



Institute for
Fiscal Studies



Options for the 2012 Budget

Carl Emmerson

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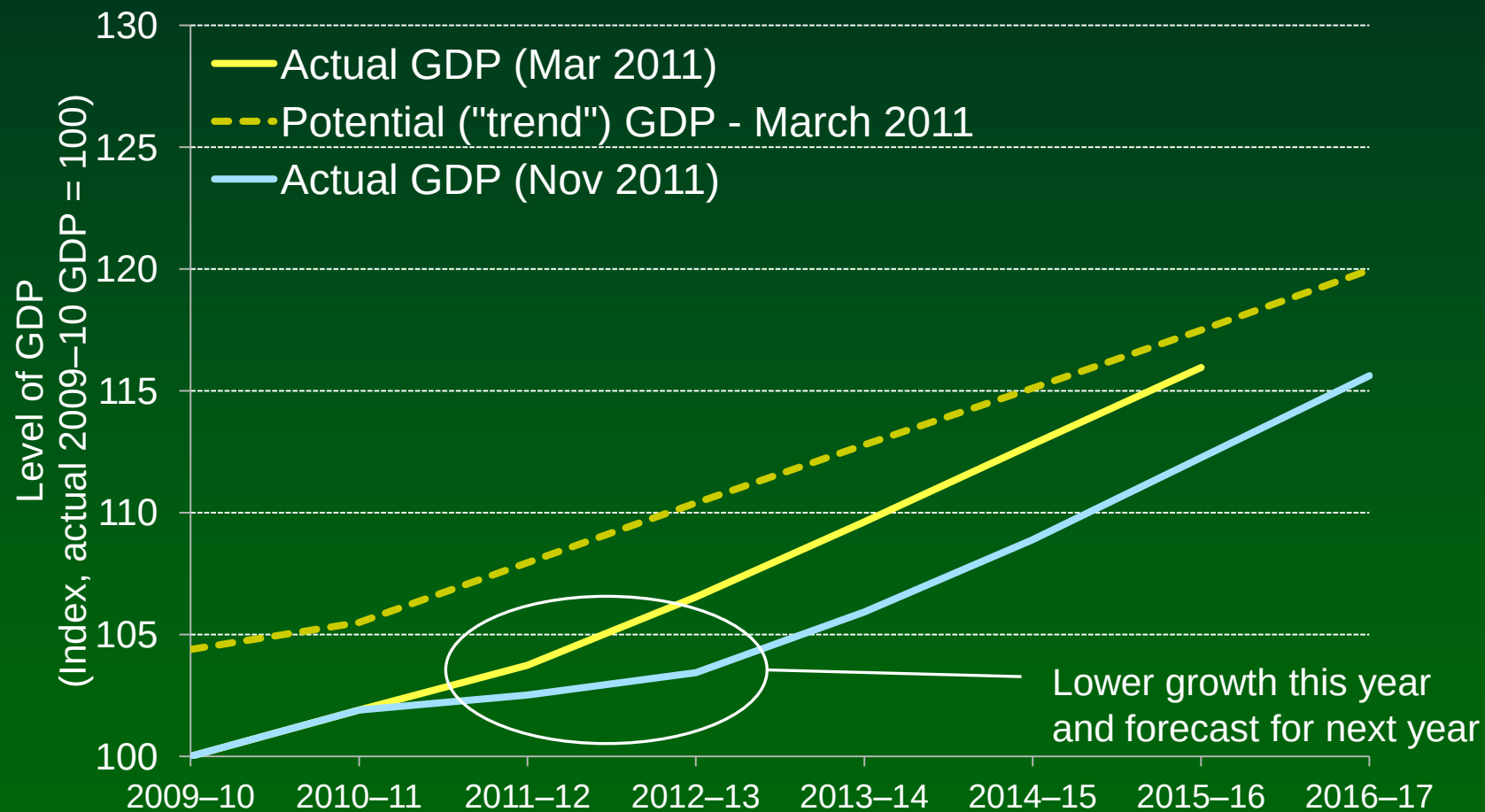


Outline

- The fiscal repair job
- The fiscal forecasts
- Key budget issues
 - child benefit withdrawal
 - raising the personal allowance
 - 50p tax rate
 - mansion tax
 - “tycoon tax”
 - pensions tax relief
 - devolution of corporation tax
- Conclusions

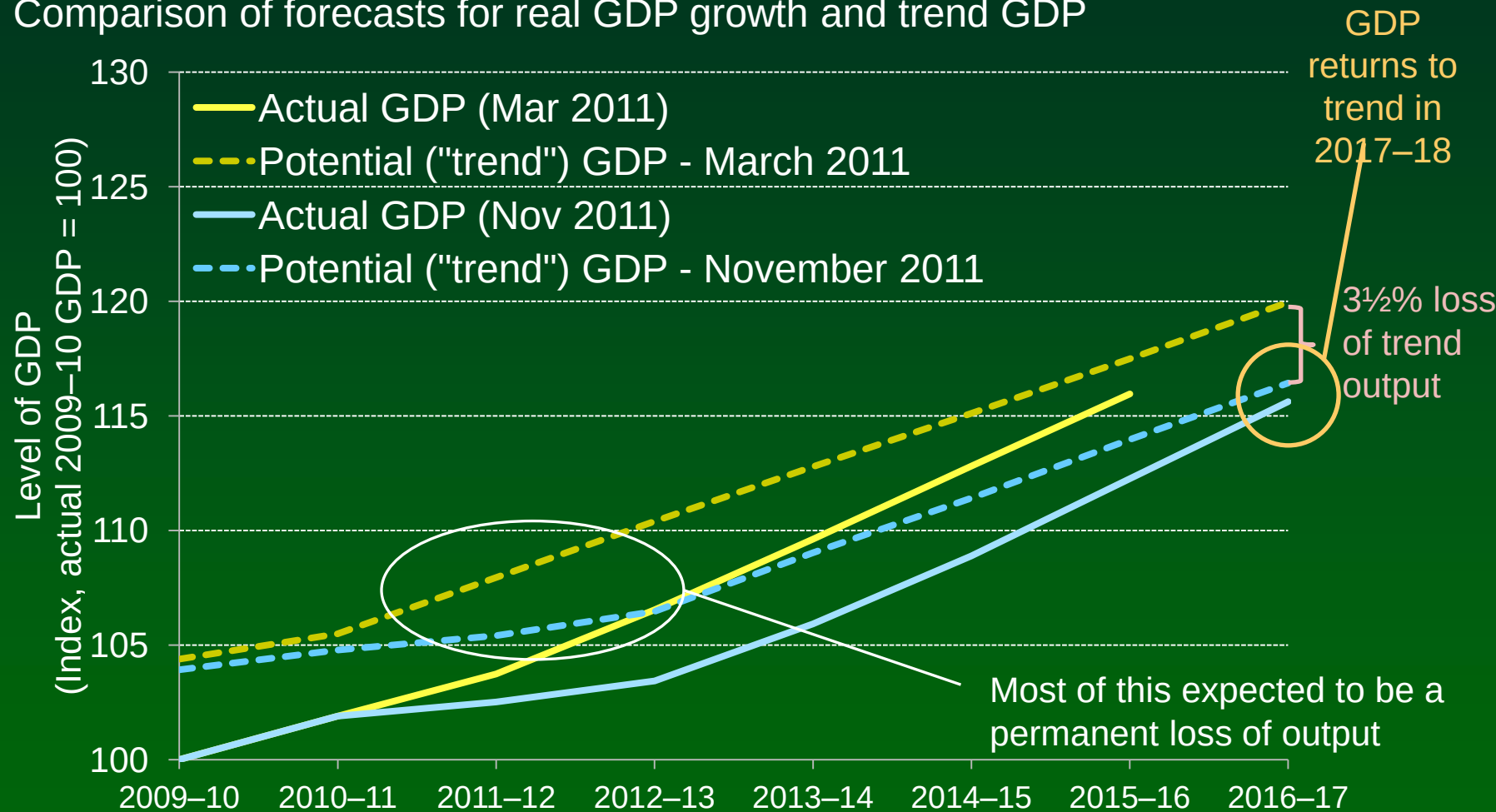
Weak short-term growth thought to reflect a permanent problem

