

Paul Johnson's opening remarks

March 19 2015

There was only one eye-catching change to the fiscal numbers in yesterday's Budget, one that occurs five years out in 2019-20. Instead of allowing public spending to fall as a proportion of national income in that year, as implied in the Autumn Statement, the default position of the government now seems to be to allow spending to grow in line with national income. That change brings the forecast surplus down from £23 billion to £7 billion. Of course surplus or deficit numbers this far in the future are of little interest in themselves – average forecast errors this far out run into the tens of billions of pounds. But the apparent change in economic philosophy in the three months since the Autumn Statement is pretty remarkable.

Put the implied increase in public service spending in 2019-20 together with the cuts beforehand and you get what OBR chief Robert Chote describes as a “rollercoaster” ride for public service spending. The cuts of more than 5% implied in each of 2016-17 and 2017-18 are twice the size of any year's cuts over this parliament.

IFS Post-Budget Briefing 2015

Ah, protests the Chancellor, this isn't taking account of the £12 billion of welfare cuts and £5 billion of anti tax avoidance measures I'm planning. If you factor those in then the cuts in public service spending look more in line with what has happened over this parliament. He is right to say they would. But it is now almost two years since he announced his intention of cutting welfare spending by £12 billion. Since then the main announcement has been the plan *not* to cut anything from the main pensioner benefits. We have been told about no more than £2 billion of the planned cuts to working age benefits. And remember apparently the "plan" is to have those £12 billion of cuts in place by 2017-18. It is time we knew more about what they might actually involve.

There were some tax changes in the Budget. Mr Osborne continued his changes to the taxation of interest income, taking most of it out of tax altogether. He also continued his reduction in the generosity of pension tax relief. With further changes to the taxation of annuities it is in changing the structure of the taxation of savings and pensions that he has been most radical over the past five years. This is possibly the one area of lasting structural change in the tax system for which he will be remembered.

But before going on to look at the spending and tax plans in more detail, let's start by examining one of the central claims of Mr Osborne's budget

speech – that we are now better off than we were in 2010, and that we are “all in it together”.

Household incomes

Mr Osborne said that “households on average will be £900 better off in 2015 than they were in 2010”. Yet Mr Miliband claims that “people are £1,600 a year worse off”. Where does the truth lie?

Before saying anything about the details it is straightforward to paint the broad picture. Average household incomes have just about regained their pre-recession levels. They are finally rising and probably will be higher in 2015 than they were in 2010, and possibly higher than their 2009 peak. But that still represents by far the slowest recovery in incomes in modern history. Having household incomes crawl back up above pre-recession levels six or seven years after the recession hit is no cause for celebration.

What’s the difference between Mr Osborne’s £900 better off and Mr Miliband’s £1,600 worse off?

In part the difference arises because Mr Miliband is talking about *gross earnings*, not *net incomes*. The latter allows the fuller description of what has happened to household living standards. Earnings have fallen more

IFS Post-Budget Briefing 2015

than other incomes. Employment has risen and pensioners' incomes have risen. And measures of changes in gross earnings don't take account of the tax system. If you are a taxpayer and your gross pay falls £1,600 then your net pay will fall by at most £1,100.

In addition Mr Miliband is looking at earnings only up to April 2014. Mr Osborne is relying on forecasts of income through to the end of 2015. All of the real increase since 2010 is in the forecast. It occurs in the last year, in 2015. There is no actual increase in the data we have so far.

As ever there is much truth in both numbers. Real earnings have fallen, as Mr Miliband says. Real incomes should be above their 2010 level as Mr Osborne says. We are for sure much worse off on average than we could reasonably have expected to be back in 2007 or indeed back in 2010.

Mr Osborne' second claim is that we are all in this together, that inequality has fallen. Mr Miliband says "it's a recovery for the few".

Our analysis suggests:

- At least across the huge majority of the population inequality has fallen a little if you assume that everyone has faced the same rate of inflation. If you adjust for differential inflation inequality in 2014-15 is very similar to its level in 2007-08;

IFS Post-Budget Briefing 2015

- The experience has been very different by age. Average incomes among pensioners have risen, among those of working age they have fallen, with especially big falls for those in their 20s. This pattern has largely been driven by falls in earnings.
- As far as tax and benefit changes are concerned, benefit cuts have hit low income working age people. Tax increases have hit those on the highest incomes much the hardest. People on middle and upper middle incomes have been remarkably insulated on average from tax and benefit changes. Looking at changes over the period of the consolidation as a whole the richest have been hit hardest. Looking only at changes implemented by the coalition the poorest have seen the biggest proportionate losses.

