IFS Green Budget Press Release

Still not half way there yet on planned spending cuts

Policy on business rates, pensions taxation and childcare needs clearer sense of direction

The IFS Green Budget, funded by the Nuffield Foundation and produced in collaboration with Oxford Economics, is published today.

The Chancellor's decision to extend the fiscal consolidation through to 2018–19 means even more dramatic spending cuts are now planned, despite the better headline economic news. By the end of this financial year only 40% of planned spending cuts will be in place.

Even with £12 billion a year of additional cuts to social security spending, Mr Osborne's plans would imply **cuts of more than 30% in "unprotected" public service budgets** since 2010. In fact, the challenge could be even greater than these headline figures imply:

- The government has already made **additional spending commitments of more than £6 billion a year** after 2015–16 – implying additional cuts elsewhere;
- The population is projected to grow by about 3.5 million between 2010 and 2018. So while public service spending is set to fall by 1.7% a year over this period, **public service spending per person is set to fall by 2.4% a year**;
- Over the same period, the number of individuals aged 65 and over, who, on average, place greater demands on the NHS, is set to grow by two million. We calculate that, even if the overall NHS budget continues to be frozen in real terms, **real age-adjusted health spending per person would be 9% lower in 2018–19 than in 2010–11**.

There are also **policy risks on the tax side.** The government's revenue forecasts assume that fuel duties rise each year with inflation. If, as recent history suggests, this does not happen, £4.2 billion a year would need making up by 2018–19. And further significant increases in the income tax personal allowance would be expensive.

Harder to quantify are the risks associated with our **increasing reliance on a small group of very rich taxpayers.** The share of income tax paid by the top 1% of taxpayers rose from 11% in 1979 to 27.5% in 2011–12. The income tax alone paid by these 300,000 very high income individuals accounts for 7.5% of *all* tax revenue. These individuals will of course also pay a large fraction of VAT and capital taxes.

Much of the expected increase in underlying revenues over the next few years is projected to come from **growth in capital taxes,** which are notoriously difficult to forecast. More broadly, **government is becoming increasingly reliant on the three main taxes** – income tax, VAT and National Insurance contributions (NICs) – which will account for two thirds of all revenue by 2018–19.

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Embargo

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Growth expected to be 2.6% in 2014

Oxford Economics, with whom we are again collaborating, expect growth of 2.6% this year and also think **growth will be more balanced than in 2013.** They expect it to be less reliant on consumer spending, with stronger performances from business investment and exports. Growth of 2.6% would leave the UK amongst the fastest growing developed economies.

While Oxford Economics forecast similar growth for the next few years as the OBR they are significantly **more optimistic about the scope for the UK economy to grow before inflationary pressures return**. That implies that the economy would be able to sustain several years of above trend growth beyond 2018–19 and that we could plan for much less fiscal consolidation as more of the deficit would prove to be a temporary phenomenon.

Macroeconomic risks to the public finances more balanced

Oxford Economics also see macroeconomic risks as much more balanced than in recent years, with real upside risks. From the public finance point of view, even if the most pessimistic of current forecasters prove correct, the planned consolidation would still be sufficient to offset the fiscal damage done by the financial crisis. If the most optimistic forecasters prove correct then none of the spending cuts planned beyond 2014–15 would be needed to return the deficit to pre-crisis levels.

Debt will continue to be a constraint

Over this parliament the Chancellor is planning to **borrow much more than he originally intended**. The OBR forecasts borrowing will be £96 billion in 2014–15, which is £59 billion more than planned in 2010. Mr Osborne has chosen not to offset this increase in borrowing with higher taxes or lower spending this side of the expected date of the general election.

The additional year of spending cuts proposed in the Autumn Statement put the UK on course to have, in 2018–19, its first budget surplus since 2000–01. Even so, **national debt in that year is still forecast to be 76% of national income**. Just paying the interest on this debt is forecast to take up nearly 4% of national income – more than the entire schools budget. Even under the government's ambitious plans for spending cuts **national debt would only return to pre-crisis levels in the mid 2030s**.

On the fiscal situation **Paul Johnson**, IFS director, commented: "*Returning growth, and forecasts suggesting we should be running a Budget surplus by 2018-19, should not lull us into a false sense that all is now well with the public finances. The outstanding debt will still be very large and the scale of additional spending cuts required to hit that budget surplus remains hugely challenging, especially on top of cuts already delivered. A combination of significant additional spending pledges already made and a growing and ageing population will only add to the challenge.*"

Andrew Goodwin, Senior Economist at Oxford Economics said: "*The UK recovery is getting ever closer to achieving 'escape velocity', although the unbalanced nature of the recovery to date emphasises the need to avoid complacency. Nevertheless, we believe that an improving global outlook will provide the basis for the recovery to broaden out this year, by supporting export growth and giving firms the confidence to invest their large cash piles.*

Our forecast also emphasises the problems associated with targeting a cyclically-adjusted measure of borrowing. Oxford Economics analysis suggests that the economy has a significantly larger amount of spare capacity than the OBR estimates which, in turn, suggests that the medicine of austerity could end up being applied in a dose higher than the patient actually needs."

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No evidence of a housing bubble yet

They may be recovering but, in real terms, **house prices remain around 25% below their previous peak**. Even in London real prices are still 17% lower. On the other hand the price–earnings ratio for first-time buyers has reached its previous peak in London and lies above its longer-term trend. London prices are underpinned by the fact that London's population has grown faster than the stock of housing – not something that has occurred across England as a whole.

The government's Help to Buy policies are in part attempting to overcome a short-run failure in the financial markets. To that extent, their support for house buyers with low deposits relative to the value of the house looks well targeted. Focusing support on those buying new build homes would be better targeted at increasing the stock of housing, and would moderate the risk that the policy might push up house prices.

