Institute for Fiscal Studies pre-Budget review

Synopsis: The Institute for Fiscal Studies paper looking ahead to the Budget and Mr Hunt's minimal room for manoeuvre.

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The Institute for Fiscal Studies (IFS) has issued its latest pre-Budget report, examining the scope for tax cuts ahead of Mr Hunt's second – and probably final – Budget. That does not mean there will not be another fiscal event before the polls, but such an exercise will only happen if the Treasury thinks the numbers from the Office Budget Responsibility (OBR) will look favourable (please see 10. below).

The IFS paper lists a dozen key findings...

1. 2023/24 borrowing is projected to be £113bn, £11bn below the OBR November 2023 forecast.

Inflation below forecast has cut debt servicing costs. The undershoot still leaves the deficit at 4.1% of GDP. over double the pre-COVID figure of 2.0%.

2. The private sector is being asked to absorb historically high volumes of Government debt to finance the UK over the next few years.

High gilt issuance, exacerbated by the Bank of England's quantitative tightening (unwinding QE), is forecast to result in the biggest increase in private sector holdings on record of 7.9% of GDP 2024/25. Looking over the next five years, this is forecast by the IFS to average 6.2% a year – more than twice the 2.8% a year seen over the last 25 years.

Hitherto, defined benefit (DB) pension funds have been reliable purchasers of gilts, but as that sector shrinks through demography and greater take up of buyouts/buy-ins, it is unclear from where – and at what interest rate level – new buyers will emerge.

3. The OBR is projected to cut its medium-term debt interest spending forecast (for 2028/29) by £10bn to £112bn.

The OBR takes market expectations for interest rates. These have fallen since last November and are now below where they were a year ago, but remain volatile. This downward revision would still leave annual debt interest spending forecast to stay at around 2% of GDP (£55bn in 2023/24 terms) above its pre-COVID level. That is £55bn which might otherwise have gone on tax cuts and/or improving services – much more than Mr Hunt has to play with next week.

4. The medium-term outlook for revenues will hinge on the forecast for nominal growth in the economy.

The IFS does not expect a big revision to the outlook for real growth in the economy, but thinks the forecast for economy-wide inflation could be revised. Ironically, lower inflation would not translate into good news for the government:

all else equal, a resultant downwards revision in the cash (nominal) size of the economy of less than 1% would be enough to eliminate the £10bn improvement in borrowing coming from lower forecast spending on debt interest (please see 3. above) by reducing nominal revenue. In part this is the payback for relying so heavily on fiscal drag.

5. New ONS long-term population projections driven mostly by higher expected net migration help increase the size of the economy but make existing spending plans even more challenging in per-capita terms.

Under the OBR's November forecast, real-terms day-to-day spending on public services was set to grow by 0.9% a year on average from 2025/26 onwards. At the time, this translated into growth in per-capita spending of 0.5% a year.

However, using the latest ONS population projections, the average annual growth in real-terms spending per capita falls to just 0.2% a year. Governments traditionally talk in terms of overall spending – how many times have you heard the phrase 'record spending'? – but the more meaningful data of inflation-adjusted spending per head receives markedly less attention.

6. Whatever happens to the OBR's estimates of the Government's 'fiscal headroom', the economic case for tax cuts before the next Spending Review is completed is weak. This is a key IFS point which the Chancellor will struggle to contest.

The IFS views the public finances as remaining in a poor position: at the Autumn Statement, the Chancellor was only just on course to meet his commitment for debt to be falling as a share of national income in five years' time. Despite this, debt was forecast to be persistently stuck above 90% of GDP over the medium term.

This is in sharp contrast to the not-so-distant March 2022 (Sunak) Spring Statement, when official forecasts were for public sector debt in 2026/27 to be more than 13% of GDP lower (at 83.1% of GDP), and on a decisively downward path. In the view of the IFS, even if the outlook for borrowing did improve significantly, net tax cuts should not be implemented before the spending cuts implied by the current spending totals are allocated to individual departments.

7. Any new tax cuts announced in the Budget would only offset part of the record-breaking increase in tax revenues as a share of national income over this parliament.

