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Conservatives plan to cut public spending to cut National Insurance

The Conservative Party plans to cut central government spending on public services outside the NHS, defence and overseas aid by £6 billion in the coming financial year in order to finance a cut in National Insurance that would offset most of the impending increase that the Government has already announced.

The National Insurance cut

The Government has already announced that all rates of NI will rise by 1% in April 2011, but the employee threshold – the point below which employees do not have to pay NI contributions – will rise by £1,170 per year. Overall, this would leave low-earners paying less NI, and high-earners paying more.

The Conservative Party proposes to go ahead with the increase in NI rates, but to raise the level of earnings at which employees start paying it (the Primary Threshold) by an additional £1,248 per year on top of the Government's proposed increase, and the point at which employers start paying NI (the Secondary Threshold) by £1,092 a year. They also plan to increase the NI Upper Earnings Limit by £1,508 a year, which means that higher earners will pay the standard rate of NI on more of their income before moving to the lower 2% rate above the UEL. This increase means that those above the new higher UEL (those earning about £45,500 a year or more) will not gain from the changes in employee NI that the Conservatives plan to make, relative to the changes already announced by the Government. Compared with the Government's plans, the Conservative Party's proposed would mean lower employee NI contributions for those with earnings between about £7,100 and £45,500, with those earning between the new Primary Threshold (about £8,400) and the current UEL (about £44,000) gaining about £150 a year.

We estimate that the Conservative Party's proposals would reduce NI revenues by £5.6bn a year in the short-term, offsetting the bulk of the £6.3 billion increase in revenues that the Treasury has predicted that the Government's announcements would raise.[1] In the long-run, however, we would expect the cut in employers' NI (compared with the Government's plans) to be passed on in the form of higher gross earnings for employees, increasing income tax and employee NI revenues, and reducing spending on tax credits. We estimate that this could cut the cost of the tax cut to around £4.3bn. (Similarly, part of the short term revenue gain from the Government's plans would be partially offset by the impact of reducing gross incomes. The short-term impacts appear as the cost of the policies in the Treasury's Red Book, while the offsetting long-term impacts are included with other unidentified forecasting changes.) But, even if the cut in employer's National Insurance is not passed on to employees then, to the extent that employers

[1] We estimate that the Government's proposed reforms would raise about £7.3 billion if there was no change in behaviour. Differences between our estimates and the Treasury's may relate to the Treasury allowing for some change in behaviour in their calculation, as well as differences in assumptions about the level of earnings and the level of employment in 2011-12.

make larger profits, this would also increase corporation tax revenues, although we cannot be sure by how much.

The Government claims that individuals earning less than about £20,000 a year would gain from the changes to employee NI they have planned, and the Conservative Party's plan would increase the earnings level at which the gains end to about £35,000. However, if employers pass the higher employer NI bill on in the form of lower wages, the point at which people stop gaining from the Government's announcements would fall from £20,000 to about £15,000 for a worker contracted in to the state second pension and not receiving any tax credits or means-tested benefits. When we account for changes in wages under the Conservative Party's plan, the point at which people would stop gaining under their proposals falls from £35,000 to £29,000 for those contracted in to the state second pension and not receiving tax credits and means-tested benefits.

Figure 1 shows how household net incomes would be affected by this tax cut in 2011–12, compared with how they would fare under the Government's plans. Dividing households into ten groups based upon their position in the household income distribution, the blue parts of the bars show the impact if employers do not pass the reduction in employer NI on in the form of higher wages, whilst the red parts show the additional effect if they do. Either way, gains are biggest in proportional terms for those towards the middle of the income distribution, and smallest at the very top and very bottom.

Figure 1: Effect of the Conservative Party's NI proposals on household net income (relative to the Government's plans)

