Institute for Fiscal Studies briefing

# IFS Green Budget

October 2024

Edited by

Carl Emmerson
Paul Johnson
Kate Ogden

In association with Citi and funded by the Nuffield Foundation

# IFS Green Budget 2024

## In summary

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# Welcome

**Welcome to the IFS 2024 Green Budget.**

This year's edition will be the first produced under a Labour government during my tenure as Director of IFS. Given the change of government, this year's Budget will be particularly significant, likely signalling the broad direction of policy on tax and spending for the rest of the parliament. It will also be the first ever in the UK presented by a female Chancellor.

Ms Reeves inherits a difficult legacy. The economy has grown faster than expected this year, but the recovery is not yet secure, and productivity growth remains disappointing. Even if much-needed reforms can be delivered, growth is unlikely to come fast enough to ease the painful choices the Chancellor will need to make if she is to stick to her own fiscal rules. There is speculation that the details of the debt rule will be changed, but the specific definition matters less than making a coherent case for any borrowing and ensuring any investment is well spent. And Ms Reeves will still be constrained by her commendable commitment to aim for current budget balance over the medium term.

Much of the challenge was foreseeable. Existing spending plans always looked implausibly tight. Agreeing in full to the recommendations of the Pay Review Bodies may have been unavoidable given recruitment and retention problems across the public sector, not to mention widespread industrial action. But it will be expensive. If the government wishes to avoid real-terms cuts to budgets for public services – one interpretation of its pledge that there will be 'no return to austerity' – it could need to find an extra £20 billion a year. Even that would not be enough to deliver ambitious improvements.

Budgets early in the parliament of a new government often do see big tax rises. But Ms Reeves has given herself little room for manoeuvre. Substantial increases to some taxes are already pencilled in and factored into forecasts. Labour's manifesto put many of the tools best suited to significant revenue-raising out of reach. The challenge will be raising revenue from the remaining options without exacerbating the worst features of the UK tax system and damaging growth. A chapter with Arun Advani and Andy Summers of CenTax looks in depth at capital gains tax, a rise in which has been widely predicted. The challenge here is to implement sensible reform, not just to raise rates – doing the latter in isolation would risk economic damage and may not raise much revenue in any case.

Tackling child poverty is high up the agenda. A 6 percentage point fall in relative child poverty was achieved during the last period of Labour government, in large part as a result of a massive increase in the generosity of the benefit system. The current government has so far resisted calls to remove the two-child limit, which we find is currently the most cost-effective way of reducing the number of children in poverty through the benefit system. Whatever the government does do, it should consider how changes affect the depth of poverty, not just the numbers that make headlines.

We have heard rather less about the challenges facing social care – growing demand from working-age adults, rising costs and unforgivable geographic variation in provision. But surely we cannot duck this for the rest of the parliament. An early decision to scrap charging reforms legislated by the previous government leaves the problem of high and difficult-to-insure care costs unresolved.

We are delighted to continue our collaboration with Citi, now in its seventh year. We are grateful both for their financial support for the Green Budget and for their chapter on the outlook for the UK economy. This provides superb insights and vital context for the rest of the Green Budget's analysis.

We are also very grateful to the Nuffield Foundation for the funding it has provided to support the Green Budget. Our most important aim for the Green Budget is to influence policy and inform the public debate. At this crucial moment, which will set the scene for the next five years, we are delighted that this work could be supported by the Nuffield Foundation, for which these are also central aims.

The continuing support that the Economic and Social Research Council (ESRC) provides for our ongoing research work via the Centre for the Microeconomic Analysis of Public Policy at IFS (ES/T014334/1) underpins all our analysis in this volume and is gratefully acknowledged.

Data from the Annual Survey of Hours and Earnings, the Family Resources Survey and the Labour Force Survey are available from the UK Data Service. This work uses research data sets that may not exactly reproduce National Statistics aggregates. The data owners and suppliers bear no responsibility for the interpretation of the data in this book.

As with all IFS publications, the views expressed are those of the named chapter authors and not of the institute – which has no corporate views – or of the funders of the research.

**Paul Johnson**
**Director, Institute for Fiscal Studies**

**Follow Paul on Twitter @PJTheEconomist**

# Foreword from the Nuffield Foundation

The Nuffield Foundation is one of the longest-standing supporters of the work of IFS. We believe it represents the gold standard in impartial, evidentially rigorous research. It is the constant point of independent reference for assessing the most important fiscal decisions facing any British government. Over the past eight years, Nuffield has supported over 20 IFS projects on many topics – across Tax and Welfare, Education and, most recently, the Justice system. However, the Green Budget remains the landmark publication of the IFS year, framing public debate on the state of the public finances ahead of the Chancellor's Budget and Spending Review. It is not only an annual audit of the government's fiscal position and policy options but it also shapes the wider public policy agenda over the longer term. This is especially the case this year as Rachel Reeves prepares to deliver her first Budget, one of the most significant in a generation.

If the challenge for the United Kingdom is to reset the terms of the relationship between a caring and productive society, the areas on which Green Budget has focused this year identify the pressure points in that equation. In devoting specific chapters to public sector pay, child poverty, capital gains tax, social care and public spending, it addresses some of the critical and interleaved questions that may determine the public verdict on the new government – the quality and affordability of public services; the obstacles facing young people from disadvantaged backgrounds in leading fulfilled and economically productive lives; the strains on the intergenerational social contract as the population ages; and the government's philosophy of taxation – the terms on which both public spending can be financed and enterprise encouraged.

The debate over the Budget will inevitably be engulfed in political rhetoric; amidst the heat, there will be an urgent need for some light to be shed. The Green Budget, in addition to getting to the heart of the complex trade-offs facing any Chancellor, also displays IFS's rare ability to translate these into the accessible language of wider public discourse. In so doing, it is a genuinely emancipatory and inclusive force. This quality makes it central to the Nuffield Foundation's ambition – to advance social well-being, to champion research that can make for better policy, and to support those who translate policy into effective practice and so make people's lives better. The Green Budget is an anchor to that purpose and we are proud to continue to support it.

Tim Gardam

**Tim Gardam**
**Chief Executive**
**Nuffield Foundation**

# Foreword from Citi

We are delighted to be collaborating again with IFS on the production of the Green Budget in what is now our seventh annual collaboration. IFS continues to shine a critical and objective light on the key issues facing the UK public finances. IFS reports are always essential reading for policymakers, investors and corporate leaders alike.

The new UK government has promised the delivery of economic stability with tough spending rules. The Chancellor has made constant reference to the challenges faced by the UK public finances, but she reiterated in her recent speech to the Labour Party Conference that there would be no increases in income tax, National Insurance or VAT in the forthcoming Budget, but also no return of austerity. The self-imposed tightrope walk across the public finances makes the 30 October Budget a particularly critical one.

The focus on tight spending by an incoming Labour government has so far been taken well by financial markets, although UK consumer confidence measures have been disappointing in recent months while some areas of the public sector have seen substantial pay increases. It is important that any tax changes within the forthcoming Budget are made within a framework aimed at improving overall tax design, a point that IFS has already noted. It is also important that any changes to the rules on government borrowing are spelled out in a compelling and coherent manner.

Citi's Economics team has again provided a major contribution to the Green Budget with a detailed chapter on the UK economic outlook. I would like to thank Benjamin Nabarro, Citi's Chief UK Economist, for his detailed work in support of this year's Green Budget. I would also like to thank IFS for the opportunity to collaborate again on the Green Budget.

**Andrew Pitt**
**Head of Global Insights**
**Citi**

# 1 | UK economic outlook: navigating the endgame

Benjamin Nabarro (Citi)

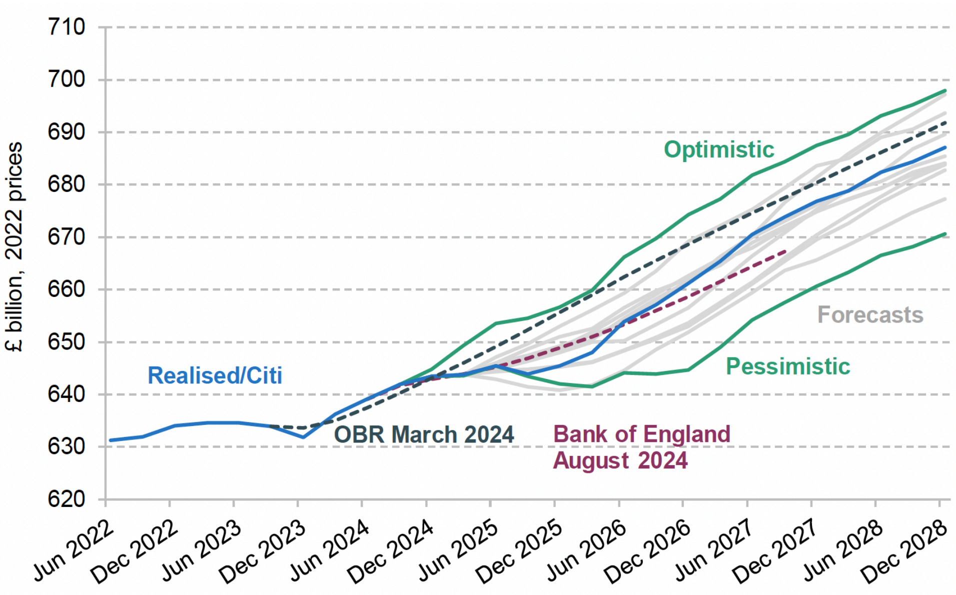
The UK's economic recovery is not yet secure. The UK has been buffeted by a series of adverse supply shocks in recent years and has struggled to reallocate. After years of minimal productivity growth, we see some potential for catch up as these shocks fade. But the outlook for demand is deteriorating, with headwinds expected from both fiscal and monetary policy and reduced tailwinds from China, the EU and the US. The last vestiges of 'conflictual inflation' seem to be fading, but the full effects of tight monetary policy are yet to be felt. Firms remain cautious, and we expect household saving to remain somewhat elevated. Unemployment is likely to increase modestly in the coming year, and growth will remain subdued.

