Autumn Budget 2018

Briefing from Prospect • @ProspectEconom www.prospect.org.uk

30 October 2018

Autumn Budget 2018 – initial summary

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Introduction

On 29th October the Chancellor published his Budget for 2018, alongside new economic forecasts from the independent Office for Budget Responsibility, updating those provided alongside the Spring Statement of March 2018. This briefing focuses on issues that may be of particular interest to Prospect members.

Sources for figures included are Office for Budget Responsibility unless otherwise indicated.

Latest revision of this document: https://library.prospect.org.uk/id/2018/01899
This revision: https://library.prospect.org.uk/id/2018/01899/2018-11-06

Economy

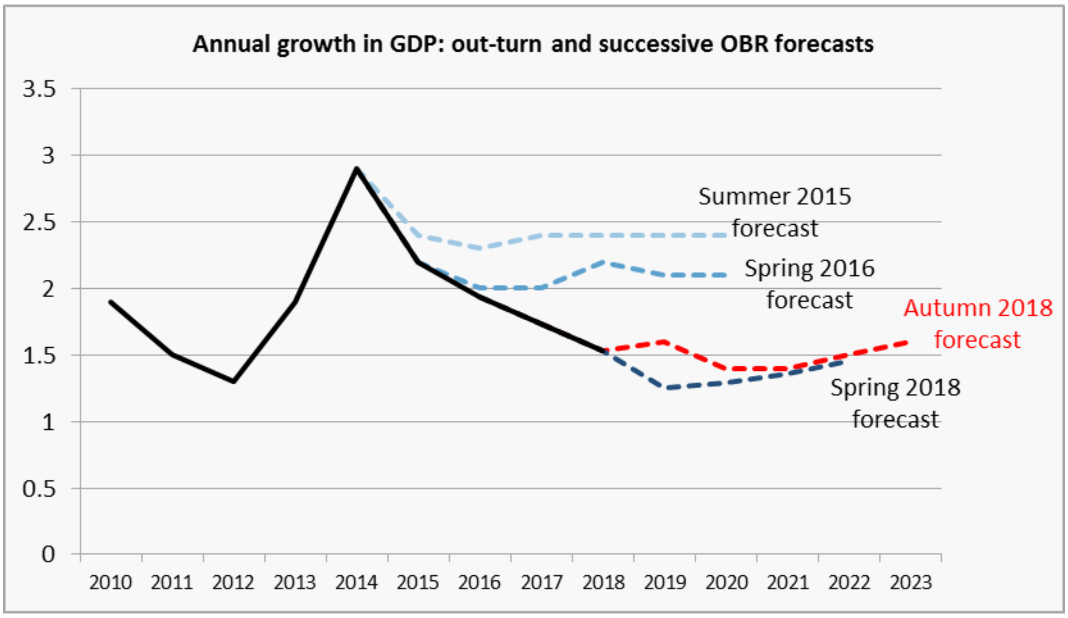
As the OBR makes clear, **official short- and medium-term growth forecasts** are especially uncertain at this point because it is still not known whether current negotiations will reach a deal on the UK's withdrawal from and future relationship with the EU by next April.

Whatever the long-term economic implications of the UK's future relationship with the EU, it is widely expected that a "no deal" outcome could have a significant negative impact on growth over the next year or more, while the smoother transition that an agreement would allow could provide a beneficial boost.

The OBR's central forecast assumes that an agreement is reached, but that (as entailed by the Government's stated objectives for its negotiations) this would entail some restrictions on trade and migration that slow export growth and reduce labour mobility.[1]

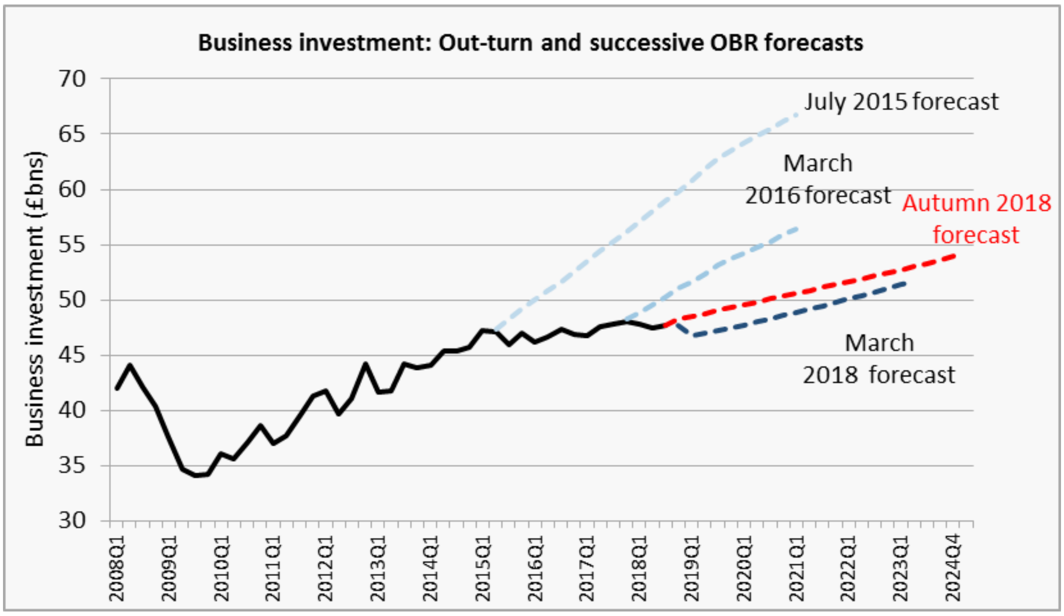
This forecast has not dramatically changed since March this year, with annual GDP growth remaining at around 1.5% for the next five years.

This is significantly lower than that forecast prior to the 2016 referendum – though growth forecasts were already then on a downward path compared to a year previously. (Prior to the financial crisis, the UK's underlying or long-term "trend" growth rate was usually thought to be around 2.5%).

