

Summary

Chapter 1

The global economy

- The outlook for world growth at the beginning of 2013 looks brighter than a year ago, thanks to a decline in key 'event risks' such as a eurozone break-up, a Chinese hard landing and the 'fiscal cliff' in the US.
- US growth is expected to outpace growth in the other major economies over the next two years, reaching around a 3% annual rate by 2014. Upside risks to growth are also more prominent in the US than elsewhere.
- Although financial tensions have eased, the eurozone is likely to continue to contract in 2013, in part because of further fiscal tightening. Fiscal tightening will affect many of the UK's other key trading partners, including the US and some emerging countries. Despite looser monetary policy, growth across all advanced economies will likely be modest in 2013 and not contribute meaningfully to higher world growth until 2014.
- Emerging economies such as China and India showed some signs of improvement in late 2012, and growth is expected to accelerate in both countries in 2013 and 2014, helped by policy stimulus during 2012 feeding through.
- World growth is forecast to rise from 2.3% in 2012 to 2.4% in 2013 and 3.4% in 2014. A key downside risk to this forecast remains the threat of a break-up of the eurozone, although the probability of this has diminished significantly since mid-2012. Plausible upside risks relate to more decisive policy action and a faster recovery of business confidence leading to a more rapid pickup in consumption and investment.

Chapter 2

The UK economic outlook

- The UK economy flatlined in 2012, with a poor trade performance offsetting more encouraging trends in consumer spending and business investment. However, near-term prospects look brighter. The export environment is likely to improve this year, led by the US and emerging markets, reducing the drag on growth from net trade. At the same time, the domestic economy should continue to strengthen and GDP is forecast to grow by around 1% this year.
- Growth should gather pace in the later part of 2013 and average 2.1% in 2014. Key to this pickup in activity is a further substantial fall in inflation, which boosts consumers' purchasing power. In addition, the robust financial position of UK firms is expected to underpin a pickup in business investment.
- We judge that there is currently a significant amount of spare capacity in the UK economy, with the output gap estimated to have been 5% of potential output in 2012. The financial crisis is likely to have caused substantial permanent damage to potential output, but the vast bulk of this damage has already occurred and we expect potential output growth to average 1.9% over the period from 2013 to 2017. Such a large output gap will provide the conditions for the recovery to gain momentum over

the medium term, with GDP growth expected to accelerate from 1% in 2013 to 2.9% in 2017. Our forecasts are not dissimilar from those of the Office for Budget Responsibility, but are above the market consensus over the longer term.

- The risks around our central forecast are more balanced now than they were for most of 2012, though domestic risks do remain skewed slightly to the downside. The most significant domestic risk remains the high level of consumer indebtedness, which may weigh more heavily on the upturn. On the upside, a more aggressive recovery in business investment remains a plausible alternative, though it would likely be dependent on policymakers surprising us with faster and more decisive solutions to the eurozone's problems. The UK's biggest downside risk also relates to the eurozone: a scenario where multiple countries leave the eurozone would likely cause another deep recession in the UK.

Chapter 3

The productivity puzzles

- There are now more people in employment in the UK than before the recession. But output remains below pre-recession levels. At the same point after the recessions of the early 1980s and 1990s, the reverse was the case: employment levels were still lower than before the recessions, but output had more than recovered its pre-recession level. The result is a fall in labour productivity since 2008 that is much larger and more persistent than in previous recessions.
- In 2012Q3, measured real output per worker was 3.2% lower than in 2008Q1 and 12.3% below its pre-recession trend. Part of the fall comes from an increase in part-time work and the resulting reduction in average hours. However, output per hour has also fallen – by 2.6% between 2008Q1 and 2012Q3 – and is 12.8% below its pre-recession trend.
- Changes to the industrial composition of the economy do not explain any of the fall in aggregate labour productivity, and we conclude that changes in the types of people employed can explain only a small part of the fall.
- Real wages have fallen since 2008. Labour supply appears to have been more robust, and the labour market more flexible, than was the case during previous recessions. This has likely contributed to lower real wages, which in turn allow firms to retain more workers than they otherwise would during periods of falling demand, and thereby to lower labour productivity.
- In contrast to previous recessions, there has been no surge in levels of economic inactivity – i.e. in the numbers of people of working age neither in employment nor looking for employment. This seems likely to be associated with a benefit system that has tighter job search requirements.
- The evidence in favour of continued 'labour hoarding' is weak: flows into employment have remained strong and we would expect the majority of firms to have adjusted their labour inputs by now.
- Business investment has fallen significantly during the recession and remains 16% below the pre-recession high. To the extent that this has reduced either the level or quality (or both) of available capital, we expect low investment to have contributed to lower labour productivity. In addition, a higher cost of capital relative to wages

