**Introductory remarks**

**Paul Johnson 06/12/2013**

Good news at last. Growth this year and next will be higher than predicted back in March. But that good news hides some more disappointing news for the chancellor. In the very first paragraph of its *economic and fiscal outlook* the OBR states categorically "We judge the positive growth surprise to have been cyclical, reducing the amount of spare capacity in the economy, rather than indicating stronger underlying growth potential".

In other words all that has happened, according to the OBR, is that the growth they were expecting anyway has come along a bit sooner than expected. As a result there is no improvement in underlying borrowing numbers. Since March, there has been no improvement at all, indeed a slight worsening, in forecast cyclically adjusted net borrowing in 2017-18. And the predicted effect on the public finances of this year's higher growth is very limited – only just over £3 billion of additional tax revenue compared with Budget forecasts. The rest of the improvement since last year comes from yet more predicted underspends and yet more in year spending cuts.

Of course it is good to get some growth under our belts after such a long period of stagnation. And getting it early does have some useful fiscal consequences. In particular forecast levels of public sector debt have come down quite appreciably – though it is still forecast to peak at 80% of national income.

So to be consistent with the strategy he has been pursuing Chancellor Osborne could not afford a net giveaway in yesterday's Autumn Statement. In the very long run he has confirmed further increases in the state pension age. But up to 2017-18 he has really only achieved neutrality by stating that a series of definite giveaways – tax cuts and specific spending pledges – will be accommodated within the very tight spending envelope he had already set himself, and by assuming that still more anti avoidance measures will be successful. Continuing to announce tax cuts and to make new spending commitments, unfunded beyond 2015-16, can only increase the difficulty of reaching the fiscal balance he is targeting.

But he has said that he wants to extend the effective consolidation for another year, into 2018-19 by freezing total spending that year. Since "annually managed expenditure" will still be rising then that implies another hefty cut to departmental budgets. He doesn't need to do that to meet the Government's fiscal targets. And, if he is still in number 11, he may not find it easy given the pressures on spending that will without doubt have built up by then. As the OBR has pointed out, achieving this would require "general government consumption to fall to its lowest level as a share of national income since consistent data began in 1948". Our own analysis suggests that the same is true of our broader definition of spending on public services.

For let's not forget the scale of the cuts in spending still to come. By the end of 2013-14 DELs (that's Whitehall spending on public services) will have been cut by just over 8%. Absent further welfare cuts, or tax increases, plans to 2018-19 now imply cuts of more than 20% in total public service spending.

This would actually imply an acceleration in the rate of public service spending cuts – from 2.3% a year between April 2011 and March 2016, to 3.7% a year between April 2016 and March 2019. Simply to avoid such an acceleration in cuts in this kind of spending would require cuts in welfare (or other AME) spending of a further £12 billion a year by 2018-19.

**The scorecard**

So if we look at all the tax and spending measures together is the Chancellor in fact on course to achieve the fiscal neutrality? Up to a point, but only up to a point.

Why do I say that?

First, there is a series of tax cuts – on fuel duties, marriage allowances, employer National Insurance Contributions and business rates – which between them will cost around £2.5 billion a year into the medium term. They are only partially offset by an extra half a billion from an increase in the bank levy and an, inevitably uncertain, billion or so from anti avoidance measures. The scorecard shows the net cost approaching £1 billion annually in 2018-19. Since no new spending measures are scored that far out, this is in fact a small medium term giveaway.

Second, the annual £750 million cost of the free school meals policy is assumed swallowed up within the overall spending envelope from 2016-17. In other words that cost will have to be found at a later date by cutting even deeper into other spending. This is the last in a line of announcements of substantial spending *increases* which will have to fit within the shrinking spending envelope that has been set for 2016 and beyond. Recall promises to increase spending on social care and on childcare made in the budget. And don't forget the nearly £4 billion a year in additional NI payments that public sector employers will need to make. Between them these commitments add around £7 billion of additional spending pressures into the period from 2015-16.

Third, in his speech the Chancellor claimed that the additional cost of student loans arising from lifting the cap on the number of students in higher education would be “financed by selling the old student loan book”. This may work in the near-term fiscal numbers, but economically it makes little sense. Selling the loan book will be broadly fiscally neutral in the long run, bringing in more money now at the expense of less money later on. Lifting the cap on numbers will cost money every year.

The Chancellor continues to make specific promises on spending increases whilst stating that he will keep total spending at the same level. He can’t keep doing that. And whilst the costs of his tax cuts are pretty definite, the benefits from his anti avoidance measures, and indeed of the increase in the bank levy, are rather less certain.

**Tax measures**

It has been well trailed, but yesterday was the first formal government announcement of the introduction of a new transferable allowance for married couples. Spouses and civil partners will be able to transfer £1,000 of their income tax personal allowance to their spouse or civil partner so long as neither is a higher rate taxpayer. This will be worth £200 a year to slightly less than a third of married couples.  The government expects an initial take up rate of only around 70% by those who are eligible.