Comparison of forecasts for real GDP growth and trend GDP



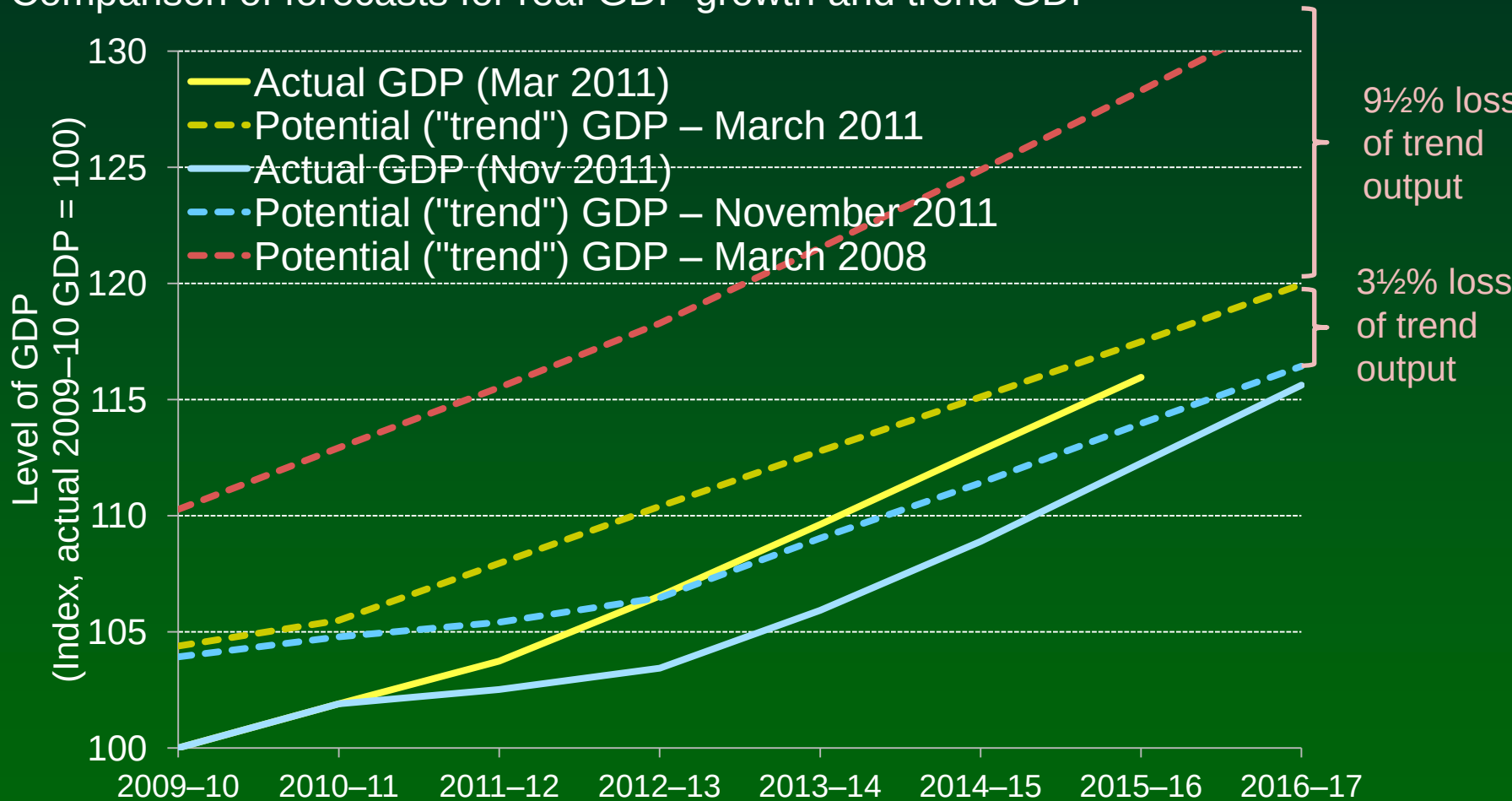
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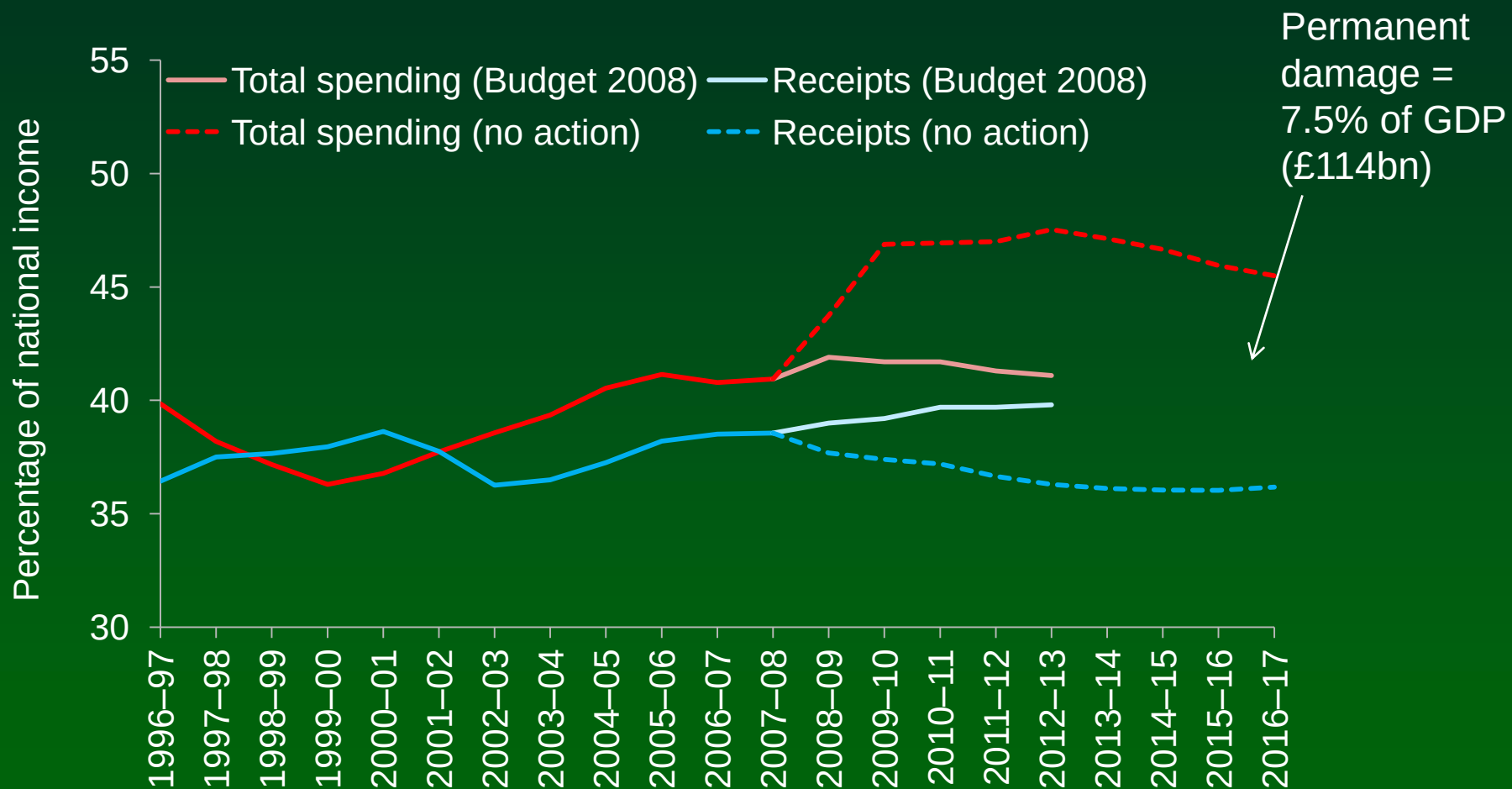


