

## Spring Budget 2017

### IFS Director Paul Johnson's opening remarks

Spring Budgets seem to be going out with something of a whimper. Yesterday's was one of the smallest I can remember in pretty much every dimension – number of policies, scale of policies and size of fiscal impact.

I'm not complaining, mind. There will be another Budget in November and the whole point of moving to a single fiscal event a year was to avoid the temptation to do too much fiddling. I presume that bigger changes will come later this year. We will see.

I also rather like the promised consultations. That we are to get a consultation on business rates rather than diving in to change immediately is a good thing. As is further consultation on treatment of the self employed. It is perhaps harder to welcome further consultation on the funding of social care, much though a clear long term strategy is needed. We have had strategy after consultation after commission on this. As Elvis said "a little less conversation, a little more action please".

As to the content there were only two tax changes of any substance – the increase to self employed NICs and the reduction in the tax free allowance for dividend payments. The former is a modest but welcome change designed to shore up the tax base and create a slightly less unequal playing field between the self employed and employees.

The latter reflected the concern that if you increase tax on the self employed you increase their incentive to incorporate. It undoes most of a change introduced less than a year ago.

The only substantive spending announcement was for more money for social care. My colleague Polly Simpson will say something about that.

On the public finances the OBR made by far its biggest ever revision to forecasts between Autumn and Spring for the current financial year. In November it thought we would be borrowing £68 billion this year. It now thinks we will be borrowing just £52 billion. Yet it has barely changed its forecasts for future years. We remain on course to be borrowing about £20 billion in 2020 – that's £30 billion more than intended a year ago. That leaves a lot of work to do in the next parliament to get to the planned budget balance. It looks like being, I'm afraid, a third parliament of austerity.

### **The public finances**

The better figures for this year to a large extent reflect some one-off increases in receipts, and some one-off spending reductions.

Into the medium term the public finance projections are essentially unchanged since November. That's partly because Mr Hammond didn't do very much and partly because the OBR's economic forecasts have barely changed. So we remain on course to meet Mr Hammond's target of keeping borrowing below 2% of GDP in 2020-21; indeed we are on course to meet that with £26 billion to spare.

Keeping some headroom against the fiscal target makes sense given the uncertainty over economic outcomes over the next few years. But the desire to get to budget balance during the next parliament, especially given demographic pressures, will necessitate yet more years of spending restraint or perhaps yet another post election tax rise.

One rather remarkable comment from the OBR is that:

“Cumulative growth over the forecast as a whole is slightly weaker than in November, as we now believe the economy was running slightly above potential at the end of last year”

That’s an economy, recall, in which GDP per capita is still barely 2% above its 2008 level. That’s nine years to grow as much as it would normally grow in one. What the OBR is saying is that despite that truly dismal record all of the productivity – and with it earnings growth – we would normally expect has been lost forever. This remains the big story of the last decade – a decade without growth, a decade without precedent in the UK in modern times.

### **Taxation of self employment and incorporation**

One of the things that flattered the public finances this year was much bigger than expected revenue from a change to the taxation of dividends that was announced in July 2015 and implemented in April 2016. This change increased the tax rate on dividends by 7.5 percentage points. Because it was announced almost a year before being introduced people had plenty of time to arrange their affairs to ensure they didn’t actually have to pay it. And arrange their affairs they did. The result has been a big increase in revenues this year – with a big fall expected next year. A lot of that has been driven by a very small number of wealthy individuals. It seems that just 100 fortunate individuals paid a lot of tax this year, thereby saving £100 million in tax eventually – that’s £1 million each on average – by taking their dividends early.

People respond to tax incentives – especially the very wealthy who pay an awful lot of the tax on which we rely.

Even so the OBR has warned that we are on course to lose £3.5 billion of tax revenue by 2021 as a result of more incorporations. It also reckons that we will lose an additional £1

billion of tax revenue as a result of further increases in the number of self employed. That's because owner managers and the self employed pay a lot less tax than employees.

The 2% increase in NICs for the self employed closes a small fraction of the gap between employees and the self employed. In combination with the abolition of class 2 NICs to be introduced at the same time it will leave any self employed person with profits of less than about £15,570 better off. The maximum loss, affecting those with profits over £45,000, will be £589 per year. The tax advantage to being self employed will still run into the thousands of pounds. The really big difference in treatment is the fact that employers pay 13.8% NI on anything they pay to their employees and nothing on anything they pay to self employed contractors.

