House of Commons Library

Research Briefing

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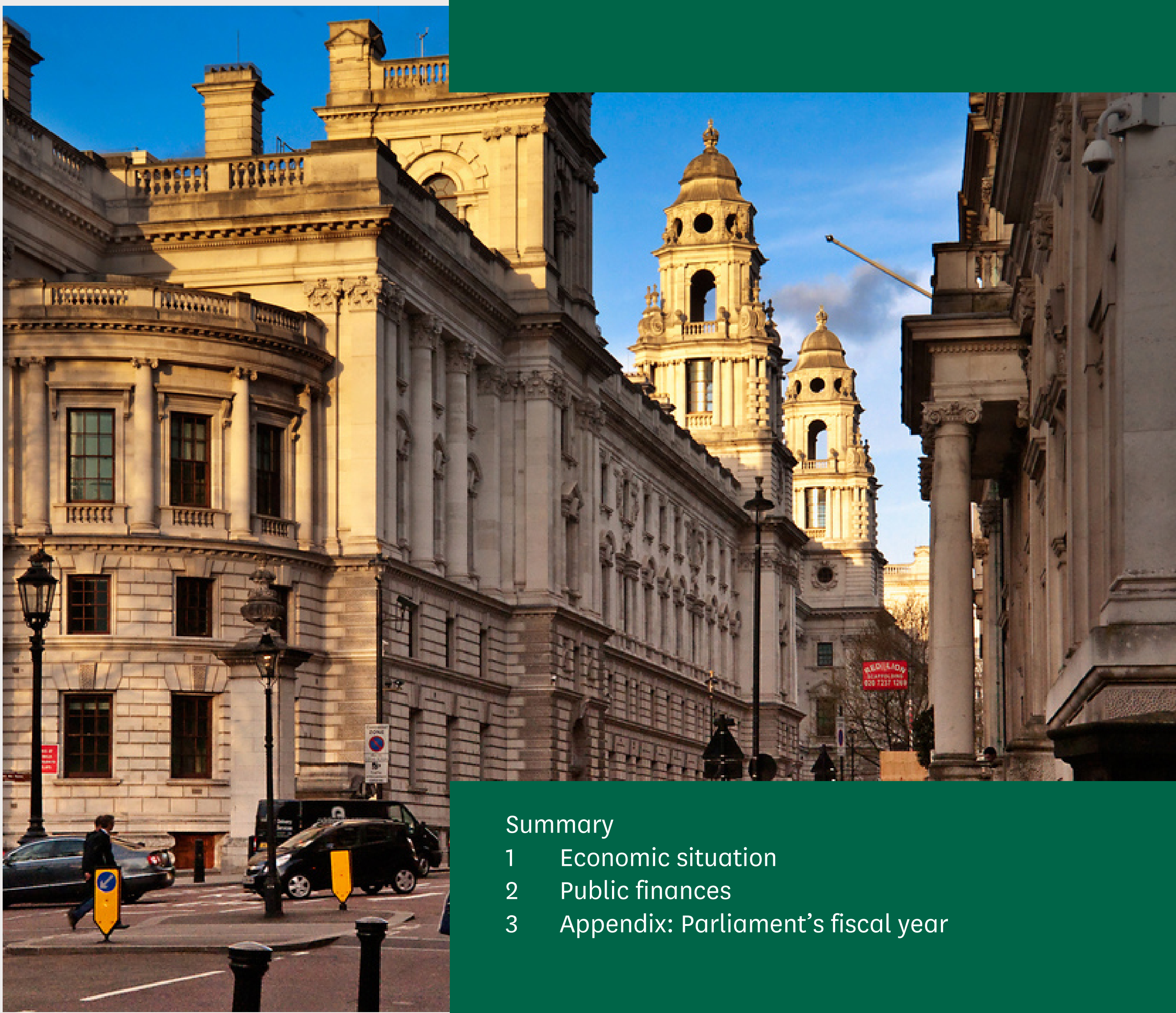
Background to the September 2022 fiscal statement



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Contents

Summary

This briefing sets out the background to the Chancellor's fiscal statement, which will be presented to Parliament on 23 September 2022. High inflation, the threat of a recession and falling real household incomes are among the issues the new Chancellor, Kwasi Kwarteng, faces.

To support households, businesses and other organisations with rising energy costs, the new Government has already announced an Energy Price Guarantee. It means a household with typical consumption will pay around £2,500 on energy annually, for the next two years.

The Office for Budget Responsibility will not be publishing revised forecasts for the economy and public finances.

Economic situation

Economic growth has been weak over the course of 2022, with the outlook for 2023 deteriorating as inflation has been rising. Consumers' ability to spend, a key driver of economic growth, has been hit by the higher cost of living.

The pace of consumer price rises – the inflation rate – has been relentlessly moving upward over the past 18 months. A combination of strong global demand for consumer goods, rising energy and petrol prices, and Russia's invasion of Ukraine have led to the inflation rate hitting a 40-year high of 10.1% in July, before easing slightly to 9.9% in August.

The Government's announcement of a cap on household energy prices means further expected rises in the inflation rate will now not be as severe. This will likely mean the economic downturn, or possibly recession, that many economists expect heading into 2023 will be less pronounced.

The Bank of England is expected to continue to raise interest rates to try and depress inflation, which is well above the Bank's 2% target. Many economists think the Government's energy price support package will result in inflation being higher in a few years' time than it would be otherwise, potentially leading to the Bank raising interest rates further.

How are public finances performing?

The Government's budget deficit – the difference between its spending and income from taxes and other sources – has fallen from the peacetime records reached during the worst of the coronavirus pandemic. However, it remains relatively high by historical peacetime standards.

The OBR forecast in March 2022 that the budget deficit in 2022/23 would be equivalent to 3.9% of GDP. However, developments since March 2022 mean the deficit will likely be larger than that.

The recently announced energy price guarantee might add around £60 billion to borrowing this year, while other support for households, announced in May 2022, could add around £10 billion. Both were announced after the OBR had forecast a budget deficit of around £100 billion for 2022/23.

Government's spending on debt interest is growing, largely due to rising inflation, but other factors are also pushing up debt interest costs. Compared with autumn 2021, the UK's main interest rate is higher, and investors want higher rates of interest when they lend to the Government.

Inflation might benefit tax receipts, as it usually pushes up the value of the things tax is levied on, such as consumer spending. The scale of this indirect boost to revenues is very uncertain but is unlikely to be sufficient to cover the increase in debt spending in 2022/23.

What might the fiscal statement cover?

It's thought that the Chancellor, Kwasi Kwarteng, will use the statement to fulfil some of the pledges that the Prime Minister made during the Conservative Party leadership election.

It's widely expected that the Chancellor will reverse the recent 1.25%-point increase in National Insurance contributions and cancel the upcoming increase in the main rate of corporation tax.

The corporation tax main rate is currently set to increase from 19% to 25% in April 2023. Reversing both tax increases could lower forecast government receipts by around £30 billion a year. The Prime Minister says that she has "a bold plan to grow the economy through tax cuts and reform". The Chancellor will publish a growth plan alongside the fiscal statement.

When the Energy Price Guarantee was announced no estimate of its cost was provided. The Chancellor might set out an estimated cost in the statement.

The fiscal statement will not be accompanied by revised forecasts for the economy and public finances from the OBR. This means the OBR will not judge whether the Government is still on course to meet its targets for the public finances, following the Chancellor's statement and recent changes in the economy.

The latest economic data are also available on the Library's UK economy dashboard.

The Library website has a page which brings together our publications on the Ukraine crisis and another for the cost of living and inflation.