Weak short-term growth thought to reflect a permanent problem

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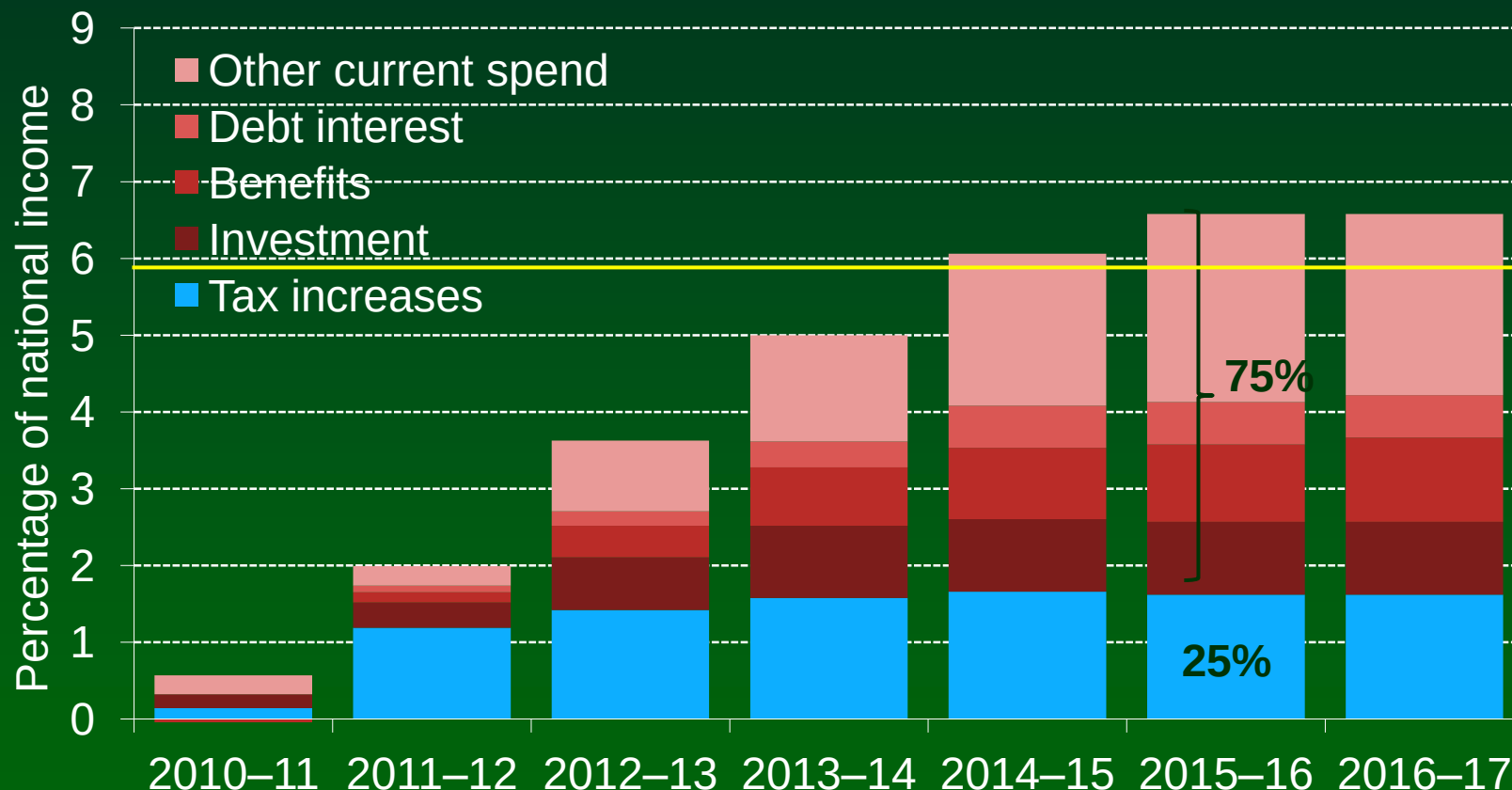


