Budget Briefing: The Age of the Trillion-Pound State

28 October 2021

The Big Picture

- Thanks to the spending increases announced in the Budget, public spending as a share of GDP is projected to stand at 41.6% in 2024-27. This is down from 53% during the pandemic – but almost two percentage points higher than in 2019-20, and indeed than the the post-War, pre-Covid average of 39.8%. Total public sector current expenditure was £790bn in the year before the pandemic but will pass the £1,000bn mark in 2025-26, and reach £1,050bn in 2026-7. **Boris Johnson is set to usher in the era of the trillion-pound British state.**

- The Chancellor is attempting to navigate the choppy channel between getting borrowing under control and bringing down the national debt as a share of GDP while increasing spending across all departments. The fiscal wiggle room for this manoeuvre has come partly from taxes (the Health and Social Care Levy) **but mostly from revised GDP growth forecasts, which account for around 70% of the new headroom**. Growth is now projected to be 6.5% this year (2.3 percentage points higher than in March forecasts) and 6.0% in 2022, before falling back to an average of 1.4% in 2023-26. The Chancellor's ambitious combination of retrenchment and spending therefore hinges on economic growth arriving as expected, without further major disruptions from Covid or global economic shocks. Clearly the Government's spending plans are exposed to substantial downside risk, if it aims to stay within the new fiscal rules announced yesterday.

- In the short term, GDP growth is being driven by the bounce back from the pandemic. But in the longer term, growth is linked to **extremely bullish projections for productivity**, which – measured in terms of output per hour worked – is projected to grow by an average of 0.32% per quarter in 2022-27. In comparison, the average quarterly increase in output per hour worked was just 0.13% in the five years prior to the pandemic, and 0.17% in the decade following the financial crash.

Yet the Budget was light on support for supply-side reforms needed to boost productivity growth in the short-to-medium term, instead pumping extra cash into the demand side of the equation. For example, the Budget pledged £500 million in new early years spending, but offered little to address the subsidies and regulations that push up childcare costs to begin with.

- Measures around R&D, skills and life-long learning confirmed in the Budget will hopefully enhance productivity growth in the longer term, but those benefits will take time to play out. There is a danger that the planned increase to the national minimum wage outpaces productivity growth, stoking inflation. The Budget also contains welcome measures on attracting workers, such as launching new Scale-up, High Potential Individual, and Global Business Mobility visas, and the new re-domiciliation regime – but while these will make it easier for companies and internationally mobile capital to relocate to the UK, they will again take time to deliver. As it stands, **Boris Johnson's Government wants to deliver a high-wage, high-skill economy, but it seems to want to do so via a high-tax, high-spend state.**

- The OBR expects inflation to average around 4% in 2022, perhaps reaching as high as 5%, but ultimately sees it as relatively transitory rather than persistent, caused by snarled-up supply chains and surging commodity prices as global economic activity picks up after the pandemic. **Nevertheless, the highest sustained rate of inflation in decades is going to put pressure on the cost of living, wiping out two thirds of the planned 6.6% increase in the minimum wage for the lowest paid workers.**

- Funding for the devolved administrations will rise by 13.8%, from a £66 billion per year baseline to £74.7 billion. **As things stand the average Scottish resident will have around 21% more spent on them than someone living in England.**

