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What is in the new chancellor's in-tray?

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Summary

The new chancellor, Kwasi Kwarteng, faces a difficult autumn. He will need to steer the economy through a huge energy price spike and a likely recession, while also delivering on the promises the new prime minister made on the campaign trail. This paper outlines the main tasks in his in-tray.

The most immediate problem to tackle is the energy crisis but problems continue beyond that. A combination of higher consumer price inflation and higher interest rates will eat into the £30 billion of 'headroom' the then chancellor, Rishi Sunak, announced in the March budget. Inflation might lead to a boost to tax revenues in cash terms, even as the economic outlook is downgraded in real terms, but it is likely that headroom will be at least a little smaller than expected six months ago. Kwarteng will need to balance competing tax and spending demands within this more difficult economic and fiscal context. Liz Truss has promised expensive tax cuts and more defence spending but her chancellor will also be under pressure to help other public services facing high inflation and rising wages.

The Truss campaign team argued that her tax cuts would boost growth and that this would make the fiscal situation easier. But this is not a good way to do this. The new chancellor should instead look at ways of improving the tax system and ways of using other policy levers to try to improve economic growth over the next few years. Even then, Kwarteng will need to wrestle with the long-term fiscal reality that higher spending demands are leading the UK towards higher, not lower, taxes.

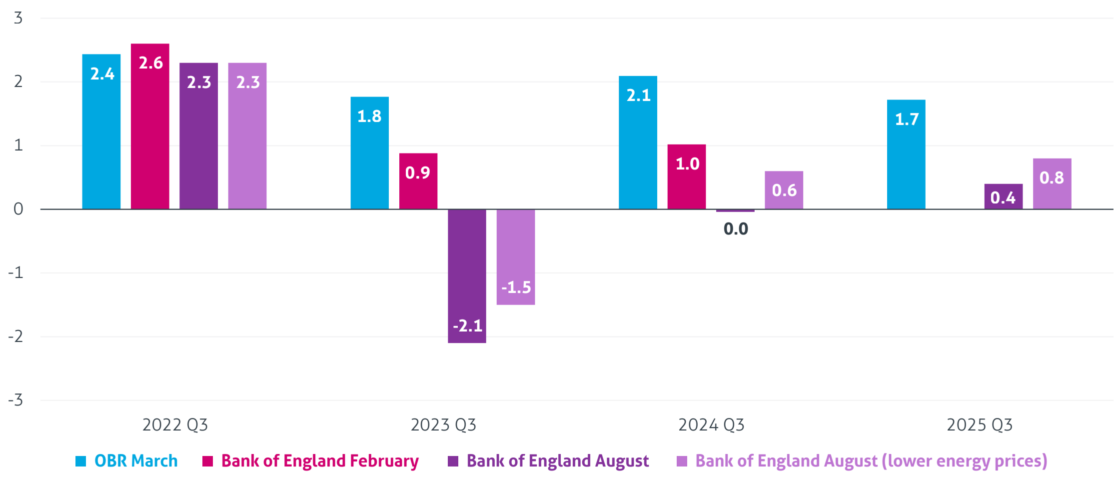
Introduction

Kwasi Kwarteng will have been given difficult news by Treasury officials when he entered No.11 Downing Street. Continued rises in energy prices have worsened the outlook for the economy and household finances since the Office for Budget Responsibility (OBR, the official economic and fiscal forecaster, on whose projections the Treasury bases its budgets) last published an analysis, alongside the budget in March.[1]

Then, the OBR predicted that the UK would continue growing at around 2% a year over the next three years. But more recent forecasts from the Bank of England – which also produces economic forecasts for the UK – suggest a far grimmer picture (Figure 1), even if energy prices fall from their current highs. The Bank now predicts that the UK will enter recession at the end of this year – similar in scale to that of the early 1990s – followed by a weak recovery in 2024 and 2025. Household finances will be hit more sharply than in previous recessions as inflation – driven by high global energy and food prices – is forecast to top 13% in October and the recession itself will lead to job losses. The Bank forecasts that household incomes could fall in real terms by 3.7% over this year and next.

This picture will create pressure for the government to do more to help households and businesses this winter, particularly with rising energy bills. It is also likely to feed into a worsening longer-term fiscal outlook.