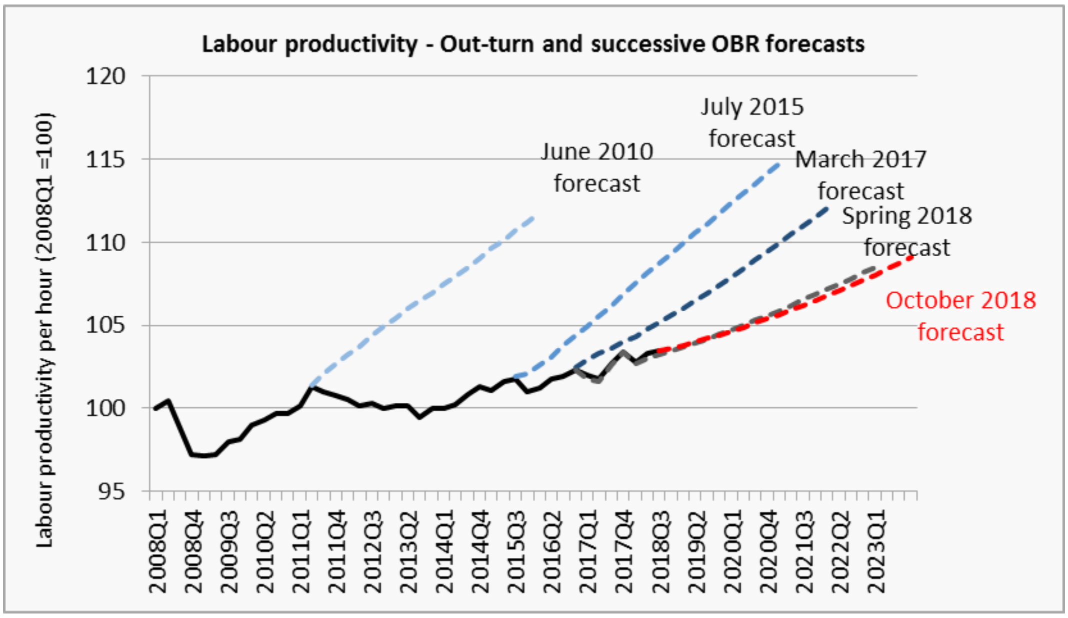


[1] The Chancellor claims that "The OBR's forecast is based on a pretty much mid-way point between no deal at all and an EEA solution. The deal that we're trying to negotiate with the European Union now represents an improvement from the point of view of the British economy over that midpoint and therefore should deliver us an upside in the form of higher economic growth and better outcomes than were otherwise anticipated". Interview with Kamal Ahmed, BBC, 12 October 2018, quoted at https://www.resolutionfoundation.org/app/uploads/2018/10/Tunnel-Vision-Pre-Budget-Report-2018.pdf

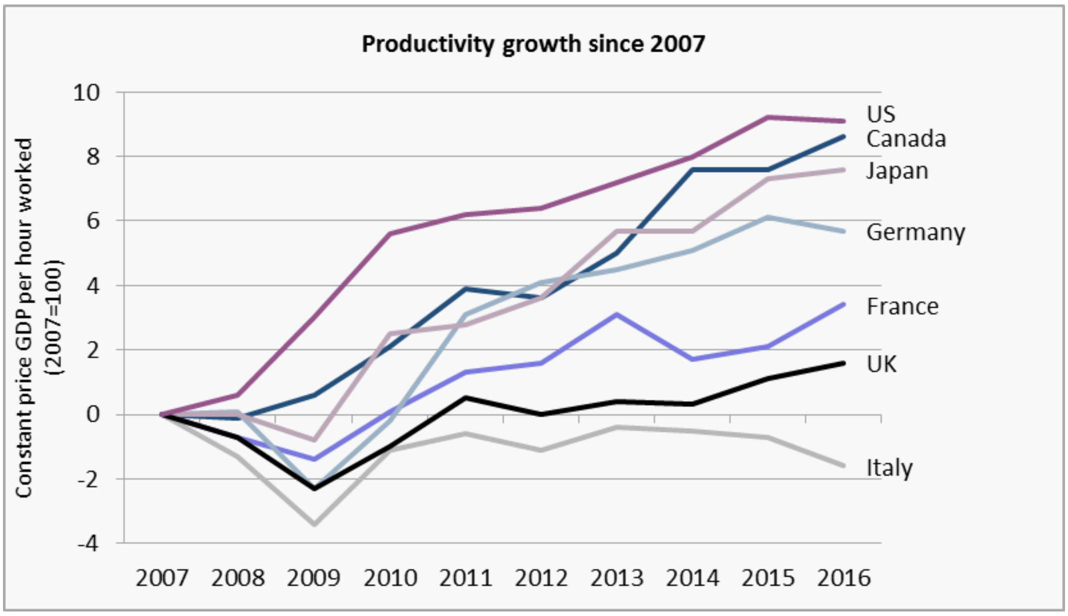
A key factor in the UK's economic slowdown over the past few years has been the failure of **business investment** to meet levels forecast a couple of years ago. Uncertainty following the Brexit referendum will have played a part in this, though business investment has been undershooting official forecasts for a longer period.