Taxing Times

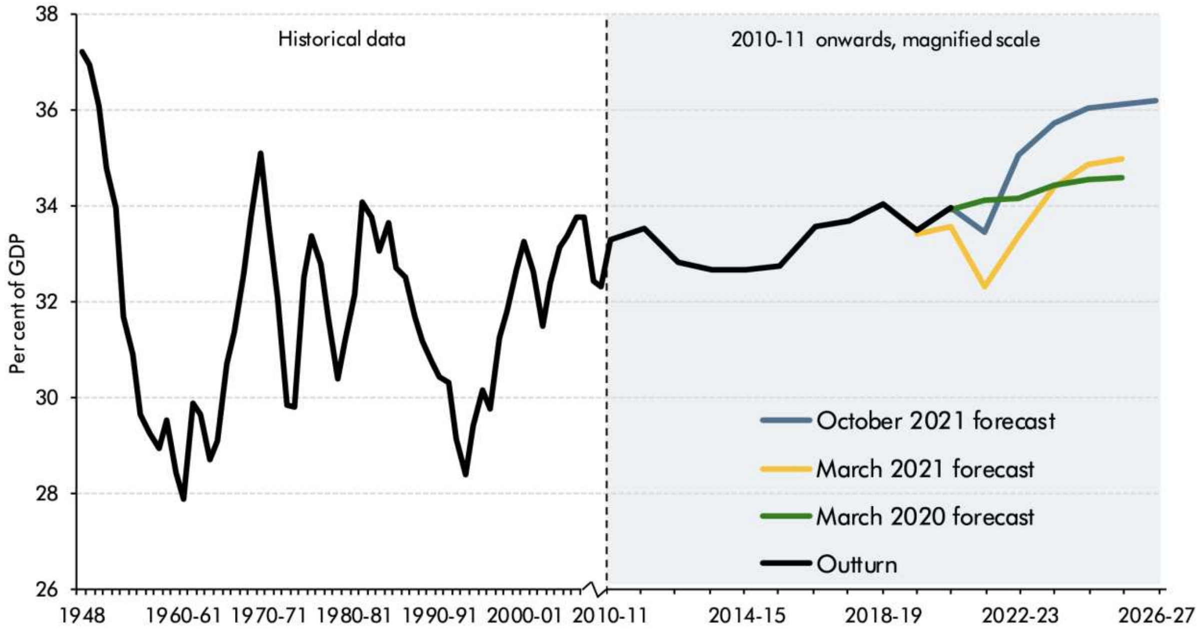
- While the Budget contained some encouraging announcements on tax policy, we must not lose sight of the overall picture: **some £5.5 billion of tax cuts and reliefs – many of them temporary – should be set against the £18 billion tax increase for 2022-23 that was announced in September** via the Health and Social Care Levy, and the heavy increases in corporation tax that will kick in the following year.

- The Chancellor also did nothing in this Budget to address the resulting corporation tax cliff edge: in April 2023, the headline tax rate will rise from 19% to 25%, the super-deduction for capital investment will expire, and the Annual Investment Allowance will fall from £1 million to £200,000. Research by the Centre for Policy Studies and the US-based Tax Foundation has shown that **the UK will go from having**

a very attractive corporate tax system to a deeply uncompetitive one – effectively overnight. This is bound to have a negative impact on investment and growth and is precisely the opposite of the approach the Government should be taking.

- As the chart below from the OBR shows, the tax burden is going to grow faster than was forecast in March 2020 and March 2021. **Even factoring in positive revisions to GDP, the tax-to-GDP ratio will soon reach its highest level since 1951**. The Chancellor said in his Budget speech that his goal is to reduce taxes – if he's going to make good on that rhetoric, he has a lot of work to do.

Chart 3.2: National Accounts taxes as a share of GDP



Note: Both outturn and forecast are based on the vintage of nominal GDP data that was available when we closed the pre-measures forecast, so do not reflect upward revisions in the latest Quarterly National Accounts. All else equal, applying the upward revision to 2020-21 nominal GDP of 2.3 per cent to all years of the forecast would reduce the National Accounts tax-to-GDP ratio by 0.8 per cent of GDP across the forecast. This would still leave the tax-to-GDP ratio at its highest since 1951.
Source: ONS, OBR

- It is sensible for the Chancellor to freeze fuel duty again, given rising cost of living pressures and supply chain disruptions. **Fuel duty also has a levelling-up angle to it: while only 14% of inner London workers commute via car, in every other region of the country it's above 70%**. However, declining fuel duty revenues also underline the need for longer-term thinking about how we charge for road use. Replacing fuel duties and other motoring taxes with some form of road pricing is going to be essential as the transition to electric vehicles gathers pace.

- **Freezing alcohol duties is another welcome measure, and the planned reforms represent a significant rationalisation of an outdated system**. Nevertheless, there will still be unnecessary complexity (do we really need six different duty rates?) and it isn't clear that the tax system needs to take a view on *where* consumers choose to drink (the proposed draught relief will be a welcome fillip to pub-goers but isn't good tax policy). It is also worth noting that the UK will still levy very high alcohol duties compared with the rest of Europe after these reforms take effect.