Financially that is a small change. Its impact on incomes will be modest and its cost will come to a lot less than 10% of that of the increase in the main personal allowance over this parliament. It will complicate the income tax system.

It might seem more likely to be a worthwhile complication if it were the first step to a bigger change. But the way in which it is being introduced suggests that is not the plan. For the allowance is to be withdrawn in its entirety once 40p tax becomes payable. It will introduce a cliff edge into the income tax system – earn £1 more, lose £200. A £200 cliff edge may not be too much to worry about. But one really would not want to make the cliff any higher. So whatever one's view of the pros and cons of a transferable tax allowance, this one really has not been introduced in a way which makes it easy, or desirable, to extend it and make it a significant part of the tax system.

In terms of cost to the Exchequer the freezing fuel duties for yet another year is actually slightly more significant than the new marriage allowance. Put this year's freeze alongside the previous freezes under this government and the Treasury will be foregoing a pretty significant £6 billion in revenue every year from the end of this parliament. That's a big statement of priority at any time, even more so in this time of ultra tight budgets. The long term future of this very important revenue source is in serious doubt.

Mr Osborne took one other "temporary" tax reduction into another year when he extended small business relief for business rates once more at a cost of half a billion pounds. Forever extending temporary reliefs like this has two effects. First, it increases uncertainty for business – will the relief exist next year? What will my tax bill be next year? Second, the more businesses get used to the relief the harder it becomes to undo it. An avowedly temporary measure becomes a permanent one. The structure of the tax system is, largely inadvertently, changed. And half a billion of annual revenue is lost forever, not just for the one year scored in the public finances.

No doubt the extension of the rate relief, alongside the limiting of the increase to 2%, will be welcome by those businesses and property-owners that benefit. It would though be good to know what the government thinks the structure of business rates should be in the long run.

**Energy prices**

The same question could be asked about the taxes and charges on energy bills. About £112 of the average energy bill is accounted for by energy and climate change policies. Measures announced this week will not change the fact that most of the costs of renewables and taxes on electricity production will feed through to bills. But they will transfer some, but not all, of the costs associated with supporting energy efficiency and providing rebates for low income consumers, from energy bills into general taxation. Several questions are left unanswered:

- It is unclear what will happen to the warm home discount after 2015-16. Will it exist at all, will it continue to be tax financed, or will its cost be moved back onto bills?
- The Energy Company Obligation is the latest in a long run of similar policies. It is set to run only until 2017. What, if anything will be put in its place then?
- It remains that case the electricity use is effectively taxed much more heavily than gas use; and energy use by businesses is now taxed significantly more heavily than that by households. Will this inefficient state of affairs persist?
- Can investors be confident that the significant increases in the costs of renewables, due to hit energy bills over the next few years, will in fact be paid for as planned?

## Household incomes

Of course one of the major reasons for the cuts to energy charges has been concern about the "squeeze" on household incomes. The chancellor and the shadow chancellor have been using different statistics to paint two different pictures of what has been happening. What is the real situation?

Mr Osborne is using a National Accounts aggregate called Real Household Disposable Income. The *per capita* measure of this rose 0.9% in 2012 but is projected to fall slightly this year. From its name it sounds like exactly what you'd want to look at. The trouble is it is collected as an input to the national accounts, not as something with which to measure living standards. As a series it behaves quite differently both since 2008 and over long periods of time to other series measuring living standards. It includes some income which does not accrue to the household sector at all. And its actual construction is opaque. It tells us something about household incomes but it should certainly not be used in isolation to measure how they are changing.

Mr Balls refers to a loss of £1,600 a year. What is that number? It is the fall in individual mean gross annual real earnings, deflated by the RPI, between Spring 2010 and Autumn 2013. It is a measure of individual earnings, not household income. It misses the effects of tax and benefit changes and ignores those out of work. It is deflated by the RPI – an index which has lost its National Statistics classification and is increasing faster than those indices that do have that seal of approval.

That said a £1,600 fall is a fall of about 6%. That is pretty consistent with what we know from survey data happened to household incomes between 2009-10 and 2011-12.

We don't have a good household income series which tells us quite what has happened to average living standards since 2010 up to the present day. But we do know from household surveys that income fell sharply in 2010 and 2011. It is almost certainly significantly lower now than it was in 2010. And while it should start to grow it will surely still be below its 2010 level by the time we get to the election in 2015.

That household incomes are lower than before the recession and are lower than they were in 2010 is hardly surprising. We have just lived through the deepest recession in generations and measured output is still below its pre crisis level. And earnings have been hit particularly hard. In part that is the flipside of the strong employment numbers and is directly related to the apparent fall in productivity. On the upside this period has seen much lower unemployment than might have been expected and, up to now at least, a considerable fall in the level of income inequality.