Public finances and public spending

The overall public finance numbers are hardly changed over the next few years by comparison with the Autumn Statement forecasts.

The deficit will be about £90 billion this year, about three times what Mr Osborne had intended back in 2010. That reflects a combination of low growth in the early years of the parliament and the Chancellor's flexible attitude to deficit reduction.

IFS Post-Budget Briefing 2015

To be clear. The only realistic way in which he could have achieved a significantly lower deficit would have been by cutting spending more or raising taxes more.

Mr Osborne surprised many of us yesterday by announcing that, contrary to expectations and previous forecasts, he now expects to meet his old supplementary fiscal target of debt falling as a proportion of GDP in 2015-16. How has he done this? By selling more assets, largely shares in financial institutions bought as part of the financial sector bail out in 2008. Their sale makes no difference to the overall public sector balance sheet.

Other forecast changes slightly strengthen the public finances going forward, largely a result of lower forecast inflation reducing expected spending on debt interest and welfare. The chancellor is looking to use some of that money slightly to reduce public spending cuts in 2016-17 and 2017-18. But the big difference from the Autumn Statement numbers lies in 2019-20. In a sharp change of tack it seems it is no longer the intention to keep cutting and create a £23 billion surplus; rather public service spending will be allowed to rise substantially.

Overall, though the actual path of spending cuts over the next parliament seems more uncertain than ever.

IFS Post-Budget Briefing 2015

That's partly because there are big differences between the parties. In fact our latest estimates suggest that Labour would be able to meet its fiscal targets with no cuts at all after 2015-16.

But the Budget suggests spending cuts of £40 billion by 2018-19, but "just" £26 billion by 2019-20. Even with a majority Conservative government is that pattern really the most likely outcome?

And then there's the question of how much of that cut will come from public services. The Chancellor argues that because he is committed to £12 billion of welfare cuts and £5 billion of anti tax avoidance measures the required cuts to public service spending are much more modest. But if he really wants us to believe that then he needs to be more explicit about how he actually thinks he can cut welfare spending and raise substantial additional sums from clamping down on tax avoidance.

Finally, don't forget the range of rather hidden pressures on public spending. Look in table 2.2 of the Red Book, the table that shows the public finance effects of policies announced in previous budgets. You'll find a figure of £3.7 billion alongside a line saying "contracting out of NICs". That is in fact an extra £3.7 billion of NI contributions required from public sector employers – a £3.7 billion reduction in spending power. Another £1 billion will be required from them to pay for extra costs of public service pensions.

IFS Post-Budget Briefing 2015

And once again in this Budget the chancellor has made some unfunded commitments – the help to buy ISA and the extra money for mental health will be paid for by unspecified cuts elsewhere.

The upshot of all this? My guess is that even under a majority Conservative government, annual cuts in public service spending will not turn out much more dramatic than those we have seen over this parliament. We won't be on the OBR's rollercoaster. But it is a terrible shame that, despite all the mass of information in the EFO, I am left guessing. Whitehall departments are going to have to plan for some dramatically differing scenarios, one of which they will have to implement in just 12 months time.

Tax changes

The chancellor has spent an awful lot of money increasing the income tax personal allowance, reducing fuel duties and cutting rates of corporation tax. He spent more money on the first two of these yesterday. But the big structural reforms have come in the taxation of pensions and savings. We saw some additional changes yesterday.

A further reduction in the amount that can be saved free of income tax in a pension is a further erosion of a rather sensible part of the tax system – allowing people to save from pre-tax income and pay tax on withdrawal.

While a reduction in the lifetime limit is less problematic than reductions in

IFS Post-Budget Briefing 2015

annual limits and rates of relief (as proposed by Labour) there are better ways to reduce tax relief for pensions in particular by reducing the extraordinarily generous treatment of employer contributions by the NI system.

The proposed change to the tax system to allow people to cash in their annuities looks in principle like a sensible move. What effect it will have in practice is less clear. Allowing a market to exist does not mean it will spring into existence. There is a classic adverse selection problem here. Who is most likely to want to cash in their annuity? Someone who now knows they don't have long to live. How much will they get for their annuity? Not much. What might annuity companies assume about anyone wanting to cash in? That they have reason to believe they won't live long. How much will they get paid for their annuity? Not much.

Finally, adding flexibility to ISAs and taking most interest income out of tax altogether is a welcome simplification.

In conclusion

As expected the last Budget of this parliament did not usher in any dramatic changes. Chancellor Osborne has resisted the temptation to offer lots of pre-election goodies. But whoever is Chancellor after the election will be left with plenty of work still to do.