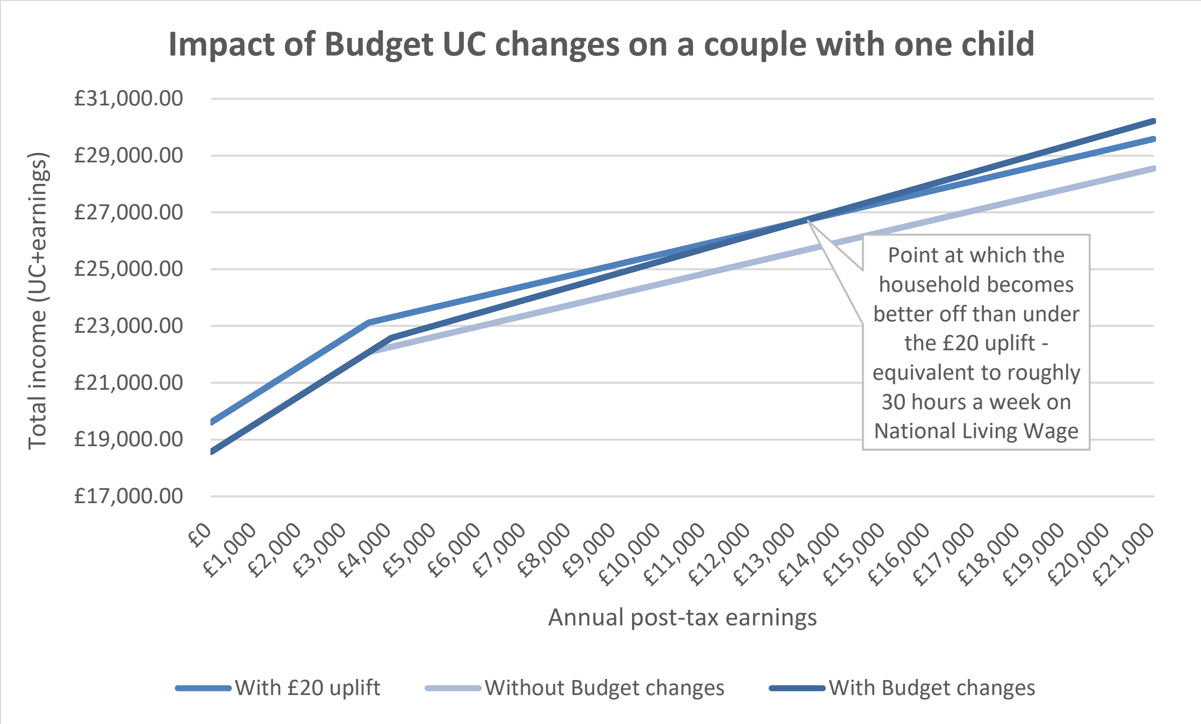
- The Chancellor has announced some welcome measures on business rates but postponed the larger reforms that the system needs. Investment relief for green technology and decarbonisation is a good move; 12-month relief on other property improvements is a helpful but limited policy. **However, if the goal is to encourage investment, we ought to remove all improvements from the tax base and levy business rates solely on underlying site values**. We also need to look beyond a one-year freeze in the multiplier and recognise that the UK taxes businesses property extremely heavily by international standards. Further reform is surely going to be needed.

Winning on Welfare

- **The Centre for Policy Studies has campaigned consistently in recent years for a reduction in the Universal Credit taper rate – as the Chancellor recognised in his speech**. In January we called for the emergency support through the £20 uplift to be extended for six months but not kept permanently, and for the taper to be cut to 55p and work allowances increased. The Chancellor's decisions, outlined below, have closely mirrored those recommendations.

- **The Universal Credit taper rate will be cut from 63p to 55p in the pound**. This is the amount by which a claimant's benefits are reduced for each £1 they earn above their 'work allowance'. The work allowances will also be increased by £500 per year. Work allowances are the amount of earnings which are disregarded before tapering begins – currently only people with children or with limited capability for work are entitled to a work allowance.

- Together these measures are expected to eventually add around £3 billion to the annual welfare bill. **The changes will mean that a working couple with children, where one works full-time and one part-time, could be around £700 better off per year than they were even with the £20 uplift.**



Source: CPS calculations. Assumes couple are renting and receiving £800 per month in housing support. Does not include support with childcare costs.

Favouring the Public Sector over the Private Sector

- The Chancellor has announced that **this year's public sector pay pause will end** and the normal process of pay increases in line with recommendations from the independent pay review bodies will resume.