The hole in the public finances



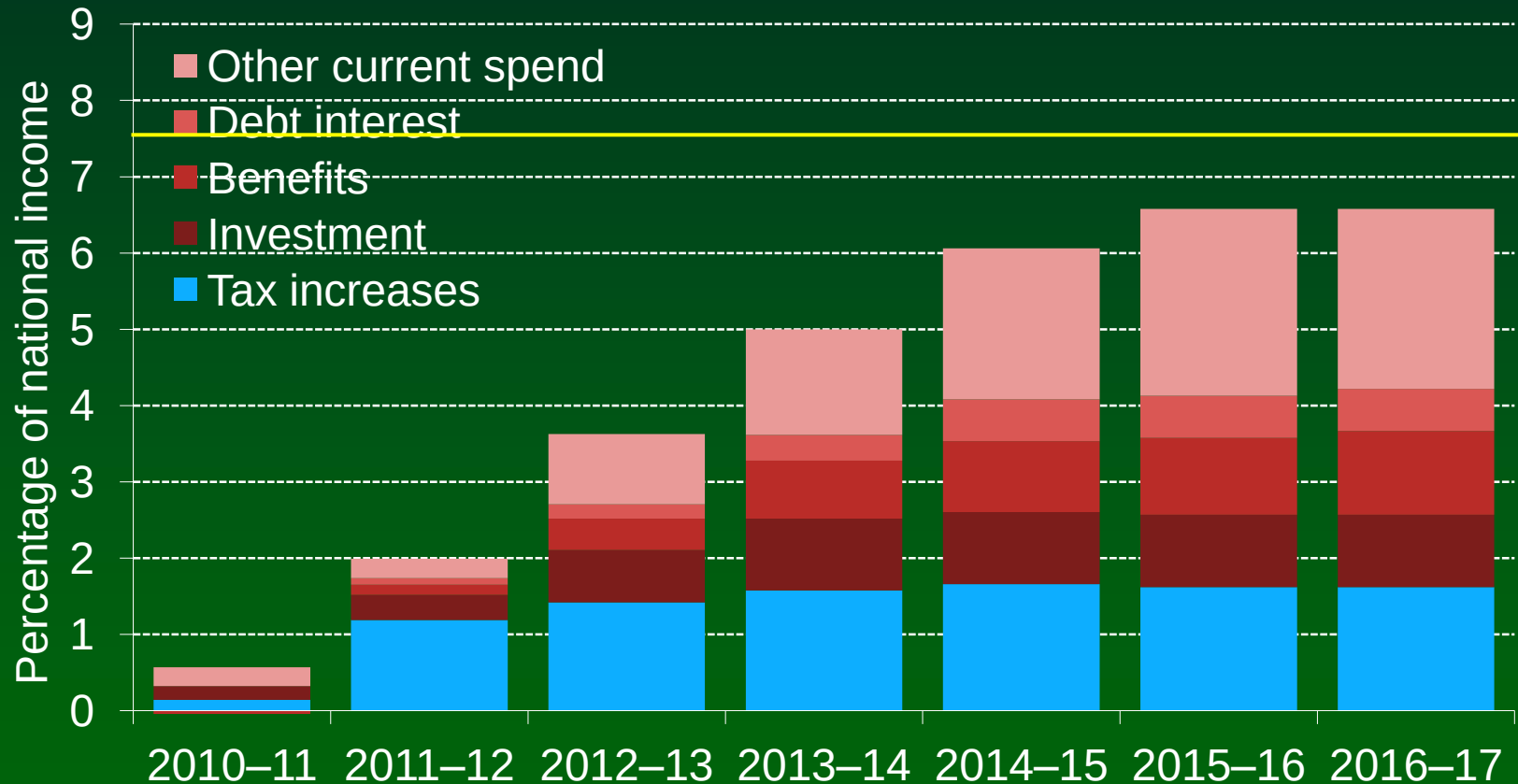
The cure (March 2011): 6.6% national income consolidation over 6 years

March 2011: 5.8% national income (£91bn) hole in public finances



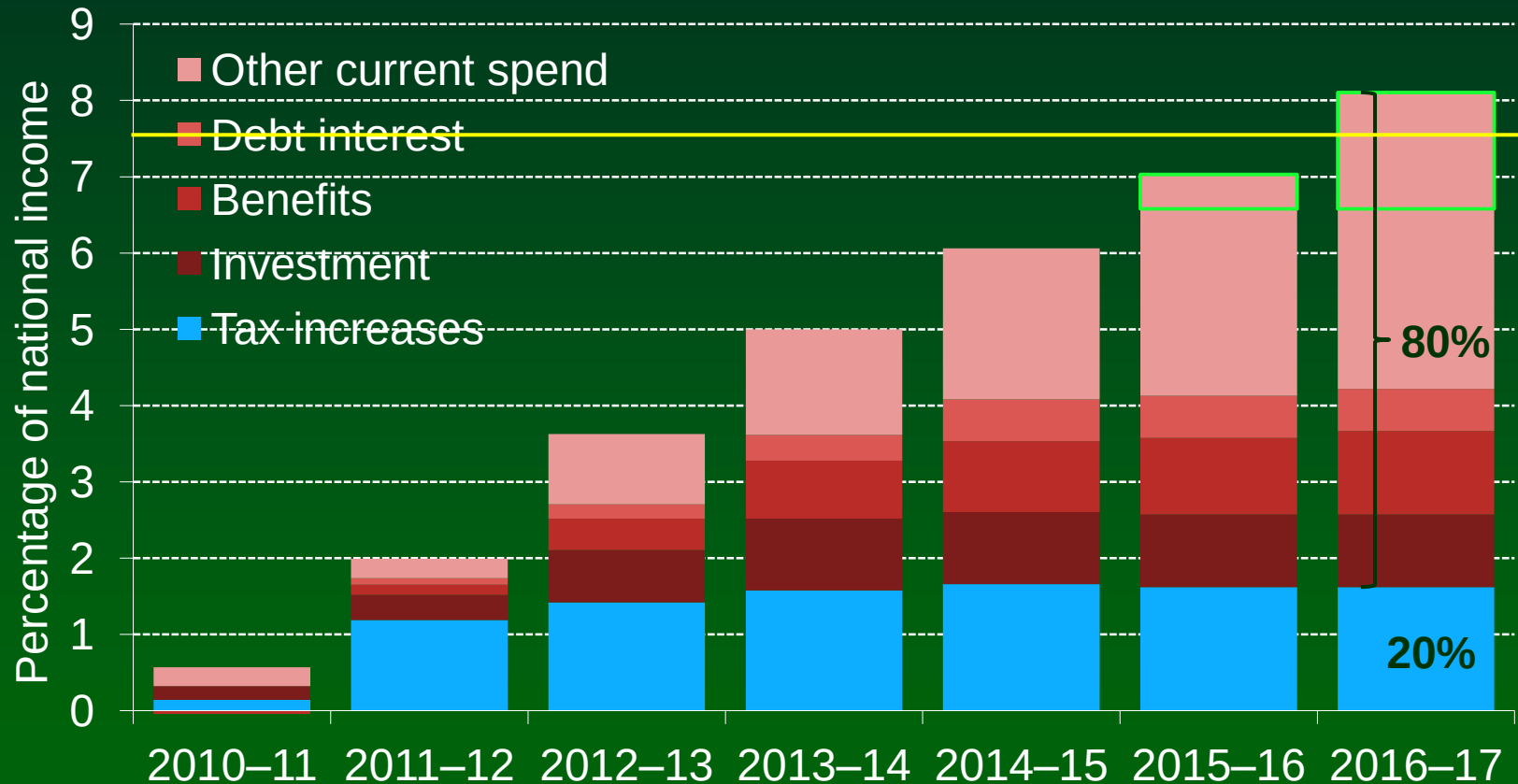
The cure (November 2011):