Further significant increases in personal allowance would be expensive and poorly targeted at helping the low paid

The personal allowance will reach £10,000 this year, taking two million people out of income tax but costing nearly £10.7 billion per year by comparison with the plans inherited by the government.

Further increases would be even less well targeted on the low paid than previous increases: 1 in 6 workers now pay no income tax so cannot gain from income tax cuts. In addition many pensioners would now also gain from further increases. We estimate that just 15% of the gains from further increases in the personal allowance would accrue to workers in the bottom half of the income distribution. Labour's proposed 10p starting rate of tax would be, if anything, less well targeted on the low paid and would add unnecessary complexity. It is hard to find a coherent economic rationale for it.

If the objective is to help the low paid through tax cuts then increasing the point at which employee NICs start to be paid would be better.

Despite the apparent consensus, the case for additional spending on childcare has not been made

Public support for early childhood education and care, at more than £6 billion annually, has already more than doubled as a share of national income in the last 20 years. The main political parties are promising further increases. But current support – delivered through a combination of direct provision, subsidy for private provision, means tested benefits and tax breaks – is not well designed. Recently announced reforms will further complicate things.

The biggest problem is that little is known about the effectiveness of this spending. Some is helpful in improving outcomes for poorer children, but most spending is not aimed at this. There is little evidence that current spending is effective in terms of increasing mothers' labour supply.

Rather than simply continuing to promise more money politicians should state more clearly what they want to achieve, work harder to evaluate the effectiveness of current policy, and be more willing to embrace reforms to how support is targeted and to the way in which it is delivered.

Tinkering with business rates increases uncertainty and complexity

Business rates raise more than £26 billion a year. Because bills have not fallen with the economic cycle, receipts have risen from 3.9% of all tax revenues before the recession to 4.5% now.

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Business rates could be reformed to make them more responsive to the economic cycle. In any case, ensuring that rateable values are kept more in line with actual rental values year-to-year would make tax bills more transparent, fairer as relative property prices change, and less prone to sharp changes at revaluation.

But recent changes have been in the opposite direction. The revaluation of properties that was due to take effect in 2015 has been delayed until 2017 creating an almost certainly unintentional pattern of winners and losers.

This is the first delay in revaluation since business rates were introduced in 1990. We have also seen the first change in indexation, and a 'temporary' cut to small business rates relief has already been extended four times and seems likely to be extended again beyond March 2015. 'Temporary' reliefs have also been introduced for some, as yet unspecified, retail premises. The lack of a coherent long-term strategy is rather evident.

No easy money in reducing income tax relief for pension contributions

There is a myth that further restricting income tax relief on contributions to private pensions would be an equitable and largely harmless way of raising substantial sums of money. It would not be. It would impose a degree of double taxation on pension saving. It would also further disadvantage young savers relative to current pensioners, and would add more complexity for those in defined benefit pension schemes.

There are reforms, though, which could raise money for the Exchequer and would be more rational. First, those with the biggest pension pots can currently withdraw up to £312,500 as a tax free lump sum. This money will never have been subject to income tax. This subsidy could be reduced. Second, pension contributions made by employers on behalf of their employees escape NICs entirely. This is excessively generous. Employer NICs could be levied on employer pension contributions, potentially raising £10.8 billion a year. A simpler alternative would be to start charging NICs on pensions in payment, starting at a low level and increasing over a long period. Each 1 percentage point charge would raise about £350 million a year.

Care needed in responding to increases in energy prices

Analysis of the extent to which there is a problem in the way that energy markets work remains piecemeal with little agreement on the best way forward. The time has perhaps come for the independent Competition and Markets Authority to undertake a wholesale review of the market.

Social and environmental charges within energy bills are not optimally designed. But an overall reduction in these charges risks increasing the cost of meeting government targets for reduced carbon emissions. Households already face much lower carbon prices than do businesses. The effective carbon price on gas is negative – i.e. its consumption is subsidised relative to spending that is subject to the full rate of VAT. This is inefficient. There should be more focus on achieving a consistent carbon price as an efficient part of policy to reduce emissions.

Carl Emmerson, IFS Deputy Director said: *"Despite the state of the public finances, tax cuts and spending increases are being considered by government and opposition. They seem agreed in promising additional spending on childcare despite a remarkable lack of evidence as to its effectiveness. They seem equally set on further cuts in income tax either though more increases in the personal allowance or the introduction of a 10p starting rate. Either could be expensive and would be poorly targeted on the low paid."*

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*We are delighted to have produced this year's Green Budget in collaboration with **Oxford Economics** and are very grateful to the **Nuffield Foundation** for providing funding. We are also grateful to the **Economic and Social Research Council** for funding much of the day-to-day research at IFS that underpins the analysis in this report.*

Notes to Editors:

1. The Green Budget 2014, edited by Carl Emmerson, Paul Johnson and Helen Miller, will be launched at 10:00 on Wednesday 5th February 2014 in Beveridge Hall, Senate House (http://www.ifs.org.uk/events/986). To reserve your place please contact mailbox@ifs.org.uk;

2. The full report will go live on the IFS website shortly after 10am. For embargoed copies or other queries, please contact Bonnie Brimstone on 0207291 4818 bonnie_b@ifs.org.uk;

3. Previous editions of the Green Budget can be found at: http://www.ifs.org.uk/budgets;

4. The Nuffield Foundation is an endowed charitable trust that aims to improve social well-being in the widest sense. It funds research and innovation in education and social policy and also works to build capacity in education, science and social science research. The Nuffield Foundation has funded this project, but the views expressed are those of the authors and not necessarily those of the Foundation. More information is available at www.nuffieldfoundation.org.

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