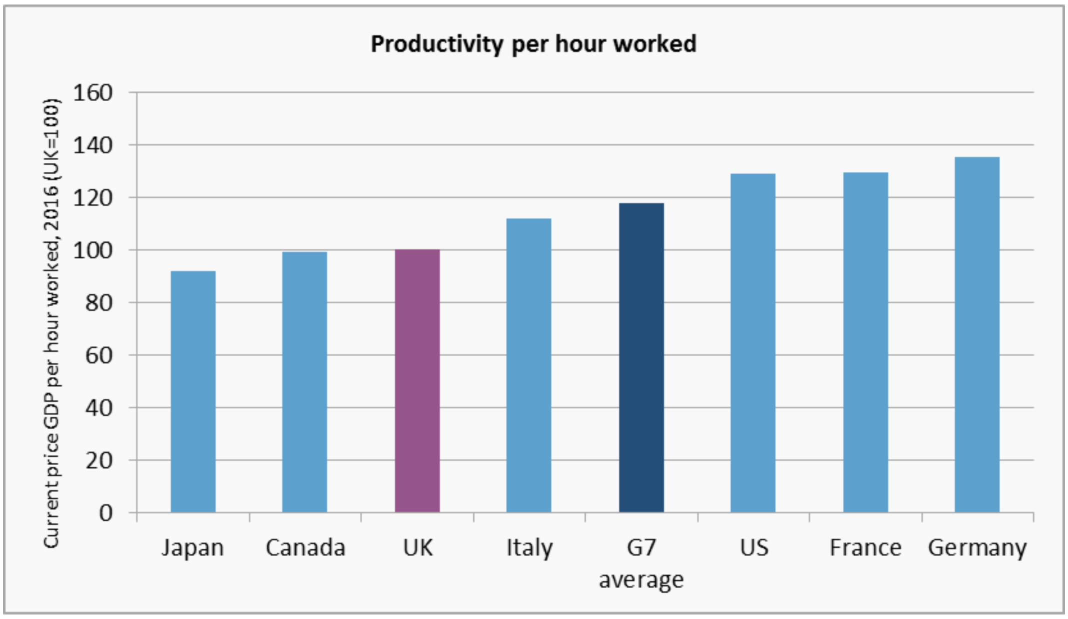


As well as forming a direct component of GDP growth, the level of business investment is widely seen as a key cause behind **stagnating productivity** that has been in evidence since the 2008 financial crisis. Last year the OBR argued that there were no longer grounds to assume that productivity growth would eventually return to its pre-crisis trend of around 2% a year, and forecast a much slower rate of growth for future years that is another key reason for the deterioration of its growth forecasts.



International comparisons now show that the UK's output per hour worked is now 20% behind the average for other G7 economies – and that the gap with the US, France and Germany is around 30%.





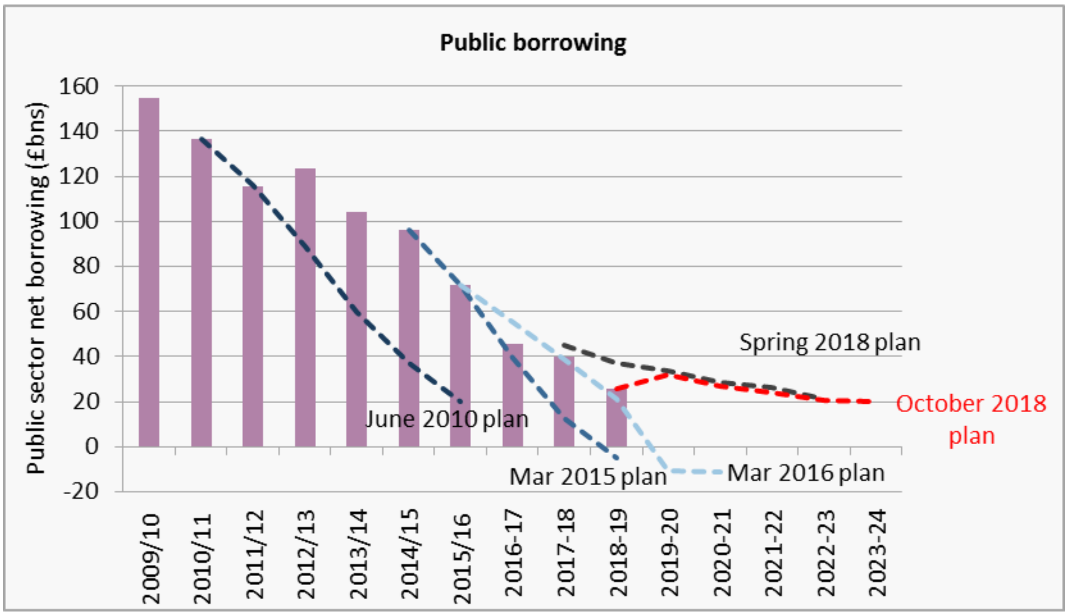
Source: Office for National Statistics[2]

2 https://www.ons.gov.uk/economy/economicoutputandproductivity/productivitymeasures/datasets/internationalcomparisonsofproductivityfirstestimates

Public finances

Lower growth forecasts have resulted in a significant deterioration of the outlook for the public finances over recent years, and repeated extensions of the Government's official timetable for reducing public borrowing.

However this Budget confirmed that this trend has been partially offset this year by higher-than-expected tax revenues which have now prompted the OBR to revise up its forecasts for tax revenues in future years.



This improvement in the OBR's "fiscal" forecast has provided the Chancellor with some extra leeway to increase spending without raising tax *rates* or revising his borrowing plans over the next five years.

The Chancellor stressed, however, this was dependent on growth forecasts that could be derailed by a "no deal" outcome to current negotiations with the EU.

It should also be noted that the spending increases allowed for fall a very long way short of what would be required to reverse the many "austerity" measures of recent years (see below).

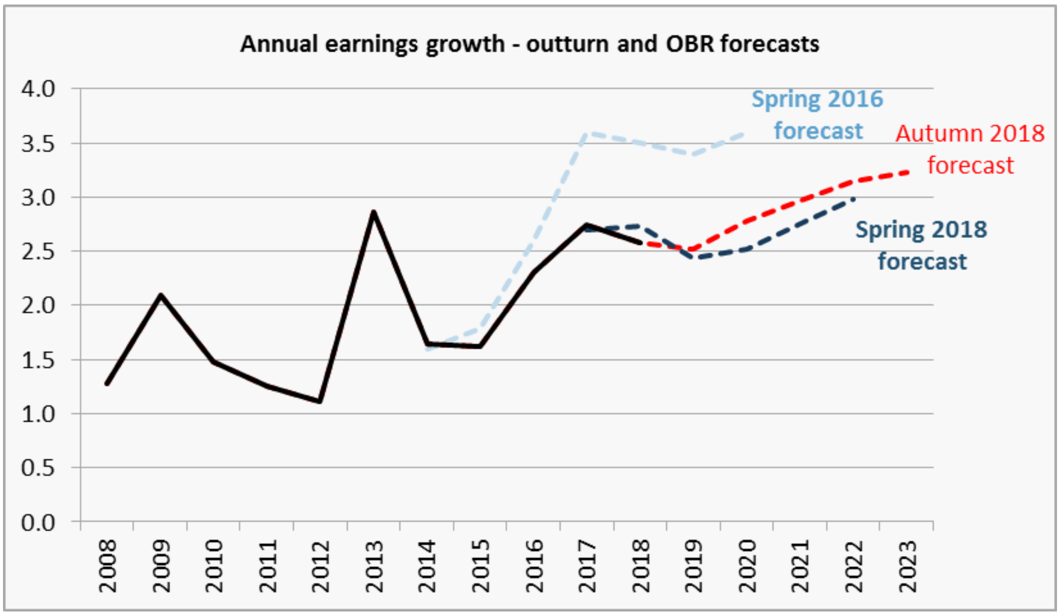
Wages and living standards

The Chancellor proclaimed in his speech that "the OBR is forecasting sustained real wage growth in each of the next five years".[3]