Even after the cuts to National Insurance in the Autumn Statement, OBR forecasts suggest that taxes in 2023/24 will be £66bn higher than they would have been had their share of national income been held at its 2018/19 level. Tax revenue as a share of GDP is forecast to continue rising so that in 2028/29 (the end of the OBR's forecast period) it will be equivalent to £104bn bigger, in today's terms, than it was in 2018/19.

This increase is fuelled by freezes to thresholds in the personal direct tax system and the big increase in the main rate of corporation tax that was implemented in April 2023.

8. Continued freezes to rates of fuel duties would depress revenues.

Fuel duties are a favourite bête noire of both the IFS and the OBR. In the OBR's Autumn Statement forecast it was forced by convention to assume that the 5p cut to rates of fuel duties would be allowed to expire in March 2024 and that they would then increase each year in line with the RPI. Ten year+ past behaviour suggests it is much more likely they will remain frozen at their current level in cash terms, which would reduce revenues in 2028/29 by £6bn.

Similarly, if English business rate relief for retail, hospitality and leisure sectors – first introduced at 50% as a temporary measure during the pandemic and then increased to 75% and twice extended – continues, then the cost of this tax cut, which was put at £2.4bn in 2024/25, will persist.

Both are examples of how temporary tax fixes turn into permanent fiscal distortions.

9. The Autumn Statement forecasts were predicated on a fresh round of spending cuts.

Public sector investment is planned to be frozen in cash terms, whereas maintaining investment (net of depreciation) at its current share of national income in 2028/29 would require an additional outlay of £20bn. While overall day-to-day spending on public services would rise in real terms by £17bn, after accounting for plausible settlements for spending on the NHS, childcare, defence, schools and overseas aid, the IFS reckons other areas of Government would face real-terms cuts of £18bn by 2028/29. This is equal to an average cut of 3.4% a year for four years or an average cut to per-person spending of 4.0% a year.

While it is possible that these spending plans will come to fruition, there is clear risk that whoever is in office after the next election will be unwilling or unable to deliver them. Maintaining real-terms spending on unprotected services would require a cash top-up of £20bn; maintaining it in per-capita terms would require a cash top-up of £25bn.

10. Another risk to the credibility of the public finance forecasts is that a second fiscal event in 2024 occurs in the run-up to the general election if it looks as if the OBR's fiscal forecasts will strengthen, but not if they appear likely to deteriorate.

So far, Jeremy Hunt has tended to follow the pattern of Chancellors since 2010 in offsetting improvements but not deteriorations in the borrowing forecast, leading to a ratcheting effect over time.

For the IFS, this pattern of fiscal choices means that the OBR's 'central' forecast cannot really be thought of as central. It is exacerbated by frequent fiscal events that implement permanent policy changes in response to changes in 'headroom' that are small relative to the uncertainty inherent to any medium-term forecast.

11. Further tightening spending plans may appear to generate further 'headroom', but this would not be a transparent or credible strategy and the Chancellor should avoid this temptation.

The IFS believes that specific and immediate tax cuts should not be 'paid for' by unspecified future spending cuts. Moving from 0.9% annual real increases in day-to-day spending to 0.75% (as the Chancellor is reportedly considering) would reduce planned spending in 2028/29 by £3bn, but only by increasing the implied cuts to unprotected budgets by the same amount.

Similarly, the next fiscal event after the March Budget will see the forecasts extended to 2029/30. While this might – driven by tight spending plans being extended by a further year – be expected to reduce borrowing at the end of the forecast horizon by around £10bn, the IFS says the economic case for using this to finance tax cuts in advance of a detailed Spending Review would remain weak.

12. Tax cuts without tax reform would represent another missed opportunity.

If the Chancellor is determined to cut taxes and wants to boost growth then better options exist than just cutting the rates of income tax, National Insurance contributions or inheritance tax, according to the IFS.

To the IFS, stamp duties on purchases of properties and shares are particularly damaging taxes and should be towards the front of the queue for growth-friendly tax cuts. And tax reform that made our existing taxes less economically damaging could be easier to do in the context of a sizeable tax cut as it would help limit the extent to which some would lose out.

Comment

The IFS view, which closely matches the Resolution Foundation stance, is unlikely to prevail in the current political climate. As of today, another (1%) National Insurance cut looks probable, as well as the inevitable fuel duty freezes.

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