Nov 2011: 7.5% national income (£114bn) hole in public finances

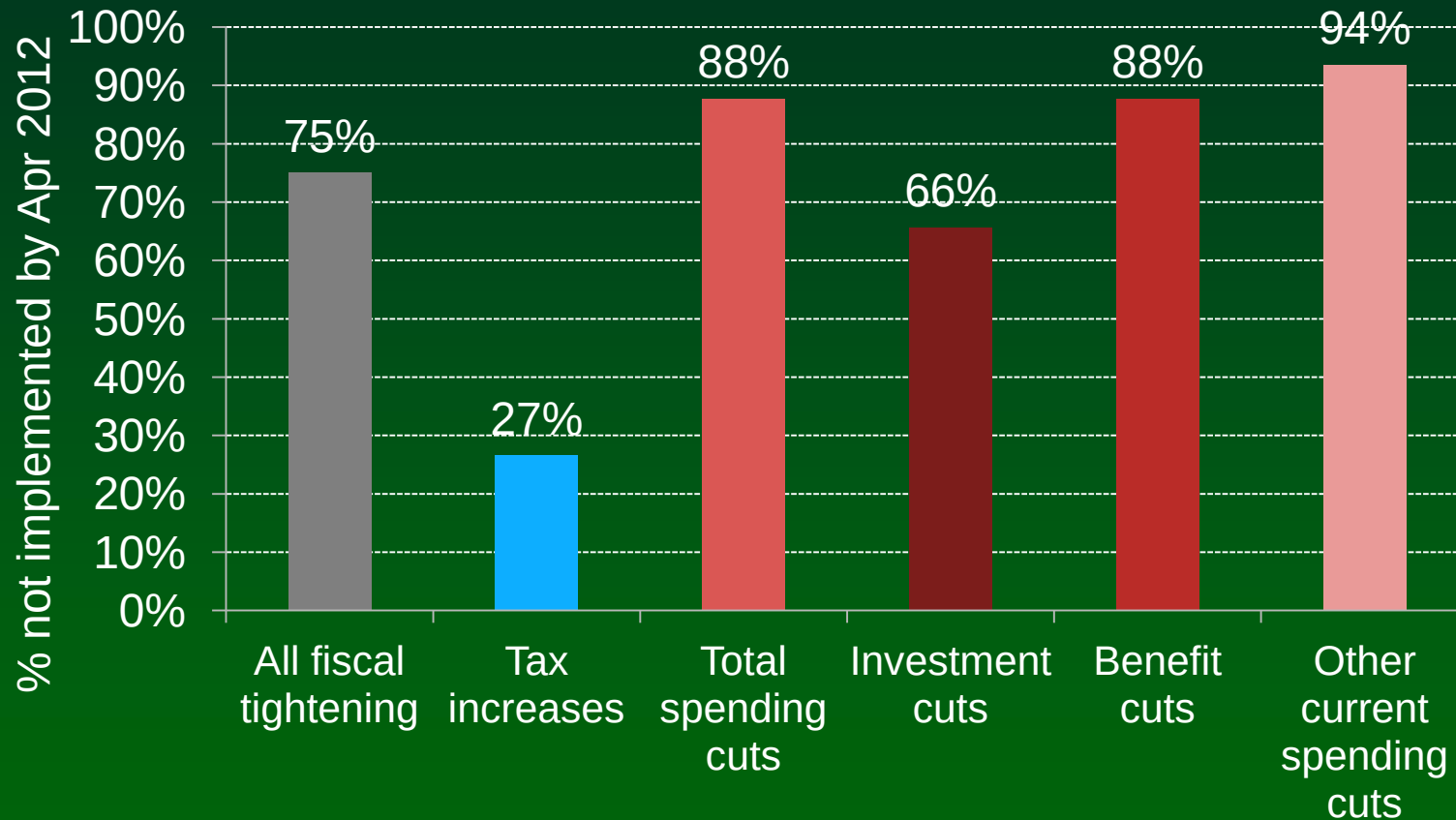


The cure (November 2011): 8.1% national income consolidation over 7 years

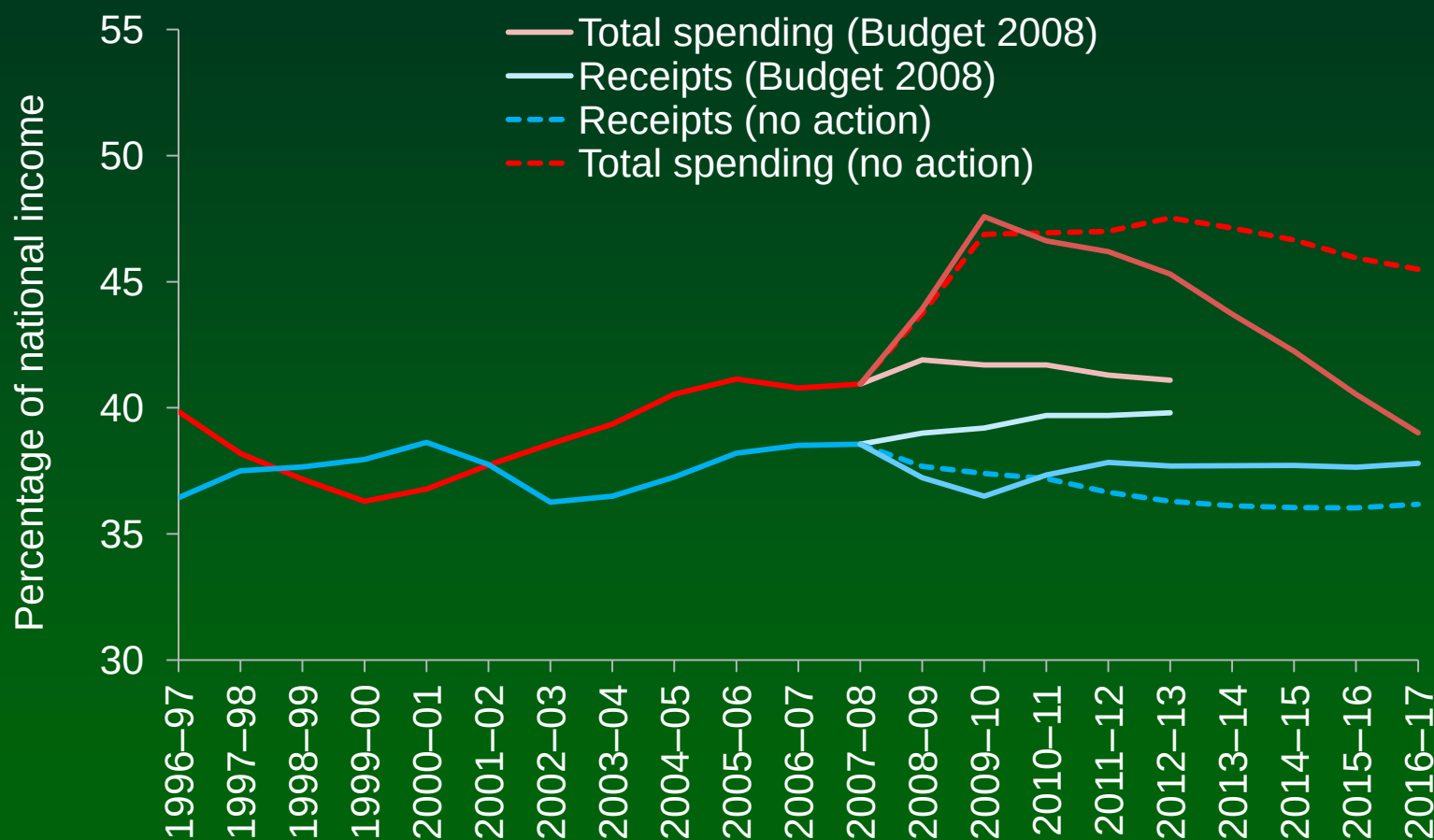
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The pain to come

