Introductory remarks

Paul Johnson 06/12/2012

This year's Autumn Statement had even more of a feel of a mini-Budget about it than last year's. And not all that "mini" either. We got pretty much the full gamut of tax and spending announcements that you'd expect in a Budget, and some big fiscal and economic news to boot. The idea that there is only one Budget a year has been laid pretty firmly to rest.

Part of the reason for this was the economic and fiscal news. It was bad. Again. The OBR is forecasting that the economy will be 3.6% smaller in 2016-17 than it had thought back in March.

Mr Osborne has had, effectively, to abandon one of his fiscal rules – that debt should be falling in 2015-16. His other rule – that we should expect to achieve cyclically adjusted current budget balance within five years – remains intact. In part that's because the OBR reckons that most of the loss in output won't be permanent. One of the odd features of the forecast now is that a significant output gap is still forecast for 2017-18, but the OBR has not said how it thinks that gap will be filled, nor precisely what impact closing it would have on the public finances.

Even so the period of austerity has had to be extended for another year to 2017-18.

Much of the fiscal activism though had nothing to do with the economic news, or with meeting the fiscal rules. Welfare cuts over the next couple of years largely pay for two tax cuts – the cancellation of the fuel duty increase and the further increase in the income tax personal allowance.

Add in the tax increases and overall the changes announced yesterday will take from the richest, and from those of working age receiving benefits and tax credits, and will give a little to those in work on modest earnings and to pensioners.

The big decisions over spending allocations for 2015-16 are promised in a spending review next year. But the outline of that review is beginning to take shape. Yesterday's cuts will reduce benefit and tax credit spending by some £3.5 billion in 2015–16. Protection for the NHS, schools and overseas aid was confirmed for another year.

Other spending faces a torrid time. It looks like 2015-16 will see a further 3% real cut in other budgets on average.

Roll forward to 2017-18, and if the NHS and schools continue to be protected, and no more welfare cuts or tax rises are found, then these unprotected spending areas – police, local government, defence, environment, transport – face cumulative real terms cuts of 16% in the three years to 2017-18, or cuts of nearly a third since 2010.

That begins to look close to inconceivable. Further welfare cuts and tax rises must be on the cards. £27 billion worth would be required to protect other spending in real terms.

The fiscal numbers

It's worth starting by setting out the numbers for this fiscal year. One could be forgiven for finding the Chancellor's speech yesterday less than crystal clear on this.

Stripping out the effect of gilt transactions with the Bank of England, and ignoring Royal Mail Pension assets, borrowing this year is forecast to be £120 billion – almost exactly what the OBR forecast in March and just £1 billion less than borrowing in 2011-12.

How can that be when the economy is doing less well than forecast and tax revenues are down on forecast? Two things have come to the Chancellor's rescue. First, the OBR has assumed underspends of £7.5 billion. Second, it has scored £3.5 billion from the auction of 4G licences.

The latter is obviously a one off. As for the former the OBR has changed its assumptions about the future and is now building continued under spending into its forecasts. Given recent experience that may be understandable. But it is odd. Will the OBR set out spending estimates greater than stated spending limits in the future if governments start to increase spending regularly as happened in the past?

This banking of under spends has one rather odd consequence. Remember the additional £5 billion of capital spending for 2013-14 and 2014-15 announced on Tuesday? Well yesterday the OBR said it expects a £3 billion capital under spend for those two years. So by comparison with its March numbers, the OBR numbers show only an additional £2 billion of capital spending, not £5 billion.

Let's move into the medium term.

Stripping out all the confounding changes, the government is now expecting to borrow nearly £40 billion more over just the last two years of this parliament than it expected back in March.

Debt is due to peak at nigh on 80% of national income in 2015-16. It was supposed to be falling in that year, not peaking. So the Chancellor's supplementary target is due to be missed.

He has chosen not to try to meet it. Probably wisely. But, despite the fact that the OBR thinks most of the loss in output will be temporary, to meet his main fiscal mandate he has had to extend the period of spending cuts into 2017-18 – an eighth year of cuts. That is even more unprecedented than the unprecedented seven years of cuts announced last year, itself superseding the unprecedented five years originally announced.