We expect headline CPI to undershoot the 2% target through much of 2026. The labour market is weakening and the risk of embedded inflation is receding. We think this suggests the Monetary Policy Committee has already been too slow to cut rates. Further delay may mean ultimately bigger rate cuts are required in the years ahead.

While the UK faces the legacy of the latest round of macroeconomic policy mistakes in the near term, we anticipate a fuller economic recovery through 2026 and 2027 as supply-side improvements are realised. This presents a window of opportunity for more meaningful structural improvements. After two decades of effective growth 'failure', the gap has widened between what the UK economy can affordably sustain and the demands being placed on it. There is an urgent need to raise trend growth. This will require a cogent strategy, making fewer self-imposed macroeconomic policy mistakes, and a new playbook in the face of supply shocks.

In this chapter, we begin by discussing the structural challenges posed by the economic inheritance, and the changes needed if the UK is to transition to higher growth. We then turn to the global and domestic outlook for activity, the labour market, the outlook for inflation and the choices facing the Bank of England.

UK real GDP (chained volume measure) under different scenarios




Note: Baseline, optimistic and pessimistic Citi scenarios are described in Chapter 1. Bank of England forecast is modal, market conditioned. Independent forecasts are shown in grey.

Source: ONS; OBR economic and fiscal outlook March 2024; Bank of England monetary policy report August 2024; Citi analysis.

# Key findings

1. The UK's economic performance over the past two decades is hard to describe as anything other than a policy failure. Productivity growth has been dire – with per-worker growth over the past decade the weakest on average since at least 1850. The innovative engine behind the UK economy seems to have stalled. In 2014, a little under 6% of all firms in the UK (14,000) were 'high-growth firms' – employing at least 10 people and growing their headcount by more than 20% per annum for three years running. This has fallen to just under 4% now. Macroeconomic resilience also seems to have suffered as low growth, low investment and weak income growth have all fed back into one another.

2. The growing global challenges surrounding ecological and geopolitical transition should add to a sense of urgency. These imply further economic headwinds to growth in the years ahead, alongside heightened volatility. More physical investment will be required to ameliorate these effects. But this does not constitute a strategy for addressing the UK's existing growth shortfall. High debt levels, a structural external financing gap and elevated rates volatility mean the stock of outstanding debt is a growing vulnerability. In this sense, the UK likely finds itself in a worse position than the US or the Euro Area.

3. The UK needs to lift growth despite these growing challenges, in the context of limited policy space. Here we think the focus should be on boosting intangible and ICT investment, alongside broader efforts to improve diffusion from the technological frontier. Both growth and resilience will need to be areas of focus. The UK, as a small open economy, remains particularly exposed to future shocks. Efforts to bolster resilience, as well as better coordinating monetary and fiscal policy, will be crucial to navigating these shocks better in future. In our view, without countercyclical 'burden sharing' between monetary and fiscal policy, structural efforts to lift trend growth are unlikely to be successful.

4. The cyclical outlook we present here is one of near-term 'sogginess' and medium-term optimism. Globally, we think the near-term outlook is likely to remain somewhat weak. Supportive factors for demand – in particular, significant fiscal support – are beginning to fade. Continued structural uncertainties in China – recent stimulus notwithstanding – remain a headwind across Europe. And US growth exceptionalism does appear to be gradually fading as the impact of tighter monetary policy feeds through. We expect global activity to fall back in the second half of this year. This implies fading external support for UK growth as we move into 2025. External inflationary influences are also likely to continue to fade.

5. The UK economy has surprised to the upside since the start of 2024. We now expect real GDP growth of 1.0% this calendar year, compared with a forecast of just 0.1% back in January. But these welcome improvements are not yet indicative of a secure economic recovery. Instead, they primarily reflect transient improvements in capacity as energy prices have fallen back. For now, the outlook for the core domestic demand engines for the UK remains subdued. A sharp improvement in real incomes since the start of the year has not yet translated into stronger consumer spending. Firm sentiment and investment intentions have improved but remain on the defensive side. And public consumption is likely to prove constrained. We expect growth to remain positive but weak in the near term, with real GDP increasing by 0.7% next year.

6. A procyclical monetary policy approach risks slowing the recovery in our view. Structural changes have slowed the transmission of monetary policy into economic activity. The effects of higher interest rates may become more material as many parts of the economy are forced to borrow once more; around half of the cumulative effect of monetary policy is still to be felt. This will suppress demand, just as the supply side of the economy begins to recover. Better news in the latter case reflects lower energy prices, and rebalancing between labour and non-labour inputs in production. This is cause for optimism, although monetary headwinds will make it difficult to capitalise immediately. We expect growth to accelerate markedly through 2026 and 2027 as monetary and fiscal constraints are eased.

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7 The outlook for the household sector should improve modestly in the months ahead, although household sentiment remains somewhat defensive. Much will depend on developments in the household saving rate. The 'cash' saving rate – i.e. excluding the imputed equity of pension funds – has climbed from 3.4% just before the pandemic to around 8% now. This has been pushed higher by a combination of uncertainty, consumption smoothing and balance sheet impairments. In the months ahead, we think the saving rate may come down modestly as uncertainty dissipates – although we expect the rate to remain elevated as households overall are significantly less well off now than before the pandemic. We expect private consumption to increase by only 0.6% in 2025, compared with 1.5% in the Bank of England's baseline estimate. The outlook for firms should improve as supply growth picks up and costs decline, though any gains will come from a weak base. Business investment should recover gradually as interest rates fall.

8 Excess labour demand – present through 2022 and 2023 – has now been eliminated. We think most recent data suggest the labour market is continuing to loosen. Vacancies have continued to trend down over recent months, if perhaps at a more moderate pace than last year. Private employment dynamics also look weak, at least according to the PAYE data. As public sector employment growth slows, we think the unemployment rate will increase to 4.9% next year and 5.3% in 2026. The risks here seem broadly balanced, although a flattening in the Beveridge curve would, if anything, imply a faster pass-through from lower vacancies into higher unemployment from here. We expect a modest loosening of the labour market to weigh on wage growth and consumer confidence into 2025.

9 The UK's inflation process over recent years has been primarily 'conflictual' in that high wage growth and services inflation both reflect efforts to make up for large losses associated with an adverse terms-of-trade shock. This, we think, has contributed to sticky wage and services price inflation over recent months. But increasingly we think there are signs that these effects are beginning to fade, with the real income loss associated with the shock now having been more than fully absorbed. Evidence of further 'agitation' around either inflation or nominal wage growth seems limited, and confined to a few specific quarters. And forward expectations for both wages and prices are now broadly consistent with the inflation target. The natural decay in the UK's inflation processes primarily reflects

the relatively high 'cost of conflict' rather than the demand-destructive impact of higher rates. Inflation seems to have broadly returned to target without much direct input from monetary policy. To the degree that the latter now weighs on demand and slack, we expect to undershoot the inflation target through 2026.

**10** The Monetary Policy Committee (MPC) remains in an inflation-averse state of mind. Having cut rates for the first time in August, we expect the committee to ease policy only gradually over the coming months as evidence around inflation continues to accumulate. However, if the labour market does loosen through the first half of next year, we think that is likely to signal the committee should pick up the pace. In our view, a continued focus on the upside risks around inflation, while understandable, is increasingly inappropriate. We expect the MPC to cut rates into accommodative territory through 2025–26 as policy refocuses on the risks around the labour market, and monetary policy is forced to correct for a procyclical monetary and fiscal stance through 2023 and 2024.

**11** After two decades of stagnation, change is needed. The outlook is for a period of near-term sogginess, followed by a more robust cyclical acceleration as supply-side improvements continue to materialise. This may provide a window of opportunity. Already, in the past decade, the gap between what the UK economy can support, and what has societally been promised, has widened. This is combined with the potential for an intermittently binding external liquidity constraint that also poses more acute risks. In a context of growing international rates volatility, the UK does not have time to spare.