1 Economic situation

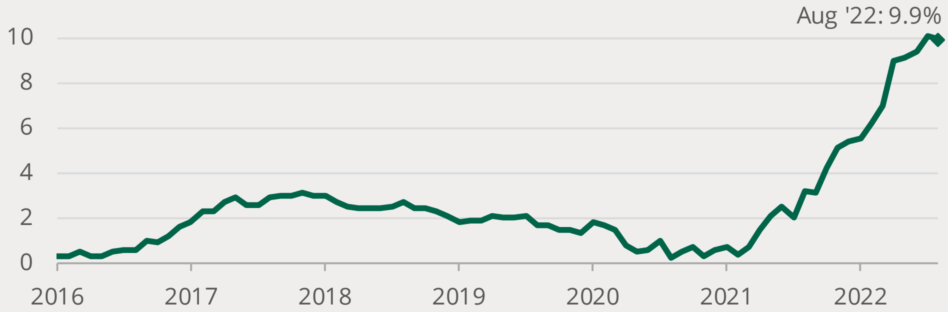
1.1 Inflation

Inflation has been rising since early 2021, due to soaring energy and fuel prices, strong global consumer demand for goods, and higher costs for businesses.

Consumer prices, as measured by the Consumer Prices Index (CPI), were 9.9% higher in August 2022 than a year before. This is slightly lower than July 2022, when prices were 10.1% higher than the year before – the Office for National Statistics (ONS) estimates that this was the highest rate since 1982.[1]

Inflation rose during 2021 and 2022

%, annual change in consumer prices (CPI)



Source: ONS, CPI annual inflation rate, series D7G7 [14 September 2022 update]

Inflation forecasts had been revised up during 2022...

Inflation was already at a 30-year high at the beginning of 2022. Since the Russian invasion of Ukraine began in February 2022, price rises in many commodity markets – such as food, metals and particularly energy – led economic forecasters to raise their expectations for consumer price inflation even further:

[1] ONS, Consumer price inflation, UK: August 2022, 14 September 2022; this is based on modelled data back to 1950 from the ONS as the CPI was only introduced in 1997

- In early February 2022, prior to the invasion, the Bank of England's Monetary Policy Committee forecast the CPI inflation rate to peak at 7.25% in April 2022 and ease somewhat during 2022.[2]
- In its latest forecasts, published on 23 March 2022, the Office for Budget Responsibility (OBR) forecast CPI inflation to peak at 8.7% in Q4 2022 and be above 7% in each quarter from Q2 2022 to Q1 2023.[3]
- In August, the Bank of England forecast inflation to peak at 13.3% in October 2022 due mainly to expectations of higher household energy bills.[4]

...until the Government's Energy Price Guarantee...

On 8 September 2022, the Prime Minister announced an energy support package, including the Energy Price Guarantee (EPG),[5] which caps energy bills. This will come into effect from October.

Ofgem's household energy price cap was due to be higher than the level set under the EPG. This means that the EPG results in a lower inflation rate over the short term, as household energy prices are included in the overall inflation figure.[6]

The announcement of the EPG has led economists to revise their expectations of how high the inflation rate will reach. For example, the Resolution Foundation think tank estimates that CPI inflation will peak at a little above 10% rather than the 14% expected before the EPG was announced (see chart below).[7] As of mid-September, other forecasters similarly expect a peak of around 10-11%.[8]

The Office for Budget Responsibility (OBR) has not been asked by the Government to update its forecasts for the Chancellor's fiscal statement, so its most recent forecasts will still be from March 2022.

Meanwhile, the Bank of England's next assessment of the inflation outlook will be published on Thursday 22 September at the conclusion of the Monetary Policy Committee's meeting to determine interest rates (see section 1.2).[9]

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2 Bank of England, Bank Rate increased to 0.5% - February 2022, 3 February 2022, Bank of England, Quarterly CPI inflation projections based on market expectations of interest rates, Monetary Policy Report, 3 February 2022
3 OBR, Economic and fiscal outlook – March 2022, 23 March 2022
4 Bank of England, Monetary Policy Report-August 2022, Chart 2.16
5 BEIS. Energy bills support factsheet: 8 September 2022, 9 September 2022
6 Library briefing, Domestic energy prices (5 September 2022)
7 Resolution Foundation, A blank cheque. An analysis of the new cap on energy prices, 13 September 2022
8 For example, Oxford Economics, Goldman Sachs, PwC and Capital Economics
9 This will be available at Bank of England, MPC Monetary Policy Summary for September meeting

FIGURE 12: **The peak inflation forecast has fallen by around four percentage points**

Annual CPI forecast, with and without the energy price guarantee: UK

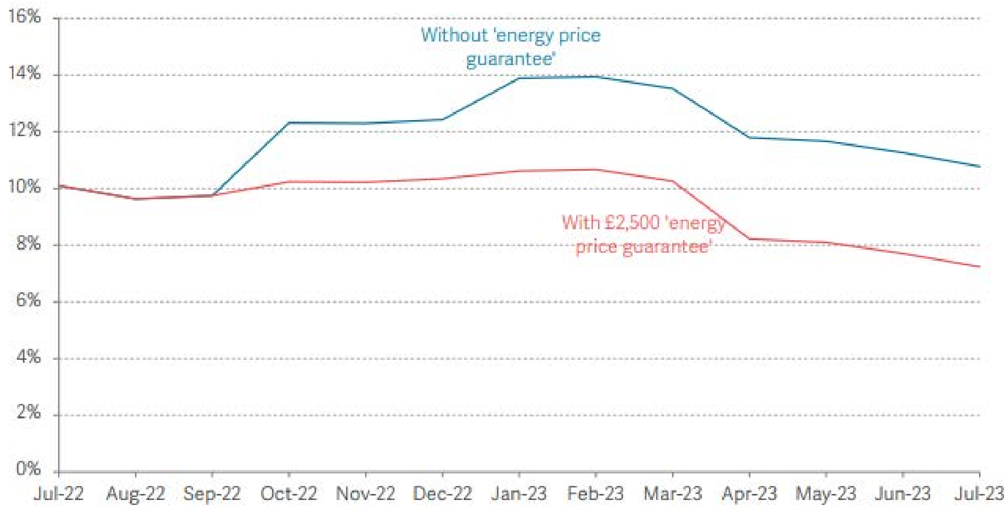


Chart taken from Resolution Foundation report, A blank cheque (PDF), 13 Sep 2022

...though this may boost inflation in future years

Economists generally think that economic growth in the short-term will be stronger – or, put another way, a downturn less severe – than it otherwise would have been with higher energy prices.[10]

Many economists think this may result in inflation being higher in a few years' time than was expected without the EPG.[11] With the EPG protecting households from the full increase in energy prices, people will have more money available to spend, potentially adding to inflationary pressures. In addition, tax cuts that seem likely to be announced by the Chancellor in his fiscal statement, will act to further boost demand in the economy in the short term.

Higher inflation prospects over the longer term may lead the Bank of England to raise interest rates by more than they would have done without the EPG.