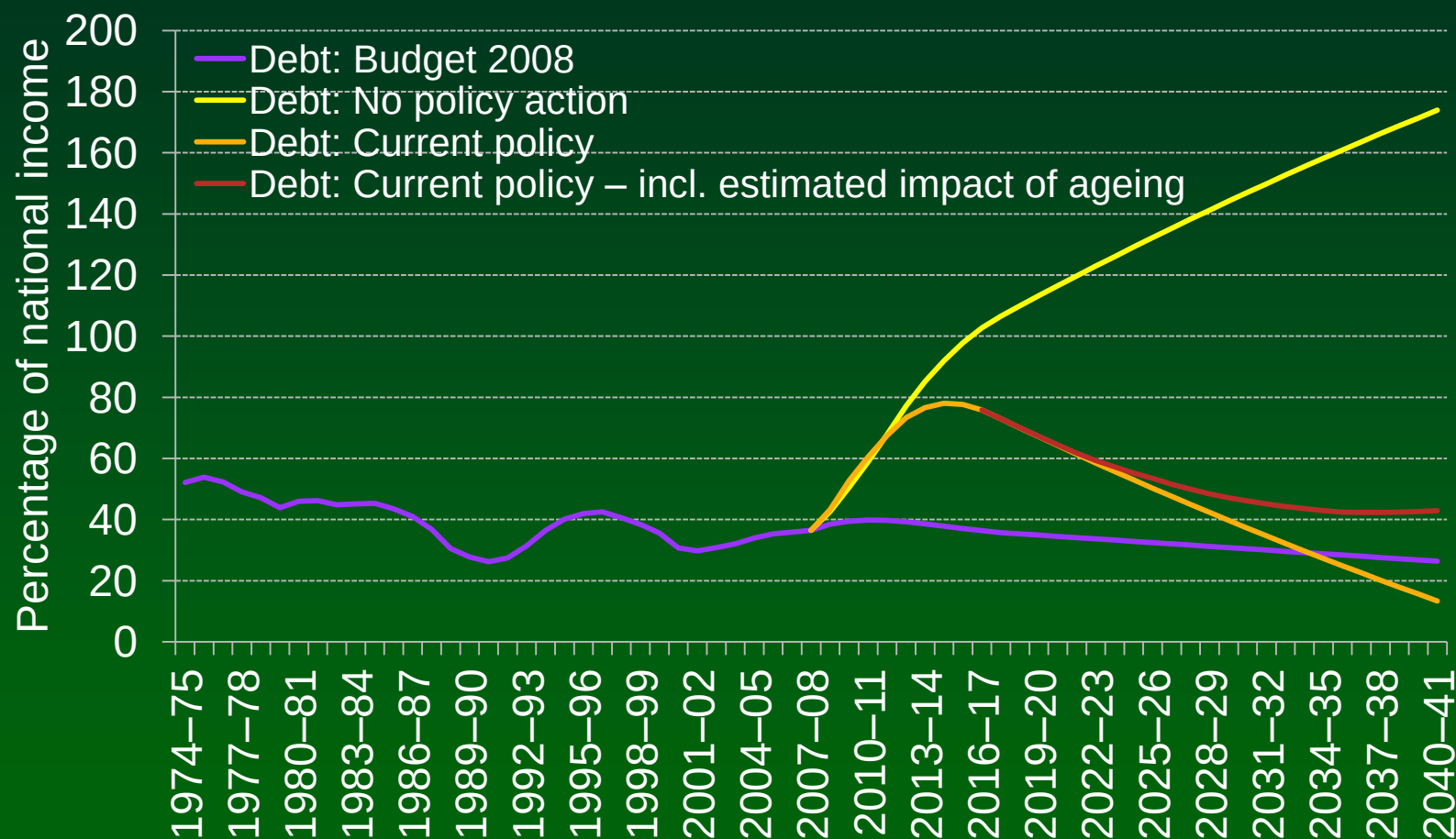


Spending and revenues brought back to pre-crisis levels



Debt back on a more sustainable path

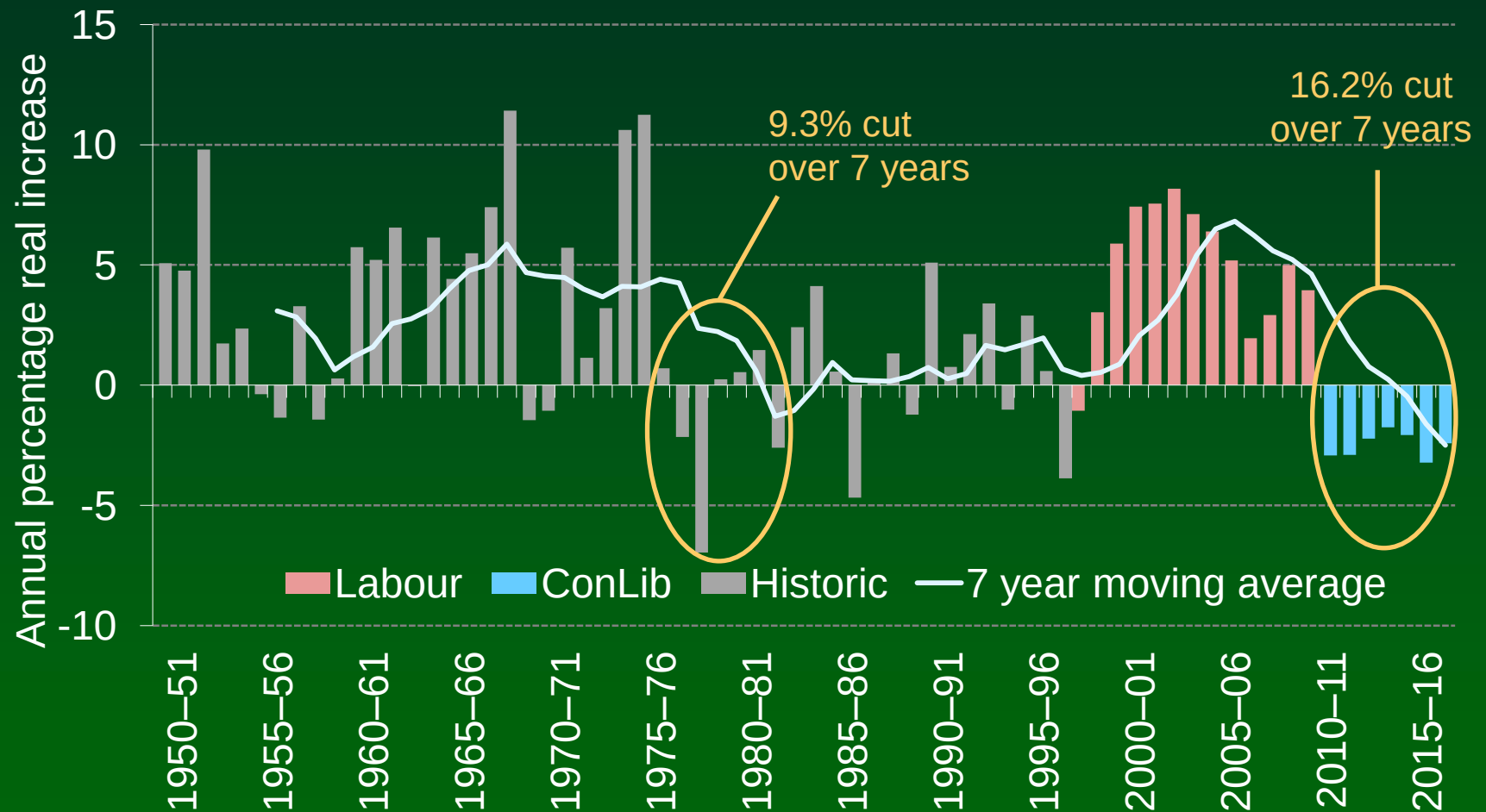
- but to remain above pre-crisis levels for a generation



