

Post Budget Presentations: Opening Remarks

Good afternoon everyone.

My name is Robert Chote, Director of the IFS, and I would like to welcome you all to this post Budget briefing. It hardly seems a year since the last one.

There is an awful lot of policy to talk about today, and kick-off at 3pm, so we will have a slightly different format to usual. I will make a few opening remarks and then we have presentations from Gemma Tetlow on the fiscal consolidation plan and Rowena Crawford on the outlook for public spending. I will then take a quick round of questions for those of you whose interest lie mostly in that area. We will then have three more presentations: Stuart Adam on business and capital taxes, Mike Brewer on benefit and tax credit changes, and James Browne on personal taxes and the distributional impact of the Budget. And then questions on those presentations and anything else anyone wants to ask about the first two at the end.

As usual, my remarks and the slides will be available on our website after the briefing.

The new Budget forecasts suggest that the financial crisis and the economic damage associated with it opened an additional structural hole in the public finances of around 5.8% of national income or £86 billion a year in today's terms. This additional structural deficit would be impervious to economic recovery and would put public sector debt on an unsustainable path if left unaddressed.

George Osborne inherited an outline fiscal consolidation plan from Labour that would have filled about 70% of this hole by 2016–17. The measures he announced yesterday will make the consolidation more than half as big again and will accelerate its pace. This should be sufficient to fill the hole by 2014–15 and a year later to do so with 0.9% of national income to spare. This is also sufficient, perhaps not surprisingly, to meet the new fiscal rule that the Government has set itself, and by a similar margin. Yesterday's measures should reduce total public sector borrowing over the course of this Parliament by 17% compared to the total implied by the plans in Labour's last Budget.

Mr Osborne has long argued that international experience recommends dividing a fiscal consolidation 80:20 between spending cuts and tax increases. The measures announced by Mr Osborne yesterday split 80:20 by 2014–15 and 85:15 by 2015–16. But because the larger package of measures he inherited from Labour split roughly 70:30, the total consolidation only gets up to 74:26 in 2014–15 and 77:23 in 2015–16. Mr Osborne has in effect compromised between his desired ratio and that of the Liberal Democrats, who in their manifesto were looking for less reliance on spending cuts. But the Coalition is clearly relying more than Labour said it would have done on spending cuts and also much more than the last Conservative government to confront a similar repair job did. The Clarke and Lamont budgets of 1993 aimed for a roughly 50:50 split between spending and tax.

This degree of reliance on spending cuts implies some very tough decisions. The Government has identified welfare cuts worth £11 billion by 2014–15. More than half come from indexing benefits to an inflation rate that tends to be lower than the ones currently used. Mr Osborne implicitly assumes that recipients were overcompensated for increases in the cost of living in

the past, an argument that is open to debate. The rest comes largely from the four biggest working-age benefits and tax credits, a mixed bag of reforms with no consistent objective beyond the desire to save money.

Turning to spending on public services, Mr Osborne pointed out that, in the absence of further welfare cuts, spending on public services outside the protected areas of the NHS and overseas aid would need to be cut by 25% in real terms by the end of the parliament – with schools and defence likely to do better than average and other departments worse. What is striking is the extent to which protecting the NHS in particular intensifies the squeeze elsewhere. Applying the squeeze evenly across Whitehall would require 14% cuts rather than the 25% plus that the least favoured departments now face. In total, the cut in central government public services spending as a share of national income now planned by the Coalition will more than reverse the entire increase we saw under Labour. We are looking at the longest, deepest sustained period of cuts to public services spending at least since World War II.

On the tax side, yesterday's package added up to an £8 billion net tax increase in 2014–15, but this comprised roughly £20 billion of tax increases offset by roughly £12 billion of tax cuts. When Mr Osborne said that “the years of debt and spending” made the £13 billion increase in VAT unavoidable you might just as well say it was his desire to cut other taxes that made it so.

In terms of their contribution to the efficiency and effectiveness of the tax system, yesterday's changes were a mixed bunch of positive reforms, backward steps and missed opportunities. For example:

- Perhaps the most welcome change was the decision to rethink the last Government's complex, unfair and inefficient plans to limit pension contributions relief for high earners. The Coalition now has a better approach than was in any of the three main party manifestos.
- The increase to increase the standard rate of VAT rather than shrink the UK's unusually extensive range of zero and reduced rates and exemptions means that the VAT system will now do more to distort people's spending decisions, so that they can buy fewer of the goods and services they want for every pound they spend.
- The cuts in the headline corporation tax rate are welcome, but the cuts in the small profits rate and the generosity of capital allowances are less welcome. This is not a simplification.
- The National Insurance break for start-ups looks complicated, potentially prone to avoidance and oddly targeted.
- And, finally, the much-debated changes to Capital Gains are a step in the right direction in narrowing the gap between CGT and income tax rates. But this was a missed opportunity to move to a more coherent treatment of saving in the tax system, although at least the Chancellor resisted the siren voices calling for the reintroduction of taper relief.

Turning to the distributional impact of the Budget, Mr Osborne and Mr Clegg have been keen to describe yesterday's measures as "progressive" in the sense that the rich will feel more pain than the poor. That is a debateable claim. The Red Book includes a formal distributional analysis of the impact those tax and benefit spending measures where it is relatively easy to identify the households affected in 2012–13. It suggests that higher income households are indeed hit harder than lower income households, although the very lowest-income 10% are also hit relatively hard.

The Budget looks less progressive – indeed somewhat regressive – when you take out the effect of measures that were inherited from the previous Government, when you look further into the future than 2012–13 and when you include some other measures that the Treasury has chosen not to model. Conversely, looking at the impact of the Budget on households with different income levels overstates how regressive it is in comparison to an analysis based on households with different spending levels, which should give a better guide to their lifetime living standards. The main reason is that the VAT increase looks regressive when viewed against snapshots of income, but progressive when viewed against households' spending. That said, perhaps the most important omission in any distributional analysis of this sort is the impact of the looming cuts to public services, which are likely to hit poorer households significantly harder than richer households.

To conclude, let me that say that whatever you may think of the substance of yesterday's policy announcements, the new Government is certainly to be congratulated on the transparency with which it has presented them. In particular, the Budget policy costing document released by the Treasury online yesterday provides far more information than we have ever received before on the details of each policy change, the way it is expected to affect behaviour, and what it will raise or cost. This comes on top of the Office for Budget Responsibility's decision to publish many more of the economic assumptions upon which official public finance forecasts are based. Both are long overdue and should increase both the understanding of and trust in fiscal policy decisions.

The Treasury said yesterday that these innovations would complement a new approach to tax policy making, promoting predictability, stability and simplicity, for example through a commitment to ensure that the majority of tax changes are confirmed and available in draft form three months before the tax year. We will need to see a couple more budgets at least to judge whether these noble aims are being lived up to. But it is not immediately obvious that yesterday's announcements promoted simplicity in themselves or set out a long-term strategic vision for the tax system.

Now let me hand over to Gemma to talk about the fiscal consolidation.