Further information

See the following Library products:

- Library briefing, Rising cost of living in the UK
- Library page collating publications on the cost of living

10 For example, Pantheon Macro, Twitter 8.20am 9 September 2022

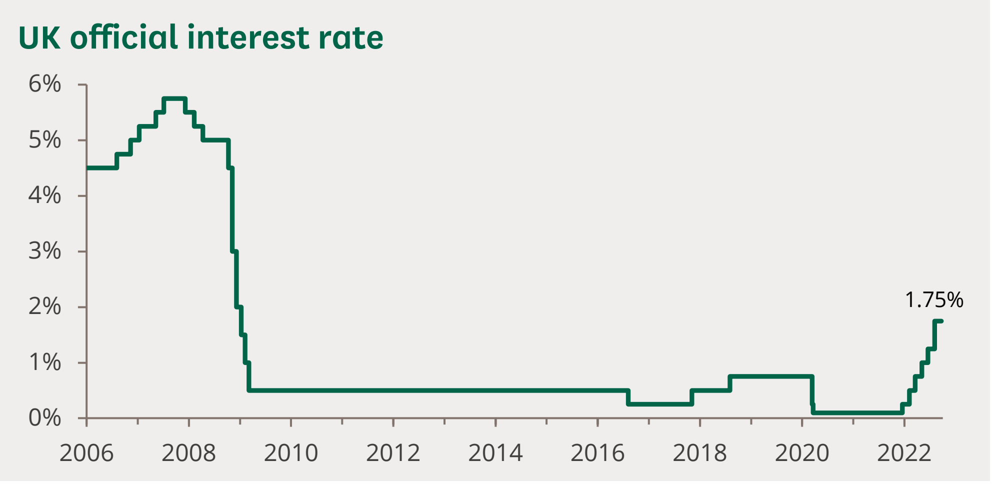
11 "Liz Truss's £150bn energy plan puts Bank of England on the spot", Financial Times, 8 September 2022

1.2 Interest rates

Despite the weak current economic environment, the Bank's Monetary Policy Committee (MPC) is expected to raise interest rates for the seventh consecutive meeting on Thursday 22 September. This is due to inflation being far above the Bank's target of 2%, and the expectation for this to remain the case for some time yet.[12]

At the time of writing, before the 22 September meeting, the Bank's main interest rate is at 1.75%. Since December 2021, the MPC has increased rates from 0.1%, which was an all-time low.[13]

Further increases later this year are expected. A poll of economists suggested that the MPC could raise interest rates to 3% by the end of 2022.[14]



Note: Correct as of 20 September 2022. Interest rates are expected to be raised on 22 September.
Source: Bank of England, Official Bank Rate History (as of 20 September 2022)

Higher interest rates work to lower inflation by raising the cost of borrowing. In turn, demand for goods and services in the economy – that is, consumer and business spending and investment – is lessened. Lower demand reduces the pressure on firms to raise prices and on workers to get higher pay rises (often because unemployment increases).

Central banks around the world have also been raising interest rates due to high inflation. For example, the US central bank, the Federal Reserve, has lifted interest rates from a range of 0-0.25% to 2.25-2.5% so far this year.[15] Meanwhile, the Eurozone's European Central Bank started raising rates this summer, with further increases expected. [16]

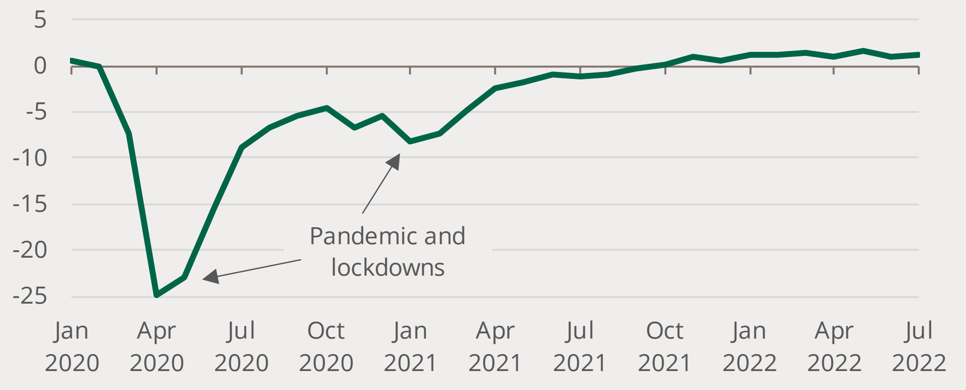
12 The specific target is set by the government, usually at the time of the Budget
13 Bank of England, Official Bank Rate History
14 "Bank of England to raise rates by 50bps again to tame inflation: Reuters poll", Reuters, 13 September 2022
15 The Fed's next meeting on Wednesday 21 September is expected to see another rate hike
16 Library economic indicators page, Interest Rates and Monetary Policy

1.3 Economic growth

Economic growth during 2022 so far has been stagnant. GDP, the total value of economic output produced, was marginally lower in July 2022 than in January 2022.[17] This weakness reflects rising inflation, which is squeezing household budgets and spending in the economy.

GDP has been stagnant over the course of 2022

% change in GDP compared to Feb 2020 (pre-pandemic level)



Source: ONS, Monthly GDP data (July 2022 release)

The economic outlook has deteriorated in recent months, as predictions for household energy bills soared over the summer. For example, independent forecasters surveyed in August expected GDP growth of only 0.5% in 2023.[18] This compares to an average forecast of 1.4% when the survey was conducted in May.[19]

In August, the Bank of England forecast the economy to go into recession later in 2022, with GDP falling in 2023.[20] The latest OBR forecast, from March 2022, was for GDP growth of 1.8% in 2023.[21]

These forecasts were all made prior to the Government's Energy Price Guarantee (EPG) which caps energy bills. As discussed in the section above, this is likely to protect household budgets to some degree – and thus economic growth – compared to a scenario without the EPG.

However, consumer confidence is low, energy bills remain at historic highs and inflation in other areas such as food remains high. In addition, economic

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17 ONS, GDP monthly estimate, UK: July 2022, 12 September 2022. July is the latest month for which data is available.

18 HM Treasury, Forecasts for the UK economy: August 2022, 18 August 2022 [these are not Treasury forecasts; rather the Treasury surveys economic forecasters]

19 HM Treasury, Forecasts for the UK economy: May 2022, 18 May 2022

20 Bank of England, Monetary Policy Report-August 2022

21 OBR, Economic and fiscal outlook – March 2022, 23 March 2022

data point to slowing economic activity over the summer.[22] This likely means weak growth or even a recession is still on the cards over the winter.[23]

1 What is a recession?

A recession is a term used to describe a period of sustained negative economic developments. This usually includes falling GDP and rising unemployment.

For example, during the financial crisis in 2008 and 2009, the value of UK economic output as measured by GDP fell by around 6% at its worst point and the unemployment rate went up from 5% to 8%.[24]

A simple and commonly used, though flawed, definition of a recession is when GDP falls for two consecutive quarters. This is sometimes referred to as a "technical recession".

For example, UK GDP fell by 0.1% during the second quarter of 2022. If it fell again in the third quarter, this would meet the definition of a "technical recession".[25]

The problem with this definition is that it ignores the wider economic context, such as unemployment and incomes, and doesn't provide any indication of the severity or breadth of an economic downturn. Nevertheless, "technical recessions" often do coincide with more considered analysis of recessions.

