

Press Release

Borrowing to take the strain until the election. More pain on spending, jobs and, recent history suggests, tax after the election

The IFS Green Budget, funded by the Nuffield Foundation, is published today.
Main findings include:

- On current plans public service spending in “unprotected” Whitehall departments could fall by a third between 2010–11 and 2017–18;
- If departments continue with trajectories implied by current plans public sector employment will have fallen by 1.2 million by 2017–18;
- But within the current parliament the Chancellor has chosen not to cut spending or raise taxes further to offset much higher borrowing resulting from a weaker economy. As a result borrowing is forecast to be £64 billion higher in 2014–15 than he originally hoped.

Departmental spending down, public sector employment down faster

Current spending plans imply an **average cut in public service spending of one third** across unprotected Whitehall departments – i.e. all excluding health, schools and overseas aid – by 2017–18. If the defence equipment budget were to be added to the list of protected areas then spending in unprotected areas would need to fall by around 35%.

Over this parliament departments are planning to **cut pay bills quicker than other forms of spending** and so far they are doing it through reducing employment much more than through real pay cuts.

This means that public sector jobs look likely to be cut faster than implied by Office for Budget Responsibility forecasts. If departments continue to cut their pay bills beyond 2014–15 at the rate they are currently planning then **public sector employment would fall by 1.2 million by 2017–18**, rather than by 900,000 as the OBR forecasts.

Avoiding such deep cuts to public services, whilst sticking to fiscal plans, would require substantial and additional cuts in social security spending; or tax rises would need to be implemented. Over the last 30 years **tax rises announced in the year after a general election have averaged £7.5 billion**. Considering this trend, and in the context of the current fiscal situation, further tax rises following the next election would not be surprising.

Borrowing up now and in the future

Over this parliament the Chancellor is planning to borrow much more than he originally intended. He will be **borrowing £64 billion more in 2014–15 than he planned just two years ago**. This is because he is choosing not to offset the forecast deterioration of £65 billion driven by a worse economic

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outlook. Announced policy measures will reduce borrowing by just £1 billion. As a result he is on course to miss his own target of debt falling in 2015.

Indeed **he is now pursuing a looser policy than that permitted by the last government's *Fiscal Responsibility Act***. Had he not repealed that legislation he would have been obliged to cut spending or increase taxes by around an additional £8 billion next year.

Measured on a consistent basis **there is a better than 50-50 chance that the government will borrow more this year than it did last year**. But more important for the public finances is their evolution over the medium term. **Oxford Economics**, with whom we are again collaborating this year, take a more optimistic view about the amount of spare capacity in the economy than does the OBR. If they are right then the fiscal consolidation plan could be made 1.2% of national income (£19 billion) less painful.

But analysis based on more pessimistic scenarios illustrates the scale of the risks that remain. Oxford Economics still see a measurable risk of a Eurozone break-up and a further recession. **Another deep recession would drive national debt above 100% of GDP**.

Other key conclusions from the IFS Green Budget report include:

Social security spending is rising from 28.5% to 32.5% of all public spending between 2010-11 and 2017-18

This is happening despite cuts in the generosity of benefits for those of working age – and those being introduced in 2013–14 will, by themselves, reduce public spending by £3.4 billion in that year.

Spending on pensioners is still rising however. From the commitment to keep universal benefits to the "triple lock" on the basic state pension, the government has chosen for the most part to protect pensioners so far. Spending on pensioner benefits has risen by over 60% in real terms since 1997-98, and now takes up well over half of the total social security budget. Maintaining this protection would imply further steep reductions in working age welfare expenditure if the government wanted to see overall social security spending cut.

Families with children will see the biggest cuts in benefits over this parliament. But seen in a longer term context the cuts will only partly offset the significant increases between 1997–98 and 2010–11. Spending on tax credits more than quadrupled to over £30 billion a year between 1997-98 and 2010-11.

Benefit entitlements for those of working age without children will, though, be on average lower in real terms in 2015–16 than they were in 1997–98.

Some reforms being introduced by this government, notably the introduction of Universal Credit, look to be part of a well thought out and coherent strategy. Others – such as the localisation of Council Tax Benefit – do not. Further efforts to reduce spending would require a much clearer strategy if both the welfare of claimants and their incentives to work and to save are not to be adversely affected more than necessary.

In spite of the austerity programme the overall effect of tax and benefit changes to be introduced in 2013–14 will be a small net giveaway.

This is because significant tax cuts, notably the increase in the income tax personal allowance, will outweigh the revenue effects of benefit cuts. On average households with someone in work will gain from these changes while households without anyone in work will lose.

The whole set of tax and benefit changes introduced between the start of 2010 and 2015–16 will hit the richest households hardest.

Falls in the point at which 40p tax is due, increases in NI contributions, withdrawal of child benefit from those on higher incomes, restrictions on pension tax relief, the withdrawal of the personal allowance for those on over £100,000 and the additional income tax rate for those on over £150,000 combine to ensure that the top 10% of the income distribution lose much more than any other group from tax and benefit changes introduced as part of the consolidation.

Next hardest hit are working-age families towards the bottom of the income distribution dependent on benefits. Those who have escaped with the smallest hit from tax and benefit changes, on average, are households in the upper middle parts of the income distribution. This is in no small part due to the increases in the personal allowance, from which basic rate taxpayers have gained substantially and two-earner families have gained twice. Many of those in work, though, have seen substantial falls in the real value of their earnings.

