

IFS Budget analysis 2014: introductory remarks

Paul Johnson 20/03/2014

Yesterday's Budget will surely be remembered for the changes to the tax regime for pensions and, to a lesser extent, savings more generally. Members of defined contribution pension schemes will, from 2015, have much greater freedom once they reach age 55 over how to draw their pension income. This should make saving in a pension more attractive. It will dramatically change the pensions landscape, both in terms of how people take income in retirement and how the pensions industry is structured.

The Chancellor also announced that Individual Savings Account (ISA) limits would be increased, with a liberalisation of the rules for how much cash can be held within them. And he scrapped income tax on up to an additional £5,000 of annual savings income for some. These changes are largely welcome as part of a rationalisation of the tax system for savings.

More on pensions and savings later.

In terms of the public finances yesterday appeared to be, as widely predicted, something of a fiscal non-event. The return of growth has not in any sense obviated the need for continued austerity. We are still looking at borrowing of

£108 billion this year – nearly £50 billion more than planned back in 2010. The Chancellor is planning five more tough years of deep spending cuts to get borrowing down to zero.

Given his stated aims, it would have been astonishing if Mr Osborne had engaged in a significant giveaway. And the Budget scorecard would seem to suggest that he managed to maintain a neutral stance overall whilst finding money for some favoured tax cuts.

I am not so sure we should take that entirely at face value though. A set of definite and permanent tax cuts look to have been matched by more unspecified spending cuts, some changes in the timing of tax receipts, and our old friend tax avoidance measures. The numbers are small in the scheme of things. But we had similar observations to make after last year's Budget. A Chancellor focussed on the sound management of the public finances over the long run would not make a habit of repeating these sorts of manoeuvres.

So let's look at those **tax and spending changes** in more detail. In particular how has Mr Osborne managed to fund another increase in the income tax personal allowance, cuts in tax on savings, an increase in the annual investment allowance within corporation tax and cuts to some excise duties? He has done several things.

First, the overwhelming fact about the public finance plans remains that spending in “unprotected” departments is set to have fallen by more than a third by 2018-19, with most of those cuts still to come. That didn’t change significantly yesterday. Further public service spending cuts appearing in the Budget scorecard appear to have offset some potential additional room for manoeuvre left by reductions in forecast debt interest and AME spending. The chancellor effectively expressed a lot of confidence in his ability to deliver these cuts. He did not take the opportunity to ameliorate them.

Second, there was another kind of spending cut dressed up in very curious clothing. The government is expecting the long term costs of public service pensions to rise. That worsens the public finances. The Treasury is, probably sensibly, “charging” spending departments for these increased costs. Because it is taking money from them, it is saying it has extra money to spend. Hey presto! A worsening of long run public finances gives the Treasury extra money to spend now. That is not a sensible way to think about fiscal policy.

Third, the liberalisation of pension rules is expected to lead to more tax revenue over the next few years. But that depends on highly uncertain behavioural assumptions about when people take the money. The Treasury expects this measure to reduce annual revenues in future years.

Fourth, there was the usual slew of policies aimed at reducing tax avoidance, with additional revenues scored. These may be important policies. But the associated revenues are by their nature uncertain. And in the case of the biggest one announced yesterday – accelerated payments in respect of disclosed avoidance schemes – the effect is to increase revenues in the initial years but to reduce revenues in later years.

One spending change about which we got more details this week was on the introduction of **tax free childcare**. The policy was first announced a year ago, to take effect from September 2015. It has been made more generous in its intended coverage but, magically, at no extra cost. So far as one can tell this just reflects new analysis resulting in new estimates. How and why that happened is not transparent. A more generous treatment of childcare costs in the Universal Credit system was also announced – to be paid for by as yet unannounced cuts to other bits of Universal Credit. It has become bizarre annual ritual to announce future savings from future cuts to this future benefit.

More seriously, and despite the obvious fact that many families will welcome additional support for childcare, we still lack a proper rationale and evidence base for the more than £7 billion a year of public money that is now spent on childcare. Beware areas of spending with quite such unanimous cross-party support. It does not always lead to the best policy.