In the US, a long-standing committee of economists meets to determine the start and end point of recession by looking at a range of economic indicators.[26] This has semi-official status and is well regarded. In the UK, the National Institute of Economic and Social Research has recently set up a committee with similar aims.[27]

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22 For example, S&P Global, UK Purchasing Managers Index for August (PDF), 5 September 2022 and ONS, Retail sales, Great Britain: August 2022, 16 September 2022

23 "Pound falls as weak retail sales raise fears UK economy is in recession", Guardian, 16 September 2022

24 ONS, Impact of Blue Book 2022 changes on gross domestic product, 22 August 2022 and Library, The UK economy: a dashboard (for unemployment rate data)

25 ONS, GDP quarter-on-quarter % change, series IHYQ [12 August update]

26 This is the National Bureau of Economic Research's Business Cycle Dating Committee

27 The UK Business Cycle Dating Committee; NIESR, Dating Business Cycles in the United Kingdom, 1700–2010, 24 June 2022

2 Public finances

2.1 The public finances in 2022/23

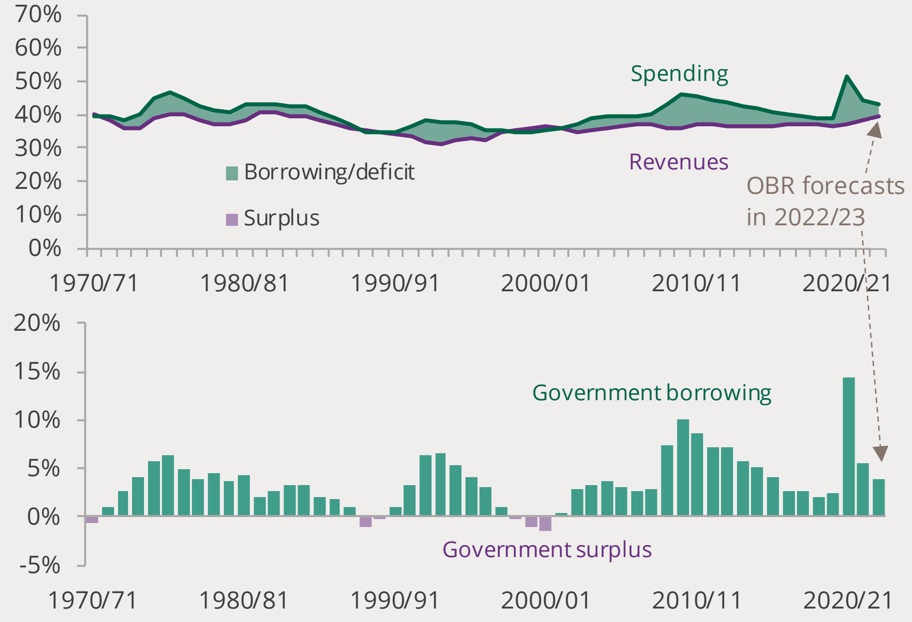
The budget deficit will be higher than forecast...

The Government's budget deficit – the difference between its spending and income from taxes and other sources – has fallen since the peacetime record reached in 2020/21. The Government's pandemic-related support for public services, households and businesses came at a huge cost in 2020/21.[28]

While the deficit has fallen, it remains relatively high by historical standards and was £134 billion in 2021/22. The deficit was equivalent to 5.6% of GDP in 2021/22, making it the twelfth largest budget deficit since 1948.[29]

When its spending is higher than receipts, the Government borrows

Government spending, receipts and borrowing, % of GDP, from 1970/71



Notes: OBR forecasts for 2022/23 were made in March 2022 and are therefore out of date

Source: OBR. Public finances databank – August 2022 (forecasts from March 2022); ONS. J5IJ

28 The Library briefings Coronavirus: Economic impact and Public spending during the Covid-19 pandemic have further information.

29 ONS. Series J5II and J5IJ; OBR. Public finances databank – August 2022

The OBR's latest forecast for the economy and public finances came in March 2022. It forecast that the Government's budget deficit would be a little under £100 billion in 2022/23, which is equivalent to around 3.9% of GDP. Today, this forecast looks optimistic.

The OBR's forecast was made only a few weeks after Russia's invasion of Ukraine had begun. The fiscal watchdog didn't expect energy costs and other prices to grow as quickly as they did in the subsequent months. As discussed below, the unexpected inflation has consequences for the public finances.

The OBR's forecast was also made before the new Government introduced the Energy Price Guarantee (EPG) and before the then Chancellor, Rishi Sunak, announced a package of support for households with the rising cost of living, in May.[30] The Library briefing Rising cost of living in the UK outlines government support for households.

The support packages will add significantly to the deficit in 2022/23. The fiscal statement might include an estimated cost of the EPG. It's thought the support might add over £60 billion to the deficit in 2022/23.[31] The scheme will run from October 2022 for two years, so it will also add to the deficits in 2023/24 and 2024/25.

The May 2022 cost of living package adds around £10 billion to the deficit in 2022/23, even after accounting for the revenues raised from the already announced windfall tax on energy companies (the energy profits levy).[32]

Section 2.2 explains what the EPG is, how much it may cost and how it's being paid for. Box 2 has further information on the energy profits levy.

...which means more borrowing and higher debt

Broadly speaking, government covers its budget deficit by borrowing. The government borrows by selling bonds, which are usually referred to as gilts.[33] These are essentially 'IOUs' which the government pays interest on. Government debt is largely the stock of this borrowing arising from many years of past budget deficits.

The record amounts borrowed during the pandemic saw government debt increase by over 15% of GDP.[34] Currently, government debt is equivalent to close to 97% of GDP. Once some largely temporary measures taken by the

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30 10 Downing Street press release, Government announces Energy Price Guarantee for families and businesses while urgently taking action to reform broken energy market, 8 September 2022; HM Treasury press release, Millions of most vulnerable households will receive £1,200 of help with cost of living, 26 May 2022

31 Resolution Foundation. A blank cheque: A analysis of the new cap on energy prices, September 2022

32 OBR. Fiscal risks and sustainability – July 2022, Box 3.3

33 The Debt Management Office (DMO) is the Treasury's agency that is responsible for debt and cash management for the UK Government.

34 ONS. Series HF6X. Comparison is made with August 2019. This is because the GDP element in the calculation is taken as a twelve-month rolling total centred on the month in question. August 2019 is the last month in which this 12 month total isn't affected by the pandemic.

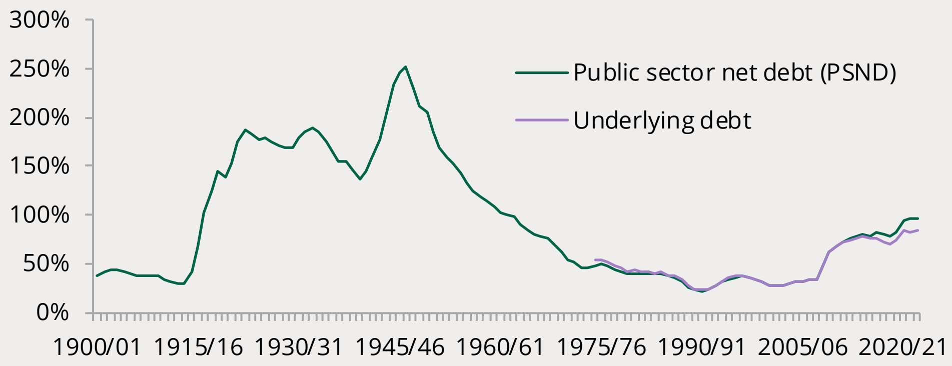
Bank of England are removed, the underlying debt-to-GDP ratio is 84% of GDP.[35]

In March 2022, the OBR forecast that the headline measure of government debt would be largely unchanged during 2022/23. It also forecast that the underlying ratio would increase by around 1% of GDP.

Instead, greater than forecast borrowing in 2022/23 will likely mean that both the headline and underlying debt ratios increase during the year. However, inflation is expected to increase the cash size of GDP, which may temper the increase in the debt-to-GDP ratio.