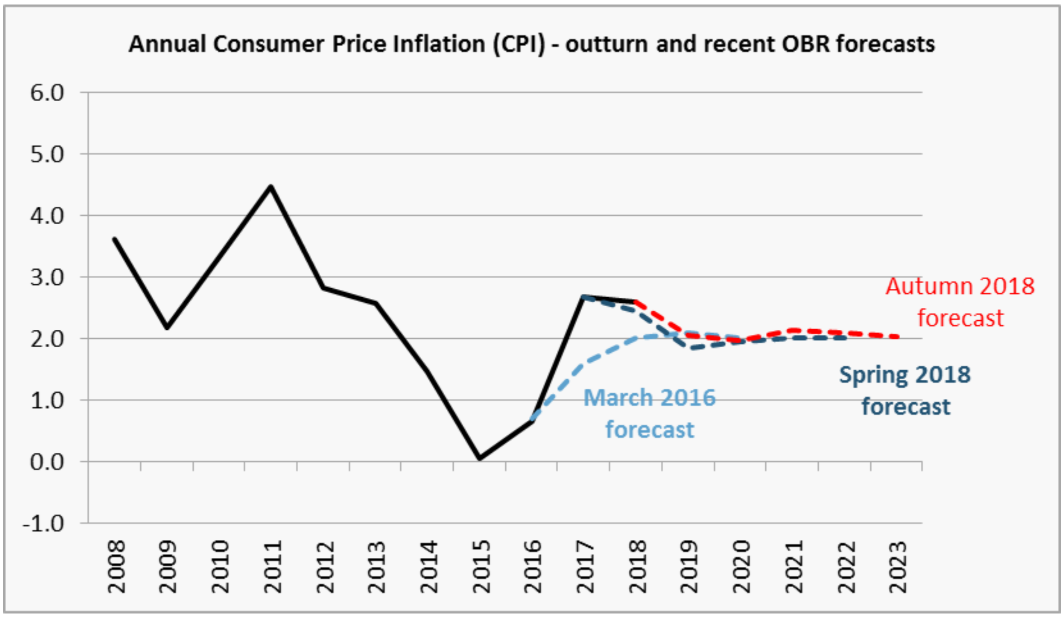
Nominal earnings growth across the economy (including private and public sectors) has increased since the financial crisis but remains low by historic standards. Forecasts have fallen significantly over the past few years, and average annual wage growth is currently around 2.5%. The OBR now expects annual earnings growth to exceed 3% in

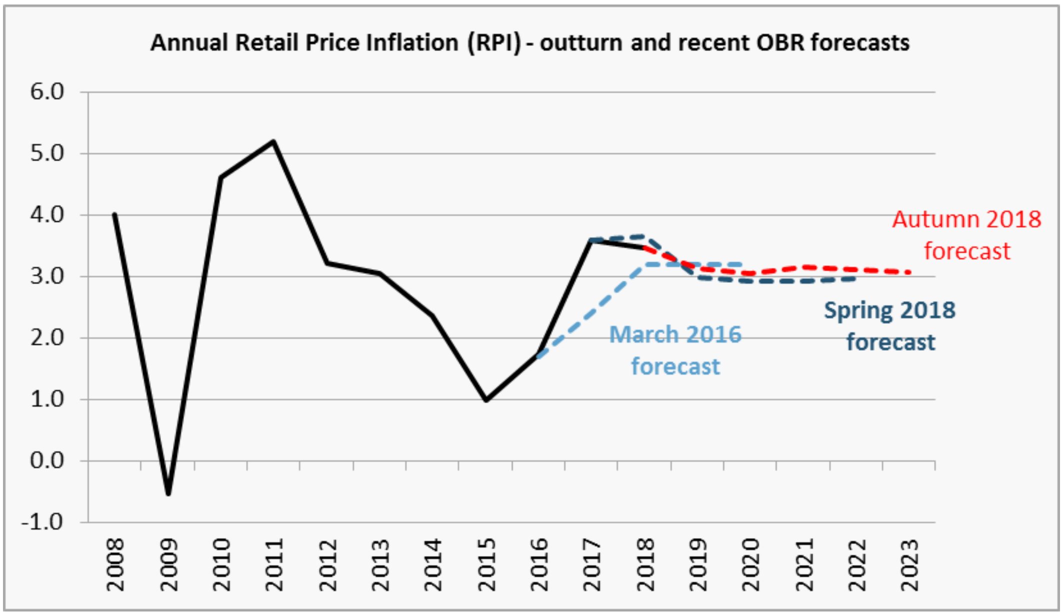
[3] https://www.gov.uk/government/speeches/budget-2018-philip-hammonds-speech

the early 2020s – though a few years ago it expected that earnings growth would already be around 3.5% today.