Can the tight spending plans be delivered?

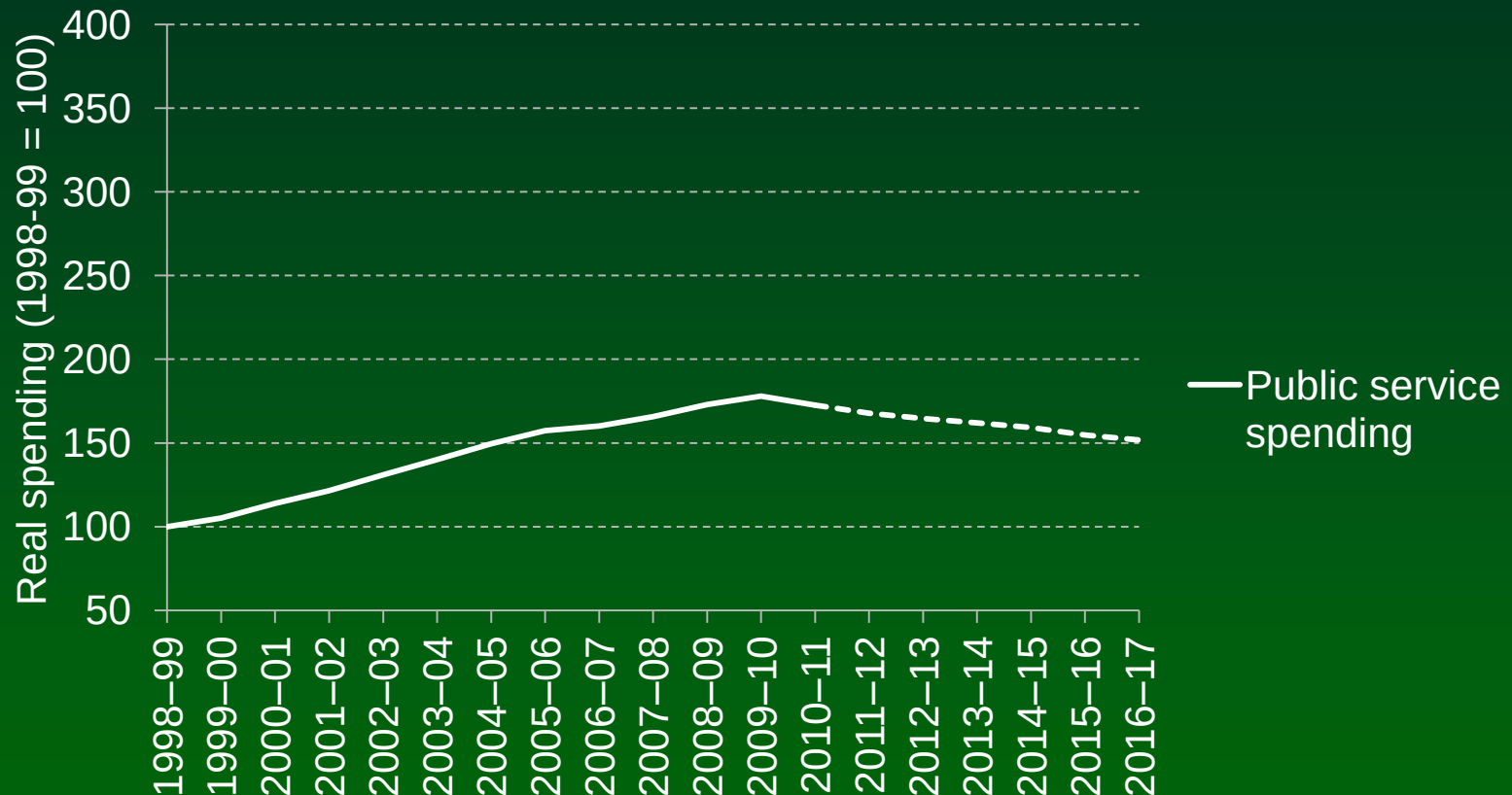
- Such cuts to public service spending not done in the UK before
 - never more than 2 consecutive years of cuts previously
 - spending plans imply April 2010 to March 2017 will be the tightest 7 years for public service spending since WWII
- Only comparable international experience is Ireland in late 1980s
- On the other hand cuts follow a period of big spending increases
 - 12 consecutive years of real increases (1998–99 to 2009–10)
 - by 2016–17 total public service spending will be the same as in 2004–05 in real terms (2000–01 as a % of national income)