combined with uncertainty over future demand may have led firms to substitute some labour for capital.

- The movement of capital to high-productivity projects may have been inhibited by a combination of bank forbearance and financing constraints that reduce the exit of low-productivity firms and restrict the entry of new firms. Aggregate labour productivity will be adversely affected during any period of capital adjustment.
- In contrast to the private sector, public sector employment has contracted sharply since the recession – the 6% fall since the end of 2009 largely reverses the increase in public sector employment over the previous decade. At the same time, output of government services, as measured in the National Accounts, has increased slightly since 2009. This suggests that public sector productivity has grown in recent years. However, we present this conclusion with some caution given the particular difficulties in measuring output of the public sector.

Chapter 4

The fiscal targets

- The Chancellor, George Osborne, has committed to complying with two fiscal targets, which constrain fiscal policy. The fiscal mandate states that the structural current budget must be forecast to be in balance or in surplus by the end of the rolling, five-year forecast horizon. The supplementary target states that public sector net debt as a share of national income should be falling at a fixed date of 2015–16.
- The latest forecasts from the Office for Budget Responsibility (OBR) show that Mr Osborne is complying with the fiscal mandate but the date at which the structural current budget is expected to return to surplus has been pushed back yet again.
- The fiscal mandate has much to recommend it and is preferable to the European Union's requirement to keep the deficit below 3% of GDP in every year. It constrains the government over the medium term to borrow only to finance investment spending, while allowing the flexibility to provide short-term stimulus in periods when the economy is underperforming and giving time for fiscal policy to adjust to shocks. But the role of the OBR and other independent commentators is crucial in ensuring that these flexibilities are not abused.
- The OBR's latest central forecast is that Mr Osborne is now on course to miss his supplementary target. However, since meeting the target would do little to ensure the sustainability of the UK's public finances, the fact that it looks set to be missed should not, on its own, cause significant concern about fiscal sustainability.
- Now would be a good time for Mr Osborne to consult on a better replacement for this rule, to complement the fiscal mandate. A rule that either targeted the total level of public debt (along the lines of the EU's debt ceiling) or in some way limited the fraction of future tax revenues that have been precommitted to meeting liabilities accrued by the current and previous governments would be better able to ensure long-run sustainability than the supplementary target.
- The Fiscal Responsibility Act 2010, legislated by the last Labour government, imposed legally binding constraints on borrowing and debt. Had the current government not repealed the Act, Mr Osborne would next year have more likely than not faced legal sanctions for failing to meet one of the Act's three provisions (that

borrowing in 2013–14 should be half its 2009–10 level) – unless he were willing to announce tax increases or spending cuts of at least a further 0.5% of national income (£8 billion in today's terms) to be implemented next year.

