

Press Release

Budget 2011: an initial response

Public finances

Unlike George Osborne's June 2010 Budget and October 2010 Spending Review, the 2011 Budget was not a big fiscal event. The net impact on the public finances of all announcements was minimal. The effective tightening over the next four years remains formidable.

But the fiscal forecasts have changed, and for the worse. Given the reductions in expected economic growth this year and next, that is not surprising. The Office for Budget Responsibility (OBR) was expecting total receipts to exceed non-investment spending by 0.3% of national income in 2015-16. It now expects a deficit of 0.2% of national income.

What has not changed, or hardly changed, on the official forecasts is the cyclically adjusted deficit – that is borrowing that is thought to be impervious to economic recovery. The OBR is still forecasting a cyclically adjusted current surplus of 0.4% of national income by 2014-15. The reason is that their estimates of potential output and potential growth have not changed.

As the OBR itself acknowledges the biggest threat to the public finances is “the possibility that we have over-estimated the amount of spare capacity in the economy, now or in the future”. In other words the forecasts are now even more dependent on a bounce back in the rate of economic growth from 2013. The OBR cut its growth forecasts for 2011 and 2012, maintained it for 2013 and raised them for 2014 and 2015. An overestimate of potential output of just 1.5 per cent would, on the OBR's estimates, be sufficient to breach the Government's fiscal mandate.

Paul Johnson, Director of the IFS, said:

“Given these forecasts it is clear why a Chancellor, sticking to his plans, did not feel able to engage in a net giveaway. Going forward he is going to be uncomfortably dependent on the judgments that the (independent) OBR makes over the (unobservable) potential output of the economy.”

Personal tax and benefit changes

All the big changes to taxes and benefits that had previously been announced to come into effect in April 2011 were today confirmed by the Chancellor. These include the 1% rise in all National Insurance rates, and the rise in the income tax personal allowance to £7,475. Overall they will leave households, and especially the richest households, worse off.

The Chancellor also announced a further step towards the government's goal of a £10,000 personal allowance: it will reach £8,105 in 2012-13, £240 higher than it would have been had it continued to go up in line with the Retail Prices Index (RPI). Unlike the change to come into effect next month, this giveaway will benefit both higher-rate and basic-rate taxpayers, as the threshold at

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which the 40p rate starts to be paid will be left unchanged in April 2012, rather than cut.

Of greater importance for the longer term is the announcement that direct tax allowances and thresholds will, in future, be indexed in line with the Consumer Prices Index (CPI) rather than the RPI. This brings their treatment in line with most benefits and will generally reduce their generosity over time. The move will bring in over £1 billion by 2015-16, according to the Treasury. The Chancellor chose not to implement CPI uprating of indirect taxes which would have benefited households at the expense of the Exchequer.

James Browne, a Senior Research Economist at the IFS, said:

“In contrast to the changes due this April, the further step towards the government’s goal of a £10,000 personal allowance announced yesterday will happen in a way which does not create more higher rate taxpayers. But the move to increase allowances and thresholds in line with the CPI rather than the RPI going forward will increase the effect of fiscal drag, and will, starting from the next Parliament, create more higher-rate taxpayers”

Simplifying income tax and National Insurance

The Budget announced a consultation on integrating the operation of income tax and National Insurance contributions (NICs), but stated that the ‘contributory principle’ will be maintained and ruled out extending NICs to individuals above state pension age or to other forms of income such as pensions, savings and dividends.

Stuart Adam, a senior research economist at the IFS, said:

“Moves to integrate the operation of income tax and NICs would be welcome. But the value of reform depends heavily on the details, which are yet to be decided. It is a shame that, even before the consultation begins, the Government has already ruled out some of the most radical options. Keeping savings and dividend income free of NICs would help to maintain incentives to save, but means it would remain hard to prevent people from converting labour income to capital income in order to avoid tax. And while there may be a good case for having a proper social insurance system, maintaining the – largely illusory – ‘contributory principle’ in its current form is hard to justify.”

