BREXIT BUDGET

£30 billion of tax rises
and spending cuts

Executive Summary

There is a consensus among economists that leaving the EU would damage Britain's economy, both in the short and long term. The Governor of the Bank of England, the IMF, the OECD and the Institute for Fiscal Studies (IFS) have all said the British economy would be smaller if we left the EU. This would leave any Chancellor facing difficult decisions. This Budget outlines the sort of decisions that will be required.

In the short-term the hit to the economy would be largely driven by economic uncertainty and volatility in financial markets, while over the long-term Britain would be poorer as a result of less trade and investment. These were the findings of the Treasury's two recent studies and are also reflected in every serious academic study that has been undertaken in the area.

If the British economy is smaller then we will have less money to fund our public services. The IFS has looked at what impact a smaller economy will have on our public finances. They conclude that the hole in the public finances would be between £20-£40 billion a year by the end of the decade. Analysis by HM Treasury makes similar findings.

This Budget takes the mid-point of the IFS's estimates, £30 billion, as the likely deterioration in the public finances and shows the types of trade-offs involved in dealing with such a deficit in 2019-20. One plausible scenario shows that:

- Health spending would be cut by £2.5 billion, defence spending by £1.2 billion and education spending by a similar amount
- The basic rate of income tax would rise by 2 pence to 22p and the higher rate by 3 pence to 43p
- Capital spending would be reduced by £2.4 billion
- Fuel and alcohol duties would increase by 5%

The balance between tax and spend would be up to the Government at the time. But there would be no easy way of dealing with this deterioration in the public finances. The Treasury's own analysis makes clear that the reduction in tax receipts would be largely structural. This means Britain would not be able to grow its way out of this problem – instead the Chancellor would have to base decisions on the simple fact that Britain would be poorer and not just poorer in the short term but poorer in the long term too. Taxes would have to be higher and spending would have to be lower to ensure the public finances were on a sustainable path. None of the difficult decisions outlined in this document would be required if we vote to remain in the EU on 23 June. If we vote to remain the OBR forecasts Britain will go on creating jobs, wages will continue to rise and the economy will grow steadily. This is the choice before the British people on 23 June.

The IFS analysis

The IFS is widely respected both in Britain and across the world for its impartiality and the quality of its analysis. On 25 May 2016 they published a document entitled Brexit and the UK's public finances.

This focused on the two key components to work out the overall impact on the public finances: the mechanical effect and the national income effect. Their conclusion was that the mechanical effect of reduced EU budget contributions would be far outweighed by the national income effect.

To reach this conclusion they examined more than a dozen studies on the GDP impact of a vote to leave. They concentrated on the estimates by the National Institute of Economic and Social Research, who forecast a GDP hit of between 2.1% and 3.5%, while also warning that most of the risk is on the downside – that is to say the fall in GDP is more likely to be bigger than it is to be smaller.

The IFS then looked at the relationship between national income and the public finances, and in particular the relationship between national income, tax receipts and spending. Using figures from the Great Recession they establish estimates of the extent to which changes in national income affect tax receipts, public spending and therefore public sector net borrowing.

Table 1: The IFS' illustrative impact on the public finances of a 1% reduction in national income

	Year 1 effect	Additional year 2 effect	Total effect
Current receipts	-0.1	-0.1	-0.2
Total managed expenditure	+0.4	+0.1	+0.5
Public sector net borrowing	+0.5	+0.2	+0.7

Source: Helgadottir et al. (2012); authors' calculations

Having looked at all these variables their central conclusion was: 'including the direct benefits of reduced budget contributions, these would lead to the public finances being between about £20 billion and £40 billion less healthy than in a scenario in which we did not leave the EU'.