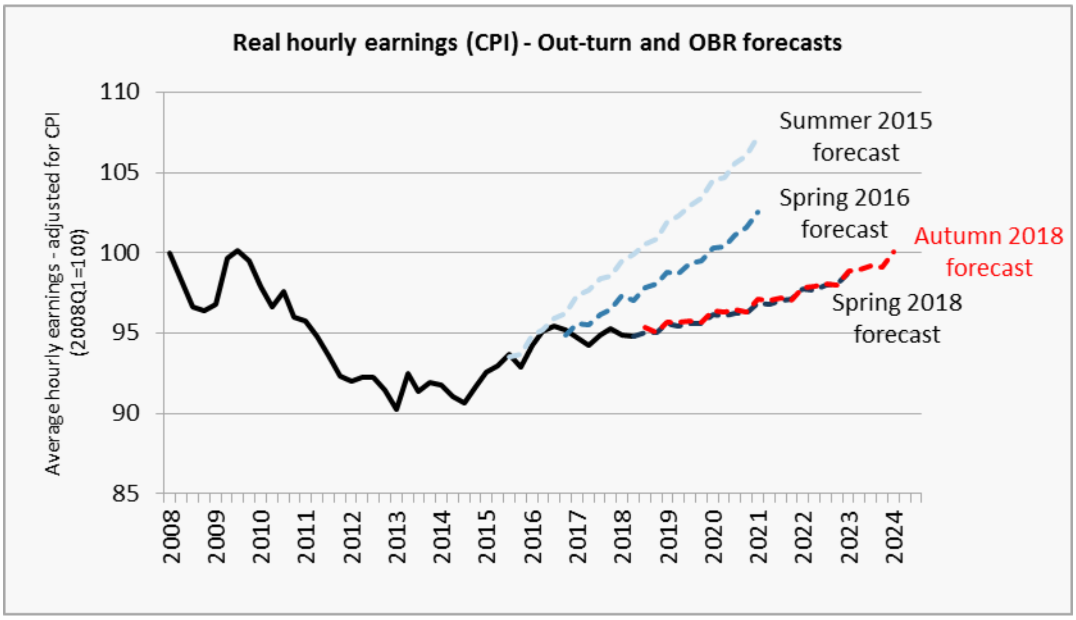
Increases in the **cost of living** were significantly above previous forecasts in 2016 and 2017, largely due to the depreciation of sterling, on both the CPI and RPI measures.

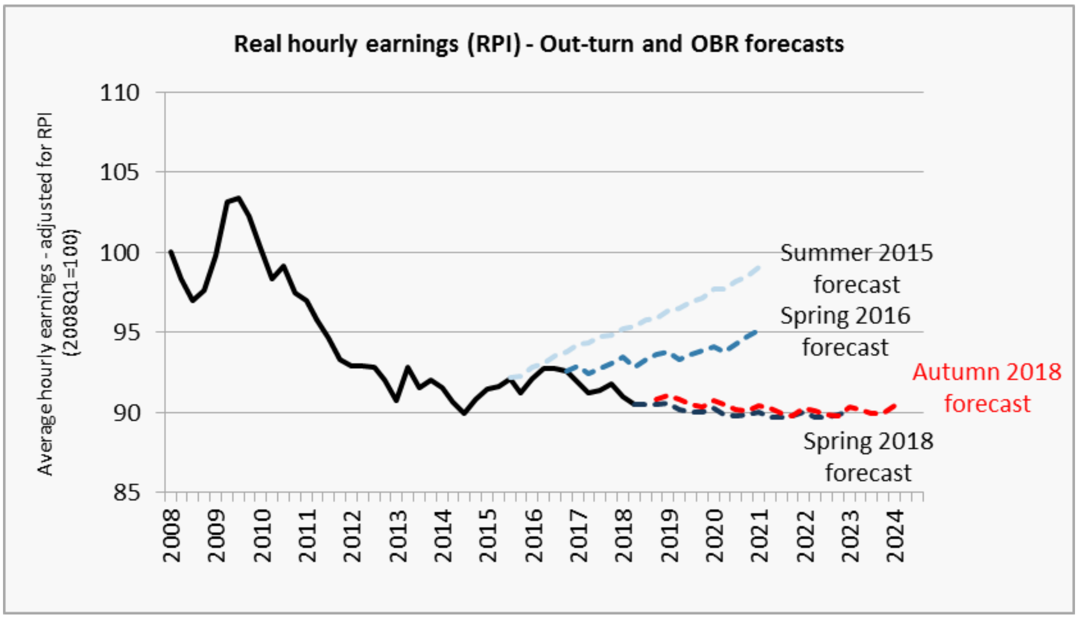




The combined effect of historically slow nominal earnings growth and rises in the cost of living has been a sustained stagnation in real wages. This has been noticeably prolonged by the acceleration of inflation in 2016 and 2017.

Average hourly earnings are still around 5% below their pre-crisis level when adjusted for the Government's preferred measure of inflation, CPI. When adjusted for RPI, they have barely recovered at all, still around 10% lower than prior to the crisis.





To illustrate the concrete impact of these changes, a worker on median earnings of around £27,200 today is still, in real terms, around £1,400 a year worse off than they were at the beginning of 2008 when adjusted for CPI; and around £2,600 a year worse off when adjusted for RPI.

Over the next five years, they can expect an increase in the real value of their wage of around £1,100 when adjusted for CPI, and a further fall in the real value of their wage of around £100 when measured against RPI.

The impact of **income tax measures** contained in the Budget will be relatively marginal compared to these trends.

The Chancellor announced ahead of the budget that he would bring forward plans to increase the personal tax allowance from £11,850 to £12,500 and higher rate threshold to £50,000 to April next year. The Chancellor claimed that a "typical" basic rate taxpayer would benefit by £130 a year. Others have estimated that this change will improve the net income of basic rate taxpayers by, on average, £73 a year, and higher rate tax payers by £330 a year.[4]

The Budget's announcements on **fuel duty, alcohol duties** and **tuition fees** are reflected in the OBR's revised forecasts for the cost of living upon which the above analysis is based. Altogether, according to the OBR, they have the effect of reducing CPI inflation by just over 0.1 percentage points in 2019-20.[5]

[4] https://twitter.com/TorstenBell/status/1056521624781053953
[5] https://cdn.obr.uk/EFO_October-2018.pdf

Freelancers and the self-employed

The Chancellor has now committed to an extension of new **rules on personal service companies** to large and medium-sized private sector engagers from April 2020.[6] The revenue expected from this measure rises to £725m a year over the next five years – suggesting that for those affected the financial impact could be significant.[7]

Prospect has concerns that this could result in many genuine freelancers and self-employed workers – such as those in film, TV and theatre – being misclassified as PAYE employees and paying more in tax, preventing them from recovering their legitimate business expenses like travel and subsistence, and consumables.

In the public sector, which saw an identical change in April 2017, there was a degree of disruption, even though most of the organisations affected had ample legal and HR support, and both members working through PSCs, and long-established self-employed sole traders, were miscategorised as PAYE employees by HMRC's online employment status checker.

Although small production companies will be exempt from the change in 2020, it is likely that a shortage of back-office technical support in larger ones will lead to incorrect decisions being made about the employment status of freelance workers, with many finding that they have to pay full employment tax, while gaining no employee benefits.