Government debt is relatively high, but has been higher

Public sector net debt, as % of GDP. Forecasts in 2022/23



Notes: Underlying debt excludes the Bank of England

Sources: OBR. Public finances databank – July 2022; ONS. Series CPOA

Debt interest costs are higher than forecast…

The government makes interest payments on its debt. Through much of the pandemic, the government was able to borrow at historic lows. Relative to government revenues, debt interest costs fell to lows last seen in the 1690s.[36]

However, government's spending on debt interest has risen recently, largely due to rising inflation. Higher inflation immediately increases government's spending on debt interest because around a quarter of government debt is index-linked. This means that the interest paid on this debt is directly linked to the Retail Prices Index (RPI) measure of inflation. The OBR estimate a 1%-point increase in inflation raises debt interest payments by around £6 billion.[37]

In March 2022, the OBR forecast that government's debt interest spending would increase from £54 billion in 2021/22 to around £83 billion in 2022/23, largely due to rising inflation.[38] Inflation has been around 1.5%-points higher

35 Excluding the Bank of England is thought to provide a better measure of the Government's underlying debt, than the headline measure of public sector net debt.

36 IFS. Green Budget 2020: Chapter 4, 13 October 2020, Figure 4.14

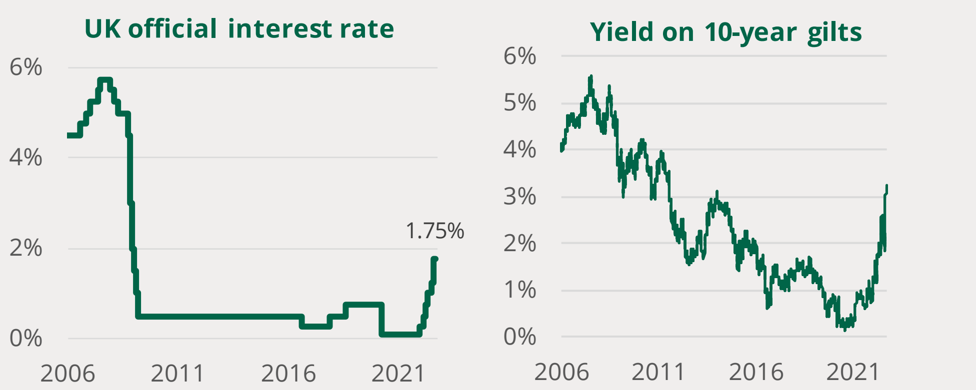
37 OBR. Debt interest (central government, net of APF) [accessed on 20 September 2022]

38 OBR. Economic and Fiscal Outlook – March 2022, paras 3.110 – 3.113

than the OBR forecast and, consequently, debt interest spending during the first five months of 2022/23 has been around 22% higher than forecast.[39]

Inflation isn't the only factor influencing debt interest costs. The Bank of England's main interest rate determines the effective rate of interest paid on some of the Government's existing stock of debt.[40] The rate of interest for new borrowing is largely determined by the rate at which investors are prepared to lend to the Government. Currently, both rates of interest are increasing and are higher than the OBR forecast in March 2022.[41]

The official interest rate and the rate at which markets will lend to the Government have increased since autumn 2021



Notes: Yield from British Government Securities, 10 Year Nominal Par Yield

Sources: Bank of England, Official Bank Rate History; Series IUDMNPY

The Bank has increased its main interest rate with the aim of getting inflation back to its 2% target. Financial markets expect the interest rate to rise to around 4% in early 2023.[42] This would be a higher rate than the OBR assumed in its March 2022 forecast.[43]

For new government borrowing, financial markets are currently willing to lend to the Government for 10 years at an interest rate of around 3.2%, up from around 0.2% in the summer of 2020. While this is a higher rate of interest than was the case during much of the last 10 years, it's significantly lower than the average over the previous 50 years.[44]

…but rising receipts might help

Higher than expected inflation could benefit the Government's tax receipts.

39 ONS. Public sector finances, UK: August 2022, 21 September 2022
40 For more on this see Box 10 of the Library briefing Coronavirus: Economic impact.
41 OBR. Conditioning assumptions [accessed on 15 September 2022]
42 Bank of England. Yield curves [accessed on 15 September 2022]
43 OBR. Conditioning assumptions [accessed on 15 September 2022]
44 OECD. Long-term interest rates [accessed on 14 September 2022]

For most excise duties, business rates, and interest on student loans, inflation determines the tax rate or interest rate charges. However, the recent higher than expected inflation won't affect most of these until 2023/24.

In the shorter term, inflation can increase the cash value of the things that taxes are levied on, raising tax receipts. Usually, for instance, higher consumer prices would push up consumer spending and consequently VAT receipts. Likewise, if inflation leads to higher earnings, more income will be taxed and taxed at higher rates, particularly as income tax thresholds aren't currently increasing with inflation.[45]

The scale of these indirect boosts to revenues are uncertain and hard to estimate. The Institute for Fiscal Studies (IFS) says it "will depend on factors such as the composition of earnings growth, the evolution of (taxable) corporate profits, and the extent to which consumers are able and willing to spend some of their savings to compensate for lower real earnings."[46]

Provisional data for the first five months of 2022/23 shows that government revenues have been broadly similar to forecast.[47] The IFS estimate – based on the Bank of England's economic forecast from August 2022 – that government revenues might be a little higher across 2022/23 than forecast by the OBR in March 2022.

Ultimately, however, the IFS expect that higher inflation will increase government's spending on debt interest by more than it will increase government revenues, adding to the deficit.[48]

2.2 The Energy Price Guarantee

What is the Energy Price Guarantee?

Announced on 8 September 2022, the Energy Price Guarantee (EPG) will provide significant support for households and businesses facing rising energy bills.

The EPG will be introduced from 1 October 2022, capping the energy bill of a "typical" UK household at an average of £2,500 per year for the next two years. A typical household will "save at least £1,000 a year (based on current prices from October)", according to the Government.[49] £150 of this saving will

45 See HC Library, Spring Budget 2021: personal allowance & higher rate threshold

46 IFS. The outlook for the public finances under the Bank of England's August 2022 forecast, 18 August 2022

47 OBR. March 2022 Economic and fiscal outlook monthly profiles [accessed on 21 September 2022]; ONS. Public sector finances, UK: August 2022, 21 September 2022

48 IFS. The outlook for the public finances under the Bank of England's August 2022 forecast, August 2022

49 BEIS. Energy bills support factsheet: 8 September 2022, 8 September 2022

come from suspending green levies – we may hear more about this in the Chancellor's statement.

The Energy Price Guarantee will "replace" the existing energy price cap (also known as the default tariff cap) set by Ofgem. It will apply to the unit cost of energy, so a household's exact bill will continue to be influenced by how much energy they use.

Businesses, charities and public sector organisations will receive support for 6 months. After the initial 6 months, only vulnerable businesses will receive support, under these plans. We may hear more this week about how the scheme for non-households will operate from the Secretary of State for Business, Energy and Industrial Strategy.[50]

A Government press release, a written ministerial statement and a factsheet on the new energy support measures give more information on the EPG.[51]

The EPG is additional to the £400 discount on electricity bills available through the Energy Bills Support Scheme, announced in May 2022 and due to start in October.

The Library briefing Rising cost of living in the UK outlines government policies to support households with rising prices, including the EPG.

The government will borrow to fund the EPG, but the cost is uncertain

The EPG's cost is very uncertain as it largely depends on volatile wholesale energy prices and energy usage. No estimate of the scheme's cost was provided when it was announced. The Chancellor is expected to provide a cost estimate at the fiscal statement, although this is unlikely to be accompanied by any scrutiny from the OBR.