Figure 1 **Forecasts for year-on-year GDP growth (%)**



Source: Institute for Government analysis of Office for Budget Responsibility, Economic and Fiscal Outlook, March 2022 and Bank of England, Monetary Policy Report, February 2022 and August 2022.

Note: The chart shows two alternative sets of forecasts produced by the Bank of England in August 2022. 'Bank of England August' shows the Bank's main forecast scenario, which assumes that energy prices follow the market futures curve for the next six months but then remains constant (at an elevated level) thereafter. 'Bank of England August (lower energy price)' assumes that energy prices follow the market futures curve throughout the forecast period.

Back in March, the then chancellor Rishi Sunak left himself around £30bn of headroom against his fiscal targets – namely that tax revenues should cover day-to-day spending by the third year of the forecast period (2025/26 for the next set of forecasts) and that debt should fall as a share of GDP between 2024/25 and 2025/26. In her leadership election campaign the new prime minister, Liz Truss, relied on this predicted headroom to claim that she could afford to promise permanent cuts to corporation tax and to remove the health and social care levy.[2]

But events since March are likely to have eaten into that headroom before any new policies are signed off let alone implemented. Higher interest rates will mean higher debt interest spending, while higher inflation will also increase spending on debt interest, benefits and pensions. Meanwhile, higher energy prices will lower real economic growth – and weaken the public finances – and this effect could be persistent if energy prices remain elevated. The major uncertainty surrounding the forecast is about how inflation will affect tax revenues. Higher inflation means higher tax revenues in cash terms, as, for example, higher nominal wages mean more of people's income gets dragged into higher tax brackets. But the scale of this boost is hard to estimate.

This paper starts by briefly setting out what the new government might need to do to help households and businesses with rising energy bills and the threat of recession in the short term. It then turns to the medium-term fiscal problems facing the new government: how the fiscal forecasts are likely to have changed since March, the likely pressure to top up departmental spending plans, and where this leaves its ability to deliver promises made in the leadership election campaign.

The cost of living crisis will be top priority this autumn

Recent independent forecasts suggest that average household energy bills will be 27% higher between October and December 2022 (and 66% higher between January and March 2023) than was expected when the then chancellor, Rishi Sunak, announced the most recent support package in May.[3] This suggests the average household will pay around £900 more for energy between October 2022 and March 2023 than expected when that package was announced.

The leadership candidates came under increasing pressure during the campaign to set out what more they would do to help households. Truss committed to scrapping 'green levies' on bills, saving households around £100 this winter. She initially rejected offering any further "handouts" to households, saying she preferred instead to cut taxes. But she shifted her position in the later stages of the campaign, first signalling that she might offer additional cash payments to vulnerable households and then indicating that she would cap energy costs for both households and businesses. She promised to announce measures targeting high energy bills "within one week" of her announcement as prime minister.

One of the most urgent tasks facing the new government is to firm up what additional support it plans to offer to households. Truss has said there will be an emergency fiscal statement on 21 September, which will presumably contain these measures. The potential for and degree of support for households facing steep rises in energy bills has been central to this debate. There are a variety of ways in which the new government could offer support to households. Help could be provided through cash payments to households or instead through direct government intervention in the price of energy. Help could be offered to all or only to those worst affected by the energy price rises. We described these options and the potential costs associated with them in our recent paper *Addressing Rising Energy Bills: What could the new prime minister do?*

Higher energy prices and lower demand could also risk heightened business failure, especially in sectors that use a lot of energy (such as transport) or are vulnerable to households cutting back on discretionary spending (such as hospitality and durable goods). While some businesses will be able to adapt to higher energy prices, others will not. If the government expects the spike in energy prices to be temporary rather than permanent, there might be a case for providing additional support to businesses with a viable longer-term future to stop them from going under this winter. The case for this would be particularly strong if businesses find it difficult to access other sources of credit to tide them over; at least in the short term, temporary government support could allow such firms to develop alternative strategies.

As the experience of various economic support packages launched during the pandemic showed – in particular, the guaranteed loans for businesses to help them stay afloat through difficult times – government can step in to support business in times of need. The question facing the new chancellor on day one will be whether and how it wants to do so now.

A weak economic outlook could wipe out some of March's 'headroom'...

