The living standards tax gap just got bigger

Why falling wages and tax giveaways have hit revenues

A TUC report based on analysis by Spencer Thompson, Senior Economic Analyst, IPPR

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Over the last five years, average weekly earnings (AWE) have continually failed to deliver, with the Office for Budget Responsibility's (OBR) forecasts for AWE growth regularly missed. What's more, across the parliament even the modest growth in AWE the OBR anticipated was well below the historic average rate of earnings growth. These trends are set out in table 1 below.

Table 1: Forecast and actual performance of AWE including bonuses 2010/11 to 2014/15

	OBR 2010 forecast	AWE (including bonuses) outturn[1]	Difference between outturn and OBR forecast	Historic average (based on AWE 2001-2008)	Difference between outturn and historic average
2010/11	1.7%	2.0%	0.3	4.3%	-2.3
2011/12	2.4%	1.9%	-0.5	4.3%	-2.4
2012/13	3.5%	1.4%	-2.1	4.3%	-2.9
2013/14	5.3%	1.5%	-3.8	4.3%	-2.8
2014/15	5.4%	0.6%	-4.8	4.3%	-3.7

This new analysis (undertaken for the TUC by IPPR) looks at what the impacts of such poor rates of pay growth will be for the public finances this financial year.[2] It shows that years of low wages mean that in this year alone the Exchequer faces a revenue shortfall of £33.4bn as a result of poorer than expected income tax performance (responsible for just under two thirds of the shortfall) and lower national insurance revenues (responsible for just over a third of the shortfall).

What's more, if earnings had grown in line with the historic average[3] then £49.6bn more in revenues would be raised this year (despite the government's tax cuts, which are discussed in more detail below).

These findings are shown in Table 2 below overleaf.

[1] The 2014/15 data are based on the September 2014 index for average earnings including bonuses. September was used because it is in the middle of the financial year and therefore provides an 'average' for the whole year, providing an assessment of progress across the year to date and a likely indicative path for future progress

[2] This analysis only considers the fiscal impacts of missing the OBR's forecasts on earnings and does not give consideration to employment effects.

[3] This rate is based on the average of AWE including bonuses from 2001-2008. This series began in January 2000 so year on year growth figures are only available from January 2001

Table 2: Revenues in 2014/15 under currently forecast rates of AWE growth and alternative scenarios for AWE performance

	Current forecast income (£bn)	Additional income if earnings performed as per OBR 2010 forecast	Additional income if earnings performed as per historic average
Income tax	159.2	21.3	31.8
National insurance contributions	115.8	12.1	17.8
Total	**275**	**33.4**	**49.6**

At the same time, the government's tax policies have led to a further shortfall. Repeated increases in the personal allowance together with moves to hold down the higher rate threshold have reduced the amount of income tax and employee national insurance[4] being paid. Our analysis suggests that, in total, revenues are down a further £9.7bn from where they would have been if the government had followed previous tax policies (albeit with CPI rather than RPI uprating of thresholds) on income tax.

The IFS's Green Budget suggests that the increase in structural borrowing since pre-crisis by 2019-20 will be £160bn and that £110 billion of fiscal tightening has taken place.[5] The extra revenue that would have come from stronger wage growth and retaining the previous government's tax policies would therefore have almost have eliminated the need for further measures to reduce the deficit[6] (beyond those spending cuts and tax rises that have already been introduced over the current parliament). If earnings growth had continued at its historic average, then even more would have been raised.

Our analysis also shows that these problems are not set to resolve themselves any time soon, with the OBR's current forecast for the next parliament still showing wage growth some way below the historic average, which will lead to further

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[4] National Insurance revenues are lost as the upper earnings limit (where the NICs rate falls to 2 per cent) is always set at the same level as the higher rate income tax threshold. Therefore, if you keep the HRT from rising with inflation (as the Government has done) more people are pushed into the 2 per cent band than if it rose with inflation. This reduces the tax benefit to the Government from limiting HRT rises.

[5] It is important to note that there are a range of estimates as to the output gap and different assessments of potential output when the economy is at full capacity give different measures of the likely future extent of structural borrowing. It is also impossible to know how years of underperformance have affected future potential output.

[6] http://www.ifs.org.uk/publications/7530, page 24, Table 1.2.

revenue shortfalls in the years ahead. These are set to total a further £23.9 billion by the end of the next parliament – and that's before further (as yet uncosted) tax giveaways are included[7]. What's more, if wages in the next parliament perform as badly relative to the OBR's forecast as they have over the last five years, the shortfall will increase to a substantial £41.0bn annual loss by 2020.

[7] In 2020/21 prices.