It's widely acknowledged that the eventual cost of the EPG is likely to be large. The IFS estimates that the EPG could cost around £100 billion in the next year alone. [52] The Resolution Foundation estimate that it could cost around £60 billion in the next 6 months and £120 billion over two years.[53]

50 Sky News, Businesses to learn next week how the government will help with energy bills, 14 September 2022; BBC. Chris Mason: Noisy politics back after pause for mourning, 20 September 2022

51 10 Downing Street Press Release. Government announces Energy Price Guarantee for families and businesses while urgently taking action to reform broken energy market, 8 September 2022; HCWS294 [on Energy Update], 8 September 2022; BEIS. Energy bills support factsheet: 8 September 2022, 9 September 2022

52 IFS. Response to the Energy Price Guarantee, 8 September 2022

53 Resolution Foundation. A blank cheque: An analysis of the new cap on energy prices, 13 September 2022

The IFS say that, given the size of the package, not providing an estimated cost when it was announced was "extraordinary, and deeply disappointing."[54]

The Government is funding the scheme by borrowing. Alongside Friday's fiscal statement, it's thought that the Chancellor will revise how much the Government will borrow this year from the markets, adding the additional borrowing for the EPG.[55, 56]

What about a windfall tax?

Some political parties and think-tanks have proposed that the EPG's cost could be partly met by reducing the windfall profits that some energy firms are benefiting from as a result of higher prices.

The Government already announced the Energy Profits Levy in May 2022, which has widely been referred to as the 'windfall tax'.[57] Opposition parties say the tax should be expanded to pay towards the EPG.[58] In dismissing the idea, the Prime Minister said "That would undermine the national interest by discouraging the very investment we need to secure home-grown energy supplies."[59]

The Resolution Foundation say that the cost of the EPG could have been lowered by reducing the windfalls that some energy firms are benefiting from. They suggest this could be done by introducing "some form of revenue or price cap similar to those being considered or implemented in mainland Europe. Where windfalls cannot be regulated down, they could be further taxed."[60, 61]

The Resolution Foundation don't think, however, that windfall taxes can bear most of the burden of the EPG as "much of the windfall from higher energy prices accruing to companies (and states) based outside the UK".

The Resolution Foundation also say a "solidarity tax", as they label it, could reduce the pressure that the EPG puts on government borrowing. The EPG will support even those on very high incomes and a solidarity tax could be used to raise revenues, particularly from higher earning households.

As an example, the Resolution Foundation say that "a 1 per cent increase in all Income Tax rates would raise £9.5 billion in tax revenue, with 60% paid by

54 IFS. Response to the Energy Price Guarantee, 8 September 2022
55 Kwarteng will struggle to hit 2.5% growth target, warn experts, FT, 13 September 2022
56 The Government's borrowing for 2022/23 is set out in the Debt management report: 2022-23.
57 HC Library. Energy (Oil and Gas) Profits Levy Bill 2022-23, 18 July 2022
58 HC Deb 8 September 2022 c404-449; Liberal Democrats Press Release, Make oil and gas giants pay for freezing of energy bills, not our children, 7 September 2022
59 HC Deb 26 May 2022 c450
60 Resolution Foundation. A blank cheque: An analysis of the new cap on energy prices, 13 September 2022
61 The European Commission's proposals are summarised in the press release Energy prices: Commission proposes emergency market intervention to reduce bills for Europeans

the top fifth of households (who may benefit by over £13 billion a year from the EPG)."[62]

2 What is a windfall tax?

A 'windfall tax' describes a one-off tax levied on companies who have made windfall profits. These are profits which have arisen due to favourable market factors. The profits are unexpected, substantial and not due to new activities undertaken by the company.

The oil and gas sector are currently making larger than normal profits. As the former Chancellor, Rishi Sunak, puts it, these profits are "Not as the result of recent changes to risk taking or innovation or efficiency. But as the result of surging global commodity prices – driven in part by Russia's war."[63]

Mr Sunak announced the Energy Profits Levy on the profits from North Sea oil and gas production on 26 May 2022. The Library briefing Energy (Oil and Gas) Profits Levy Bill 2022-23 explains how the levy will work.

There are arguments for and against levying windfall taxes, explained in the following publications:

- National Institute of Economic and Social Research (NIESR). Is a Windfall Tax a Good Idea?, 23 May 2022
- Institute for Government (IfG). Windfall taxes, 10 June 2022

Normally, windfall taxes are retrospective, with the amount due on things that have already happened. This is often an argument made in their favour, as a retrospective tax shouldn't distort economic behaviour, particularly if it is clearly a one-off.

The IfG point out that the Energy Profits Levy isn't retrospective – it applies from its announcement. It's therefore "more prone to distorting behaviour than a retrospective windfall tax may have been."[64]

2.3 Reversing tax rises

It's thought that the Chancellor will announce tax cuts in the fiscal statement. The Prime Minister has said "I have a bold plan to grow the economy through

62 Resolution Foundation. A blank cheque: An analysis of the new cap on energy prices, 13 September 2022
63 HC Deb 26 May 2022 c449-454
64 IfG. Windfall taxes, 10 June 2022

tax cuts and reform."[65] The Chancellor will publish a growth plan alongside the fiscal statement.[66]

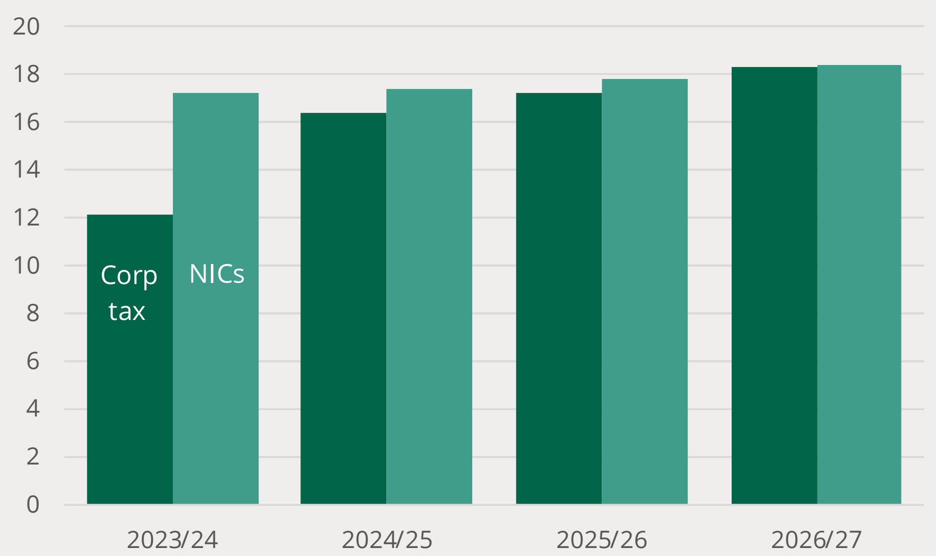
During the Conservative leadership election campaign, the now Prime Minster said her government would reverse two tax rises:

- a 1.25%-point increase in National Insurance contributions (NICs) rates for employees, employers and self-employed, which came into effect in April 2022, and was set to become the Health and Social Care Levy.
- an increase in the main rate of corporation tax from 19% to 25% which is due to come into effect in April 2023.[67]

Together, these tax rises are expected to raise government receipts by around £30 billion in 2023/24 and more than £30 billion in each subsequent year. Reversing them in their entirety is likely to increase forecast borrowing by a similar amount.