# 2 | The outlook for the public finances in the new parliament

Carl Emmerson, Martin Mikloš and Isabel Stockton (IFS)

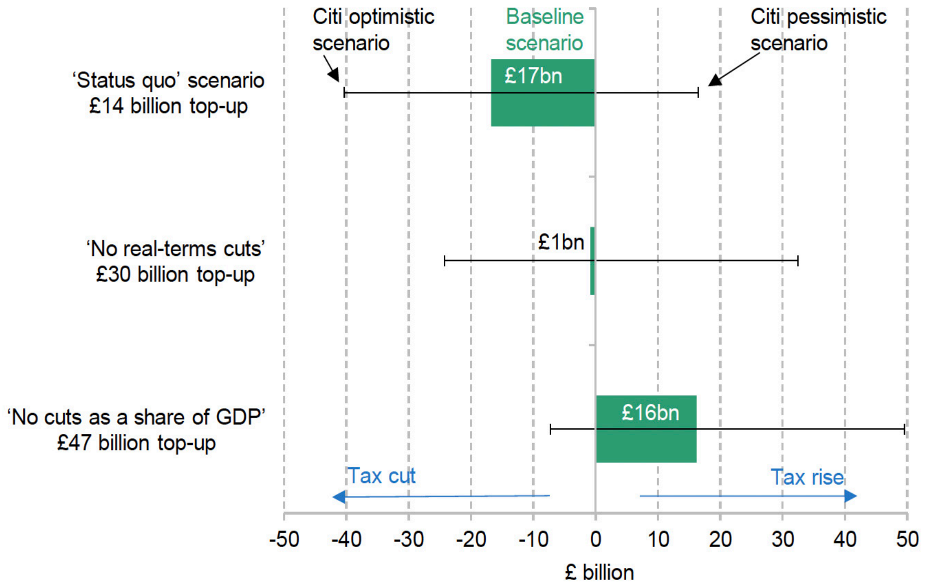
Budgets held in the first few months of a new parliament are often particularly significant, and especially so when there has been a change in the political colour of the Chancellor. Rachel Reeves certainly has some big choices to make as she prepares for her inaugural Budget on 30 October. Taking Citi's baseline economic forecast and assuming all in-year pressures except public sector pay awards identified at the spending audit fade away, and after accounting for the specific tax and spending measures in Labour's manifesto, we estimate this would leave the current budget in surplus by £17 billion in 2028–29 (0.5% of national income). This would be little changed from the March 2024 Budget.

This scenario, however, leaves in place the overall spending assumptions bequeathed by Jeremy Hunt, under which unprotected spending departments would be facing cuts over the period to be covered by next Spring's multi-year Spending Review. Were Ms Reeves to commit to no department facing a real-terms cut to its budget, this could still be consistent with being on course for current budget balance in 2028–29. But only just.

Simply maintaining day-to-day spending in real terms in areas such as skills, courts and prisons might prove to be insufficient to deliver ambitious service quality improvements. An alternative scenario – where all services see their budgets rise at least in line with national income – would require an additional £17 billion of spending in 2028–29. Under Citi's baseline scenario, and absent any cuts to spending outside of public services such as to working-age benefit spending, this would require a tax rise of £16 billion just to remain on course to deliver current budget balance in 2028–29. This would be on top of the £9 billion tax rise from specific measures set out in Labour's manifesto.

As ever, there also remains considerable uncertainty around how the economy and the public finances will evolve. Under Citi's optimistic scenario, this higher spending scenario would require no further tax rises to be consistent with current budget balance by 2028–29. But in contrast under Citi's pessimistic scenario, the size of the required fresh tax rise would triple to £49 billion. To govern is to choose. And on 30 October, Ms Reeves will need to choose.

Scale of fresh tax-raising measures that would eliminate the forecast current budget deficit in 2028–29 under different scenarios




Note: Measures are additional to specific manifesto commitments on tax, costed by Labour at £8.6 billion.

# Key findings

1. The new Chancellor, Rachel Reeves, has inherited an unenviable public finance situation. Taxes are at a historic high by UK standards and yet debt is high, rising and only barely forecast to decline in five years' time, while many public services are showing obvious signs of strain.

2. This is due to an unwelcome combination of factors that were largely apparent prior to the election. In the March 2024 Budget, annual debt interest spending was forecast to be around 1.4% of national income (£39 billion in today's terms) higher over the next few years than the period running up to the pandemic. At the same time, annual spending on state pensions and social security benefits was forecast to run 1.1% of national income (£32 billion in today's terms) higher than in 2019–20. The increase in spending on benefits to support those with disabilities and health-related conditions was particularly big – and worrying. Meanwhile, spending on the NHS continues to rise and, for the first time in many decades, the defence budget seems more likely to be increased than cut.

3. There is likely scope for additional, well-directed, growth-enhancing public sector investment. There is widespread speculation that Ms Reeves will redefine the scope of her debt rule to allow more borrowing to fund this additional investment. Many options are available, with principled arguments for and against each. Of course, redefining targets does not change the fiscal reality and, whatever the headline target, public sector net debt cannot be allowed to rise indefinitely.

4. The specific measure chosen matters less than making a coherent case for why the government should be borrowing to pay for more investment, rather than prioritising investment within a framework that has debt falling (as Ms Reeves declared was her intention before the general election). Perhaps most importantly, the government should then focus on ensuring that the increased investment budget is – and is seen to be – spent effectively.

5. While choosing an easier-to-meet target for the public sector balance sheet would allow Ms Reeves to finance additional investment spending with higher borrowing, she would still find herself constrained by her commendable commitment to aim to meet all day-to-day spending out of revenues, i.e. to aim for current budget balance over the medium term.

6. Under Citi's baseline economic scenario and assuming most pressures identified at July's spending audit prove transitory, and after accounting for specific tax and spending measures in Labour's manifesto, the forecast current budget surplus in 2028–29 could be £17 billion, or 0.5% of national income. But these restrictive assumptions on spending would still leave spending on some public services falling – even though they already include a £14 billion top-up to plans from the March Budget to fund public sector pay deals and deliver specific manifesto commitments.

7. This would leave the Chancellor with little room for manoeuvre, but the uncertainty around this is illustrated by what happens under different assumptions about the economy. Under Citi's optimistic scenario, that £17 billion surplus turns into a £40 billion surplus. Under Citi's pessimistic scenario, it turns into a deficit of £16 billion. All of these incorporate the same, restrictive assumptions on public spending and include tax rises of £9 billion from the manifesto.

8. If the government wishes to avoid real-terms cuts to day-to-day budgets for all public services, an additional top-up of £16 billion in 2028–29 would be required (on top of the £14 billion to pay for public sector pay deals and specific manifesto commitments). In the economic environment of Citi's baseline scenario, this would wholly consume the current budget surplus, and leave debt on a rising path – with or without a top-up to investment budgets to allow them to escape cuts as well.

9. But this 'stand-still' solution may well prove incompatible with ambitious targets for service performance. Ensuring all departments see their day-to-day budgets rise at least in line with national income would require a further top-up of £17 billion (i.e. a total top-up of £47 billion relative to

continued overleaf

March spending plans, or £14 billion plus £16 billion plus £17 billion). Combining this with a fresh £16 billion (0.5% of national income) tax rise would restore the forecast current budget to balance in 2028–29. This would, of course, need to come on top of the £9 billion of specific tax rises set out in Labour's manifesto, so would be a tax rise of around £25 billion in total. A net tax rise of this scale would be bigger than in the July 1997 (£14 billion) and October 2010 (£13 billion) Budgets, both of which took place early in the parliament of a new government.

**10** A longer-term focus beyond the five-year forecast horizon might promote better policymaking. By the end of the parliament, the target year of the fiscal rules will have moved forwards to 2033–34. Based on projections from the Office for Budget Responsibility (OBR), the current budget could by then be in deficit by 1.6%, reflecting spending pressures on areas such as healthcare, and the predictable disappearance of tax bases for fuel duties (as electric vehicles become increasingly common) and tobacco duties. In other words, further tax rises or spending cuts could be required before the end of the parliament to meet the government's current budget rule and address known, long-term fiscal pressures.

**11** Well-designed policies can promote higher economic growth, and more growth would ease some of the sharpest fiscal trade-offs we face. A 'Budget for investment' could undoubtedly find some opportunities for productivity-enhancing projects in the UK. But not all investment is growth-enhancing, and the OBR's model suggests the growth-promoting effect of the average public investment project is neither huge nor swift to materialise. It estimates that a sustained boost to public sector investment of 1% of national income would add less than 0.08% to the sustainable annual growth rate over the next five years and less than 0.05% over the next fifty. As a result, the average public investment project would take a long time to be self-financing.