- While private sector wages have been rising strongly recently, this is partly due to catch-up from a poor period for wages during the pandemic. **In 2020, during the height of the crisis, average private pay was falling while the public sector saw pay rises.**

- The public sector enjoys a pay premium over the private sector. The ONS have previously modelled this premium and found that, factoring in things such as pension provision, and controlling for job type, qualifications and so on, **there was a 7% public sector pay premium prior to the pandemic**.

- One important point to note is that the new Health and Social Care Levy will increase employer contributions and thus act as a tax on employment, but the Government is compensating departments and public sector employers. Because of this, **the OBR explicitly assume the new levy leads to lower wages for private sector workers but not public sector workers**.

One of the Highest Minimum Wages in the World

- **The Government is increasing the National Living Wage to £9.50 an hour in April 2022, up from £8.91 – a 6.6% increase**. They have already reduced the age at which workers are eligible for the National Living Wage (which is higher than National Minimum Wage rates), from 25 to 23. The Conservative manifesto committed to eventually reducing it to 21, and for the NLW rate to reach the equivalent of two thirds of median earnings.

- **The UK now has one of the highest minimum wages in the world. The policy of significant real terms rises puts an increasing burden on employers and distorts the labour market**. The OBR state in their forecast document that they expect a higher ongoing rate of equilibrium unemployment in the UK, as a result of the higher minimum wage rates. Ultimately, higher pay should come through economic growth and higher productivity.

The Road to Net Zero

- The Budget gave a clear acknowledgement of the significance of innovation to meet the UK's Net Zero goal – something the Centre for Policy Studies has routinely called for in its past research. Altogether, the Government outlined an ambition to increase public investment in R&D to £20 billion by 2024-25, with funding being specifically earmarked for innovation in cleaner transport, cleaner buildings, and cleaner industries. **Supporting R&D financially is vital, but the Government should not forget the crucial importance of the regulatory landscape in empowering innovation**. Better regulatory frameworks which unleash the imagination of Britain's entrepreneurs will be critical – especially in future-facing industries – on the journey to Net Zero by 2050.

- To shore up energy security in a zero-carbon fashion, the Budget reiterated the Government's desire to enable a final investment decision for a large-scale nuclear project before the end of the current Parliament. **In a recent report, we noted how financing mechanisms such as the Regulated Asset Base model could facilitate construction of new nuclear power stations at a lower cost** – provided they had in-built mechanisms to shield consumers and/or taxpayers from exorbitant cost and time overruns. The Budget notes how the Government's support for a new large-scale nuclear project will be contingent on value-for-money appraisals, and we welcome this accordingly.

- Air Passenger Duty was reformed, with a tax cut for domestic flights and the introduction of a new ultra-long-haul distance band – which would see flights to countries with capitals located more than 5,500 miles from London charged more. What this exposes is the inherent inefficiency in how APD is levied. Moving forward, **the Government should comprehensively reform APD by linking it more closely to the actual emissions intensity of aircraft and the distance they are travelling**.

- In terms of climate action, the Budget earmarked a smorgasbord of different funding pots for different decarbonisation projects. **Money for kick-starting clean technologies can be helpful, but it is not always the best approach when it comes to cutting emissions**. In another recent report, we made the case for carbon pricing to be given an elevated role in Britain's overall decarbonisation strategy – and we hope, as the Government has suggested, that news to that effect will be forthcoming.