Although the rate of Class 4 **National Insurance Contributions** remains at 9% of banded earnings, and there was no repeat of the aborted 2017 Spring Budget to increase the figure, some higher paid freelancers will find themselves paying significantly more. The Upper Profits Limit will be increased in April 2019 from £46,350 to £50,000, raising total NIC for anyone earning over this level by £230 per year. Class 2 NIC will continue to be paid "for the life of this parliament", meaning that self-employed workers continue to qualify for contributory benefits like the state pension by paying £3.00 a week from April 2019, even if they are below the Small Profits Threshold of £6,365 a year.

Alongside the Budget, the government published a response to the call for evidence on the design of the **VAT threshold**, announcing that the threshold will be maintained at the current level of £85,000 for a further 2 years until April 2022.[8]

The chancellor did not move forward with proposals to bring **relief on self-employed training costs** in line with employees. Companies giving any training to employees can treat the expenditure as a business expense, whereas freelancers paying for their own training can offset the cost against tax only if the course is intended to enhance or update existing skills. There is no relief for freelancers when they pay for training which will give them new skills, a disincentive for them to expand into a broader range of services they can offer clients.

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[6] https://www.gov.uk/government/consultations/off-payroll-working-in-the-private-sector

[7] It has been estimated that there were, in 2015, just over 300,000 Personal Service Companies operating in the UK – which, if growth rates remain constant, could be expected to approach 500,000 by 2023. If the financial impact of this measure were shared equally across this population, the average cost would be around £1,600 a year – though in reality the impact is likely to be concentrated on some subset of this group, for whom the cost will be even higher. (For PSC estimate see https://www.ipse.co.uk/uploads/assets/uploaded/66e7889e-d7f0-4a58-97a4ef2fbdc085f1.pdf).

[8] https://www.gov.uk/government/consultations/vat-registration-threshold-call-for-evidence

Pensions

Although there was advance speculation that the Chancellor would seek to raise additional revenue through changes to the taxation of pension savings,[9] no new changes were announced in the Budget.

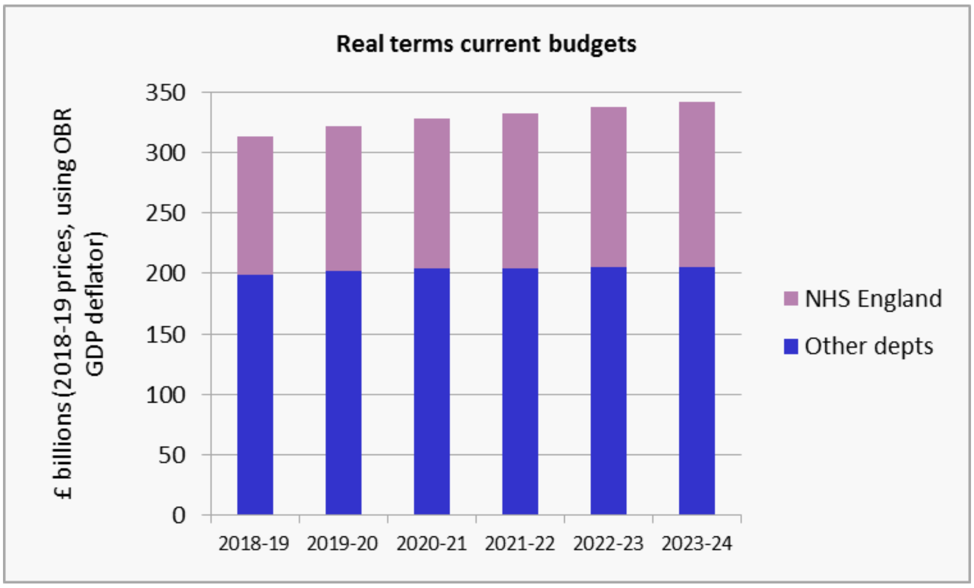
Public service funding, employment and pay

In September, the Prime Minister promised that under plans to be set out in next year's Spending Review, which is due to set Departmental budgets for 2020-21 and beyond,

> "support for public services will go up. Because, a decade after the financial crash, people need to know that the austerity it led to is over and that their hard work has paid off."[10]

Though it was promised in the Chancellor's Spring Statement,[11] a definitive envelope for next year's Spending Review was not included in this year's Budget. However the Budget did include provisional forecasts for spending into the early 2020s. The Chancellor echoed the Prime Minister's language, claiming in his budget speech that "the era of austerity is finally coming to an end".

The Budget did project significant real terms increases in non-capital spending on public services to 2023-24, largely funded by the OBR's improved forecast for tax revenues over the period. However practically all of this increase will be directed towards the NHS.



[9] See https://www.prospect.org.uk/blog/index/2018/October/12/Budget-2018-pension-tax-relief
[10] http://press.conservatives.com/post/178695544270/prime-minister-our-future-is-in-our-hands
[11] At the Spring Statement in March, the Chancellor said that "at this year's Budget I will set an overall path for public spending for 2020 and beyond. With a detailed Spending Review to take place in 2019. To allocate funding between Departments" https://www.gov.uk/government/speeches/spring-statement-2018-philip-hammonds-speech

Spending outside of "protected areas" is projected to remain largely flat in real terms (which is to say, around 20% below 2020 levels), and continuing to fall on a per capita basis. Independent commentators have highlighted this as a significant qualification to any expectation that austerity is at an end.

