

Summary

Chapter 1

Public finances: the long road ahead

- The financial crisis and associated recession led to a significant deterioration in the outlook for the UK's public finances. We estimate, based on official forecasts, that this worsening amounts to 8.6% of national income.
- This picture was broadly unchanged by the Office for Budget Responsibility (OBR)'s December 2013 forecasts, despite upwards revisions to growth in the near term. Borrowing this year is forecast by the OBR to be £111 billion, which is still £51 billion higher than it forecast back in 2010.
- The package of tax increases and spending cuts announced since the March 2008 Budget is estimated to reduce public sector borrowing by 9.1% of national income by 2017–18. This would more than offset the estimated increase in borrowing from the crisis.
- Despite this, the Chancellor pencilled in a further 0.9% of national income cut to public spending in 2018–19 in the 2013 Autumn Statement. As a result, the OBR's forecast is for a budget surplus in 2018–19, which would be the UK's first since 2000–01.
- Public sector net debt in 2018–19 is projected to still stand at nearly £1.6 trillion, or 76% of national income. This will constrain government policy for many more years to come, since such a high level of debt (at least relative to recent decades) involves substantial annual debt interest payments and leaves the government more exposed to increases in interest rates.
- If the government's plans through to 2018–19 are delivered, and the resulting levels of non-interest spending and revenues are maintained going forwards, then we project that debt as a share of national income would decline through to the middle of this century before starting to increase again due to the effects of the ageing population.

Chapter 2

Public finances: risks on tax, bigger risks on spending?

- We are now four years through what is expected to be a nine-year fiscal consolidation. If this is implemented as planned, and if the current economic forecasts turn out to be correct, then by 2018–19 the government would be running a budget surplus. But there remain significant risks to both receipts and spending.
- There is considerable disagreement among independent forecasters over how much spare capacity there currently is in the economy. But the scale of the Chancellor's fiscal consolidation plan means that even, if the most pessimistic forecasters are correct, the planned consolidation would still be sufficient to offset the estimated damage done to public borrowing by the financial crisis. If the most optimistic assessment of the amount of spare capacity in the economy is right, all spending cuts planned beyond 2014–15 could be reversed and the deficit would still be on course to return to pre-crisis trends.

- The increase in revenues over the next five years is forecast to come largely from income tax and capital taxes. The UK is increasingly reliant on a few very-high-income individuals for the former – for example, the top 1% of contributors (around 300,000 individuals) contributed 27.5% of income tax in 2011–12 – while capital tax receipts are particularly hard to forecast and are also disproportionately paid by a relatively small number of individuals.
- The OBR forecasts also assume that fuel duty rates are increased in line with inflation after the general election, which is something the coalition government has never done. Freezing fuel duties through to 2018–19 would cost £4.2 billion.
- Perhaps the greatest risk to the fiscal consolidation is that whoever forms the next government might be unwilling (or unable) to deliver the currently planned cuts to public spending. Even with the Chancellor’s mooted £12 billion of further cuts to social security benefits, the implied cuts to public services from 2010–11 to 2018–19 would mean departments facing budget cuts of 17.1% on average. If ‘protection’ for schools, the NHS and aid spending were continued through to 2018–19, other ‘unprotected’ departments would be facing average cuts of 31.2%.
- The spending squeeze will be exacerbated by the £6 billion a year of additional commitments made by the government for the years after 2015–16. In addition, a growing and ageing population will increase pressures. The ONS projects that the overall population will grow by about 3.5 million between 2010 and 2018, with the population aged 65 and over growing by 2.0 million. One implication of this is that, even if NHS spending were ‘protected’ and frozen in real terms between 2010–11 and 2018–19, real age-adjusted per capita spending on the NHS would be 9.1% lower in 2018–19 than in 2010–11.

