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THE AUTUMN STATEMENT: WHAT LIES BENEATH?

1. COLOSSAL? MAYBE. ESSENTIAL? YES.

Over the last 18 months, the recovery has gained strength with economic growth accelerating and unemployment falling sharply. However the context in which the Chancellor delivered his Autumn Statement speech yesterday was far less rosy. Borrowing from April to October this year was £64.1 billion, an increase of £3.7 billion compared with the same period last year. Productivity growth has remained in the doldrums and the promised land of strong real wage growth has failed to materialise.

A number of the policies announced by the Chancellor will help to boost productivity, a few could be damaging if poorly implemented and the rest are essentially irrelevant. In addition, what has now become clear, if it wasn't already before, is that the credibility of the deficit reduction programme rests almost entirely on the willingness and ability of the next Government to make cuts in public spending which are even bigger than those carried out in this Parliament. It can be done and it must be done.

The state will have to get smaller and government consumption will see bigger reductions. Significant cuts in departmental spending have already been made but opinion polls consistently show that people have not seen a particular deterioration in the quality of public services. The IFS may describe the required cuts in the next Parliament as "colossal" but that does not mean they are impossible. A determined and creative approach to government spending which examines how services should be delivered is crucial.

Furthermore, the fact that so much of the remaining deficit is structural gives us two options. Either we raise taxes and accept a smaller economy and lower employment or we cut and reform public spending and accept a smaller government. Doing nothing and hoping the deficit will magically disappear is not an option.

2. GROWTH

Economic growth forecasts for 2014 and 2015 were upgraded to 3% and 2.4% which is of course encouraging and is as expected. However, it is concerning that growth forecasts for the following years have been revised down by 0.4, 0.2 and 0.2 percentage points. This may reflect weaker than expected productivity growth with implications for the underlying growth rate of output.

Furthermore, it would seem that much of the increase in economic growth is predicated on sustained growth in business investment and quite substantial falls in the current account deficit. The strength of both of these shifts is unclear and if growth from 2016 onwards has already been downgraded then future downgrades in medium term growth rates are also possible.

The OBR's forecasts for average earnings have also been cut by 0.7pp, 1.2pp and 0.5pp from 2014 to 2016. Even with concurrent falls in their CPI forecasts, the scale of the reduction in their earnings forecasts implies much slower real wage growth. Although, the OBR is now promising 4% nominal wage growth from 2017 onwards; decent real wage growth is still quite far off.

The Chancellor nevertheless seems to have recognised the importance of productivity. In his speech yesterday he mentioned it five times – compared to not once in his Budget speech in March.

3. BORROWING

In spite of the increase in borrowing in the year so far compared to last year, the OBR forecast that borrowing will still fall in 2014/15. However, the deficit is now forecast to be £91.3bn this year which is still £4.9bn higher than was forecast at the Budget. Furthermore, in 2015/16 the OBR expects borrowing to be £75.9bn which is a full £7.7bn higher than it had forecast at the Budget. Mercifully there are also some small reductions in the borrowing forecasts for the following years.

Under the Government's plans, the OBR expects there to be an absolute surplus of £4bn in 2019/19 and of £23.1bn in 2019/20. The cyclically adjusted current budget deficit i.e. the structural deficit is still expected to fall although it will remain higher for longer than expected at the Budget.

The OBR is now forecasting a situation in which higher growth this year and next is accompanied by higher borrowing but lower growth in the following years comes with lower borrowing. This is completely at odds with what would normally be expected.

4. UNCERTAIN REVENUES

One of the key factors in deciding how likely it is that borrowing will fall in line with the OBR's forecasts is the growth in tax revenues. Lower wage growth has led to substantially reduced income tax receipts and whilst there should be an eventual recovery, much depends on productivity growth.

In addition, the OBR expects the Treasury to raise a net £8.5 billion from new receipts collected in the fields of base erosion and profit shifting alongside avoidance, tax planning and "fairness". These revenues are volatile and there is inevitably a great degree of uncertainty of whether these revenues can actually be generated.

Moreover, the OBR admits the significant uncertainty surrounding its costing of policies. Of the 46 newly announced policies, there is a significant bias toward costings with higher degrees of uncertainty. Whilst the costings for nine of the policies have lower than medium uncertainty, there are 17 policies which have higher than medium uncertainty.

5. STAMP DUTY

The headline proposal which the Chancellor announced was the replacement of the stamp duty slab system with a more gradual system. Instead of a clunking great tax bill which is payable whenever the threshold is passed, the new system works more like an income tax. The Government estimates that this will lead to a cut in stamp duty for 98% of transactions and the proposal cuts stamp duty revenues by approximately £800 million a year.

There has been some criticism of the stamp duty cut based on the argument that it may lead to an increase in house prices. This is muddled – such price rises are paid over the life of the mortgage whereas the stamp duty payment is a direct, upfront payment which acts as an initial barrier to ownership. Other criticism of the new higher 12% rate is more justified, as this could potentially damage transactions at the higher end of the market.

6. THE UNBEARABLE LIGHTNESS OF POLITICAL GIMMICKS

There were also a series of other targeted tax cuts including abolishing Air Passenger Duty for under 12s and from next year under 16s. There was also the abolition of employer national insurance contributions for apprentices under 25s which is a welcome boost to training and skills. In addition, the boost to R+D tax credits and the extra rise in the

personal allowance to £10,600 are steps in the right direction. The small reduction in the Supplementary Charge paid by North Sea oil companies from 32% to 30% will provide some relief.

However, such small measures show the opportunity for greater boldness in the tax system. The precarious fiscal situation makes any new tax cuts more difficult but the Government should be clearer in its intentions to eventually abolish APD, alongside proper reform of the national insurance system, business rates and north sea oil companies.

The clear announcement that the Government will work to ensure that the growth of peer-to-peer markets is protected from regulation and tax rules is important. The abolition of the so-called death tax on ISAs is another good step in merging pensions and ISAs; something which seems increasingly inevitable.

7. THE FISCAL CHALLENGE AHEAD

Public sector employment will have to continue its downward trajectory and will reach 13% of total employment in 2019/20 compared to 19% in 2009/10. However, predictions of heavy net job losses in 2010 have been proven inaccurate given the rapid rise in private sector employment. Whilst the growth in private sector employment may not be quite as impressive over the next Parliament, there is nothing to suggest that it will continue offsetting reductions in the public sector workforce.

In terms of government consumption, the OBR estimates that between 2014 and 2019, there will have to be an average annual nominal contraction of 1.4% compared to annual growth of 1% between 2010 and 2013 and annual growth of 5.4% between 1992 and 2010.

In order to achieve the fiscal targets, some of the non-protected budgets will have been cut by more than half over the decade to 2019. The need to reach the 2% GDP target on defence spending given Britain's membership of NATO will also come under strain and further cuts in welfare are quite likely. However, if the UK is to maintain medium term fiscal credibility, reduce the dead-weight loss of higher debt interest payments and keep competitive tax rates, then further public spending cuts are essential.

8. CONCLUSION

Whoever wins the next election will have to be at ease with the fact that the state must become smaller. Big new tax rises would damage growth and would never be enough to fill the yawning gap in the public finances. The task for the parties now therefore is to outline their spending plans in greater detail as well as their manifesto plans to boost productivity in the next Parliament.

9. MUST BE READ:

Jeremy Warner: George Osborne's plan to shrink the state is big news
Autumn Statement: Policy Costings

10. MUST BE READ ON CAPX:

Daniel Hannan MEP: How capitalists can win the argument
Blake Ross: Common sense versus state bureaucracy

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