Chapter 5

Public finances: outlook and risks

- Since 2008, the official forecast for the trend level of UK economic output has been revised down significantly. This, combined with a shift in the composition of the UK economy away from more tax-rich sectors, has resulted in a worsening of the public finances. We calculate that, based on official estimates, this worsening amounts to an estimated 8.2% of national income.
- The package of tax increases and spending cuts announced since the March 2008 Budget is estimated to reduce public sector borrowing by 9.2% of national income by 2017–18: 15% from tax increases and 85% from spending cuts. By the end of 2012–13, 79% of the planned tax increases and 67% of the planned cuts to investment spending will have been implemented, while just 32% of the planned cuts to benefit spending and 21% of the cuts to day-to-day spending on public services will have been delivered.
- A significant part of the downgrade in official forecasts has come in the last two years. In response, further spending cuts have been pencilled in for after 2014–15 – the end of the current spending review period – to offset fully the increase in forecast structural borrowing: but not until 2017–18. A worse economic outlook since November 2010 has pushed up borrowing forecasts for 2014–15 by £65 billion. Mr Osborne has chosen to offset only £1 billion of this. In this sense, he is running looser fiscal policy over this parliament than he intended back in 2010.
- There is great uncertainty surrounding the evolution of the UK economy and public finances. The year after the last six general elections have seen the announcement of net tax increases averaging more than £7 billion a year. Given the current fiscal circumstances, substantial tax rises in 2015 cannot be ruled out.
- Our baseline public finance forecast shows a more than 50:50 chance that (on a like-for-like basis) borrowing this year will be higher than it was in 2011–12. Economically more important is the medium-term forecast, where our projection is similar to the OBR's, although in the next three years we assume lower underspends by Whitehall departments, and hence slightly higher spending overall.
- Under the Oxford Economics central forecast, we project that, as a result of higher trend output, the public finances would be in a stronger position by 2017–18 than forecast by the OBR. In this scenario, the fiscal consolidation plan could be reduced from 9.2% to 8.0% of national income without increasing planned borrowing. The picture would be even better under the more optimistic Oxford Economics scenario.
- On the downside, if a scenario similar to the more pessimistic Oxford Economics one were to materialise, borrowing would remain high for much longer. Public sector net debt would increase sharply to above 100% of national income, leaving the UK even less well prepared to deal with future public finance challenges such as those arising from the ageing of the population and from any future recession.

Chapter 6

Public spending and pay

- The government's fiscal consolidation plan involves significant and sustained real cuts to spending on public services. Departmental spending is forecast to be cut in real terms by 10.6% between 2010–11 and 2014–15. This would reduce departmental spending as a share of national income to 21.7% in 2014–15, the level it was back in 2002–03.
- A spending review is scheduled for 2013 to allocate spending cuts between departments in 2015–16. On average, departmental spending is set to be cut by a further 2.4% in real terms, but the government has pledged to protect NHS spending, international aid and non-investment spending on schools from real-terms spending cuts. This would leave other 'unprotected' departments facing cuts to their non-investment budgets of 2.8% and to their investment budgets of 4.9%.
- Forecasts also imply further cuts to departmental spending between 2015–16 and 2017–18. In the absence of further policy announcements, departmental spending looks set to fall by 18.6% in real terms between 2010–11 and 2017–18. If the NHS, schools and aid spending were protected from cuts through to 2017–18, then 'unprotected' departments would face budget cuts averaging 33.2% over this seven-year period. To mitigate this, further tax rises or more cuts to social security benefits after the next general election might well be on the cards.
- The public sector paybill accounts for about half of total non-investment spending by departments. To date, cuts to the public sector paybill have largely been achieved through cuts in employment rather than cuts in average pay per head. Public sector employment has fallen by about 5% (300,000) between 2010–11 and 2012–13.
- The OBR forecasts that general government employment will fall by 900,000 between 2010–11 and 2017–18. This assumes the total paybill is cut at broadly the same rate as non-investment departmental spending. However, plans submitted to the Treasury by government departments suggest that the central government paybill will be cut by more than non-investment spending up to 2014–15. Incorporating these plans up to 2014–15 implies that general government employment will be 200,000 lower in 2017–18 than forecast by the OBR. If the trend of larger cuts in the paybill continues through to 2017–18, general government employment would be 300,000 lower than OBR forecasts by 2017–18.
- The government has not yet set public sector pay awards beyond 2014–15. The number of future job cuts could be reduced by maintaining tight pay awards. The OBR currently assumes that pay-per-head will grow in cash terms by 3% per year between 2014–15 and 2017–18. If this were reduced to 2% per year (similar to that under the current pay awards), then the total number of net job losses could be reduced by 140,000. Before setting future public sector pay policy, it would seem prudent for the government to investigate the impact of the current pay freeze on public sector recruitment and retention, and the relative effects of workforce quality, workforce size and cuts to non-labour inputs on public service quality.