Helping households with energy bills will, hopefully, be a temporary measure and so can be accommodated within the existing fiscal rules, which place constraints on levels of borrowing and debt only three years ahead. But any permanent tax cuts or spending increases will be constrained by those rules unless the new government announces a new, more permissive set of rules.

In its March forecast, the OBR projected that the UK's current budget deficit – the gap between the level of non-investment public spending and revenues raised by the government, predominantly through taxes – would be £42.7bn in the current financial year (2022/23). It then expected the current budget to improve to a surplus of £36.2bn by 2025/26. This is the "headroom" that as chancellor Sunak thought he had against his rule that the current budget must be in balance or surplus in the third year of the forecast.

But big changes to the economic outlook since March are likely to have altered the picture:

- State pensions, universal credit and other social security rates increase in line with inflation each year. Higher inflation means that public spending on these is now likely to be £15bn higher in 2025/26 than was forecast in March.[*]
- Government spending on debt interest also increases when inflation (specifically, the retail price index) is higher because a portion of the debt stock is index-linked. The interest rates on government debt are now expected to be higher too, following increases in the Bank of England base rate. Taking these together implies that spending on debt interest will be £20bn higher in 2025/26 than forecast in March,[**] and it is likely to be even higher still if the government finances additional short-term help for households through higher borrowing over the next couple of years.
- Somewhat offsetting this effect, some tax rates (specifically, excise duties on things like alcohol and tobacco, and business rates) increase more quickly when inflation is higher, and higher interest rates also lead to higher government receipts. These effects would increase receipts by around £17bn in 2025/26.[***]

Combined, these would increase borrowing in 2024/25 by almost £20bn.

However, while these are clearly substantial, the biggest economic influence on the fiscal numbers is the projected size of the economy. As Figure 1 showed, the Bank of England now expects the economy to grow much less in real terms over the next few years, and the OBR is likely to take a similar view given the impact of higher energy prices on the supply side of the economy. Indeed, as it set out in its recent report on fiscal risks and sustainability, persistently high energy prices could affect not only near-term economic growth but also the longer-term potential output of the UK.[4] This means the outlook for real economic growth – and thus the public finances – will be weaker.

Slightly acting against this will be the effect of high inflation on nominal tax revenues. What ultimately matters for the level of tax receipts is growth in the size of the economy in cash terms rather than real terms. There is considerable uncertainty over the likely path of nominal GDP, which the Bank of England does not forecast directly. The OBR's next forecast will almost certainly downgrade the prospects for real-terms growth – that is, adjusting for inflation. But inflation will also be higher, which means that the downgrade to nominal GDP growth will be smaller than the real-terms downgrade – if indeed there is a downgrade at all.

* We calculate this figure by taking the difference between forecast CPI inflation in the OBR's March 2022 forecast and the Bank of England's August 2022 forecast for Q3 2022 and Q3 2023 and apply the ready reckoner provided by the OBR in October 2021 to calculate the increase in social security spending in 2023/24 and 2024/25 respectively. We take Q3 because benefits are uprated each April in line with inflation the previous September.

** We calculate this figure by taking the difference between new projections for the base rate, gilt rates and RPI inflation and those in the OBR's March forecast and apply the ready reckoners for the impact of changes to inflation and interest rates on debt interest spending published alongside the March forecast. For base rate, we take market expectations at the end of August. For gilt rates, we take 20-year gilt rates at the end of August. For RPI we take the National Institute of Economic and Social Research August forecast.

*** We take changes in forecasts for interest rates, RPI and CPI explained in the previous two footnotes and apply ready reckoners for the impact on tax and spending published alongside the OBR's October 2021 forecast.

If the OBR projects that the economy is likely to be bigger in cash terms than forecast in March, despite being smaller in real terms, this could reverse some or all of the negative impact on the size of fiscal headroom from the direct effects of higher interest rates and inflation outlined above.

Given how much the outlook has changed since March, it would be irresponsible for a chancellor to make big decisions over tax and spending decisions without an updated forecast from the OBR. Truss has said she will hold a fiscal event on 21 September without an OBR forecast. Short-term measures to deal with the cost of living can be announced without an updated projection as they are not so dependent on the medium-term outlook, but permanent tax cuts or spending increases should be made with an understanding of how the fiscal numbers have moved.