The big increases in the income tax personal allowance have benefited most basic rate taxpayers, but at a net cost of £9 billion. This is a remarkable investment in a tax cut given the fiscal climate. But the policy ignores National Insurance Contributions which simply act as another tax on earnings. So in truth no earners have been taken out of the direct tax net. Here, as elsewhere, a genuinely coherent tax policy is still lacking.

If government intends that “the broadest shoulders continue to bear the greatest burden” it should reform existing taxes, not introduce new ones

Ministers should be much clearer about who they have in mind when they refer to “the rich” or “those with the broadest shoulders”. They also need to recognise that, for example, the top half of taxpayers already contribute 85% of revenue (at least of that which we can assign to households). Several elements of the current system favour the better off and do need reform:

- Capital Gains Tax. Forgiving it at death is distortionary, and entrepreneurs’ relief is expensive and very generous;
- Inheritance Tax. Exemptions for business assets, agricultural land, and gifts made over seven years before death distort behaviour. They are more easily exploited by the very rich than the merely quite rich;
- Pension taxation. Whilst there is no good case for limiting the rate at which income tax relief is available, the tax-free lump sum on private pensions is badly targeted, and the national insurance system is overly generous in its treatment of employer contributions;
- Council Tax. It is levied at a lower rate on expensive properties than on cheaper ones. It could be reformed so as to be proportional to up-to-date property values.

A government in search of raising revenue in a progressive manner could also – for the first time in nearly 40 years – simply add a penny to the main rates of income tax, raising more than £5 billion, mostly from the better off.

Corporate tax revenues have proved remarkably robust.

Despite falling tax rates and despite the long running concerns about corporate tax avoidance, there is little evidence to date of a long term downward trend in UK corporate tax revenues.

Tackling corporate tax “avoidance” relating to international activities is genuinely difficult. The UK attempts to tax profits created in the UK. Especially for multinational companies these can be hard to measure. There is

no reliable estimate of how much is lost to corporate tax avoidance. These practical and conceptual difficulties in defining and tackling tax avoidance are inherent to the current tax system and arise from the way it attempts to measure profits created in the UK. A more radical change in the corporate tax system – for example, moving to a common European tax base – therefore merits consideration.

Paul Johnson, IFS director, said:

“As economic performance and forecasts have worsened the Chancellor has followed a dual strategy. He is allowing borrowing to increase substantially in this parliament – allowing the automatic stabilisers to work – whilst promising another dramatic dose of public spending cuts in the next parliament. The effects of concentrating all those cuts on currently unprotected areas of public service spending look hard to contemplate. A more likely scenario perhaps is that other choices will be made after the next election. Taxes could rise, hitherto protected elements of public spending, like the NHS and pensions, could be hit, or the date at which we reach fiscal balance will be pushed further out.

If taxes are to rise, or social security spending is to be cut, then a much clearer strategy should be set out. There are important ways in which the tax system could be made more efficient *and* be reformed to bear more heavily on “the rich”, but there are also damaging options. And we do need to recognise that we are already very dependent on a small group for a lot of tax revenue. There are legitimate concerns about corporate tax avoidance. But over long periods revenues have held up well, and within the current structure defining and tackling avoidance effectively is difficult. Social security spending is growing as a proportion of total spending and it can create unwelcome incentives. But cutting it will inevitably often hit the vulnerable. And while Universal Credit represents a welcome simplification, too many ill thought-out reforms already risk introducing new and unwelcome complexities”.

Professor David Rhind, Chairman of the Trustees of the Nuffield Foundation, said:

“The Nuffield Foundation is pleased to support the preparation and publication of IFS’ Green Budget in 2013. It provides an independent check on government assumptions and models, including a look at alternative approaches, so that public debate, discussion and commentary are better informed. But it also exemplifies an important principle that guides much of the Foundation’s funding. That dispassionate evidence should play an important role in policy, and public scrutiny of it, is a core value of the Foundation. We can only wish that public debate about other areas of policy were informed by such robust and impartial analysis.”

ENDS

*We are delighted to have produced this year’s Green Budget in collaboration with **Oxford Economics** and are very grateful to the Nuffield Foundation for providing funding. We are also grateful to the **Economic and Social Research Council** for funding much of the day-to-day research at IFS that underpins the analysis in this report.*

Notes to Editors:

1. The Green Budget 2013, edited by Carl Emmerson, Paul Johnson and Helen Miller, will be launched at 10:00 on Wednesday 6th February 2013 in Beveridge Hall, Senate House (<http://www.ifs.org.uk/events/863>). To reserve your place please contact mailbox@ifs.org.uk;

2. For embargoed copies of this specific chapter or other queries, contact mailbox@ifs.org.uk or contact Bonnie Brimstone on 07730 667013, bonnie_b@ifs.org.uk;
3. Previous editions of the Green Budget, can be found at: <http://www.ifs.org.uk/budgets>;
4. The Nuffield Foundation is an endowed charitable trust that aims to improve social well-being in the widest sense. It funds research and innovation in education and social policy and also works to build capacity in education, science and social science research. The Nuffield Foundation has funded this project, but the views expressed are those of the authors and not necessarily those of the Foundation. More information is available at www.nuffieldfoundation.org.



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