Forecast revenues raised from increasing corporation tax main rate to 25% and NICs rates by 1.25%-points

£ billion



Sources: OBR. Economic and Fiscal Outlook – March 2022, Table A.5

NICs rates increased in April 2022, to fund increases health and social care spending. In July 2022, to provide some support to households with the rising

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65 Prime Minister's Office Prime Minister Liz Truss's statement: 6 September 2022

66 HM Treasury (@hmtreasury). "On Friday 23rd September, subject to the agreement of the House of Commons, Chancellor @KwasiKwarteng will unveil the Growth Plan to Parliament.." (Twitter). 20 September 2022 [Accessed 20 September 2022]. Available from: https://twitter.com/hmtreasury/status/1572241032124809219

67 IFS. Tax and spending policies of Conservative leadership contenders, 21 July 2022; Liz Truss vows to reverse National Insurance rise 'immediately', Evening Standard, 7 August 2022; Tory leadership: Liz Truss pledges to ditch corporation tax hike and pause Green Levy in first hustings, The I, 15 July 2022

cost of living, the level of earnings at which people start paying NICs was increased. It isn't clear whether the Prime Minister wants to reverse both changes to NICs, although decreasing the threshold at which people start paying NICs would be considered a tax increase.

We also don't know when the Prime Minister wants the reversal of NICs rates to happen. Even if the relevant legislation is taken through Parliament quickly, payroll software developers and employers often need time to implement the changes. For example, the increase to NICs thresholds was announced in March 2022 to take place in July 2022 as this was the earliest date that the change could be implemented by.[68]

When the increase to NICs rates was announced, the Government also increased the rates of income tax on dividends by 1.25%-points. It isn't clear whether the Prime Minister plans to reverse this increase. The measure is forecast to raise a little less than £1 billion after its first year.[69]

The Library briefing on the Health and Social Care Levy Bill 2021-22 has further information, including background to the rise in NICs rates, while the briefing on the National Insurance Contributions (Increase of Thresholds) Bill 2021-22 discusses the increase in the NICs threshold.

In March 2021, the then Chancellor, Rishi Sunak, announced an increase in the main rate of corporation tax from April 2023. He said the Government was providing businesses with over £100 billion of pandemic-related support, so "it is fair and necessary to ask them to contribute to our recovery."[70] The Library briefing Corporate tax reform discusses the reforms to corporation tax announced by the then Chancellor Rishi Sunak in his Spring 2021 Budget.

The corporation tax rate could be changed in this year's Finance Bill, whereas changing the NICs rate would require its own legislation.

The IFS analyses proposals to change NICs and corporation tax in its paper Tax and spending policies of Conservative leadership contenders.

The tax burden is forecast to be higher than pre-pandemic…

From 2023/24, the Government's tax revenues are forecast to exceed 36% of GDP, which is a level last seen in 1950.[71] Currently, revenues aren't quite at this level. Tax revenues were equivalent to 34.8% of GDP in 2021/22 and are forecast to be 35.5% of GDP in 2022/23.[72] These estimates are from the OBR's

68 HM Treasury. Spring Statement 2022, March 2022, para 3.6

69 HM Treasury. Autumn Budget and Spending Review 2021 Policy costings, October 2021

70 HC Deb 3 March 2021 c251-262

71 OBR. Public finances databank – February 2022 [accessed on 10 March 2022]

72 These figures are for national account taxes, which exclude other government revenues such as interest earned on its assets (such as foreign exchange reserves and student loans). Public sector current receipts is a measure of government revenues that includes taxes and other revenues. This measure is forecast to reach 40% of GDP in 2026/27, its highest level since 1982/83.

March 2022 forecast. It isn't clear how similar forecasts produced today would be, given the recent growth in inflation.

The increase in the tax-to-GDP ratio in the last forecast is largely down to the previous Chancellor's (Rishi Sunak's) policy changes, such as the increase to NICs rates and the corporation tax main rate, discussed above. The former Chancellor's decision to freeze income tax thresholds also raises significant amounts.[73]

In March 2022, when the OBR produced their forecast, some of the growth in the tax-to-GDP ratio was also due to the OBR forecasting a more tax-rich economy in 2026/27, compared with 2019/20.[74, 75]

...but so is the size of the state

Often described as 'the size of the state', government spending relative to the size of the economy (GDP) is also forecast to remain larger than it was pre-pandemic.

In March 2022, the OBR forecast suggests that government spending will settle at around 41% of GDP from 2024/25, a little higher than pre-pandemic and close to the level in 2015/16.[76] Spending was higher, following the 2007-2009 financial crisis, but it was brought down, largely through the Government's 'austerity' policy.

Inflation is forecast to increase spending on items such as welfare and public services pensions, while higher interest rates are pushing up spending on debt interest. Government policies also increase spending, relative to the pre-pandemic position. Departments' budgets were increased in both the March 2020 Budget and the 2021 Spending Review. Making Universal Credit more generous, at Autumn Budget 2021, has also increased spending.[77, 78]

The largest spending reduction is from transactions with the EU. As the OBR explain, "the cost of the Brexit 'divorce bill' [is] falling over the forecast period, whereas the cost of continuing contributions as a Member State would have been relatively stable as a share of GDP."[79] The Library briefing Brexit: the financial settlement – a summary has further information about the Brexit 'divorce bill'.

73 In the 2021 Budget the then Chancellor, Rishi Sunak, announced that the income tax personal allowance and the higher rate threshold would be frozen for four years from 2022/23 to 2025/26. The Library briefing Spring Budget 2021: personal allowance & higher rate threshold has more.
74 OBR. Economic and fiscal outlook – March 2022, para 1.25
75 The OBR has more to say on the recent tax-rich economic activity in Box 3.1 and Box 3.2 of their March 2022 economic and fiscal outlook.
76 OBR. Public finances databank – August 2022 [accessed on 16 September 2022]
77 See Library briefing, Autumn Budget and Spending Review 2021: A summary, 28 October 2021
78 OBR. Economic and fiscal outlook – March 2022, paras 3.76-3.78
79 OBR. Economic and fiscal outlook – March 2022, para 3.78

2.4 Forecasts, headroom and fiscal rules

When will there be new economic and fiscal forecasts?

The OBR produces forecasts for the economy and the public finances at least twice each financial year, one of which accompanies the Budget. The Chancellor asks the OBR to produce the forecasts for a particular date.

There will be no forecasts alongside Friday's fiscal statement. The Chancellor has not publicly asked the OBR to produce forecasts for it. Without forecasts, we won't know for certain whether the Chancellor's new policies will keep him on course to meet the Government's targets for the public finances – the so called 'fiscal rules' (see below).

During the Conservative Party leadership election there was speculation as to whether the OBR would have sufficient time to produce a forecast for an 'emergency budget' or 'fiscal event', which Liz Truss promised for early in her premiership.

The OBR confirmed that they could produce a forecast for mid-to-late September if the Chancellor requested one, because preparatory work was already underway. The preparatory work began on 29 July, with the Treasury's agreement.[80] The Chancellor has not requested a forecast for the fiscal statement, so the next forecast is expected at the 2022 autumn budget.

Some think-tanks have questioned the wisdom of making tax and spending decisions, such as those expected in the fiscal statement, without OBR forecasts.

The Institute for Government (IfG) say the Chancellor shouldn't be making "big decisions over tax and spending decisions without an updated forecast from the OBR".[81] It isn't unprecedented for the Treasury to make significant announcements without OBR forecasts – it happened on several occasions during the pandemic. But Paul Johnson, director of the IFS, says that "we should not have to get used to this way of making announcements, free of analysis, costings and forecasts."[82]

The IfG does not criticise the Government announcing short-term measures without OBR forecasts "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."[83]

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80 OBR. Letter from Richard Hughes to Mel Stride MP on the potential Emergency Budget, 26 August 2022

81 Institute for Government. What is in the new chancellor's in-tray?, September 2022

82 "Transparency is key to maintaining trust in government. Let's not cap it", The Times, 12 September 2022

83 Institute for Government. What is in the new chancellor's in-tray?, September 2022

The Treasury Committee requested that the OBR publish a forecast alongside the fiscal statement. The Chair of the Committee said that "it is vital that an independent OBR forecast is provided" as major permanent tax changes are likely in the fiscal statement and since the last forecasts the economic outlook has deteriorated and significant government interventions have been announced.[84]

Fiscal rules and headroom

The Government's 'fiscal rules' and the use of 'headroom' were also discussed during the 2022 Conservative Party leadership election. Often the focus was on whether policies, such as tax cuts, could be paid for through 'headroom' in the budget or whether the fiscal rules would be broken.[85] The two concepts are linked.