Chapter 3

The global economy

- The outlook for the global economy in 2014 is for an improving growth picture overall, but with considerable divergences in economic performance among key economies and regions.
- We forecast US growth to top 3% in 2014, with a similar pace of growth next year. Consumer spending is picking up and will be supported by improved labour market conditions and wealth gains. An easing of fiscal austerity will also bolster US growth from 2014.
- The outlook is more mixed in the Eurozone, where trends among member states are very varied. A reduced fiscal squeeze will help growth from 2014, as will improving external demand. But while Germany should post respectable growth this year, growth will remain weak at around 0.5% in Italy, France and Spain.
- Emerging economies slowed in 2013 and while we expect Chinese growth to level off at around 7% in 2014–15, growth is set to remain below trend this year in Brazil, Russia and India, where structural obstacles to continued rapid growth are becoming evident.
- World growth is forecast to rise from an estimated 2.2% in 2013 to 2.9% in 2014 and 3.2% in 2015, representing a gradual recovery towards a trend rate of expansion.

- A key downside risk to this forecast is the possibility of a slide into deflation in the Eurozone. Plausible upside risks relate to a faster recovery in the US and to more decisive reforms in the Eurozone and Japan.

Chapter 4

The UK economic outlook

- The UK recovery finally gathered pace in 2013, led by the consumer and the housing market. We expect quarterly growth rates to slow a little through 2014, as the economy makes the transition towards more balanced growth, but our forecast shows growth averaging 2.6% over the year as a whole. The contribution of the consumer is expected to ease, given that there is little scope for households to reduce their savings any further and that the recovery in real incomes is likely to be steady rather than spectacular. But the outlook for both business investment and exports is likely to improve from this year, as the global recovery strengthens.
- We judge that there is currently a significant amount of spare capacity in the UK economy, with the output gap estimated to have averaged 5% of potential output in 2013. The financial crisis is likely to have caused substantial permanent damage to potential output, though our estimates for the scale of this damage are smaller than those of most other forecasters, including the Office for Budget Responsibility (OBR). Such a large output gap will provide the conditions for the recovery to gain momentum over the medium term, with GDP growth expected to average 2.6% a year from 2014 to 2018. Our forecasts are not dissimilar to the OBR's, but are above the market consensus over the longer term.
- The risks around our forecast are more balanced now than they have been since the financial crisis. Domestically, the main uncertainties surround the housing market and the high level of consumer indebtedness. Externally, the most likely upside scenario would involve stronger recoveries in the US and Eurozone, which would boost UK export growth. On the downside, the biggest threat would be if the Eurozone were to slide into deflation; such a scenario could force Greece out of the Eurozone, with the UK's close trade and financial linkages with the Eurozone meaning that the UK recovery would slow sharply.

Chapter 5

Housing market trends and recent policies

- In the last year, the government has initiated a number of housing policies including equity loans and mortgage guarantees via the 'Help to Buy' programme and a revamped 'Right to Buy' scheme for council house tenants. In the short run, these policies were introduced to stimulate demand for housing and to revitalise the construction industry. They also reflect a longer-term objective, dating back to at least the 1980s, of encouraging wider homeownership.
- Whether influenced by these policies or by faster-than-forecast growth in economic activity, the UK housing market has picked up significantly in the past year, with prices increasing across most of the UK in 2013. However, prices remain about 9% below their previous peak in nominal terms, and 25% below in real terms. Only in London have prices reached their previous nominal peak – although they are still

17% lower in real terms. Other indicators of housing market activity have also seen a marked upturn.

- There is concern among commentators as to whether a housing 'bubble' is developing in the UK. A bubble – as opposed to simply an upturn in prices – arises when price trajectories are driven largely by speculative buying based on expected future price increases, rather than by economic 'fundamentals' such as improving underlying economic conditions and easier access to finance. On balance, the data currently available do not provide clear evidence of a housing bubble, even in London – though the likelihood of a bubble is greatest there.
- The 'Help to Buy' scheme aims to increase homeownership by reducing the deposit required to purchase a house, either via an equity loan (which directly reduces monthly repayments) or via insurance to lenders on high loan-to-value mortgages. Help to Buy will likely exert an upwards pressure on prices. Whether this ultimately makes it more difficult for first-time buyers to access homeownership depends on whether this boost to price expectations leads to an increase in supply. The government should consider targeting the policy on first-time buyers and/or reducing the cap on eligible property values (currently £600,000) in order to increase the policies' impact on affordability. In addition, if the government is concerned about a potential house price bubble, it should consider reducing the cap for both schemes and/or restricting the mortgage guarantee to new builds.
- 'Right to Buy' has been an extremely influential factor behind the expansion of homeownership since the early 1980s. Given the excess demand for public housing in some localities, there can be a trade-off between the goal of promoting homeownership through council house sales and retaining sufficient public housing to meet demand. The government seems to have signalled a major shift towards the goal of increasing homeownership, by raising maximum discounts across the country. As yet, it is unclear whether the policy will achieve the desired balance between increasing homeownership and minimising reductions in social housing.