In terms of the giveaways the biggest was, once again, the **increase in the income tax personal allowance**. A real terms increase of £320 is due to come in at a cost of £1.8 billion in 2016-17 taking the total cost of the coalition's increases to £12-13 billion a year by 2016-17. That is quite an investment. It remains unclear, though, why the Chancellor continues to ignore the fact that there is another direct tax on earnings, National Insurance Contributions, which kicks in at significantly lower earnings levels.

By sticking with his policy of raising the higher rate threshold by just 1% in 2015-16 Mr Osborne ensured that higher rate tax payers will not gain any more than those paying the basic rate. Our calculations suggest that there will be around 5.3 million higher rate taxpayers in 2015-16, up from 4.7 million this year and 3.3 million in 2010-11.

Such consistency has also been applied to continued reductions in the main rate of corporation tax. We have seen less consistency in some of the other **policies affecting business**.

The increase in the annual investment allowance for plant and machinery will be welcome by many businesses and, if extended to other forms of investment and made permanent, could be a sensible way to reduce disincentives to invest. But the fact that it is another avowedly temporary change to an element of the system which is changed with monotonous regularity is less

encouraging. Whatever the right policy, the degree of chopping and changing we have seen is not sensible. Companies need more clarity about the direction of policy.

A rather similar lack consistency is being shown in the treatment of the **carbon price floor**. Introduced by this government with a specified pattern of increases through to 2020, changes have been announced just a year after its introduction. There are arguments for limiting its effect. But they applied just as strongly last year when it was introduced as they did yesterday. This is no way to foster the sort of policy stability which is so important for investment.

Finally, let us return to those changes to the **taxation of savings and pensions**.

The changes to savings taxation involve increasing the ISA limit, in particular increasing the amount of cash that can be held within ISAs, and charging no tax on the first £5,000 of savings income for some of those with low overall incomes. As the Red Book points out, this moves the system for taxing savings – and in particular for taxing the returns to cash held in interest bearing accounts – in the direction outlined in our very own Mirrlees Review. This is to be welcomed. There is a strong case for exempting returns to cash holdings from income tax thereby avoiding double taxation of a form of saving most often relied upon by the less wealthy.

The case for increasing the availability of wholly tax free returns to equity investment is actually rather less clear cut. High returns earned by luck, judgment or hard work are not taxed at all. This can be both inefficient and inequitable.

A better way to tax equity holdings is more like the way defined contribution pensions are taxed. Allow savings out of income before tax, but tax the withdrawal in full. That way excess returns are subject to tax. That basic structure for DC pensions was not changed by the Budget announcements, but the flexibility with which withdrawals can be made was dramatically increased.

There are clearly advantages to this liberalisation. It will allow people freedom to manage, and make choices over, their own affairs. It will likely increase the incentive to save in a pension. And some of the biggest worries that have traditionally held governments back from such a move are becoming less salient. In future fewer people are expected to be falling back onto means tested benefits in retirement, and so the incentives created by means testing to reduce income or assets in order to qualify for benefits are, for many, less than they were.

That said there are some genuine uncertainties about the effect of the policy. Most importantly it will likely make annuities even more expensive for those who do want to buy them. The market will become much thinner and there

will be greater levels of adverse selection – only those expecting to live a long time will want to buy an annuity thereby driving up the price. There is a market failure here. There will be losers from this policy.

In addition, and without wanting to be seen as patronising, it is important to point out that increased choice could lead to more mistakes. People at 60 or 65 are known to underestimate their own life expectancy, and especially the likelihood of living to extreme old age. They may over spend early in retirement.

In conclusion this is a Budget which will be remembered long after most of Mr Osborne's other Budgets have been forgotten, and it will be remembered for one of the biggest shake ups in the tax treatment of private pensions we have seen in a long time. But alongside these bold changes and some welcome changes to the taxation of savings, it is also a Budget which leaves us with as little sense as we had before of quite how the very large public spending cuts still in the pipeline will actually be delivered.