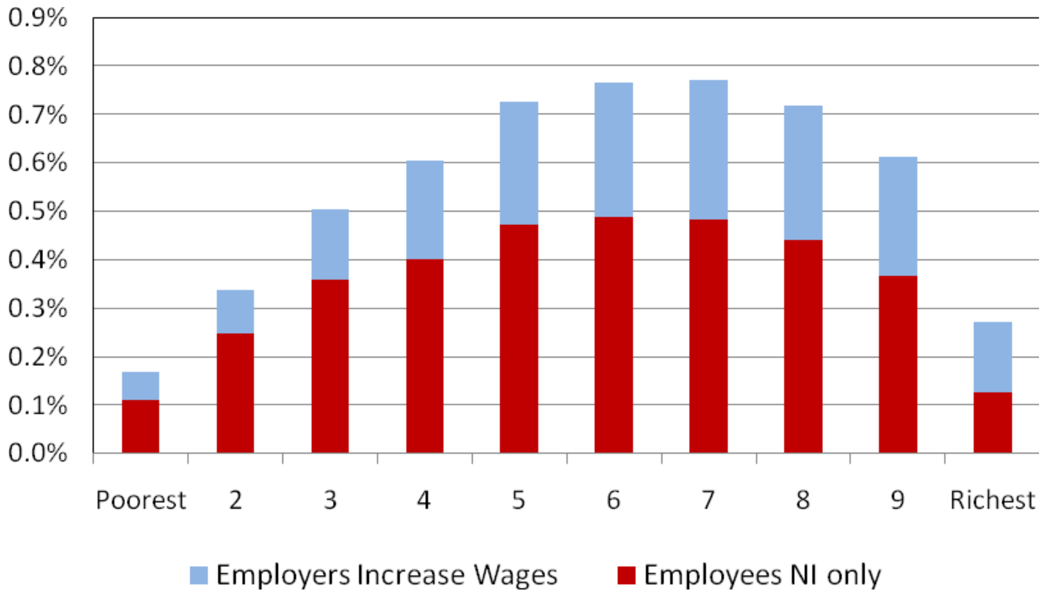

Figure 2 shows the impact of both the Conservative Party's and the Government's plans relative to there being no change in the current NI system, once we take into account the effect of employers' NI on wages. The Conservative Party's proposals mean that households in the lower and middle half of the income distribution gain (with the average gain highest at about 0.5% of net income for decile groups 3 to 5), whilst households towards the top lose, on average (about 1%, on average, for the richest 10% of households). The Government's plans would leave losses, on average, across the income distribution, except for the poorest 20% of households.

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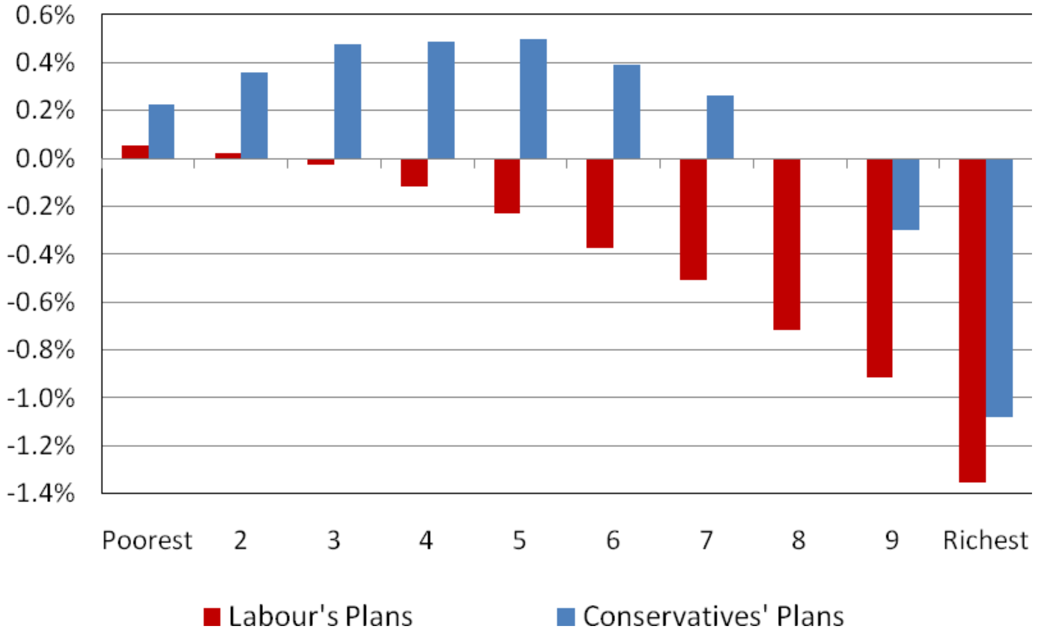
Figure 2: Effect of the Conservative Party's and the Government's proposals on household net income (relative to no NI changes)