The Government has **fiscal rules**, or targets, for its debt and its day-to-day borrowing. The target for government debt is for underlying debt to be falling, as a percentage of GDP, by the third year of the OBR's forecast. Another target says the government shouldn't be borrowing for day-to-day spending by the third year of the OBR forecast.

In its forecasts, the OBR judge whether the Government has a better than 50% chance of meeting each of its fiscal rules. With no forecasts being published, we won't get the OBR's view as to whether the Government is still on course to meet its fiscal rules following the fiscal statement.

The Library briefing The UK's fiscal targets discusses these rules in more detail, as well as the Treasury's wider policy for managing the public finances.

Headroom is the amount by which the Government is forecast to meet its fiscal rules in the target year (currently 2025/26). The OBR forecast in March 2022 that the debt target was being met by 1% of GDP, which is around £28 billion of 'headroom'. The target for day-to-day borrowing was being met by around £36 billion.

Can headroom be used to cut taxes?

Traditionally, Chancellors have aimed to keep some sort of headroom as a buffer in case forecasts deteriorate. In theory, a Chancellor could use the headroom to permanently increase spending or decrease tax revenues, but this would decrease the buffer.

We don't know what the headroom would be if the OBR made a forecast today and there won't be a forecast accompanying the fiscal statement. The broad consensus is that if a forecast were made today, it is likely that the headroom

84 Treasury Committee. Treasury Committee calls for independent economic forecast to be published alongside emergency budget, 20 September 2022

85 BBC News. BBC debate: Liz Truss and Rishi Sunak fact-checked, 26 July 2022

might be at least a little smaller than forecast in March 2022, but this is very difficult to predict.

If the Chancellor makes permanent tax cuts – such as those described above – they would reduce any headroom that may still exist. The Financial Times calculates that if a forecast were made today, it might find that the headroom has been wiped out by higher interest and benefit spending, even before the cost of tax cuts are added in.[86]

Suspending or changing the fiscal rules

The fiscal rules could be suspended if the Chancellor believes there has been "a significant negative shock to the UK economy". A statement could be made to Parliament suspending the rules. At subsequent budgets, the Chancellor would then present the government's plan to return to a position where the suspension can be lifted.

There is no definition of what constitutes a "significant negative shock to the UK economy". The Chancellor is the arbiter of whether this threshold is met.

The fiscal rules can also be changed and have been changed on several occasions, particularly since 2011. The current rules took effect in January 2022. If the Chancellor wishes to change the fiscal rules he must lay revised rules before Parliament which must be approved by a vote of the House of Commons.

2.5 Inflation and the public finances

The level, duration and nature of inflation has consequences for the public finances in both the short and medium term.

Above we discussed the short-term effects of inflation on the public finances. Rising inflation immediately increases government's spending on its inflation-linked debt while potentially increasing tax receipts. The indirect effect on tax receipts is less certain than the effect on interest spending.

Higher inflation also directly affects spending on benefits, state pensions and public service pensions, but not immediately. Such spending is increased by a larger amount if inflation is higher.[87]

However, the effect isn't immediate as the payments are increased by a lagged measure of inflation. For instance, benefit payments will increase in

86 Inflation, debt costs and Truss's pledges risk £60bn UK budget hole, Financial Times, 2 September 2022

87 The impact on the basic state pension would depend on whether higher inflation affected the triple guarantee (uprating is by the greater of earnings growth, inflation or 2.5 per cent).

April 2023 by the September 2022 rate of inflation, which could be around 9-10%.

As mentioned previously, for most excise duties, business rates, and interest on student loans, inflation determines the tax rate or interest rate charges. Again, as with benefits, the effect is often lagged.

It isn't possible to bring these effects together and say whether inflation is good or bad for the public finances, particularly in the medium term. The OBR point out that for the public finances the "consequences of higher inflation depend crucially on the source of that inflation – imported inflation that reduces real wages is fiscally costly; domestically generated inflation driven by rising wages is beneficial."[88]

Spending on public services

Government departments' spending plans for public services are set in cash terms (ie not adjusted for inflation) until 2024/25. Departments' spending plans aren't linked to inflation, so their budgets won't automatically increase following recent unexpected inflation.

Rising prices do, however, put pressure on departments' cash budgets. Higher prices mean that departments have less spending power – they can buy less with the same cash budget. Ultimately, higher than expected inflation makes spending plans less generous than originally intended.

Higher inflation has already meant that larger pay increases have been offered to public service workers than were assumed when their budgets were set in the 2021 Spending Review. Departments also face rising costs for inputs such as energy and fuel.

The Chancellor will judge whether public services can manage this inflationary pressure. There's been no hint that Mr Kwarteng will increase departments' budgets in the fiscal statement. However, should he wish to ensure public services have the same spending power as planned this year, £8 billion would need to be added to departments budgets, according to the IFS. An additional £18 billion would be required in the two subsequent years.[89]

88 OBR. Economic and fiscal outlook - October 2021, Box: 3.2

89 IFS. The inflation squeeze on public services, 10 August 2022

3 Appendix: Parliament’s fiscal year

Parliament has a role in both raising tax and approving Government spending. Parliament’s fiscal calendar can vary, but the below summarises the process and timings for a typical financial year:

- **April**: Government departments’ spending plans (Main Estimates) are published
- **July**: Government departments’ spending plans (known as the Main Estimates) are debated in the House – using procedures introduced in 2018.[90]
- **July:** A Supply and Appropriation (Main Estimates) Bill is introduced and, if agreed, receives Royal Assent, formalising the Main Estimates as departments’ initial budgets for the year
- **July:** Government departments lay their annual reports and accounts (for the financial year ending the previous March) before Parliament
- **November:** The Budget is published. Following this, a Finance Bill is introduced. Royal Assent of the Bill should be reached before the start of the following financial year.
- **November:** The OBR publishes its economic and fiscal forecasts.
- **February:** Government departments publish revised spending plans (Supplementary Estimates). These are debated in the House – using procedures introduced in 2018.[91]
- **February:** The Government requests advance funding for the first four months of the next financial year (known as the Vote on Account) for each department.
- **March:** A Supply and Appropriation (Anticipations and Adjustments) Bill is introduced and, if agreed, receives Royal Assent. This is a formal agreement to revise in-year budgets which are set out in Supplementary Estimates; and advance money for the new year in the Vote on Account.
- **March:** The OBR’s economic and fiscal forecast is published. The Chancellor makes a formal response to the forecast in the spring

[90] Public spending: New debates in the House, House of Commons Library, 24 January 2018
[91] Public spending: New debates in the House, House of Commons Library, 24 January 2018

statement. The spring statement may also review and consult on wider challenges for the economy and public finances.

Further information is available in the following Library briefings:

- The Budget and the annual Finance Bill, April 2022
- Revised Government spending plans for 2021/22, March 2022
- Main Estimates: Government spending plans for 2022/23, June 2022

Parliament's Scrutiny Unit also publishes useful information on the estimates process and scrutiny of public spending.

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