Opening remarks for post-PBR briefing

Good afternoon everyone.

My name is Robert Chote and I am Director of the IFS.

Welcome to our post mortem on this year's historic Pre-Budget Report. I will make some opening remarks – which will be available in hard copy after we finish – and then we have four presentations for you:

- Carl Emmerson will talk about the changes to the Chancellor's public finance forecasts

- Gemma Tetlow will talk about the fiscal rules and the public finances in historical perspective

- Stuart Adam will talk about the indirect and some business tax measures

- And Mike Brewer will look at the winners and losers from the measures overall

This was not a Pre-Budget report so much as two unusually large Budgets sandwiched together. The Chancellor announced a short-term fiscal stimulus designed to limit the depth and duration of the recession, followed by a long-term fiscal contraction designed to recoup the costs of the stimulus and – more importantly - to repair a dramatic deterioration in the underlying health of the public finances. He will be pumping £16 billion of extra spending power into the economy next year and then taking all that out - plus a further £22 billion - just three years later.

The Government has opted for a fiscal stimulus worth about 1% of national income and hopes that this will mean that the economy shrinks by about half a percent less than it otherwise would. The stimulus will mean gains for households right across the income distribution next year, with the biggest percentage gains for those on the lowest incomes.

Given current concerns about the effectiveness of interest rate cuts the case for accompanying them with a temporary fiscal stimulus is stronger than it otherwise would be. But the effect of the stimulus and the effect of interest rate cuts are both uncertain. That in itself is a good reason for us not to put all our eggs in either basket. The concern that a fiscal giveaway could raise the government's borrowing costs and put uncomfortable downward pressure on the pound is of course a serious one. But on balance the risk of acting may be less than the risk of refusing to. However, it certainly underlines the need to be serious about getting the public finances back into good shape once the stimulus has passed.

So let me turn to the subsequent fiscal contraction.

The Chancellor is having to raise taxes and cut spending from 2010-11 in part to recoup the costs of the stimulus – the VAT cut may be temporary, but various other elements – such as the increase in the personal income tax allowance and the rise in the level of earnings at which we start to pay National Insurance – are permanent and need to be paid for elsewhere.

But by far the most important reason for the squeeze is that the Treasury believes that the credit crunch will punch a permanent £60 billion hole in the capacity of the economy. The PBR estimates that the amount of output and spending that the economy can sustain without pushing up inflation will fall by 4% between the mid-2007 and mid-2009. This reflects the impact of the credit crunch on the normal functioning of the economy and on the amount of capital we have available to use in the production process. Presumably it also reflects the likely disappearance of part of our financial sector. And if oil and commodity prices had not begun to fall in recent months the damage would have been even bigger.

Punching this hole in the economy will cost the Treasury about £40 billion in lost tax revenues and higher social security spending – and this will not be recouped by the economic recovery. It has to be added to the structural budget deficit we would have been running anyway – plus the revenue losses from falls in the housing market and stock market.
The net result is that the public sector will still be running a structural budget deficit of 5.6% of national income in 2010-11, a year after the main elements of the fiscal stimulus package have been exhausted.

The size of this deficit explains why borrowing remains so high for so long and why debt continues to rise for six more years despite the combination of tax increases and cuts in public spending announced yesterday. Having met the golden rule – to borrow only to invest – with £20 billion to spare over the last economic cycle, the Government is now on course to break it by almost £300 billion over the current economic cycle. Net debt is expected to breach the 40% of national income ceiling set out in the sustainable investment rule by more than £250 billion.

Despite the excitement created by the increases in National Insurance and the new higher rate of income tax, it is important to understand that most of the looming fiscal squeeze comes in the form of spending cuts as a share of national income rather than tax increases. The Treasury expects to see the tax burden increase by 1.4% of national income between 2010-11 and 2013-14, but to cut spending by 2.5% of national income.

In 2012-13 the Government will raise around £4 billion net from tax increases compared to almost £19 billion from spending cuts. The tax and benefit changes during the fiscal squeeze will increase incomes in the bottom half of the income distribution and reduce them at the top – especially the very top. But those who are hailing the Chancellor's return to overt redistribution from rich to poor may wish to pause briefly and consider who might be affected by the squeeze on public spending.

The introduction of the new 45p income tax band on incomes above £150,000 understandably caught everyone's attention, being the first increase in the highest income tax band since 1974. The Treasury estimates that this will raise £1.6 billion in a full year, although this has to be a very tentative guess. If more of these people declare less taxable income, put more into their pensions, increase charitable giving or engage in avoidance than the Treasury expects then it may raise less than it hopes.

Almost as important in revenue terms – and much less obvious to the naked eye – is the impact of taking away the personal income tax allowance for people on high incomes. This in effect creates two new 60% income tax bands for incomes between £100,000 and £106,450 and between £140,000 and £146,450 for no obvious economic rationale.

This will create a very powerful incentive for people with incomes within these bands to increase their pension contributions until their taxable incomes fall to the bottom of the bands.

Reflecting these changes my colleague Mike Brewer will illustrate in his talk how the Chancellor apparently believes that the marginal income tax rate should change as incomes increase. I should warn those of you who favour a simple, non-distorting structure for marginal tax rates that you may find some of these pictures distressing.

That caution in place, let me hand you over to Carl…