**12** Policymakers have often chosen to prioritise other objectives over growth – for example, accepting barriers to trade in return for more regulatory sovereignty when it comes to the EU single market and customs union. The new government's manifesto commitments on industrial strategy suggest it will balance a whole host of objectives alongside growth, including lower-carbon production processes, reduced geographical inequality, and improved resilience in crises. These are all entirely valid objectives, but government should acknowledge the very real trade-offs involved.

# 3 | Options for the 2024 Spending Review and beyond

Bee Boileau, Max Warner and Ben Zaranko (IFS)

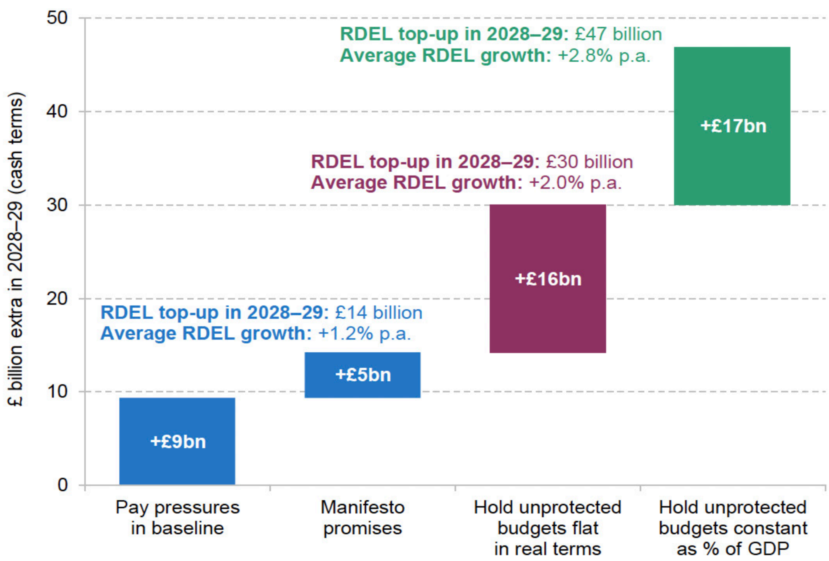
Since the new government took office, there has been significant focus on the spending pressures facing departments in the current financial year, 2024–25. According to the Treasury, these pressures total some £22 billion more than what was budgeted for in the March Budget. While it is customary for a new Chancellor taking office after a change of government to declare, aghast, that the government's finances are in a worse state than they had expected, Rachel Reeves does have some grounds for this claim. The extent of overspends on things such as asylum costs does add to the scale of the fiscal challenge ahead. But this does not change the fact that the broad contours of that challenge have been long apparent and long ignored by both the Conservative and Labour parties. It can be ignored no longer.

This October, Ms Reeves will conduct a one-year Spending Review, in which she will finalise departmental budgets for 2024–25 (in light of the aforementioned overspends), set the overall level of departmental spending for 2025–26 and allocate this between different departments. She will also set spending totals for years beyond 2025–26. Next spring, she will hold a multi-year Spending Review, allocating spending totals from 2026–27 onwards between departments. The decisions and choices made at these Spending Reviews will be consequential, and possibly parliament-defining.

The spending plans inherited from the previous government would, if implemented, mean making substantial real-terms cuts to 'unprotected' public services (i.e. those outside of health, defence, aid and childcare) and to government investment. Given the poor state of many public services, the ambitions and commitments in the Labour manifesto, and the scale of the public sector pay awards announced over the summer, it seems inevitable that the previous government's spending plans will need topping up. The only questions are by how much, and from where this funding will come.

In this chapter, we consider the Chancellor's options at the two upcoming Spending Reviews. We present a number of illustrative scenarios which highlight the fact that the required top-ups can get quite large, quite quickly, under seemingly reasonable assumptions. Just delivering the Labour Party manifesto and funding additional public sector pay pressures would require total departmental spending to be £20 billion higher than current plans in 2028–29 (£14 billion of which would be for day-to-day spending – see the graph). Avoiding real-terms cuts to unprotected day-to-day budgets and to departments' investment budgets on top of this would require a total increase of £40 billion. And even this top-up would leave spending growing not only more slowly than under the last Labour government, but more slowly than Mr Sunak planned as Chancellor at the time of the last Spending Review.

Options for topping up the resource (day-to-day) envelope in 2028–29




Source: OBR's Economic and Fiscal Outlook (March 2023) and authors' calculations.

# Key findings

1 This October, the new Chancellor, Rachel Reeves, will conduct a one-year Spending Review, setting detailed departmental allocations for 2025–26. Alongside this, she will update plans for the overall level of departmental spending – the 'spending envelope' – for 2026–27 onwards. Next spring, she will hold a multi-year Spending Review, setting departmental spending totals for 2026–27 onwards. Her decisions at these Spending Reviews will be of great economic, fiscal and political importance.

2 Shortly after taking office, Ms Reeves published Treasury analysis that claimed to reveal £22 billion of additional in-year spending pressures for 2024–25. Some of these pressures – most notably, additional spending on public sector pay – will be permanent. This only adds to the scale of what was already a daunting challenge: the new government has inherited a tight set of spending plans that would see day-to-day spending on public services grow by just 1% per year (implying cuts to some unprotected departments) and cuts to capital budgets.

3 The overarching challenge facing the Chancellor is that – as has been apparent for some time – those spending plans for future years are almost certainly going to need to be topped up. Given the pressures on a whole range of public services and the ambitious promises in the Labour manifesto, the only question is one of scale.

4 The one-year Spending Review to be concluded this autumn will agree final departmental budgets for 2024–25 (in light of in-year overspends) and set detailed allocations for 2025–26. Here, the key issue is the extent to which budgets for this year and next are increased to reflect recent public sector pay deals and other in-year pressures, and the extent to which departments are instead asked to absorb higher costs. Which departments are prioritised for additional funding – and which, if any, are left facing real-terms cuts – will be revealing, as will the extent to which investment is prioritised over immediate day-to-day pressures.

5 Alongside these short-term allocations, the even more fiscally consequential choice to be made this autumn is over the spending envelope for the rest of the parliament. Just to maintain the 1% real growth assumption bequeathed by Jeremy Hunt, fund this year's pay pressures on a permanent basis and honour the specific spending commitments in the Labour manifesto, we estimate that day-to-day

departmental spending (RDEL) will need to be topped up by £14 billion in 2028–29. This is, in effect, the 'status quo' scenario. Given commitments on areas such as the NHS, defence, aid and childcare (which would see spending on those areas increase more quickly), this would still mean making cuts to some unprotected public services.

6 If Ms Reeves also wishes to avoid making cuts to unprotected budgets, we estimate that she would need to increase her day-to-day spending plans for 2028–29 by a further £16 billion (£30 billion in total, enough to deliver average real-terms growth of 2.0% per year). Even if these budgets are spared real-terms cuts and rise with inflation, maintaining delivery of public services such as prisons and the police could still be challenging. To instead increase funding for these areas in line with national income would require funding to be topped up by a further £17 billion (or £47 billion in total) in 2028–29. These are illustrative scenarios but highlight that the required top-ups can get quite large, quite quickly, under seemingly reasonable assumptions. Even this £47 billion top-up to the day-to-day spending total would only take average real-terms growth to 2.8%: less generous than the 3.3% initially planned at the 2021 Spending Review (though the subsequent surge in inflation eroded that to 2.2%).

7 Ms Reeves and Sir Keir Starmer have indicated that they intend to prioritise capital investment. We estimate that the Labour manifesto implies an additional £6 billion of capital spending in 2028–29. Even with this increase, capital spending (CDEL) would fall by 0.8% per year in real terms over the next four years. Avoiding real-terms cuts to departments' capital budgets would require spending to be £10 billion higher in 2028–29 than under previous government plans (£4 billion on top of our £6 billion estimate of Labour's manifesto commitment). Growing capital spending in line with national income would require spending to be £19 billion higher in 2028–29 than previous government plans. This would still be considerably less ambitious than the original Labour plan for £28 billion of additional green investment per year.

8 Taking day-to-day and capital spending together, we estimate that just delivering the manifesto and funding additional public sector pay pressures would require total departmental spending (TDEL) to be £20 billion higher than current plans in 2028–29. Avoiding real-terms cuts to unprotected RDEL and overall CDEL on top of this would require a total increase of £40 billion. And growing unprotected RDEL and overall CDEL in line with national income would require a total increase of £66 billion.

9 Some of the in-year spending pressures identified by Ms Reeves stem from the poor budgeting practices of the previous government. But most stem from the fact that the generosity of departmental budgets has become detached from what those departments have been asked to deliver. Cumulative economy-wide inflation over the three years covered by the last Spending Review is now forecast to be more than twice as high (15% versus 7%). Departments budgeted for pay awards of around 3%, 2% and 2% in those three years; in the event, they turned out closer to 5%, 6% and 6%. Had day-to-day funding grown at the rate originally planned, it would have been £10 billion higher in 2023–24 (even after the ad hoc top-ups to budgets for that year). On top of that, the UK population has grown by 1.8 million (2.7%) since 2021–22, versus a forecast of 800,000 (1.1%) in October 2021, which will have added to the pressures on (some) departmental budgets.