Table 2: estimates of the impact on GDP of a vote to leave examined by the IFS

	GDP change (%)	Impact on borrowing (% of national income)	Impact on borrowing (£bn 2016-17 terms)	Impact on borrowing per household (£, 2016-17 terms)
Société Générale	-6	+3.8	+74	+2,750
PwC/CBI	-4.25	+2.6	+50	+1,850
Nomura	-4	+2.4	+46	+1,700
Citi	-4	+2.4	+46	+1,700
OECD	-3.3	+1.9	+37	+1,350
NIESR				
(impacts for 2019)				
- WTO pessimistic	-3.5	+2.0	+40	+1,450
- WTO optimistic	-2.8	+1.5	+30	+1,100
- FTA pessimistic	-2.5	+1.3	+26	+950
- FTA optimistic	-2.2	+1.1	+22	+800
- EEA pessimistic	-2.4	+1.5	+29	+1,050
- EEA optimistic	-2.1	+1.3	+25	+900
Deutsche Bank	-3	+1.7	+33	+1,200
Morgan Stanley	-2	+1.0	+19	+700
Credit Suisse	-1.5	+0.6	+12	+450
HSBC	-1.25	+0.5	+9	+350
JP Morgan	-1	+0.3	+6	+200
Mansfield	+0.1	-0.5	-9	-350
Economists for Brexit	+1.6	-1.5	-30	-1,100

The Treasury's analysis

In its analysis of the short-term impacts of leaving the EU, HM Treasury forecast that borrowing would increase by between £24 billion and £39 billion by 2017/18, while in its long-term analysis it forecast that tax receipts would be between £20 and £45 billion permanently lower if Britain was to leave the European Union.

In a document entitled Cyclical Adjustment of Public Finance Modelling, the Treasury also examined the extent to which this deterioration in the public finances would be structural or cyclical and modelled the path of borrowing over the next five years.

Table 3: Treasury estimates of the increase in PSNB across the Budget 2016 forecast horizon

(£billion)	2016-17	2017-18	2018-19	2019-20	2020-21
Shock scenario					
PSNB	12	24	25	25	26
Structural PSNB	9	18	21	23	26
Cyclical PSNB	3	6	4	2	0
Severe shock scenario					
PSNB	19	39	37	36	35
Structural PSNB	13	25	28	32	35
Cyclical PSNB	6	13	9	4	0

These figures are in line with the IFS estimates, and show that by the end of the forecast period the deterioration in the public finances would be entirely structural. This means the increase in the deficit would remain even after the immediate impact of leaving the EU had dissipated. Any Government would either have to increase taxes or reduce spending to close this permanent gap in the public finances.

Table 4: Treasury estimates of the increase in PSND

(£billion)	2016-17	2017-18	2018-19	2019-20	2020-21
Shock scenario	12	36	61	86	112
Severe shock scenario	19	58	95	131	166

Scorecard: £30 billion of tax rises and spending cuts

The scorecard below gives an illustrative example of the sorts of difficult decisions that would be required to deal with a £30 billion deterioration in the public finances. The potential tax revenues have been calculated using HMRC ready reckoners.

These are publicly available up to 2018-19. They are then up-rated to the target year 2019-20 by using the OBR's assessment of how public sector current receipts grow over time. Potential savings from reduced spending are calculated using the 2019-20 departmental budgets set out in the march budget.

Table 5:

		2019-20 (£ million)
Spending		
1	Resource spending (excluding Health, Education and Defence)	+5,750
2	Health	+2,500
3	Education	+1,150
4	Defence	+1,200
5	Capital spending - Including transport and major infrastructure	+2,400
6	Pensions	+2,000
Personal Tax		
7	Basic rate, raise by 2 pence to 22p	+9,700
8	Higher rate, raise by 3 pence to 43p	+3,500
9	Inheritance tax: increase standard rate by 5 percentage points	+600
Duties		
10	Alcohol (beer, cider, wine and spirits): increase duty by 5%	+500
11	Fuel: increase duties on petrol and diesel by 5%	+1,400
	TOTAL POLICY DECISIONS	**+30,700**
	Total tax policy decisions	**+15,700**
	Total spending policy decisions	**+15,000**

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