The Institute for Fiscal Studies warned that

> *"this is no bonanza. Many public services are going to feel squeezed for some time to come. Cuts are not about to be reversed".*[12]

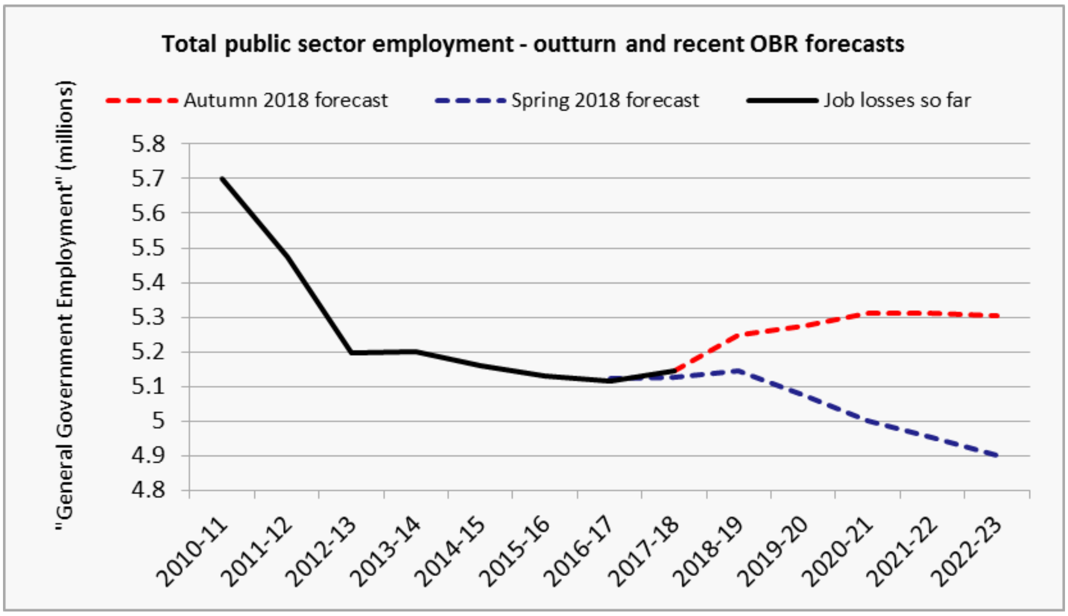
The Resolution Foundation pointed to departments such as transport, justice, DCMS, education and defence as likely to face further large budget cuts over the next five years.[13]

The Chancellor has implied that, should the resolution of Brexit negotiations result in an improvement to growth forecasts, he might be able to increase these spending plans in the Spending Review.

The increased forecast for total public service spending is reflected in forecasts for **public sector employment**.

In Spring 2018 the Office for Budget Responsibility expected another 250,000 jobs to be lost in the public sector over the next five years, on top of the 550,000 lost since 2010. It now expects an additional 160,000 jobs to be created in the public sector over the next five years.

The implication of the Chancellor's NHS funding promises are that these are likely to be overwhelmingly in health and social care, while other areas of the public sector may continue to suffer headcount reductions.



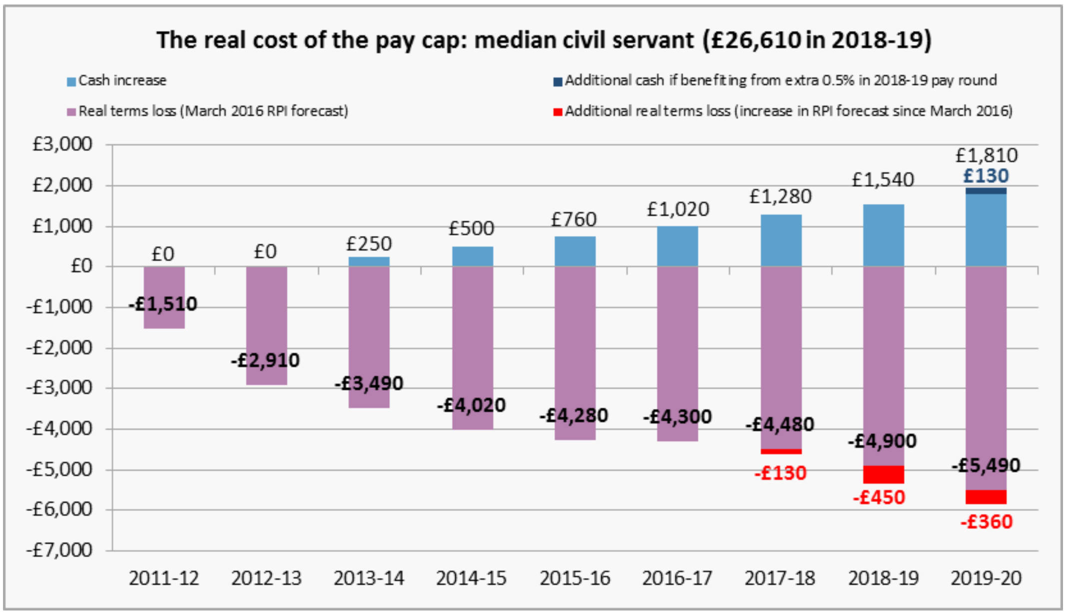
[12] https://www.ifs.org.uk/uploads/budgets/budget2018/pj_budget2018.pdf.
[13] https://www.resolutionfoundation.org/app/uploads/2018/10/How-to-spend-it-RF-Report.pdf

The Treasury's Budget document states that "since 2016" the Government has been able "to provide additional support to public services" including "the lifting of the **public sector pay cap**".

It does not acknowledge that average pay increases in the civil service remain limited to 1.5% and that only in the NHS has "additional support" been provided to public sector employers in the form of funding for pay increases over and above the 1% provided for in this year's budgets (set by the 2015 Spending Review).

Against new official inflation forecasts published with the Budget, the Government's **public sector pay policy** has cost the median civil servant (earning around £26,610 in 2018) a total of around £30,500 over the 7 years since 2010.

The extension of the "cap" from 1% to 1.5% (for those who benefit from it) makes a relatively small dent on this cost – less, in fact, than the additional cost of the higher than expected inflation of recent years.