...and departments may ask for more funds to compensate for higher inflation and public sector pay growth

Any new figure on fiscal headroom is likely to understate the scale of the fiscal challenge that the new government faces because it will be predicated on the assumption that the government can sustain the departmental spending plans that were fixed in cash terms last October. But inflation has turned out to be higher than was anticipated and public services have ended up offering larger pay rises this year than were anticipated when the spending settlements were announced.

Public sector pay

By far the biggest pressure facing public services is on pay. The cost of employing public sector workers was around £235bn in 2021/22,[5] accounting for almost half of departments' day-to-day spending – and in some services, such as hospitals and schools, staffing costs total more than 60%.[6]

This is a difficult environment in which to decide public sector pay. Public sector workers, alongside those in the private sector, are seeing big falls in their real household incomes. At the same time, the government is concerned that inflation currently caused by higher energy prices will become more persistent if it leads to a wage-price spiral where higher inflation expectations feed into higher wage demands, which in turn push inflation higher.

Both declining real incomes and the risk of runaway inflation are genuine concerns. But public sector pay is not the best tool to deal with either. Cost of living support can be targeted much more effectively through the social security system, while the Bank of England's Monetary Policy Committee has capacity to reduce inflation through setting interest rates. Instead, public sector pay should be set to ensure that public services can recruit and retain the size and quality of workforce that it needs to deliver services to the intended standard.

Public sector pay is set each year by the government after recommendations are made by public sector pay review bodies. The latest set of review body reports were published in July, along with the Johnson government's announcements of pay awards for the year April 2022 to March 2023. For the most part, the government accepted the review bodies' recommendations. Two choices were apparent across the pay decisions the government made. First, the government prioritised pay increases for the lower-paid, with high-paid public servants receiving more modest settlements. Second, pay increases were more generous than was expected at the time of the October 2021 spending review. In most services pay is increasing by around 5% on average, less than inflation and somewhat less than private sector wages but much more than the 2–3% assumed in October.[7]

Given the need to recruit and retain high-quality staff, it was necessary to increase pay by more than originally planned for this financial year. During the coronavirus pandemic, the lack of private sector vacancies created an environment in which the public sector could recruit and retain staff more easily than it had been able to in earlier years. However, the economic recovery since mid-2021 has been characterised by a very tight labour market with vacancies outstripping numbers looking for jobs and recruiting difficulties have returned. In the NHS there is estimated to be a shortage of 12,000 doctors and 50,000 nurses,[8] while the number of teacher recruits is not enough to meet demand.[9] At the same time, the government is struggling to hire enough judges to hear the cases needed to reduce the backlog in the courts.[10]

Average weekly pay in the private sector is expected to increase by a little over 5% in 2022,[11] implying that the pay awards announced for the public sector will be just enough to maintain the relative attractiveness of public sector work. However, it is notable that recruitment and retention is a problem for higher-paid roles, such as judges and doctors, as well as more junior roles, suggesting that the approach of lower pay awards at the top is risky, particularly as pay for this group in the private sector is rising faster.

While the awards match, at least nearly, private sector pay increases, they still entail large cuts in real terms and several unions have balloted members over whether to strike. Should that happen Kwarteng will need to decide whether to reopen settlements this year. It is possible that strikes will also be indicative of broader retention difficulties but in any case are likely to cause considerable disruption to public services already struggling to recover from the pandemic.

The main reason the government has avoided bigger pay increases is cost. Compared with initial plans at the spending review, awards of 5% add around £6bn to the public sector pay bill. This would, for example, be twice the annual saving from reducing the civil service headcount by 91,000 (20%), which the new prime minister has pledged to do.

Unless the government provides additional funding to account for the higher pay awards to which it is already committed, departments and public services will need to spend less than planned elsewhere – or cut staff numbers – to keep within their existing budgets. If departments wanted to offer more generous awards in future years, these other cuts would need to be even larger.

The government is likely to face the same dilemma again next year and absorbing another large nominal pay increase will be more difficult then. Day-to-day departmental spending, excluding emergency Covid support, is much higher in real terms in 2022/23 than 2021/22. However, increases over the rest of the spending review period – which runs to 2024/25 – are much lower. The Bank of England's latest forecast implies that earnings in the private sector will still be increasing by around 5% next year, implying that more big pay increases will be needed to keep up. If the government decides to revisit spending settlements over the remainder of the spending review period this autumn, the likely path of public sector pay should be a central consideration.