10 There was no crystallising moment since the last Spending Review to force the previous government to reassess the adequacy of departmental budgets in light of substantially higher inflation and population growth. Ms Reeves has set out proposed changes to the fiscal framework that would, if kept to, go some way towards addressing this. In particular, holding a three-year Spending Review every two years would reduce the extent to which planning assumptions can be overtaken by events, and reduce the extent to which the generosity of departmental budgets and the demands on departments can diverge. This is sensible, but the Treasury should also consider introducing a force majeure clause that automatically triggers a new Spending Review when inflation or pay awards come in outside of a pre-agreed range.

# 4 | Pressures on public sector pay

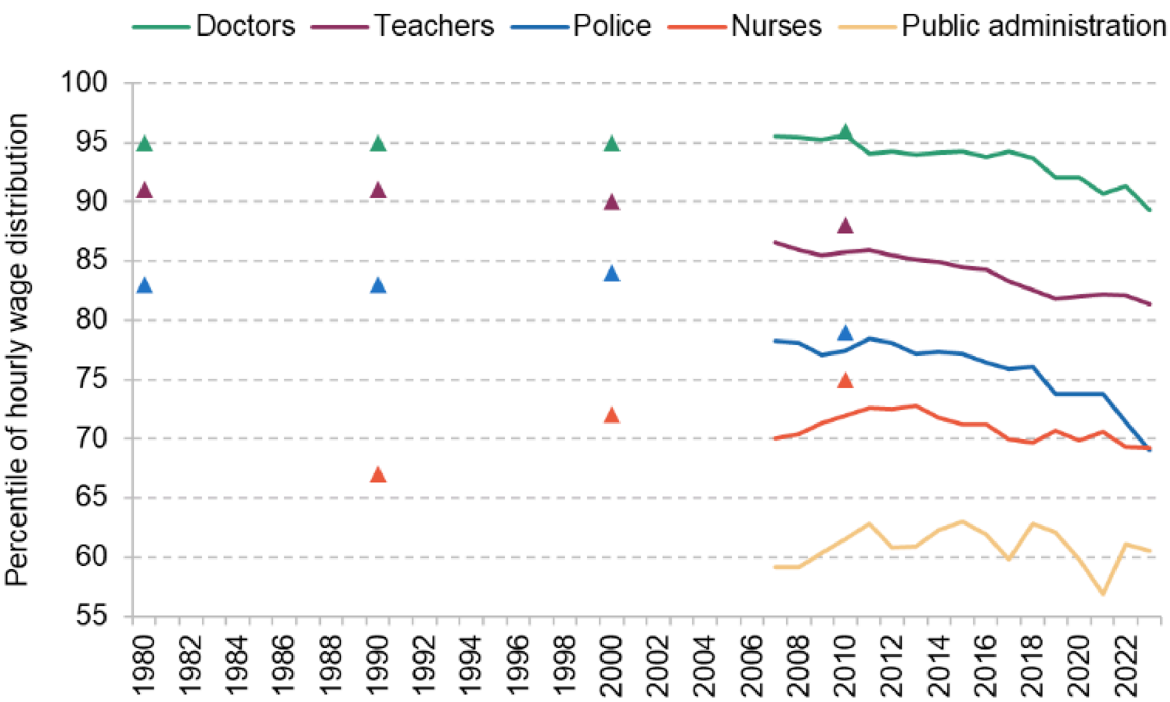
Jonathan Cribb, Magdalena Domínguez and Andrew McKendrick (IFS)

The public sector employs 5.9 million people in the UK. The employment, pay and productivity of these employees are an important determinant of the material standard of living of millions of families, as well as a crucial input into the provision of public services. Getting the structure and level of public sector pay right will affect whether the government can attract, retain and motivate the appropriate number and mix of staff required to deliver the government's desired range and quality of public services. The scale of spending on public sector pay – £270 billion in 2023–24, or 22% of total UK government spending – also makes pay growth an important pressure on public spending.

Improving public services was a key plank of the Labour manifesto, which also highlighted the existence of 'recruitment and retention crises' across public services. One of the new government's first announcements, coming at the end of July 2024, was that it would accept in full the independent Pay Review Bodies' recommendations. These were for public sector pay awards of between 4.75% and 6%. The new Chancellor has presented the additional public spending as part of the 'unfunded pressures' inherited from the previous government. A key question remains: to what extent will public sector pay growth continue to be an important pressure for a government trying to both deliver high-quality public services and exercise spending control?

In this chapter, we describe how pay for different public sector occupations has evolved, comparing this with wages in the private sector and providing new analysis of the changing position of different public sector occupations in the overall earnings distribution. We draw on evidence from the reports of the independent Pay Review Bodies to examine the particular recruitment and retention problems affecting different parts of the public sector. We also highlight some common issues with the structure of remuneration: the degree of wage compression within occupations; the extent (or lack) of regional pay differentials; and very generous pensions, often requiring high employee contributions.

Position (percentile) of median pay of major public sector occupations in the overall hourly pay distribution




Note: See note to figure 4.5 in the full report for occupation codes included in each group.

Source: J. Cribb, C. Emmerson and L. Sibieta, 'Public sector pay in the UK', Institute for Fiscal Studies, Report 97, 2014, https://ifs.org.uk/publications/public-sector-pay-uk; authors' calculations from the Annual Survey of Hours and Earnings (ASHE).

# Key findings

1 The new government has accepted the pay recommendations of the independent Pay Review Bodies (PRBs), meaning that public sector employees will see their pay increase by between 4¾% and 6% in 2024–25, depending on occupation. Chancellor Rachel Reeves has put the cost at an additional £9.4 billion on top of the 2% pay rises budgeted in the 2021 Spending Review.

2 While public sector pay increases for 2024–25 are in line with forecast pay growth in the private sector, pay trends in the two sectors have not followed the same path since 2010. Public sector pay held up much better than private sector pay between 2009 and 2014, but since then the situation has reversed. Whilst real private sector pay is now above its level at the start of 2019, public sector pay is, in real terms, only 1% higher and it is still below where it was in 2010.

3 Median pay relative to the overall hourly pay distribution has evolved differently over time for different public sector occupations. Broadly, it is better-paid public sector workers who have seen bigger falls in pay, with doctors' pay slipping from the 95th percentile of the hourly pay distribution to close to the 90th percentile since 2007. Teachers have seen falls from the 87th percentile to the 81st percentile. In contrast, while nurses and those in public administration have seen their pay fluctuate, by 2022 they are at roughly the same point in the distribution as they were in 2007.

4 Each area of the public sector faces specific challenges, though recruitment and retention are common concerns across much of the sector. In the NHS, there is an increasing reliance on international recruitment and agency staff to fill posts. The NHS 'Long Term Workforce Plan' also aims to increase the number of staff from 1.75 million in 2023 to between 2.3 and 2.4 million by 2036–37, which implies that NHS pay may have to rise faster than that in the wider economy to ensure NHS careers are sufficiently attractive.

5 The teacher vacancy rate of 0.6% is twice the rate it was pre-pandemic. Training targets (as set by the Department for Education's Teacher Workforce Model) are being missed by big margins in most subjects, with less than a fifth of the target in business studies and physics being met. Although retention rates are not much lower than between 2013 and 2020, they are lower in subjects that are training the fewest teachers. More-experienced teachers have seen some of the largest real-terms falls in pay since 2010.

6 Police officers, in contrast to other areas of the public sector, have seen their pay deteriorate more for those lower down the pay scale. This is particularly true for constables on the bottom pay grade, whose pay has gone from being around the 34th percentile of the earnings distribution in 2014 to around the 26th percentile in 2023. Many police forces are still experiencing shortages of officers, despite the large efforts made by the Police Uplift Programme.

7 The prison service is on the front line of one of the most salient challenges currently facing the public sector – the severe shortage of prison places. In terms of staff, retention is the main challenge. The leaving rate of prison staff was 13% in 2023, with officers who had been in post for less than a year the most likely to leave. Although pay has remained stable in relative terms over time, and is in general higher than in 'comparable professions', it is still low compared with the rest of the public sector and the wider economy.

8 People on 'senior salaries' make up much less than 1% of the headcount of the public sector. In general, the occupations included in this group are not experiencing challenges to the same extent as other parts of the public sector, though this is not universally true. The largest of the groups – the senior civil service (SCS) – has seen pay fall in real terms by between 12% and 16% (depending on seniority) since 2013 and is characterised by a large degree of churn, with 25% of

continued overleaf

the SCS changing roles or departments, or leaving the SCS entirely, in 2022–23. Of those who leave, almost three-quarters are regarded as 'regrettable' losses. The judiciary (which is also covered in the 'senior salaries' remit) faces severe recruitment challenges, though retention is largely not an issue.