Chapter 6

The squeeze on incomes

- Average living standards have fallen dramatically since the recession, as income growth has failed to keep pace with the rate of inflation. Our projections suggest that real median household income in 2013–14 is more than 6% below its pre-crisis peak. This fall in average incomes has largely been driven by declines in real earnings.
- Households have differed in their inflation experiences. On average, low-income households have benefited less from falls in mortgage interest rates and have been hit harder by high food and energy price inflation than high-income households. We estimate that over the period 2008–09 to 2013–14, the inflation rate for low-income households was, on average, 1 percentage point higher per year than that for high-income households. As a result, we calculate that the average price level faced by households in the bottom quintile rose by 7.1 percentage points more than that faced by households in the top quintile between 2007–08 and 2013–14.
- The declines in living standards experienced by low- and high-income households appear very similar once differences in their inflation rates are accounted for. When we assume that the living costs of all households grew in line with the CPI, it appears

that the fall in real income between 2007–08 and 2013–14 was 6.3 percentage points larger at the 90th percentile of the income distribution than at the 10th percentile. However, once the differences in their inflation rates are taken into account, we estimate that the fall at the 90th percentile was only 0.7 percentage points bigger.

- Looking forward, there is little reason to expect a strong recovery in living standards over the next few years. According to the Office for Budget Responsibility, real earnings are not expected to return to their 2009–10 levels until 2018–19. Further discretionary cuts to benefits and tax credits will put downward pressure on real incomes, particularly for low-income households. Given this, it seems highly unlikely that living standards will recover their pre-crisis levels by 2015–16.

Chapter 7

Policies to help the low paid

- Low pay is more common among groups whose productivity is lower. This does not mean that low pay is entirely due to low productivity – it may reflect the ability of some employers to use market power to pay workers less than their productivity.
- Policymakers should be clear about whether they want to help low-paid individuals or low-paid families. A substantial minority (30%) of those who are low paid have partners who are not low paid. Hence, policies that help all low-paid individuals would also help some relatively high-income families.
- Further increases to the income tax personal allowance would not be particularly effective in helping the low paid. The lowest-income 17% of workers will pay no income tax in 2014–15 anyway. A large majority of the giveaway would go to families in the top half of the income distribution, or with no one in work (mostly pensioners). And many of the lower-income gainers would gain only partially as their universal credit and/or council tax support would be automatically reduced.
- Raising the employee NICs threshold would be a better way of supporting the low paid, and strengthening their work incentives, through the direct tax system. Aligning this threshold with the personal allowance would cut taxes for 1.2 million workers with earnings too low to benefit from an increase in the personal allowance, would benefit only workers, and would simplify the direct tax system.
- In-work benefits provide a more precise and cost-effective way of supporting low-earning working families than changes to direct taxes. Raising by 20%, from currently planned levels, the amounts that a family can earn before universal credit starts to be withdrawn would exclusively benefit this group. It would be a bigger giveaway in entitlements to working families in the bottom three income deciles than the gains to that group of raising the personal allowance to £12,500, despite costing £10 billion per year less. But it would make 200,000 more families eligible for universal credit (although some may not take up this entitlement), leading to weaker incentives for some people to earn more and higher administration costs.
- The Chancellor favours real increases to the National Minimum Wage (NMW) to help those on low pay. Although the NMW appears not to have had negative employment effects so far, increases should be considered carefully.