Other cost pressures

Public services also face other costs beyond pay, many of which are also increasing. First, there is the price of energy, which accounts for a much smaller share of public service budgets than household budgets but is still not inconsiderable. What publicly available data there is suggests that in 2020/21, four service areas – education, defence, prisons and probation, and police – spent a combined £1.6bn on electricity, gas, oil and fuel.[*,12] This amounts to only 0.6% of annual expenditure for these services but a big increase in price can still make a substantial difference. Energy prices are now expected to be almost four times as high next year as they were in 2020/21. If other public services spend the same share of their budgets on energy, then together they would require an additional £8bn to be allocated to energy.

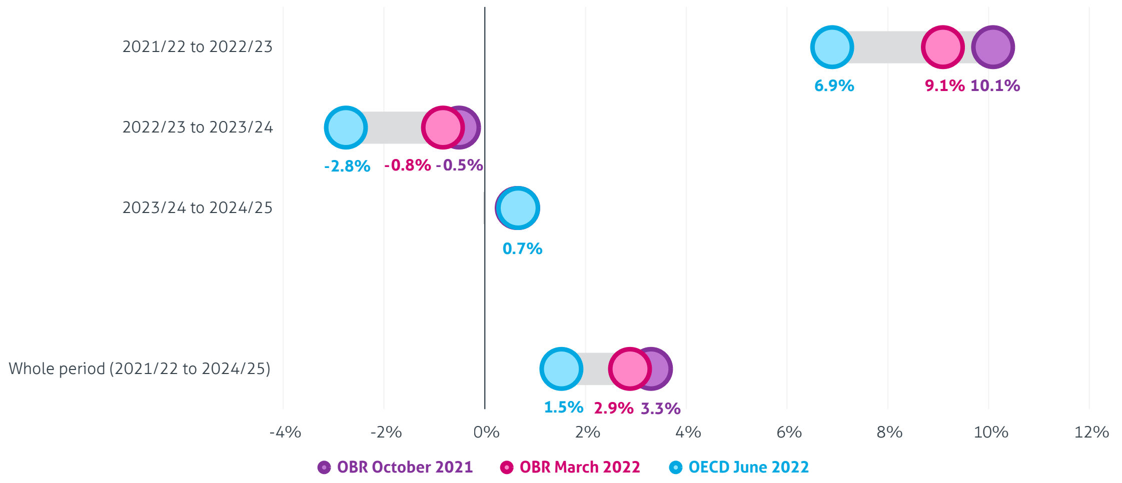
Second, other goods and services are also increasing in price, many more quickly than the Bank of England's 2% target.[13] As energy and food, the goods with the biggest price increases, make up a smaller share of public service budgets than for households, public services will be affected less. But they will still require much more funding than expected in October 2021, when the spending review set departmental spending totals in cash terms for the next three years, to deliver a given service quality.

At the time, those settlements were much more generous than spending plans had been over the preceding 10 years and were similar in generosity to the spending reviews of the mid-2000s. Adjusting for forecast economy-wide inflation at that time (which should account for higher wage and energy costs as well as other price increases) the plans implied increases in day-to-day spending of 3.3% per year, with those increases front-loaded in 2022/23. Less optimistic March forecasts led to those being downgraded to increases of 2.9% per year – and economy-wide price inflation is likely to be even higher now. Taking the OECD's forecast for economy-wide inflation from June 2022 suggests the spending review would now imply real terms increases of only around 1.5% per year.[**]

* Specifically, this covers spending on the NHS and schools in England, prisons and probation in England and Wales, and defence spending across the whole UK.

** The Bank of England does not provide a forecast for economy-wide inflation, also known as the GDP deflator, and so we use the most recent OECD forecast as it is also a credible independent forecaster.

Figure 2 **Average annual increase in real day-to-day spending over the spending review period under different inflation forecasts**



Source: Institute for Government analysis of HM Treasury, Spending Review 2021, October 2021, HM Treasury, Spring Statement 2022, March 2022, Office for Budget Responsibility, Economic and Fiscal Outlooks, October 2021 and March 2022 and Organisation for Economic Co-operation and Development, World Economic Outlook, June 2022.