**9** The Armed Forces have seen a planned big reduction in headcount over time. But the number of individuals choosing to leave before the end of their contracted period has grown above its pre-pandemic level. Although real-terms falls in pay are smaller than for other public sector occupations, members of the Armed Forces are generally unsatisfied with their pay. The Armed Forces are in receipt of one of the largest pay rises from the 2024–25 PRB recommendations, alongside doctors and the judiciary.

**10** A substantial part of public sector workers' remuneration comes in the form of generous defined benefit pension accrual. Members of these public sector arrangements receive, on average, an employer's pension contribution that the government values at at least 23% of salary. Membership of these arrangements generally requires a significant employee contribution in order to participate. Lower-paid workers in particular are more likely to opt out given the size of these contributions: more than twice as many of those earning £10,000 to £16,000 a year opt out as of those earning over £31,000 per year (13% versus 6%). A recurring theme across PRB reports is concerns about the financial implications of high employee pension contributions needed to participate in the schemes and support for greater flexibility in the approach to pensions.

**11** The challenges in recruiting, retaining and motivating public sector employees and the need for expansion of the NHS workforce in line with the 'Long Term Workforce Plan' mean that there will be pressure for public sector pay to rise faster than average earnings over the coming parliament. Based on March 2024 forecasts from the Office for Budget Responsibility, increases in public sector pay in line with average earnings over the next four years would, if the numbers employed remained constant, cost around £6 billion per year by 2028–29. If average public sector pay were to rise by 1 percentage point per year faster than average earnings for four years, the cost would rise to £17 billion per year by 2028–29. This would rise further if the public sector workforce increased in size.

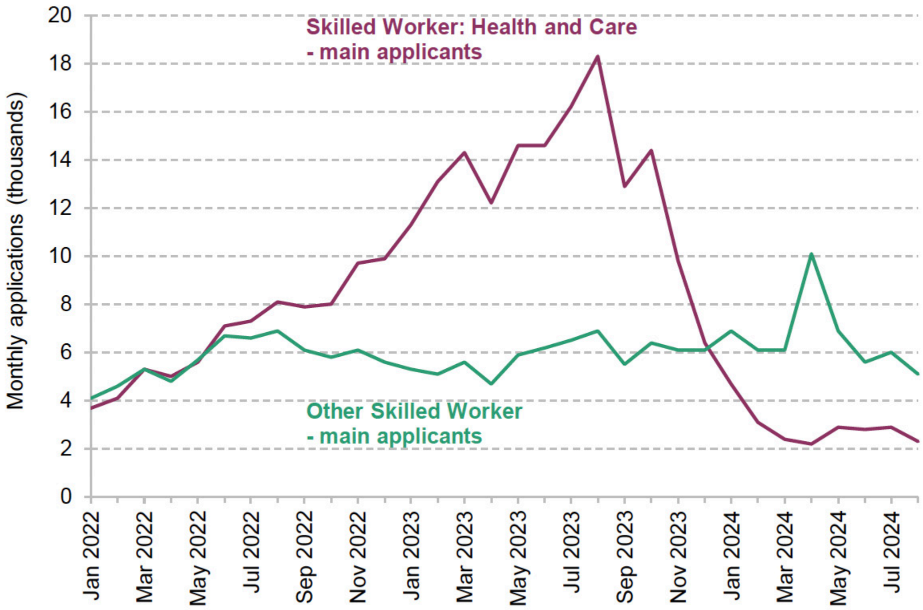
# 5 | Adult social care in England: what next?

Antonella Bancalari and Ben Zaranko (IFS)

The adult social care sector is large, important and growing. It is also a sector marked by its complexity. Care is provided formally, by trained professionals (the sector employs more than 1.5 million people), and informally, by family and friends (an estimated 5 million people provided at least some informal care in 2021), and often by some combination of the two. Of those trained professionals, a majority work in the private sector, with only around one-in-six employed directly by the state. State support is provided primarily via local authorities, whose budgets are increasingly reliant on local council tax revenues. Eligibility for local authority funding towards social care costs in England is governed by both a needs test and a means test, meaning that council funding is provided only to those with the most severe care needs and financial assets below £23,250. The new government has scrapped the reforms legislated by the previous government, which would have increased the generosity of the financial means test and introduced a lifetime cap on care costs. This kicks the 'insurance problem' in social care – the fact that people have extremely limited ability to protect themselves against high care costs – back into the long grass.

Yet, the introduction of a lifetime cap on care costs was never a comprehensive solution to all of the sector's ills. Whether or not the charging reforms had gone ahead, there are several knotty issues in need of policy attention and political will. In other words, completely aside from whether we have some sort of lifetime cap on care costs, there are outstanding questions around the social care workforce and the role of immigration (the number of applicants for Health and Care visas has plummeted – see the graph), the stringency of the needs test, rapidly growing demand for care among working-age adults, geographic variation in provision, interactions with the local government finance system, and much else besides. Scrapping the charging reforms does not park adult social care as an issue.

Monthly applications for 'Skilled Worker' and 'Skilled Worker: Health and Care' visas, January 2022 to August 2024




Source: Home Office, 'Monthly monitoring of entry clearance visa applications', September 2024 release, https://www.gov.uk/government/statistics/monthly-entry-clearance-visa-applications/monthly-monitoring-of-entry-clearance-visa-applications.

In this chapter, we set out the current state of the adult social care system and its key features, consider some of the looming policy challenges in this area, and explore potential future developments for the sector.

# Key findings

1 Local authorities in England have budgeted £24.5 billion for spending on adult social care services in 2024–25. Around half of this spending goes towards support for working-age adults and around half goes towards support for adults aged 65 and above. Adult social care spending now accounts for more than 40% of all local authority spending on services.

2 Eligibility for government support towards adult social care costs in England is subject to both a financial means test and a needs test. That is, publicly funded adult social care is rationed in two ways: only those with limited financial resources and assessed social care needs above a certain threshold qualify for support from their local council. Both the means test and the needs test have become more stringent in the last 15 years. There is no cap on the costs that an individual can incur. Around one-in-seven 65-year-olds can expect to incur lifetime care costs of more than £100,000, but individuals have limited ability to protect themselves against extremely high care costs. This is the 'insurance problem' in social care.

3 The new Labour government has decided not to proceed with the previous government's adult social care reforms, which would have seen the introduction of a lifetime cap on adult social care costs and a more generous financial means test. As a result, despite decades of handwringing, the insurance problem in social care remains unresolved. This is not an area in need of new technical solutions – the solutions are already known and well understood; it is a question of political priorities.

4 The introduction of a lifetime cap on care costs, while welcome, would not be a comprehensive solution to all of the sector's ills. Whether or not the charging reforms had gone ahead, there are numerous knotty issues in need of policy attention and political will. In other words, completely aside from whether we have some sort of lifetime cap on care costs, there are outstanding questions around the social care workforce, the stringency of the needs test, rapidly growing demand for care among working-age adults, geographic variation in provision, and much else. Scrapping the charging reforms does not park adult social care as an issue.

5 Demand for care services among working-age adults is growing quickly: the number of new requests for support from individuals aged 18–64 grew by 18% between 2014–15 and 2022–23 (more than three times faster than population growth for that age group), alongside sharp increases in disability benefit claims. These trends signal growing pressure on social care services for younger adults, in addition to the more commonly discussed pressures from an ageing population.

6 In fact, despite significant growth in the older population, the number of older people receiving state-funded care in England has dropped by 10% since 2014–15 due to tightening eligibility criteria, and we estimate that public spending on adult social care failed to keep pace with demographic pressures between 2009–10 and 2022–23. Looking ahead, to meet demand pressures (particularly from an ageing population) and rising costs, the Office for Budget Responsibility projects that UK-wide public spending on adult social care would need to increase by 3.1% per year in real terms over the next decade. After adjusting for savings from the scrapping of charging reforms, that would see spending rise from 1.3% of national income in 2023–24 to around 1.5% in 2033–34 (and then to 1.9% in 2053–54 and 2.2% of national income in 2073–74).

7 Adult social care is the responsibility of 153 local authorities in England, increasingly funded by local council tax revenues since 2010. It therefore matters not just how much is spent at a national level, but where it is spent. In the absence of a well-functioning local government finance system, there is a risk of a severe mismatch between local funding and local needs. This will be of particular importance if the government is serious about introducing a 'National Care Service' with consistent service provision across the country. At a minimum, the government should commit to implementing, and keeping up to date, new formulas for assessing councils' spending needs (existing funding is to a large extent based on formulas last updated in 2013 and in some cases, rather ridiculously, using data from as far back as 2001).

8 Immigration policy significantly affects the adult social care workforce in the UK, with a growing proportion of employees from non-EU countries, now comprising 16% of the workforce, while EU worker representation has decreased. Monthly applications for Health and Care Worker visas have plummeted from an estimated 18,300 in August 2023 to 2,300 in August 2024. The new government has given no indication that it plans to reverse the previous government's tightening of eligibility for these visas. The trade-off here is a simple one. If the government wants to decrease the number of migrants entering the care sector, it must be prepared either to accept a smaller workforce (i.e. a deterioration in care quality and/or coverage) or to boost the funding allocated to local authorities to raise wages and attract more domestic workers.