Spending plans

Mr Osborne has provided a spending envelope through to 2017-18. He has promised a spending review for next year which should give us details of spending in the first year of the next parliament: 2015-16.

For that first year we have benefit and tax credit cuts of about £3.5 billion already announced. That number rises to £4.5 billion by 2016-17, the year for which £10 billion of cuts were mooted in the Budget.

Given this, and with the NHS, schools and the aid budget again protected, it looks like spending on other public services will have to fall by around 3% in 2015-16. That is a big cut on top of the cuts over this spending review period.

Beyond that the impact on most areas of spending will depend on decisions on the big two – welfare and the NHS – which between them account for nearly half of all spending. Protect them completely, and protect schools, and every other area of spending will have to fall by 16% in the three years after the next election. On top of what has happened in this spending review period that would take cuts in unprotected departments to an average of over 30%. That looks close to inconceivable.

There are big choices on health and welfare, crucially surely including benefits for pensioners, still to be made. And it is hard to believe that there won't be more tax rises to come.

Indeed current plans suggest not an 80:20 split between spending cuts and tax increases by the end of the forecast period but an 85:15 split. So there is room to raise taxes and still keep to the announced tax-spending balance.

Tax and welfare changes

So what of the specific tax and welfare changes announced? There were a lot of announcements. Too many one might say.

The most eye catching change was to limit increases for most working age benefits to just 1% a year for three years starting next April. These changes will clearly create real losses for poor households with the least ability to cope with real falls in their incomes.

That said it is the case that for the last four years benefits have been rising substantially faster than earnings. That is one reason why 2010-11 saw the biggest fall in income inequality in this country in any of the 50 years for which we have comparable data.

Also announced were cuts to the proposed value of Universal Credit – savings from changing the assumptions about the parameters of a benefit that doesn't yet exist.

At the other end of the income spectrum two measures will see richer households lose.

One is a further limiting of the value of pension tax relief. As a way of taking money from the better off this, especially the element limiting the amount that can be saved in any one year, has little to recommend it. The frequency of changes makes planning for retirement increasingly hard.

Perhaps less heralded but at least as big is a further cut in the real value of the point at which people start paying the higher, 40%, rate of income tax. We estimate that by 2015 there will be one million more higher rate taxpayers than there are today, taking the number to nearly 5 million – double the number at the end of the 1990s. The higher rate is no longer something faced only by the highly paid few.

At the same time Mr Osborne found £1 billion to move the income tax personal allowance up by a seemingly paltry £235, illustrating yet again what an expensive policy this is at a time of fiscal hardship. The total annual cost of the increases in the allowance, which will take just over 2 million people out of income tax, will exceed £9 billion by 2014.

The other significant tax cut was the announcement that the 3p increase in fuel duty due in January will not be implemented. In case you weren't paying attention that is the 3p increase which was originally the inflation uprating due in April 2011, which was delayed in Budget 2011 to January 2012; then in Autumn Statement 2011 it was delayed to August 2012. In June 2012 it was delayed to January 2013. Then finally laid to rest yesterday.

This is no way to make policy. More importantly the gap left by a seeming inability to keep the level of taxes on motorists even constant in real terms is of mounting fiscal concern.

Put these changes together and the effects of yesterday's announcements will be to reduce incomes in the bottom half of the distribution, slightly increase them in the upper middle – among workers on modest salaries and among pensioners – and to reduce incomes for the best off.

That pattern is consistent with that of the broader set of tax increases and welfare cuts put in place as part of the consolidation. Working age individuals receiving benefits and tax credits have been hit. The richest few percent have been hit very hard. Those with children have suffered more than those without. Pensioners, and those in work on more modest incomes have borne less of the burden.

Some of course are riding out the hard times quite comfortably. But when you take account of what has happened to earnings, all parts of the working age population have been losing out. In that limited and rather unhappy sense most of us really are in this together.