Retaining the generosity of spending plans set out in October 2021 would be expensive. Based on the OECD projections, the chancellor would need to increase spending by £24bn in 2024/25 just to maintain the generosity of its October plans. Should the fiscal forecasts move, this could well use up all the headroom against the fiscal targets, and more.

The government could choose not to increase spending plans to cope with higher cost pressures. This is a legitimate choice – and one that Sunak in essence made in March when inflation forecasts first were revised upwards – but it would effectively be a decision to cut back on public services compared with the original spending review plans. Most will not be able to hire as many people or purchase as many other goods and services, and performance would almost certainly suffer as a result.

More money would also be required for promises on extra defence spending

A further pressure on the spending side is Truss's commitment to increase defence spending in response to the war in Ukraine. She has said she would increase defence spending to 3% of GDP by 2030 from 2% of GDP now. The OBR calculates that this would be sufficient to retain the UK's position as the second largest spender in Nato in absolute terms (behind only the US).[14]

This pledge would cost £24bn in today's terms. And while the government would not need to increase the defence budget by that amount immediately, to do so steadily over the next eight years to get to the 2030 target, it would need to spend an additional £7bn in 2024/25, the final year of the current spending review, and £11bn in 2025/26.

If total departmental spending did not increase to match the MoD's larger budget, this would imply even less generous increases for other departments. This policy would also represent a reversal of the trend over the past 30 years where higher spending on health and other public services has been affordable in part because spending on defence has fallen substantially as a share of national income from its Cold War level.[15]

Truss's tax cuts will be costly…

Truss promised to reverse two tax rises. One, the health and social care levy (a 1.25 percentage point increase to National Insurance contributions) came into effect this April. The other, an increase in the headline rate of corporation tax from 19% to 25%, was due to come into effect in April 2023.

These planned tax rises were expected to raise substantial revenue and ensured that public spending on health and other public services could be increased in the October 2021 spending review while leaving some headroom against the fiscal rules. Reversing the health and social care levy would cost around £12bn per year, while scrapping the corporation tax rise would cost around £17bn per year from 2025.

…may breach the fiscal rules…

Both are likely to wipe out any headroom that is likely to exist against the current fiscal rules when the OBR produces its new forecasts. Therefore, if the chancellor wants to stick to the current fiscal rules and implement these tax cuts, he is likely to need to find other tax rises or spending cuts.

…and could fuel inflation in the short term

The main argument that Sunak made against Truss's tax proposals during the leadership campaign was the possibility that they would fuel inflation further. Any broad-based cut in taxes would boost demand, increasing consumer spending and/or business investment. Inflation is already at 9% and is expected to peak at over 13% later this year. The Bank of England's mandate is to reduce inflation back to its 2% target. The tools it has at its disposal to do this – mainly increasing interest rates – act by dampening demand in the economy. The Bank of England believes demand is already too high given the supply capacity of the economy. While tax cuts might boost supply capacity in the longer term, it takes time for this to happen and so in the short term they will simply boost demand. The Bank of England is therefore likely to respond to any tax cuts by increasing interest rates and so offsetting the increase in demand.

How far tax cuts do fuel inflation would depend on the extent to which the additional money flowing to households was spent, or money flowing to companies invested. Given that Truss's explicit justification for the National Insurance cut was to help people with the cost of living – and the justification of the corporation tax cut is to boost investment – these policies would be inflationary if they had the effect that Truss says she desires.

The fiscal rules could be changed to make space for tax cuts...

The chancellor could change the fiscal rules to allow more borrowing to help pay for the tax cuts. Since 1997, chancellors in the UK have imposed fiscal rules on themselves to ensure that medium-term fiscal policy is consistent with sustainable long-term public finances. This has been done to help stop politicians with potentially short political lives being tempted to borrow too much now and store up problems for future generations. The UK has adopted various different fiscal rules over that time period, with some allowing more borrowing than others, and there is no single right answer to what the UK's fiscal rules should be.