9 Successfully implementing various proposed policies and initiatives for the sector – such as the 'Fair Cost of Care' reforms and the new 'Fair Pay Agreement' aimed at raising fees for providers and wages for care workers, respectively – will likely necessitate additional funding from the government. Without more detail on what these policies (particularly the Fair Pay Agreement) will entail, it is impossible to say how much more funding. The structure of the adult social care market complicates policy in this area. Only one-in-six care workers are employed directly by the public sector. A large majority of care home beds are provided by the private and voluntary sectors, with a significant role for a small number of large providers (the largest 30 care home providers supplied 30% of overall capacity in 2017) and for private equity (which owned approximately 13% of for-profit care home beds as of 2022).

10 Individuals who provide at least 35 hours of care a week may be eligible for carer's allowance of £81.90 per week. Currently, if the carer earns more than £151 per week after tax, they no longer qualify. This cliff-edge is highly undesirable and can lead to cases where individuals have to repay large amounts to the Department for Work and Pensions if their earnings edge above the threshold. It would be better to have the £81.90 per week automatically adjust to earnings and be subject to a gradual taper (akin to the taper in universal credit).

# 6 | Child poverty: trends and policy options

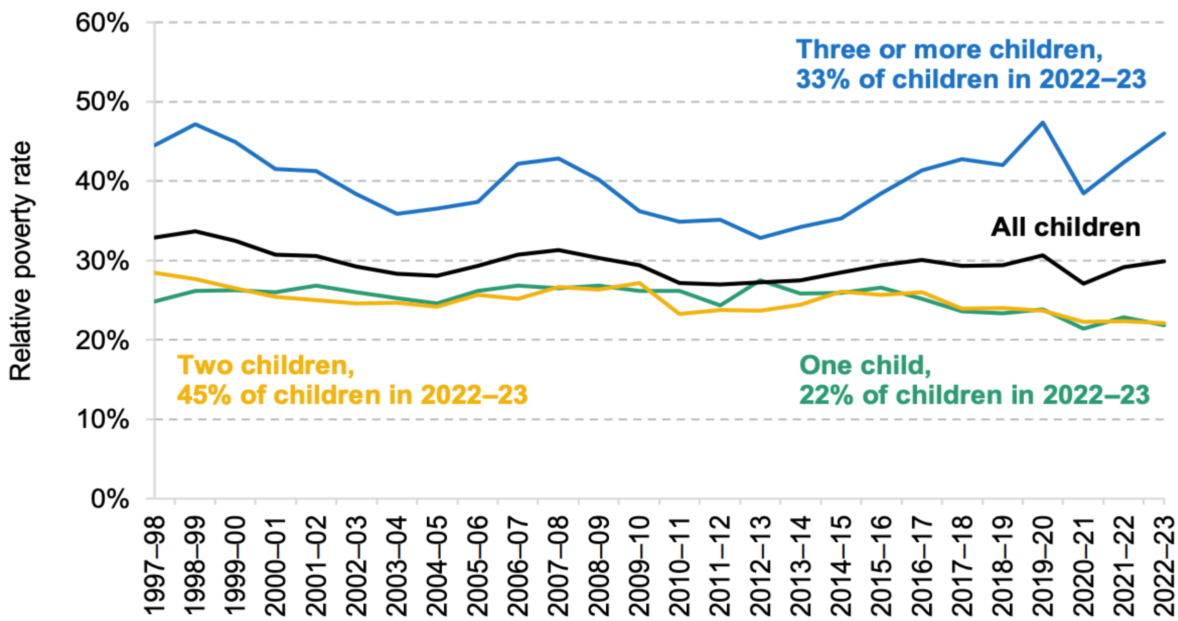
Anna Henry and Tom Wernham (IFS)

Tackling child poverty is high up on the policy agenda for the new government. This is perhaps no surprise given that 4.3 million children in the UK (30%) currently live in relative poverty, 730,000 more than in 2010. The government has set 'breaking down barriers to opportunity' for children as one of its five missions, and launched a ministerial taskforce tasked with developing an 'ambitious' cross-government strategy to reduce child poverty, set to be published in Spring 2025. These words evoke the ambitions of the last Labour government, which oversaw – through big increases in the generosity of financial support for low-income families with children and in the context of favourable economic conditions – a 6 percentage point fall in child poverty. But so far, no specific policies directly targeting income poverty among families with children have been announced.

The government has various policy options in its mission to alleviate child poverty. A more generous benefit system would be a fast and direct way to boost the incomes of the very poorest and could be used to target the specific groups of children that are most at risk of poverty. Labour market policies could also be attractive if they boosted the employment and earnings of parents and at a lower cost to the exchequer, but would be less well targeted at reducing child poverty specifically. In any case, a careful approach to supporting children in low-income households needs to consider how policies affect not only whether children are above or below an arbitrarily drawn poverty line, but also their effects across the income distribution.

In this chapter, we review trends in child poverty in recent decades and how support through the benefits system has changed over time. We then consider a range of policy options the government has if it wishes to alleviate child poverty, both through potential reforms to the benefits system and through the labour market.

Relative child poverty rates after housing costs are deducted over time, by number of children in family




Note: Incomes have been measured net of taxes and benefits. All incomes have been equivalised using the modified OECD equivalence scale. Relative poverty is defined as having income less than 60% of contemporaneous median income. The 1997-98 to 2003–04 period excludes Northern Ireland.

Source: Authors' calculations using the Family Resources Survey, 1997-98 to 2022-23.

# Key findings

1 The poverty rate is a useful summary measure of how low-income families are faring, comparing their total household income with a specified poverty line. For example, a couple with no children would need to have household income below £17,100 to be classed as living in relative poverty in 2022–23. For a couple with two young children, the relative poverty line would be £23,900 as they are judged to require a higher household income to maintain a similar standard of living.

2 Relative child poverty stands at 30% (4.3 million children). Under Labour governments from 1997–98 to 2010–11, during which there was a policy focus on reducing child poverty, the relative poverty rate for children decreased from 33% (4.2 million children) to 27% (3.6 million children). Half of that decline was reversed from 2010–11 to 2022–23. The child poverty rate is highest among families with three or more children, and almost all of the rise in child poverty over the 2010s was concentrated in this group. Children of lone parents, those in rented accommodation, and those in workless households are all also more likely to be in poverty, though the child poverty rate in working families increased from 18% in 2010–11 to 23% in 2022–23.

3 Overall, the benefits system provides less support for low-income households with children now than it did in 2010. Though rates of support for families with children are still much higher in real terms than in 1997, the below-inflation uprating of many benefits from 2011 to 2019 made the system less generous. Various other policies, such as the two-child limit, removal of the family premium, the household benefit cap, and cuts to housing support, have also substantially reduced the incomes of affected families. As a result of the first three of these reforms, a typical social renting out-of-work lone parent with three young children has seen their disposable annual income cut by £4,000, or a fifth, relative to what it would have been had these reforms not been implemented.

4 The government has a number of levers it can pull through the benefits system if it wants to reduce child poverty. Among the policies we consider, the single most cost-effective policy for reducing the number of children living below the poverty line is removing the two-child limit. This would cost £2.5 billion a year but would reduce child poverty by 540,000 (4 percentage points) in the long run, equating to an annual cost of around £4,500 per child lifted out of poverty. This compares to removing the household benefit cap, which would reduce child poverty by 10,000 at an annual cost of around £47,000 per child, or increasing LHA rates to the 50th percentile of local rents, which would reduce child poverty by 40,000 at an annual cost of £11,000 per child.

5 The poverty rate, while a useful summary measure of how those on low incomes are faring, is based on an arbitrarily drawn poverty line, and does not tell us everything about the impact of reforms on the living standards of children in low-income families. For example, whilst removing the two-child limit would lift large numbers out of poverty, many of the children deepest in poverty would benefit less if the household benefit cap remained in place, and households already capped would not gain at all. Removing the household benefit cap alone would lift very few (10,000 children) above the poverty line but would significantly alleviate the depth of poverty faced by some of the poorest children and provide a bigger proportional boost to their incomes. When designing its child poverty strategy, the government should therefore consider effects of policies across the distribution of incomes, not just around the poverty line.

6 Labour market policies present another lever the government may pull to reduce child poverty, though they will necessarily be less well targeted. The government has highly ambitious plans to increase the employment rate to 80%, which could reduce child poverty by 200,000 to 350,000 if achieved – though hitting that goal will be much easier said than done. Or it could increase the minimum wage. But neither increases in the minimum wage nor widespread increases in employment are likely to be well targeted at low-income households or to give large income gains to those who do benefit.

# 7 | Capital gains tax reform

Stuart Adam (IFS), Arun Advani (CenTax and University of Warwick), Helen Miller (IFS) and Andy Summers (CenTax and LSE)

There is widespread speculation in the run-up to her first Budget that the new Chancellor, Rachel Reeves, will raise capital gains tax (CGT).

