

## **Opening remarks: Tax changes do not amount to a reform programme**

**Paul Johnson**

**Director**

**Institute for Fiscal Studies**

The Chancellor must have been relieved yesterday to be able to deliver a Budget without revealing that economic and fiscal forecasts had got a whole lot worse. But he is only meeting his borrowing forecast this year because a £5 billion undershoot in tax receipts is, despite the scale of the planned cuts, slightly more than offset by a £6 billion underspend – £5 billion of that by government departments.

And of course the underlying problems remain. Borrowing this year is due to come in at £126 billion and is forecast to fall much less rapidly over the next five years than hoped this time last year. As he announced in November, the Chancellor is only meeting the fiscal mandate he has set himself by cutting spending hard in the first two years of the next parliament.

Within the tight fiscal constraints, Mr Osborne introduced a range of tax changes, including the reduction in the 50p rate. Despite the range of changes it is hard to see this as the Budget of a truly tax-reforming Chancellor. The hotchpotch of reforms bears as many marks of political expediency as it does of strategic reform.

### **Pensioner tax allowances**

Most of the tax changes were well trailed; only one was not.

The “surprise” was the announced phasing out of the additional personal allowance enjoyed by pensioners. One reason for surprise might be that the government has otherwise fairly comprehensively protected pensioners from benefit cuts and many

of the tax increases that have affected the working age population. Our analysis shows that they have lost considerably less from recent tax and benefit changes than any other demographic group. And over the past decade and more pensioner incomes have risen faster than those of the working age population.

Many pensioners have incomes too low to pay tax and therefore will not be worse off because of this measure. Well-off pensioners do not benefit from the additional personal allowance and therefore will not lose out from its removal. The group who will lose the most are those turning 65 in the next year or two who expected to benefit from this allowance.

But perhaps this change should have been less of a surprise. The increase in the standard personal allowance leaves the gap between it and the additional allowance much reduced in any case. If the justification for the additional allowance was to keep pensioners with very modest levels of private income out of the income tax system, the higher personal allowance will now largely achieve that. Despite this morning's headlines, this looks like a relatively modest tax increase on a group hitherto well sheltered from tax and benefit changes. From this Budget we calculate that pensioners will lose on average about one quarter of one per cent of their income in 2014.

But the Chancellor should perhaps have given more notice of the change, giving new retirees especially more chance to adjust, and making the change once the full £10,000 personal allowance is in place. And he should have avoided dressing up what is clearly a tax increase as merely a simplification.

## **The personal tax allowance**

The increase in the income tax allowance to £9,205 in April 2013 was of course well trailed and puts the government comfortably on course to meet its commitment to get to a £10,000 allowance by the end of the parliament. The changes announced yesterday were expensive. They cost an estimated £3.5 billion. And that price tag was kept down by ensuring that higher-rate taxpayers will gain rather little from the increase (and those with an income much above the £100,000 level at which the personal allowance is tapered away will actually lose). This will be done by reducing the point at which people start to pay higher-rate tax – and thus once more significantly increasing numbers of higher-rate taxpayers. So while the overall number of income tax payers will fall by 675,000 this change will increase the number of higher-rate payers by 325,000. Put that together with the freeze in the basic rate limit, and fiscal drag more generally, and the number of higher-rate payers could increase from 3.7 million in 2011 to 5 million by 2014.

This is part of a long-term trend towards the encroachment of 40% income tax onto people earning above-average but relatively modest salaries. It would be useful to know if the Chancellor has a view as to what proportion of taxpayers should be paying at the higher rate. It will reach 15% next year, having been just 5% in the late 1980s.

## **The 50p rate**

The higher rate that has got rather more attention is of course the 50p rate. HMRC's analysis suggests that the 50p rate only raised around £1 billion in 2010-11, a lot less than the £2.6 billion previously forecast by the Treasury and – prior to yesterday – assumed in the OBR's forecasts. As the HMRC put it, "it is difficult to construct a

plausible outcome consistent with a yield estimate as high as those original forecasts". And some of the data they base this on are certainly dramatic. They find an astonishing 25% drop between 2009-10 and 2010-11 in the recorded incomes of those with incomes over £150,000.

That said, they also acknowledge the very considerable uncertainty around their estimates. The estimates depend on a range of assumptions about what might have happened in the absence of the 50p rate, and especially on how much of the drop in recorded income is down to one-off "forestalling" – that is people taking income a year early before the 50p rate was introduced. The truth is we still do not know the true effect of the 50p rate on revenues.

The worry for the Chancellor is that the estimate that cutting the top rate to 45% will only cost £100 million is particularly uncertain. It assumes a "no behaviour change" cost of £3 billion offset by a behavioural change of £2.9 billion. The first number we know reasonably accurately; the second number is estimated with great uncertainty. Even if we knew the effect of introducing the 50p rate – which we don't with any precision – responses may not be symmetric. Those who have got a taste for avoiding the 50p rate may continue to avoid the 45p rate (even if they wouldn't have done so had the 50p rate never existed). The experiment with the 50p rate does not appear to have gone well.

### **Stamp duty**

Mr Osborne looked for other ways to get money from "the rich" and lighted on a big increase in stamp duty on properties worth more than £2 million. This does at least suggest he is confident that his measures aimed at curtailing stamp duty avoidance will be effective.

Assuming the new rate doesn't just lead to more avoidance it will certainly only hit the lifetime wealthy who want to buy and sell these properties. But to see another Chancellor increase again such a poorly designed and distorting tax does not bode well for tax reformers. It will now cost at least £140,000 in stamp duty to buy a house worth more than £2 million. That may not cause much popular outcry but the problem is that this will do even more to lock people into their current housing. The mooted "mansion tax" – an annual charge on occupation of expensive houses – whilst not perfect, might have been preferable. As set out in the Liberal Democrat manifesto it could also have raised considerably more revenue. Even better would have been a serious attempt to reform the taxation of housing more generally. We must one day surely move away from basing council tax in England and Scotland on 1991 values and charging it in a way which is dramatically regressive. There is a strong case for charging more tax on expensive properties. Stamp duty is the wrong way to go about it.

## **Pensions**

Finally I want to welcome two announcements about pensions. One is that the government will look at some form of automatic indexing of state pension age to longevity. Given the sheer scale of costs associated with demographic change over the next few decades that is a welcome commitment.

The second is the commitment to consolidate basic and earnings-related pensions into a single flat-rate pension for new pensioners during the next parliament. Whilst pension policy changes much too often this promises to be a welcome simplification which should stand the test of time. But history will still weigh upon this policy. There will be winners and losers. And the simple-sounding flat rate of £140 a week will not

actually involve many people receiving £140. The problem is that time spent “contracted out” of earnings-related pensions will result in a pension being deemed to have been earned. So for many years most pensioners will still be receiving less than this headline flat rate from the DWP. And those who have accrued more than £140 in state pension will receive the higher amount. This is not a criticism of the policy. But it is a warning that this may be much more difficult to communicate than perhaps initially appears.

### **Conclusions**

To conclude. Perhaps one worry for the Chancellor as the dust settles on his third Budget is that in his attempt to achieve a fiscally neutral package he has created some risks. We know pretty much for sure that the increase in the personal allowance will cost about £3.5 billion in 2014-15. We do not know with anything like such certainty that the cut in the 50p rate will cost only £100 million. We do not know that the proposed caps on tax reliefs will bring in the £300 million or so the Chancellor is banking on. Nor do we know that the stamp duty changes will raise the nearly £300 million that he has pencilled in.

This Budget may turn out to be less fiscally neutral than intended.