What does the proposal imply for the structure of earnings taxation? In its 2007 Budget, the current Government announced a set of reforms that would have led to a significantly simpler Income Tax and NI contributions schedule. The personal allowance (the amount of income you can receive before you start to pay income tax), and the employee and employer's NI thresholds were to be aligned, as were the Higher Rate Threshold (the amount of income you can have before you start to pay the 40% rate of income tax) and the NI UEL. Including the impact of employers' NI on the cost of employing someone, the marginal tax rate would have been 0% for about the first £5,700 of income, 39% between £5,700 and about £44,000, and 48% above this. The Government's subsequent reforms, combined with their proposed changes to NI, have moved us far from this simple structure, as we discussed in our analysis of last year's Pre Budget Report[2]. The Conservative Party's proposals would add to, rather than remove, these complexities, because the higher-rate threshold and the NI UEL would no longer be aligned. This would mean a combined income tax and NI rate (again including employers' NI) that goes from about 40% below the higher rate threshold, to 58% between the higher rate threshold and the new higher NI UEL, before falling back to 49%. There seems no sensible reason for such a complex rate structure. It is also noteworthy that the combination of the Government's and the Conservative Party's proposed reforms would mean that the first £1,800 of earnings above the income tax personal allowance would face a combined income tax and NI rate of 20%, very similar to the combined rate of 21% that existed before the abolition of the 10p income tax band (these two rates ignore employer NI; including employer NI, both rates are 30%).

The Conservative proposal may also affect people's working decisions. Compared with the Government's proposals, by raising the point at which NI contributions first become payable, it increases the attractiveness of working relative to not working (although losses in housing and council tax benefits will offset much of this for some poor households). But those facing the new combined 58% rate will face weaker incentives to increase their earnings. Compared with the current NI system, both the Government's and the Conservative Party's plans will mean that all workers above the new primary

[2] http://www.ifs.org.uk/budgets/pbr2009/tax_ben.ppt

threshold will face weaker incentives to earn more, thanks to the rise in the rates of NI.

The spending cut

To finance the National Insurance cut, the Conservatives plan to cut central government spending on public services outside the NHS, defence and overseas aid by £6 billion more than the Government between this financial year and next, with cuts in subsequent years to be determined in a formal Spending Review. The Conservatives are planning to cut public spending by slightly more than we estimate that their National Insurance cut would cost, which offers them some margin for error if the cost turns out to be greater.

The Government is currently planning to cut public services spending outside the NHS, defence and overseas aid by 2.4% in 2010–11, after adjusting for whole economy inflation. We estimate that the additional £6 billion cut planned by the Conservatives would increase this to 5.1% and would leave these unprotected areas of spending 2.8% below the level planned by Labour. (The figures do not sum precisely because of rounding and we cannot be entirely precise about the declines until new 2010–11 Departmental Expenditure Limits are published in the Treasury's next annual public spending statistics). The largest unprotected area would be schools.

The impact of the spending cuts on people at different points of the income distribution would depend on where the axe falls. So we cannot say how the pattern of losses would compare to the patterns of gains from the NI cut.

The Conservatives argue that this reform would shift the balance of the looming fiscal tightening from the one-third tax increases and two-thirds spending cuts planned by the Government in 2013–14 towards one-fifth tax increases and four-fifths spending cuts. This is true in isolation, but we also know that the Conservatives wish to tighten fiscal policy more quickly over the coming Parliament – if the Budget forecasts are correct we estimate that their fiscal target implies the need for an additional 0.6% of national income (£8 billion) tightening on top of that planned by the Labour by 2015–16. To aim for a roughly 80:20 ratio implies that this plus 0.7% of national income (£10 billion) of the tightening planned by the Government in that year (and not yet allocated between tax and spending) would need to be divided into roughly £4 billion of tax increases and £14 billion of spending cuts.

By cutting spending next year and delivering the tax cut a year later the Conservative proposal would take additional spending power out of the economy for a year at a time at which the recovery is likely to be at its most fragile. Combined with Labour's existing plans, it would increase the discretionary fiscal tightening between this year and next to £29 billion or more than 2% of national income – significantly larger than that planned for subsequent years, even though the recovery should by then be stronger.

The Conservatives claim that the spending cuts can, in effect, be rendered painless by efficiency savings that they say their advisers have identified. Whether or not that is true, using the bulk of these spending cuts to finance the NI cut means that they are not available to contribute to the task of reducing government borrowing that the Conservatives have set such store by. Reducing the deficit more quickly than the Government plans to will therefore require even greater cuts to public services spending, or to greater reliance on welfare cuts or tax increases that might be as economically costly as the NI increases they are seeking to mitigate.

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Notes to Editors:

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