Carbon tax

The other main environmental measure announced was a carbon price support rate which will apply to energy generation from 2013-14. This tax will supplement the carbon price in the EU Emissions Trading Scheme and will provide more certainty over the cost of carbon.

Paul Johnson, IFS director said:

“This new tax has some welcome features: it represents the first carbon price that will directly affect households as well as businesses, and helps improve certainty which could encourage investment in renewable generation. However, it adds another layer of carbon pricing to an already complex structure of rates applying to different

fuels and energy users and does not bring us any closer to a consistent economy-wide price for carbon.”

Fuel duties and taxes on North Sea oil

The Chancellor today announced an immediate 1p/litre cut in fuel duties. He also announced that this year's planned inflation adjustment of 3p/litre would be postponed until January 2012, and the inflation adjustment planned for April 2012 will now take place in August 2012. This costs £1.9 billion in 2011-12. The long term cost of the change, including the ending of the 1p a year escalator, will be £2.1 billion annually. This is effectively paid for by increasing the supplementary charge on the profits of North Sea oil and gas profits from 20% to 32%. There is a “fair fuel stabiliser” in the sense that both policies (the end of the escalator and the increase in North Sea Taxes) would be reversed if oil prices fall in a sustained way below \$75/barrel.

Andrew Leicester, Senior Research Economist at the IFS, said:

“The 'Fair Fuel Stabiliser' announced by the Chancellor is very different from the more formal mechanism linking fuel duties to oil prices that the Conservative Party talked about before the election. If oil prices stay high but volatile, this policy will do little to stabilise pump prices. The Chancellor also insisted that green taxes will rise as a proportion of total receipts. This remains the case on current Treasury forecasts, but by the narrowest of margins.”

Alcohol taxes

The Chancellor announced a 25% rise in taxes on high strength beers (those with alcohol by volume content above 7.5%), and a 50% cut in the duty on weak beers (ABV 2.8% or less). This may encourage consumers to substitute from stronger to weaker products, and producers to manufacture more low-strength products. The impact of the policy is, however, likely to be small: in 2010, low-strength beer accounted for 1% of alcohol volume sold off licence and high-strength beer just 0.8%. The change will bring the tax rate on strong beer close to the tax rate on spirits, but will not change the relatively low tax levels on strong ciders: a can of cider at 7.6% ABV will be taxed at 7.1p per alcohol unit, whilst a can of beer of the same strength will be taxed at 23.2p/unit.

Encouraging investment and growth

The Budget and the accompanying ‘Plan for Growth’ set out a broad range of measures aimed at encouraging business investment. The largest of these is a 2ppt cut to the main statutory corporate tax rate, bringing it to 26% in April this year and to 23% by April 2014. For banks, the positive effect of the additional 1ppt cut in the main rate (over that announced last year) will be offset by an increase in the Bank Levy in January 2012.

There is also a raft of smaller (in revenue terms) measures which are aimed at encouraging business investment. These comprise cuts to regulations and simplified planning processes alongside a large number of initiatives aimed at promoting specific industries and encouraging regional growth. Notably, the Government will introduce enterprise zones which offer targeted support, including 100% business rate relief, in 10 areas identified as having ‘untapped potential’.

Helen Miller, a Senior Research Economist at the IFS said:

“Reductions in corporation tax of the magnitude planned for the next few years are likely to boost corporate activity in the UK. Reforming planning regulation and simplifying the tax regime are also welcome moves that could have positive long term effects on economic activity. But measures aimed at very specific industries or geographic areas have not always proved successful. Past UK experience with enterprise zones suggests that their main effect may be to cause activity to relocate rather than to create new activity.”

ENDS

Notes to Editors:

1. IFS will present a full analysis of today’s Budget at a lunchtime briefing, 1pm – 2.30pm Thursday 24 March 2011 at the Drill Hall: <http://www.drillhall.co.uk/p75.html>. Complimentary places are available to members of the press. If you would like to attend for further information, contact: Bonnie Brimstone at IFS: 020 7291 4800, bonnie_b@ifs.org.uk.



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