- The Labour Party plans to incentivise employers to increase the wages of all their workers to the Living Wage. Despite its voluntary nature, the policy may distort employers' behaviour in undesirable ways: for example, firms may not employ some low-paid workers who they otherwise would have, as in order to get the tax rebate all employees must be paid the Living Wage. Employers may also simply alter the timing of wage increases to benefit from the policy, leaving pay unaffected in the long term. Overall, it is unclear whether the policy would raise revenue for the exchequer, as claimed by the Labour Party.

Chapter 8

State support for early childhood education and care in England

- Policymakers have devoted increasing attention to the challenge of enabling parents to access high-quality, cost-effective early childhood education and care (ECEC) over the last 15 years. The government currently subsidises childcare costs in England in three major ways: employer-provided vouchers that are tax advantaged; support for low-income working families via tax credits; and access to a free part-time nursery place for all 3- and 4-year-olds and disadvantaged 2-year-olds.
- The last Budget announced that tax relief for employer-provided vouchers would be phased out in favour of a more accessible scheme that is equivalent to making childcare spending free of basic-rate income tax. It also announced a number of changes to the way in which childcare support will be provided via universal credit. Because of the way these two systems will interact, there will effectively be three different regimes subsidising working families' spending on childcare from 2015, each with different rules. It would be simpler if these different schemes were combined into one.
- As well as the government's latest reforms, policies to help families meet the costs of childcare have received increasing attention from other parties, with proposals to extend free entitlement to nursery education (at least for some families) having been made by both Labour and the SNP. Yet despite increasing cross-party support, there is a remarkable lack of clarity over the objectives and evidence underlying the current public debate.
- It is not clear whether the main aims are to improve child development, increase parental labour supply or reduce socio-economic inequalities: a clear overarching strategy would help bring some much-needed focus to the debate in this area. And while there is good evidence that high-quality childcare benefits children's development, especially children from less advantaged backgrounds, robust evidence on the impact of ECEC on parents' employment is surprisingly limited. We also know very little about the impact of the policies to support childcare that have been introduced in England in recent years.
- Given all these uncertainties, the case for further extending universal provision of ECEC is in fact not as easy to make as would seem to be implied by the growing consensus in this area. There is a danger that the current policy bidding war – welcome as it will be to many parents looking for additional support – will result in ill-targeted and inefficient use of scarce resources. We have already stumbled a long way in the dark in this policy area. It is time to stop stumbling, shine a light on the policy landscape, and plot an effective route forward.

Chapter 9

What is driving energy price rises?

- There is much discussion and debate about increases in energy bills, often without clear explanation of the main drivers of the increases.
- Policy debates tend to centre around two potentially interlinked questions. Are prices higher than they should be because markets are not effectively competitive? Are prices being driven up too far, or at too fast a pace, because of the push for secure low-carbon energy?
- There are many critics of energy companies, the regulator and the government, but analysis of what the problem is remains piecemeal and there is no agreement on the best way forward. This is perhaps not surprising as the industry is complex and information transparency is a problem.
- Given the lack of confidence in the industry and the policymakers, whether well founded or not, the time may have come for the independent Competition and Markets Authority to undertake a wholesale review of the market.
- Any such review needs to consider the sector in the round, including the impact of existing policy, to determine what the problem is and what the scale of any detriment is. Until the problem is better understood, there is inevitable risk in pushing forward with short-term policies that could potentially create their own distortions.
- Reducing social and environmental charges within energy bills risks increasing the cost of meeting government targets for reduced carbon emissions. Carbon prices are lower for households than for businesses and are much lower for gas consumption than for electricity. This is inefficient. There should be more focus on achieving a consistent carbon price as an efficient part of policy to reduce emissions.