Chapter 7

Tax and welfare reforms planned for 2013–14

- Tax and welfare reforms in 2013–14 will amount to a small net ‘giveaway’ in aggregate, at an average of about £33 per household (£0.9 billion in total) in that year. This may come as a surprise, as these changes are taking place in the context of efforts to reduce the budget deficit substantially. However, tax and benefit measures implemented since April 2010 as a whole do represent a significant net ‘takeaway’ of £1,360 per household (£35.9 billion in total).
- The 2013–14 reforms comprise a £6.2 billion gross giveaway mostly offset by a £5.3 billion gross takeaway. The gross giveaway is mostly accounted for by tax cuts, with a large increase in the income tax personal allowance being the most substantial. The gross takeaway is accounted for by various welfare cuts and some small tax rises. Overall, tax measures amount to a net giveaway of £4.2 billion and welfare measures amount to a net takeaway of £3.4 billion. This broad pattern of tax giveaways and welfare takeaways means that the changes, on average, reduce net incomes towards the bottom of the income distribution and increase net incomes in the middle and upper parts of the distribution.
- This set of changes should be seen in the context of a whole raft of reforms implemented, or to be implemented, as part of the fiscal consolidation plan. Up to 2015–16, those at the very top of the income distribution will have tended to lose the most, by some distance, from tax and benefit changes introduced since 2010. Those on working-age benefits, found predominantly towards the bottom of the income distribution, will have been hit the next hardest. Households in the middle and upper-middle will have tended to lose less than other groups, in no small part because they are the biggest gainers from the substantial increases to the income tax personal allowance. However, those on middle and higher incomes have been most squeezed by the failure of earnings to grow in real terms, and this is forecast to continue in 2013–14.
- In terms of the structural changes to the tax and welfare system, the government’s record is mixed. On the welfare side, Universal Credit will shortly start to replace six means-tested benefits and tax credits with a single integrated benefit. This could constitute a welcome simplification and remove some of the weakest incentives to work faced by claimants under the current system. But the localisation of Council Tax Benefit, also taking effect in 2013–14, may well undermine some of these advantages.
- The government has clear strategies both in relation to income tax for individuals on low incomes and for corporation tax, and has stuck to them. Elsewhere, a clear tax strategy is lacking. Perhaps the prime example is fuel duties, for which policy has been set in a haphazard way by repeatedly delaying (and eventually cancelling) annual cash-terms uprating that would otherwise have kept their level constant in real terms.
- A more careful and systematic statement of how things should be indexed would also be welcome. Indexation policy matters hugely for the future shape of the tax and benefit system and the public finances. A change in April will mean that future Local Housing Allowance rates – which set the maximum rents against which private sector tenants can claim Housing Benefit – will depend upon historical local rent levels but not current ones. This is difficult to square with any intelligible policy objective. And

the government's recent comments on relative patterns of benefits and earnings growth suggest that it may not view straightforward price indexation of most benefit rates – the current default assumption – as the appropriate rule. An explicit statement of what it thinks *is* appropriate in the long run is needed.

Chapter 8

Options for cutting spending on social security

- Spending on benefits, tax credits and state pensions accounts for 30% of all government expenditure. As the government seeks further deficit reduction measures by 2017–18, it will presumably consider reductions in social security spending, and tax rises, alongside spending on public services.
- The period from 1997–98 to 2010–11 saw significant increases in the generosity of benefits for pensioners and for families with children, though those of working age without children fared less well. Welfare cuts being introduced during the current parliament have reduced entitlements for those of working age but pensioners have been largely protected. These cuts have only partly offset the increase in generosity for families with children seen between 1997–98 and 2010–11, but entitlements for those without children will, on average, be lower in real terms in 2015–16 than they were in 1997–98.
- An obvious way of making savings to the social security budget across the board would be to increase benefits by less than inflation in the next few years. The Autumn Statement contained proposals to increase most working-age benefits by 1% for the next three years. Further savings could be achieved by freezing these benefits, extending below-inflation uprating to more benefits or extending the period of below-inflation uprating to more than three years. To achieve large savings, state pensions would need to be affected.
- In a speech in the summer of 2012, the Prime Minister suggested some areas where he believed that the benefit system was too generous and gave claimants what he saw as perverse incentives, in particular around support for housing costs for young people and support for large families. Changes in these areas could potentially generate large savings, but it is unclear how far the government is prepared to go in reducing support. Introducing exemptions to cuts could further distort incentives; for example, if those aged under 25 were excluded from Housing Benefit unless they had children, those under 25 would have a stronger incentive to have a child.
- Savings could also be achieved by more radical changes to the benefit system – for example, by means-testing more disability and carer's benefits and by removing the last vestiges of the National Insurance system for those of working age. But these would be big changes in the nature of the support given by the benefit system. Careful consideration about who is deserving of support, and how much, should be given before making such changes.