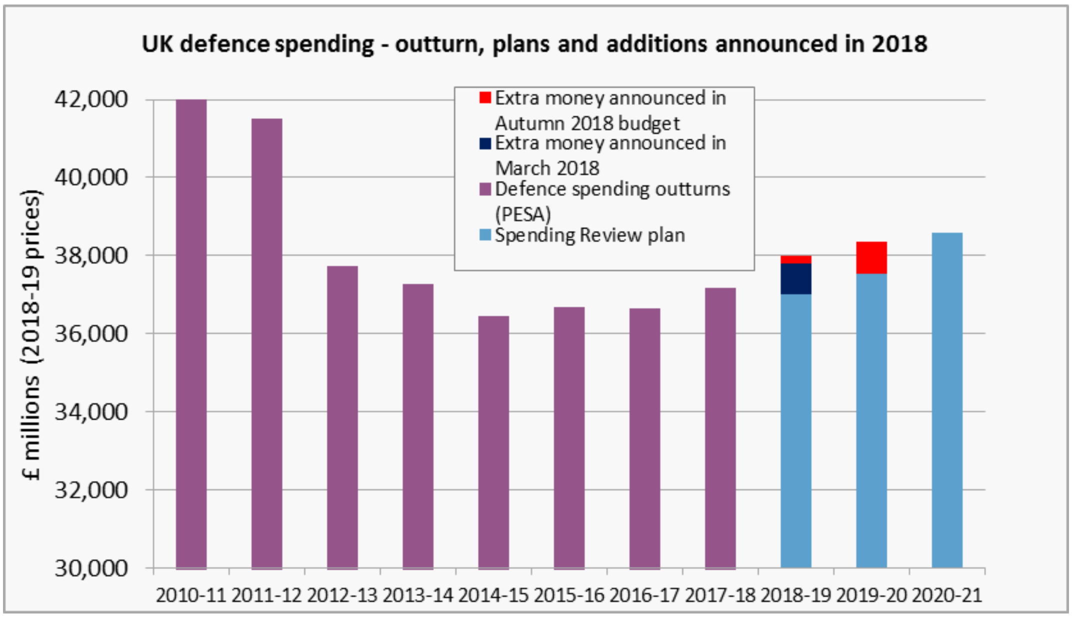
Announcements and developments relevant to key sectors

Defence

The chancellor allocated an **additional 1bn** for defence spending, on top of the MoD's Spending Review allocations, over two years (£200m this year, £800m next year).

The Budget document indicates that this will include "prioritising key capabilities such as offensive cyber, anti-submarine warfare and the nuclear deterrent". It comes on top of an additional £800m allocated to the current year's budget that was announced in March.[14]

In terms of overall funding, this is not a negligible addition to the MoD's budget but certainly does not reverse the real terms cuts seen since 2010.



Energy

The Budget confirmed advance reports that, in the event of a "no deal" scenario meaning the UK can no longer remain a member of the EU Emissions Trading System, "the government would introduce a Carbon Emissions Tax to help meet the UK's legally binding carbon reduction commitments under the Climate Change Act."

In response Energy UK said

> *"We welcome the clarity government has provided on carbon price support rates up to 2020-21. While it is not our preferred solution we are encouraged by the intention to maintain a carbon price signal in the case of a 'no deal' Brexit scenario. Energy UK believes that maintaining a robust carbon price signal is critical to boost the confidence of potential investors in low-carbon generating technologies."*[15]

Alongside the Budget, the government launched a consultation how regulatory regimes can "encourage greater innovation in the utilities sectors", including electricity, gas, water and telecommunications.[16]

IT and telecoms

[14] https://www.gov.uk/government/news/800-million-agreed-for-defence
[15] https://utilityweek.co.uk/budget-confirms-carbon-tax-post-brexit-no-deal/
[16] https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752041/encouraging_innovation_in_regulated_utilities.pdf

The Treasury's Budget document states that it announces "the next steps in the rollout of full fibre":

- £200 million of previously announced money is allocated to "pilot innovative approaches to deploying full fibre internet in rural locations, starting with primary schools, and with a voucher scheme for homes and businesses nearby. The first wave of this will include the Borderlands, Cornwall, and the Welsh Valleys"
- alongside the Budget, the government published consultations "to mandate gigabit-capable connections to new build homes and speed up the delivery of upgraded connections to tenants, making it quicker and easier for communications providers to roll out full fibre networks"
- the government announced that "Suffolk is the first local area to be awarded £5.9 million of funding from the third wave of the Local Full Fibre Networks challenge fund, enabling next-generation full fibre connections to key public buildings"

Alongside the Budget, the government launched a consultation how regulatory regimes can "encourage greater innovation in the utilities sectors", including electricity, gas, water and telecommunications.[17]

Science

The Budget announces further allocations from the previously announced "National Productivity Investment Fund" for "science and innovation", including:

- "Up to £121 million for Made Smarter to support the transformation of manufacturing through digitally-enabled technologies"
- "Up to £78 million for the Stephenson Challenge, supporting innovation in electric motor technology "
- "£235 million to support the development and commercialisation of quantum technologies, including up to £70 million from the Industrial Strategy Challenge Fund, and £35 million to support a new national quantum computing centre"
- "an additional £20 million in 2019-20 for the UK Atomic Energy Agency to accelerate its ground-breaking work on the development and commercialisation of fusion technologies"
- "£50 million invested in "new Turing AI Fellowships to bring the best global researchers in AI to the UK, and £100 million in an international fellowship scheme
- "£115 million to extend funding for the Digital Catapult, which has centres in the North East, South East and Northern Ireland, and the Medicines Discovery Catapult in Cheshire "
- £50 million per year fund" to "stimulate the use of cutting-edge science and innovation in government" in areas such as "public health and cyber security". The

17 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752041/encouraging_innovation_in_regulated_utilities.pdf

fund “will focus on joint programmes between government and industry, and will begin in 2021-22”.

- an additional £120 million “through the Strength in Places Fund” to “support clusters of science and innovation excellence across the UK”

The Campaign for Science and Engineering commented that the Budget

> *“hints at a welcome approach of deploying Government to stimulate and make best use of research and innovation itself, for example in a new £50m per year fund to 'stimulate use of cutting-edge science and innovation in government'. Such innovation will drive the 'better front-line services' in the NHS promised by the Chancellor, and can be extended across Government departments.”*[18]

Transport

The Budget announced the draft Roads Investment Strategy 2, under which the government expects to allocate £25.3bn of the National Roads Fund to **Highways England** between 2020-25.

However it has been suggested that Highways England’s plans could be disrupted by the Chancellor’s announcement of the end of the Private Finance Initiative (and its successor “PF2”). Earlier this year it was expected that expected both the £6.8bn Lower Thames Crossing and the £1.6bn A303 Stonehenge tunnel to be financed through PF2[19]

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[18] http://www.sciencecampaign.org.uk/news-media/press-releases/case-responds-to-2018-budget.html

[19] https://www.transport-network.co.uk/25bn-for-RIS2-but-PFI-ban-could-cost-Highways-England/15409; see also https://www.constructionnews.co.uk/analysis/cn-briefing/someone-tell-highways-england-pfi-just-got-canned/10036680.article