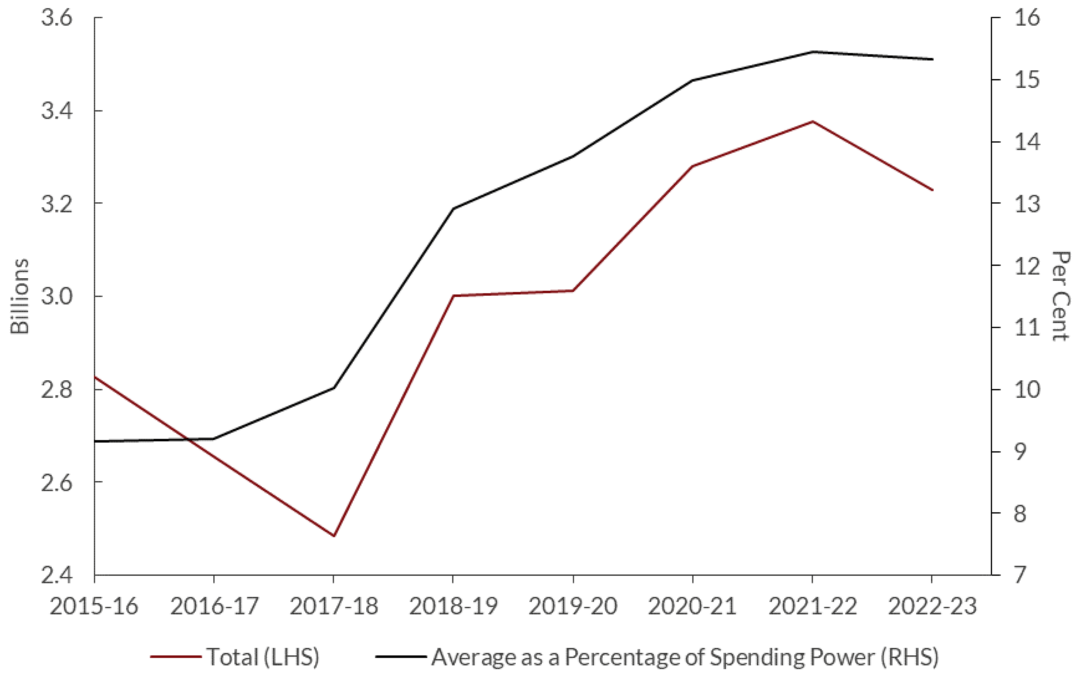
Figure 8: Regional allocation of public investments across devolved nations and English regions



In relation to local authorities finances, no further support for local government finances will compromise the provision of critical public services on which some of the most vulnerable people in society depend, including support to deal with homelessness, provide social care and deliver home-to-school transport for pupils with special needs.

Despite the previously announced support package of some £600 million, the reality is that local authorities are spending around 15 per cent of their annual budgets on just servicing their debt (Figure 9). More drastic cuts to public services provision and hikes in Council Tax are likely, and the larger negative impacts fall squarely upon poor households who are already struggling.

Figure 9: Debt interest payments from local authorities in England, 2015-16 to 2022-23



Source: NIESR Analysis of DLUHC Revenue Outturn Summary by Local Authority (various years) and DLUHC Core Spending Power by Local Authority (various years)