A tax system which charges thousands of pounds more in tax for employees doing the same job as someone else needs reform. It distorts decisions, creates complexity and is unfair. The incentives for companies to claim that people who work for them are self employed rather than employees are huge.

You'll note that the Chancellor at the same time announced that the £5,000 tax free dividend allowance, introduced less than a year ago, would be cut to £2,000. To change it so quickly does not look like coherent policy making. It happened because he worries that by increasing tax on the self employed he increases the incentive to incorporate. He is right to worry. Rates of incorporation have been rising and they are sensitive to the tax treatment.

All in all these feel like baby steps in the right direction. But they are sticking plasters not the fundamental look at the tax base as well as tax rates that is required. A lot more work, analysis and consultation is needed.

Part of the problem of course is that the increase in class 4 NICs does look like a breaking of the manifesto commitment not to raise NI. Just as the last Labour government broke its manifesto pledge not to raise the basic or top rates of income tax when it increased the top rate to 50%. As we said at the time these were silly pledges. To commit yourself to not raising the three main taxes – income tax, NI and VAT – ties your hands to an absurd extent. No party should repeat these sorts of promises.

**One brief word on business rates.** The transitional protections announced yesterday will be welcome and are needed in large part because the revaluation which has led to changes in rates took place seven years after the last valuation. That's a lot of time for relative property values to change and hence for bills to change. Mr Hammond suggested yesterday that revaluations will be more frequent going forward. That will be welcome. In brief what is happening now is that business rates in London are rising a lot. They are not rising on average elsewhere. We estimate that an extra £800 million of London rates will go into the central pot or be redistributed directly to poorer regions.

### **Incomes and earnings**

Of course in all this what really matters to people is what is happening to their incomes. Income and earnings growth over the next few years still look like being weak. On current forecasts average earnings will be no higher in 2022 than they were in 2007. Fifteen years without a pay rise. I'm rather lost for superlatives. This is completely unprecedented.

Within that rather gloomy picture some other interesting things are happening. Employment remains, and is projected to remain, extremely strong. And among those in work earnings have been rising faster for the low paid than for the high paid. The rising National Living Wage means that will continue.

Overall the highest earners, the top 1%, are having a particularly bad decade. Our calculations suggest that the top 1%, having pulled away from the rest over the 2000s are being reeled back in. The ratio between earnings at the 99<sup>th</sup> percentile and those at the median hit 5 to 1 in the late 2000s. It is back at 4.6 to 1 now, about where it was in 1999.

And that compression of the earnings distribution looks set to continue. Which will keep earnings inequality down. But it is bad news from the point of view of tax revenues. Such growth as we have had has not been tax rich. And going forward the OBR warns that:

“the top end will be disproportionately hit by the UK exiting the EU (due to effects on higher paying sectors including financial services). Changes in the distribution are therefore expected to deliver a small drag on the effective tax rate over the next five years”.

### **Changes in April**

Let me finish by just reminding you that however brief yesterday’s budget may have been there are plenty of big changes coming in this April. The biggest of them are cuts to benefits – to ESA and to tax credits. These will have much bigger effects on people’s incomes than anything announced yesterday.

Tax credit changes in April will not affect current claimants immediately but will mean big losses in the longer term. The removal of benefit from third and subsequent children will mean that in the long run 600,000 three child families will be an average of £2,500 a year worse off than they would have been, while 300,000 families with four or more children will be £7,000 a year worse off on average. This and the reduction in the “family element” of tax credits will save around £5 billion a year in the long run, dwarfing all of yesterday’s announcements combined.

And here's a thing. If you're really concerned about changes affecting the low income self employed it is to Universal Credit that you should be looking. New rules mean that anyone declaring as self employed will, after a year, be deemed to be earning at least equivalent to working 35 hours at the National Living Wage (or minimum wage for younger people). Such a change makes some sense in the context of the difficulty of monitoring actual incomes. It is due to save £1.5 billion a year. The NI changes are very small by comparison.

### **To conclude**

Clearly the most controversial announcement yesterday was the increase in self-employed NI rates. This appears to break a foolish manifesto commitment not to raise any of the major taxes. On the other hand it is a small change taking a small step to correcting a big problem with the current tax system. That problem needs a much more thorough review and strategy to deal with it, as do many other problems in the tax system. If politicians continue to make silly manifesto pledges about not changing taxes and the rest of us resist sensible changes such as this we will end up with the tax system we deserve – inefficient, inequitable, complex and increasingly unable to raise revenue in the face of a changing economy.