The chancellor could adapt the rules to allow day-to-day spending to exceed current revenues by a fixed amount – say 1% of GDP – rather than requiring at least balance as the current rules do. Alternatively, he could require that balance be reached only in the fifth, rather than third, year of the forecast period: the fiscal rule adopted by George Osborne as chancellor in 2014 and proposed by the Labour Party before the 2019 general election.[16]

One suggestion Truss made on the campaign trail was that she could provide more fiscal latitude by treating debt accrued during the pandemic like 'war debt', separate from other debt and to be paid off over a long time period. It is not clear that there is a coherent distinction to be made between debt issued in 2020 and 2021 and debt issued earlier or later. But in any case this would not provide any additional headroom against the current fiscal rules – nor would it have done against earlier iterations of rules adopted in the UK. The current set of rules, as is typical, place a limit on the difference between (day-to-day or total) spending and receipts, or changes in the debt stock as a share of GDP over time. In short, reclassifying a portion of the debt stock would make very little difference to either.

...but the chancellor should keep some margin in reserve

Given how uncertain the economic outlook is, a chancellor intent on meeting their fiscal rules – whatever they may be – should keep headroom in reserve in case forecasts deteriorate further. This was the rationale Sunak gave for keeping a buffer of £30bn in March. Even then, the OBR judged that, based on historic revisions to fiscal projections, there was only around a 60% chance that the targets would be met in 2024/25 (which was the relevant year for the rule to be met in the March forecast).

Having some kind of buffer avoids the need to make major adjustments to fiscal policy at short notice when forecasts disappoint, which can create uncertainty and so harm the economy. But if Kwarteng does want to retain some margin of error, that further reduces the scope for unfunded tax cuts.

Longer-term spending pressures will also make it hard to cut taxes permanently

Choosing to borrow more in the medium term is a legitimate political choice, albeit not a costless one given that the interest on higher debt will need to be paid (likely at higher rates than in recent years) in future budgets. However, permanently higher borrowing is not a long-term solution, and tweaking the fiscal rules does not avoid the fiscal reality that spending cannot consistently exceed taxes by an ever-growing amount.

OBR analysis shows that maintaining lower taxes will become even more difficult over the next few decades. In its *Fiscal Risks and Sustainability* report, published in July 2022, it outlined how pressures on public services will grow more quickly than the tax base over the coming decades, principally because an ageing population will demand more health and social care and pay less tax.[17] Other pressures, such as the inevitable demise of fuel duty as a revenue source as the economy transitions to electric vehicles, make the outlook even worse.

The analysis shows that, in the long term, spending will need to increase as a share of GDP if the government is to continue to provide the same quality and scope of public services. This suggests that taxes will need to go up, rather than down.

The UK could continue with lower tax revenues, but it follows that this would need to be accompanied by cuts to the scope or quality of public services. This would again be a legitimate choice for politicians to make, but Truss will need to lay out how she would cut back on public services to make the UK a lower tax country in future.

Low taxes will not necessarily boost growth…

The counter-argument to the OBR's analysis, put forward by the Truss campaign, is that lower taxes will lead to higher growth, which will in turn lead to higher tax revenues and so ease the fiscal pressures outlined in that analysis.

That holds in one respect: the fiscal arithmetic appears so difficult in part because productivity growth in the UK has been poor for the past 15 years and is expected to remain lacklustre. It would be easier to maintain the current scope and quality of public services with fewer tax rises if growth were to return to something like the 2% per year the UK was accustomed to for much of the preceding 50 years.*

But it is naïve to expect the tax cuts that have been announced so far to lead to substantially higher growth. Lower corporation tax rates will not automatically lead to higher growth – indeed the evidence,[18] including from the last decade in the UK, suggests there is a weak link between corporation tax rates and investment and growth. Higher profits will not necessarily lead to higher investment but could instead lead to higher shareholder payouts, including to those outside the UK. Even models that embed optimistic assumptions about the relationship between corporation tax rates and growth find that a rate cut will not pay for itself.[19] There is also little reason to expect cuts to National Insurance to make a big difference to growth, as it will have only a small impact on people's incentive to work or to work more.