Chapter 9

Broad shoulders and tight belts: options for taxing the better-off

- A stated aim of many government ministers is to ensure that the well-off bear the greatest burden of fiscal consolidation. They tend to be less forthcoming about who they consider to be 'rich' or 'well-off'. Are they referring to a judgement about people's wealth or their income?
- Tax payments are already very concentrated on those with the highest incomes, and the fiscal consolidation so far has hit those right at the top of the income distribution (though not the remainder of the top half) harder than those in the bottom half.
- The burden of increases in all rates of income tax, National Insurance contributions (NICs) or (to a lesser extent) VAT would fall disproportionately on those in the top half of the income distribution. Such increases would affect many of those in the upper-middle of the income distribution who have so far been spared much of the pain of tax and benefit reforms introduced as part of the fiscal consolidation.
- The most obvious way of targeting a tax rise at higher-income individuals would be to increase the higher rate of income tax or the additional rate of NICs. Either could raise significant amounts, with the losses concentrated among those in the highest-income tenth of the population.
- Many unattractive alternatives exist that could raise revenue from those with high incomes and/or high wealth. A wealth tax would have major economic and practical disadvantages. Restricting income tax relief on pension contributions would be expensive to administer, be unfair and inappropriately distort behaviour. Stamp duty land tax (SDLT) is wholly ill-conceived and increasing it makes it worse.
- There are, however, more attractive options. Forgiveness of capital gains tax (CGT) at death and inheritance tax (IHT) reliefs for business assets, agricultural land and gifts made more than seven years before death are highly distortionary. The tax-free lump sum on private pensions is badly targeted, and the NICs treatment of employer pension contributions is excessively generous. Proposals for a 'mansion tax' have a sensible logic underpinning them, but it would be better to make council tax proportional to up-to-date property values.
- Many of the existing taxes examined in this chapter – CGT, IHT, SDLT and council tax – could be improved in a way that both makes them more efficient and, if so desired, raises more revenue from the rich. It would be sensible to look at reforming these taxes before considering the introduction of new ones.

Chapter 10

Corporate tax, revenues and avoidance

- Corporate tax revenues fell sharply in the recession. Receipts were lower in 2011–12 than previously expected and they are not forecast to rise again until 2016–17. This is the result of a combination of discretionary cuts to the main tax rate and weak expected growth in taxable profits. By 2017–18, revenues are forecast to be at their lowest level as a share of national income and total receipts since 1984–85.

- The large fall in corporate revenues across the recession was caused mainly by a sharp fall in financial sector receipts and there remains uncertainty about how strongly they will recover.
- There has been renewed attention on corporate tax avoidance. The UK attempts to tax profits that are *created* in the UK. These can be hard to measure and firms have an incentive to manipulate 'UK profit' to avoid tax. How much is lost to corporate tax avoidance is not known.
- Some of the difficulties in defining and tackling tax avoidance, which are both conceptual and practical, are inherent to the current tax system and arise from the way it attempts to measure profits created in the UK. A more radical change in the corporate tax system – for example, moving to a common European tax base – therefore merits consideration.
- Taxation of North Sea oil and gas has been an important source of revenue for successive UK governments. Revenues were relatively high following the recession (due to a spike in the oil price and an increase in the tax rate) but are forecast to decline as production falls.
- North Sea companies are subject to tax at over double the main statutory corporate tax rate. This is implemented in a way that distorts investment decisions. The tax regime is unnecessarily complex and creates additional uncertainty by changing too frequently.