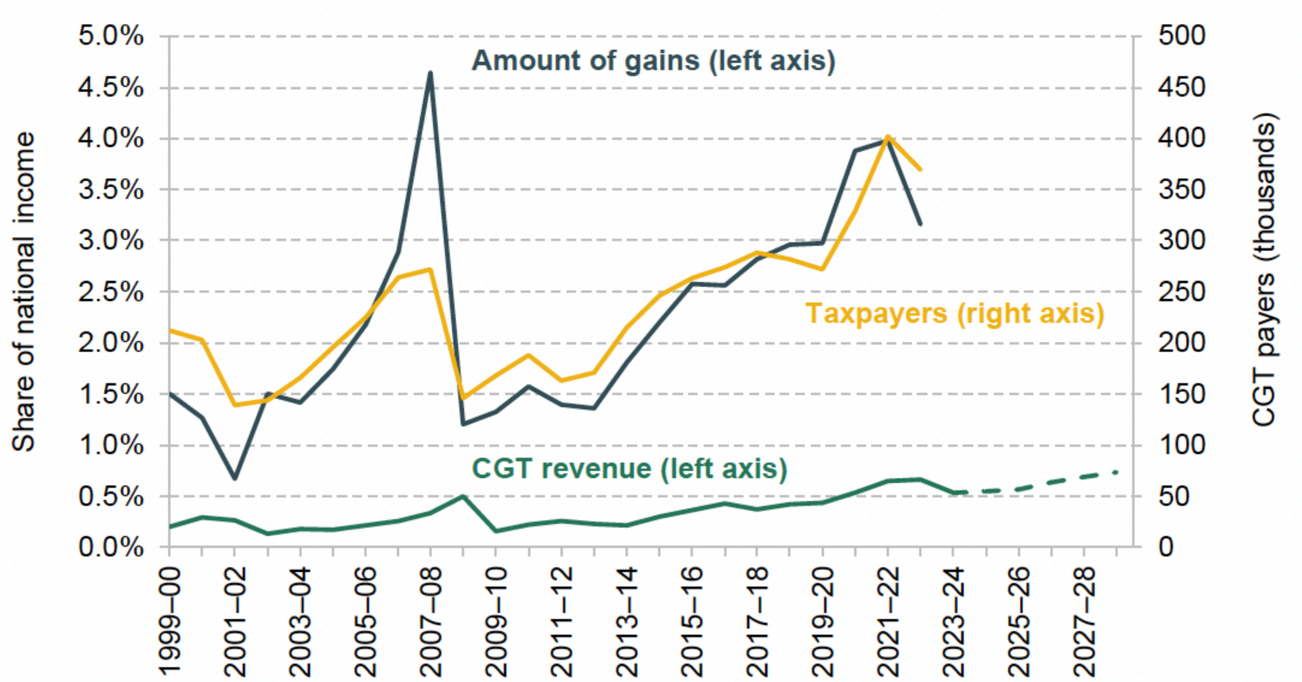
CGT raises around £15 billion per year, less than 2% of total tax revenue. Revenues have risen significantly over time (see the graph) and are forecast to rise further, partly reflecting the increasing role of wealth accumulation in the UK economy.

Despite being a relatively small tax, CGT is important. Its design is flawed and this matters for both the efficiency and fairness of the tax system.

CGT rates vary across assets and are (almost always) significantly lower than tax rates on income. These rate differences are unfair and create undesirable distortions, including to what people invest in and how they choose to work. The design of the tax base reduces UK productivity and growth by discouraging saving, investment and risk-taking and leading to a misallocation of capital away from its most productive use. Unaddressed, these problems would be significantly worse at higher tax rates.

Removing the harmful distortions created by the poor design of the UK's CGT should be a key focus of policy. This chapter sets out how the tax base could be reformed to reduce greatly the distortions to saving, investment and risk-taking. With a reformed tax base, tax rates could be increased with much less distortion to choices over whether, when or how to invest. We summarise a 'big-picture' solution that involves reforming the tax base while aligning overall marginal tax rates across all forms of gains and income. We also discuss steps that could be taken towards this end goal and who would win and lose as a result.

Capital gains, taxpayers and revenue




Note: 'Amount of gains' refers to taxable gains measured after the deduction of losses plus attributed gains but before deduction of the annual exempt amount or of taper relief, where relevant. Individuals and trusts are included in all figures. Dashed line is a forecast.

Source: Revenue and GDP measures from OBR Public Finances Databank, August 2024. 'Total taxpayers' from table 1 of HMRC capital gains tax statistics, August 2024. 'Amount of gains' is from A. Advani and A. Summers, Capital gains and UK inequality. CAGE Working Paper 465, 2020, https://warwick.ac.uk/fac/soc/economics/research/centres/cage/manage/publications/wp465.2020.pdf.

# Key findings

1. Capital gains tax (CGT) raises around £15 billion per year, less than 2% of total tax revenue. Revenues have risen significantly over time and are forecast to rise further, partly reflecting the increasing role of wealth accumulation in the UK economy.

2. CGT is paid by around 350,000 people (0.65% of the adult population). 3% of CGT taxpayers realised gains of more than £1 million and this group accounted for two-thirds of CGT revenue. The average gain among this group of 12,000 people (0.02% of the adult population) was £4 million. Around half of taxable gains relate to unlisted shares in private businesses.

3. CGT rates vary across assets. They are lower than tax rates on earned income and, in most cases, income from capital. These rate differentials are unfair and create a range of undesirable distortions.

4. The design of the tax base is flawed. Ultimately, by discouraging saving, investment and risk-taking and distorting who holds assets and for how long, it reduces productivity and well-being.

5. Higher rates of CGT would worsen these problems caused by the tax base. But keeping tax rates low cannot solve those problems. There is a strong case for reform.

6. The tax base could be reformed so that CGT does little to discourage saving and investment. This requires giving more generous deductions for purchase costs and losses. There are several ways to do this in practice.

7. Ultimately, we advocate aligning marginal tax rates across all forms of gains and income, while reforming the tax base. Tax rates could be aligned at any level; for example, rates on capital gains (and capital income) could be increased while rates on employment income were reduced. In practice, the 'big-picture' solution we set out would include substantially higher CGT rates.

8. Higher CGT rates would increase the incentive for people to leave the UK before realising gains to avoid UK CGT. One option to address this would be to tax people emigrating from the UK on their accrued but unrealised gains, whilst exempting new arrivals from UK CGT on gains they made whilst living abroad. There are challenges with this approach, but it is operated by some other countries.

9. Steps could be taken towards a better-designed system. Low CGT rates on business assets are poorly targeted at entrepreneurship. They lead to more money being held in companies, but do not achieve the commonly stated policy goal of increasing owner-managers' investment in their own businesses. Business asset disposal relief should be scrapped in favour of more generous deductions for investment costs. Removing CGT uplift (or 'forgiveness') at death should also be a priority.

10. The government should seek to make reform credibly lasting. It should set out clear principles and a rationale for reform and commit to the new regime for the length of the parliament. Instability and unpredictability are bad for investment.

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## Individual membership

IFS members help to ensure that both government and opposition are held to account for the promises they make and that policymakers understand the full impact that their choices will have on businesses, households and public finances. Unlike others, we do not have a large endowment fund to underpin our work. It is the support of our members that enables us to respond swiftly, accurately and forcefully to political and economic developments, shed light on events in the news and speak truth to power.

**Join us as a member today to help to shape the policy agenda and preserve our independence of analysis and thought for the future.**

Find out more: www.ifs.org.uk/membership

## Corporate membership

Annual membership fee: £6,000 (+ VAT)

Insight into public policy issues

- Five free places at all charged IFS events, including a delegate place at our prestigious residential conference.
- Reduced member rate attendance for all other staff of the company.
- One free copy of all our printed publications and substantial discounts on all additional copies.
- Corporate members' electronic updates.

Access to the policy debate

- Invitation to private presentations by IFS staff each year, on topics such as our annual Green Budget report or our Budget analysis.
- Invitation to private dinner/breakfast events with high-profile guest speakers.

Profile as an organisation with input into the policy debate

- Your organisation listed as a corporate member on the IFS website.
- Demonstration of your organisation's commitment to corporate social responsibility through supporting IFS as a registered charity.

Find out more: www.ifs.org.uk/membership

## Gold corporate members

Annual membership fee: £12,000 (+ VAT)

All the benefits of Corporate Membership, plus bespoke options, such as:

- Additional free places at all IFS charged events, including the prestigious IFS residential conference.
- A private individual briefing once a year with the IFS Director or Deputy Director at the member's office with local staff on topics of member's choice.
- The opportunity for the Director or Deputy Director to participate as a guest speaker at an event organised by the company.
- An invitation to join senior IFS staff and a high-profile speaker at a private dinner following the IFS Annual Lecture; our most recent speaker was Heidi Williams.

Find out more: www.ifs.org.uk/membership