Chapter 10

Taxation of private pensions

- In 2012, about £70 billion was contributed to funded private pensions, which had a total fund value in 2011 of over £2 trillion. The amount contributed is likely to rise as automatic enrolment goes forward. The way in which pensions are taxed, therefore, is crucially important. Yet this is an area beset by misunderstanding.
- One needs an appropriate benchmark with which to compare the current system. A good starting place would be a system in which contributions to private pensions are free of tax, no tax is levied on any returns, but tax is paid on all pension income when it is received.
- The current UK tax system is overly generous compared with this benchmark system in two ways. First, up to one-quarter of a private pension can be taken entirely free of income tax. Second, roughly three-quarters of pension contributions – those made by employers – escape National Insurance contributions (NICs) entirely. Two factors work in the opposite direction. First, limits apply to the amounts that can be saved in a private pension without penalty. Second, while returns are free of tax at the personal level, these returns are still likely to be affected by both corporation tax and stamp duties.

- HM Revenue and Customs (HMRC) estimates that the net cost of tax relief on pensions provided by income tax and NICs in 2011–12 was £38.3 billion. But this is relative to a benchmark where individuals are not able to benefit from tax-rate smoothing by only paying tax on pension income when it is received and where the system encourages individuals to spend rather than to save. A better estimate suggests the true cost of income tax and NICs relief on pension saving is less than half the official estimate. Taking into account the impact of taxes at the corporate level – corporation tax on normal returns and stamp duty on purchases of shares and property – would reduce this figure further.
- HMRC estimates also suggest that a disproportionate amount of tax relief goes to those on high and very high incomes. But these data are not a good guide to how reliefs are genuinely distributed: the fact that a large slice of up-front relief goes to high-income individuals purely reflects the fact that they make a large proportion of pension contributions and pay a large share of income tax revenues.
- Reducing the annual allowance or the lifetime limits, or restricting income tax relief on pension contributions in any other way, would be expensive to administer and arguably unfair and would inappropriately distort behaviour. Better ways to boost revenues would be to tackle the two elements of the system that look generous relative to a reasonable benchmark – i.e. the tax-free lump sum and the generous NICs treatment of employer pension contributions. As far as NICs are concerned, they could be imposed on employer contributions. But there is a case for, instead, introducing a small and increasing levy on pensions in payment.
- Consideration could also be given to offsetting some of the impact of corporation tax and stamp duties on the returns achieved by pension funds.

Chapter 11

Business rates

- Non-domestic rates – business rates – are levied on the estimated market rental value of most non-residential properties. They raised £26.1 billion in 2012–13, 4.5% of total revenue. Recurrent taxes levied on business property are higher in the UK than elsewhere in the OECD.
- Taxing business property inefficiently discourages the development and use of business property. If possible, it would be better to tax the value of the land excluding the value of any buildings on it, which would have no such effects.
- Business rates are currently based on 2008 rental values. Property valuations are normally updated every five years. As a result, bills do not rise and fall with the economic cycle like most other taxes do, and the proportion of total revenues coming from business rates has risen from 3.9% to 4.5% since before the recession.
- Average bills are limited to rise with the retail price index (RPI), a somewhat discredited measure of inflation. They therefore levy an ever-declining share of property values, which tend to rise more quickly.
- Since 2010, the government has made a number of changes to business rates. The revaluation of properties that was due to take effect in 2015 has been delayed until 2017 to avoid sharp changes in bills. This will probably delay, rather than remove, large changes in bills. Retail premises in northern England and offices in London,

among others, look like being losers from this delay. It would be better to move in the opposite direction: frequent, regular revaluations would mean changes in bills were small, gradual and routine. Rateable values should also be indexed between revaluations to keep them more in line with market rents.

- Relief for low-value properties was made 'temporarily' more generous in 2010, and has been extended every year since. In 2014, some retail properties will also become eligible for temporary relief. These temporary reliefs lack a clear justification and add to the increasing complexity and instability of the system.
- Since April 2013, local authorities in England have been able to retain (for a limited period) between a quarter and a half of the rates revenue raised from new developments. The idea is to provide incentives to local authorities to allow business development, while preventing large disparities arising between authorities' resources. The government could go further by allowing local authorities to retain a larger share of revenues or by giving them more power to increase business rates.