…well-designed policies matter more

There are no silver bullets but there is evidence that some other policies are likely to be more effective at boosting growth than simply slashing headline tax rates. Previous Institute for Government research has highlighted many inefficiencies in the UK tax system, which distort decisions and so hold the economy back.[20] For example, the additional tax imposed on employees compared to the self-employed leads to many

* Of course, some of the increase in GDP would not necessarily lead to better public services if the public sector needed to pay more to attract workers away from a more productive private sector that paid higher wages. But there would still be a net benefit to the public finances from stronger growth.

inefficient contractor arrangements when an employment relationship might be better. Similarly, the capital gains tax system under-taxes some forms of capital income, distorting decisions about how owners of companies should take their remuneration. Several reforms, agreed upon by many tax experts, could improve the structure of the tax system to ensure that it is not arbitrarily changing people's decisions and so help the economy operate more efficiently as a result.

Tax reform, as opposed to tax cuts, is politically more difficult because there will inevitably be some losers. But reforms could be much more effective at boosting growth than changes to headline rates, which retain the distortions of the existing system. Well-designed tax reforms would also be fiscally – though again, probably not politically – less costly for a given impetus to growth.

Our previous research has also recommended how the process to develop tax ideas should be designed to ensure that the measure fits the politician's objectives. Good tax policy is made when a government consults at an early stage, before it has decided on the final measure, setting out clearly what it wants to achieve. We have also argued that tax policy needs to be considered together with spending policy. And we recommend the use of reviews of the tax system to identify the right policies and build the case for change. In one area, Truss has adopted this approach, proposing a review into how the tax system could be reformed to ensure it does not unduly penalise those with caring responsibilities. This is welcome. But in other areas she has announced headline-grabbing tax cuts without a detailed analysis of whether they are the best tool for the job or how they will be paid for.

Government also has other levers beyond the tax system if it wants to boost business investment. As a recent Institute for Government paper has highlighted, weak business investment has been a major problem for growth in the UK. While there are no easy answers, that paper points to the importance of a stable economic environment (something the UK has not had for the last 15 years) and stable funding through long-term contracts immune from political interference. It also emphasises the need to focus on micro issues that might be holding back investment in specific sectors rather than taking a high-level approach. There have been several policy successes in recent years, such as catapult centres that have supported innovation in key technologies and longer-term planning in UK Research and Innovation. Developing a coherent industrial strategy to promote business investment in particular sectors is likely to be more effective, and more affordable, than Truss's plan to lower headline tax rates.

Conclusion

The most urgent task facing Kwasi Kwarteng as the UK's new chancellor is how to respond to the further rise in energy bills from October. While Liz Truss did make a promise to offer help with high energy bills late in the campaign, saying she would announce measures "within one week" of her announcement as prime minister, she did not spell out how far her government intends to go – and for whom. She has said she will suspend green levies on bills and hinted she might go further. There are various options available, which could cost several billion pounds in the short term. The new chancellor will need to make a quick decision to provide reassurance to households already facing sharp increases in energy bills.

Beyond that, Kwarteng also faces difficult choices about the balance between tax, spending and fiscal sustainability in the longer term. Truss committed to tax cuts worth £29bn a year during the leadership campaign, predicated on the £30bn of headroom that the OBR estimated the government had against its fiscal rules back in March. Truss also committed to spend more on defence.

With the economic outlook having deteriorated since March, it is possible that some or all of that headroom will have disappeared. If the new chancellor wants to commit to permanent tax cuts or spending increases, he should ask the OBR for an updated economic and fiscal forecast so he has the best possible information about the situation he faces.

Delivering the promised tax cuts and starting to make steady progress towards the defence spending pledge could cost an extra £11bn a year by 2025/26. Meeting those promises would leave the new chancellor facing a difficult choice between finding spending cuts (or tax rises) elsewhere or shifting the goalposts on the fiscal rules. These choices will be made more difficult by the fact that public services are already being squeezed by higher-than-expected inflation, making cuts elsewhere harder to find without impacting service quality. Restoring the real-terms budget increases planned in October 2021 would cost £24bn in 2024/25, the last year of the 2021 spending review.

On the campaign trail, Truss brushed aside these concerns by suggesting that her tax cuts would unleash stronger economic growth, making the arithmetic far simpler – and that she would rush them through in an emergency fiscal statement this month. It would be convenient if this were true, but the available evidence suggests that cuts to headline tax rates of the sort she proposes will not have this effect. In the face of the very real economic difficulties the UK faces, the country would be better served if the new prime minister and chancellor took time to consider the evidence on the likely impact of the policies they are considering – and whether there might be other options that would better achieve their objectives.

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