An Elephant in the Room

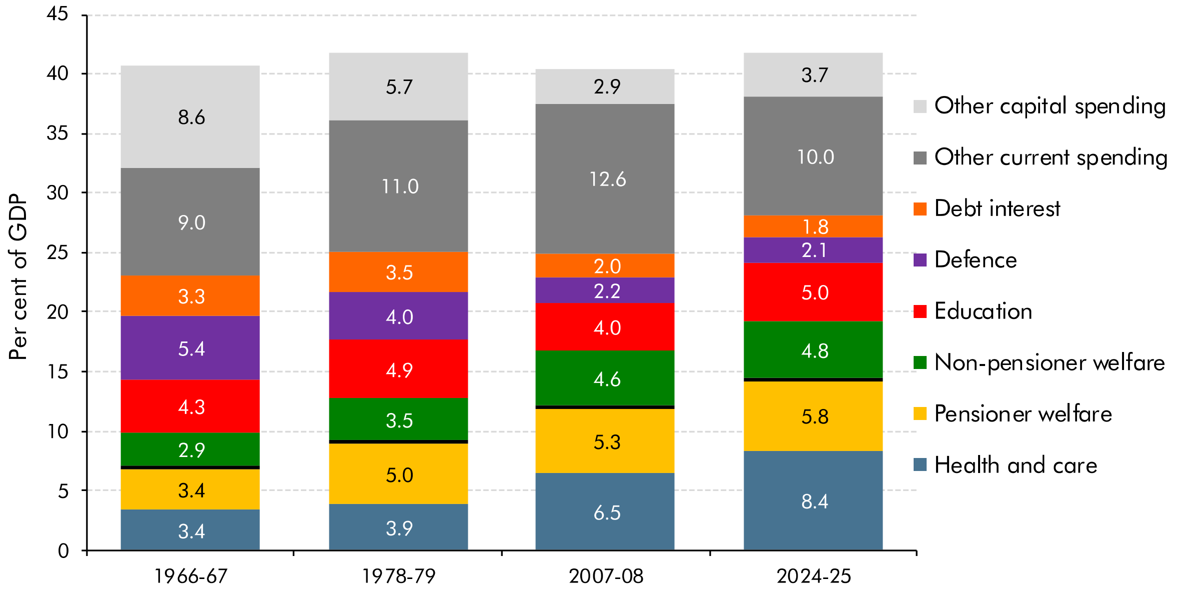
- Sometimes our ageing population, and particularly pension benefits, are seen as the main driver of an expanding state. **Unfortunately, while pensioner welfare *has* expanded – and is likely to do so further – it is only part of the problem for those who want to keep the size of government under control**.

- As the OBR chart below shows, pensioner welfare has risen from 5% of GDP in 1978-79 to 5.3% in 2007-08 and is predicted to be 5.8% in 2024-25. **In the longer term, falling home ownership and weak savings rates don't bode well for halting this trend**.

- Nevertheless, **such growth has actually been less significant than the growth in non-pensioner welfare**, which increased from 3.5% in 1978-79 to 4.6% in 2007-08 and is predicted to be 4.8% in 2024-25. Universal Credit is taking up a rising share of non-pensioner welfare, but in recent years growth was spread across disability benefits, housing benefit, income support (e.g., for single parents), and tax credits.

- More importantly, **both pensioner *and* non-pensioner welfare have been dwarfed by the rise in healthcare spending, which has shot up from 3.9% of GDP in 1978-79 to 6.5% in 2007-08 and is predicted to be 8.4% in 2024-25**. It shows absolutely no sign of slowing down.

Chart 3.11: The composition of spending: historical trend and illustrative projection



Source: Bank of England, DHSC, DWP, HMT, IFS, OBR

- This makes it all the more essential that we see real reform and rising productivity in the NHS. In previous periods of generous funding, NHS productivity has actually fallen. With overall health spending set to rise to £177 billion a year by 2024-25, that needs to change. Moreover, **our research has shown that current reform plans – focused on healthcare integration – risk producing limited gains (or even worsening outcomes) while increasing bureaucracy**. Bolder thinking is needed.

Further CPS Reading

On fiscal rules…
After the Virus: A Plan for Restoring Growth by Sajid Javid MP & Centre for Policy Studies

On tax…
The UK's International Tax Competitiveness by Tom Clougherty & Daniel Bunn
The Case for Freezing Excise Duties by Tom Clougherty & Gerard B. Lyons
A Framework for the Future: Reforming the UK Tax System by Tom Clougherty et al.

On Universal Credit…
Make Work Pay: A New Agenda for Fairer Taxes by Tom Clougherty
The Universal Credit Uplift: The Way Forward by James Heywood
Fair Welfare by James Heywood & Jonathan Dupont

On public sector pay…
Public Sector Pay: The Case for Restraint by Centre for Policy Studies

On the minimum wage…
The Case Against Raising the Minimum Wage by Jethro Elsden

On getting to Net Zero…
Driving Change: How Hydrogen Can Fuel a Transport Revolution by Eamonn Ives
Bridging the Gap: The Case for New Nuclear Investment by Eamonn Ives
Pricing Pollution Properly: How Carbon Pricing Could Decarbonise the UK by Eamonn Ives

On the NHS…
Why the Health of the NHS Depends on Growth and Reform by Centre for Policy Studies
Is Manchester Greater? A New Analysis of NHS Integration by Karl Williams