7-year ~~6-year~~ squeeze on public service spending



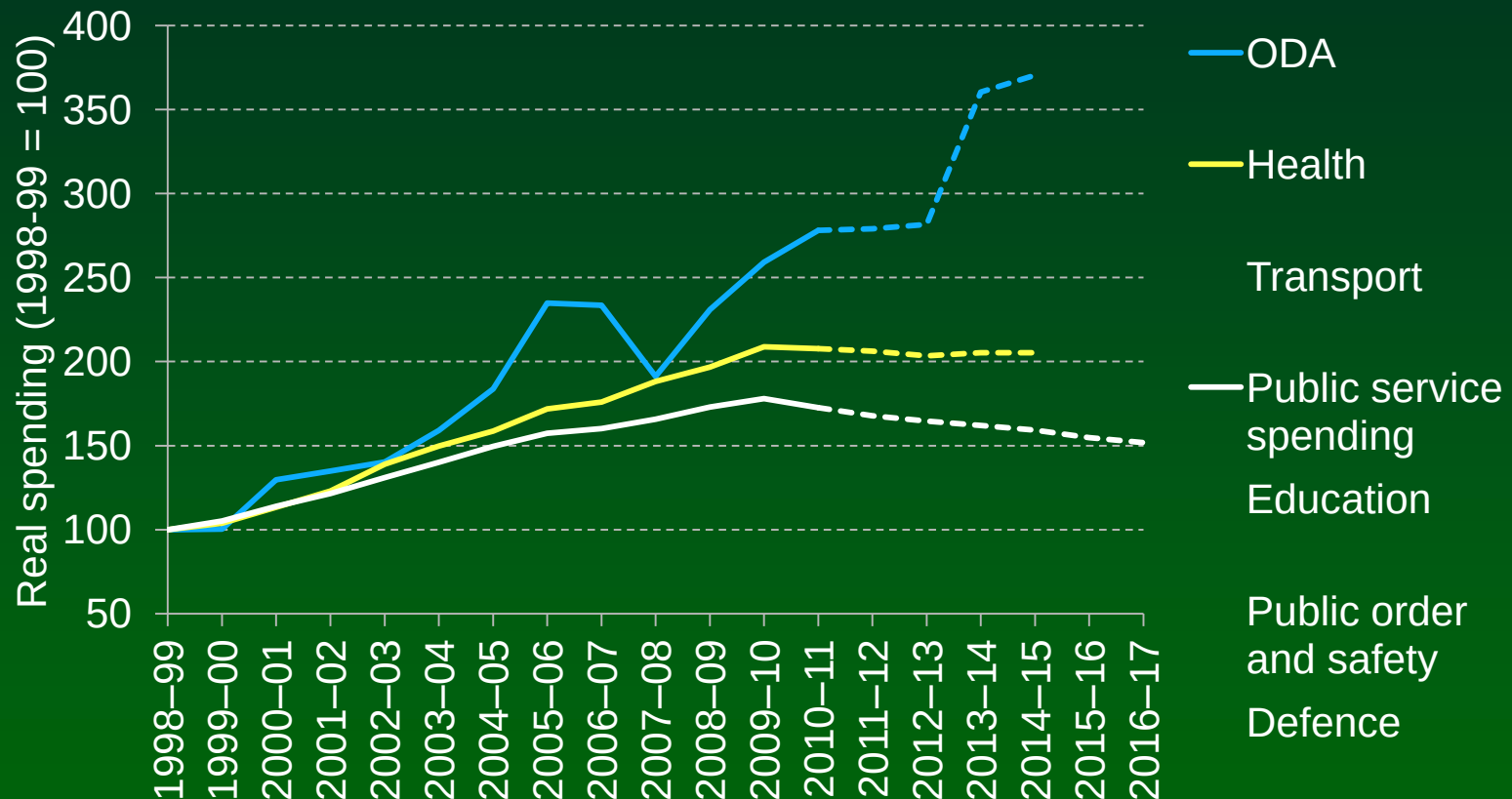
Can the tight spending plans be delivered?

- How tight will they feel?



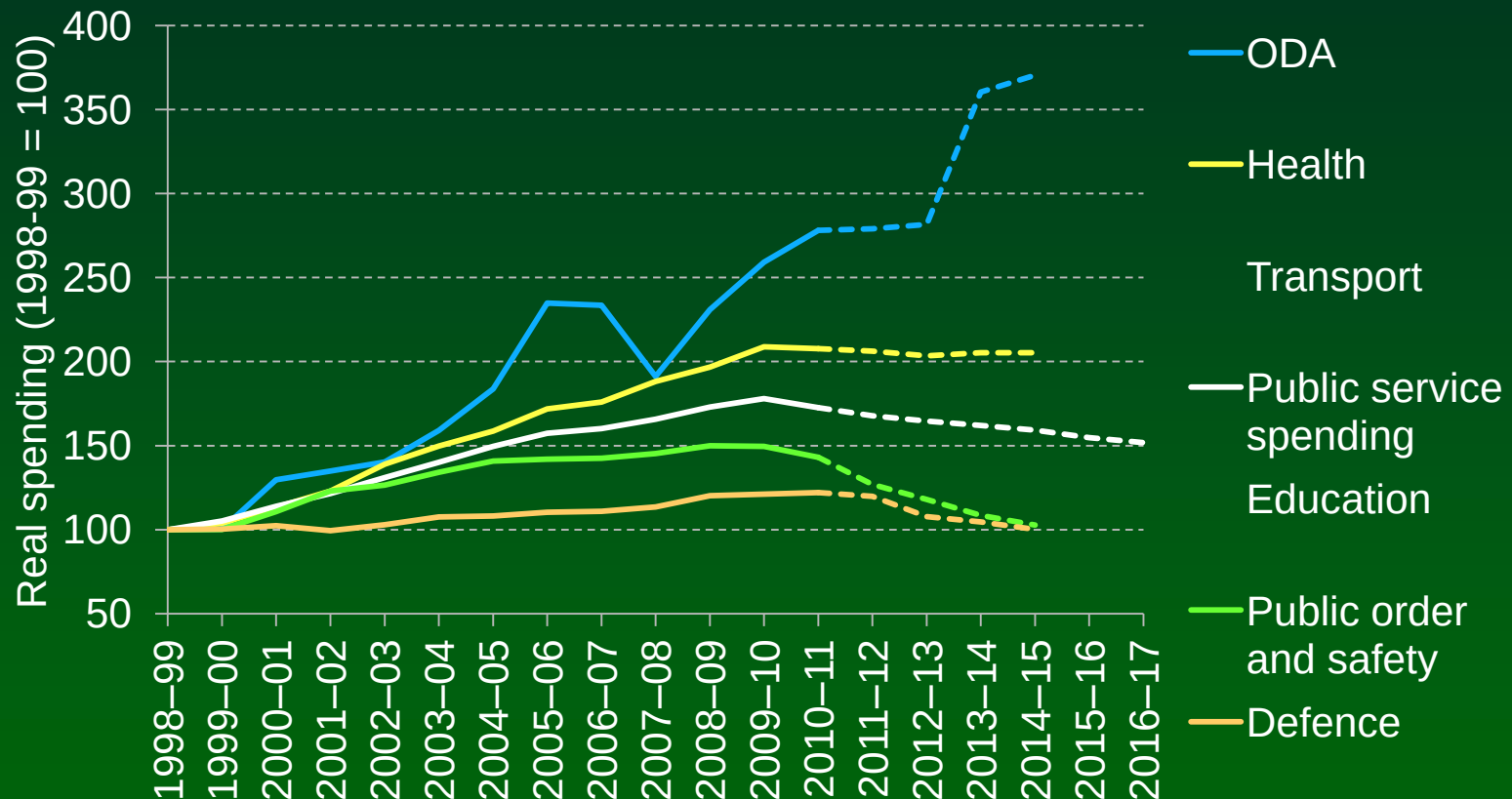
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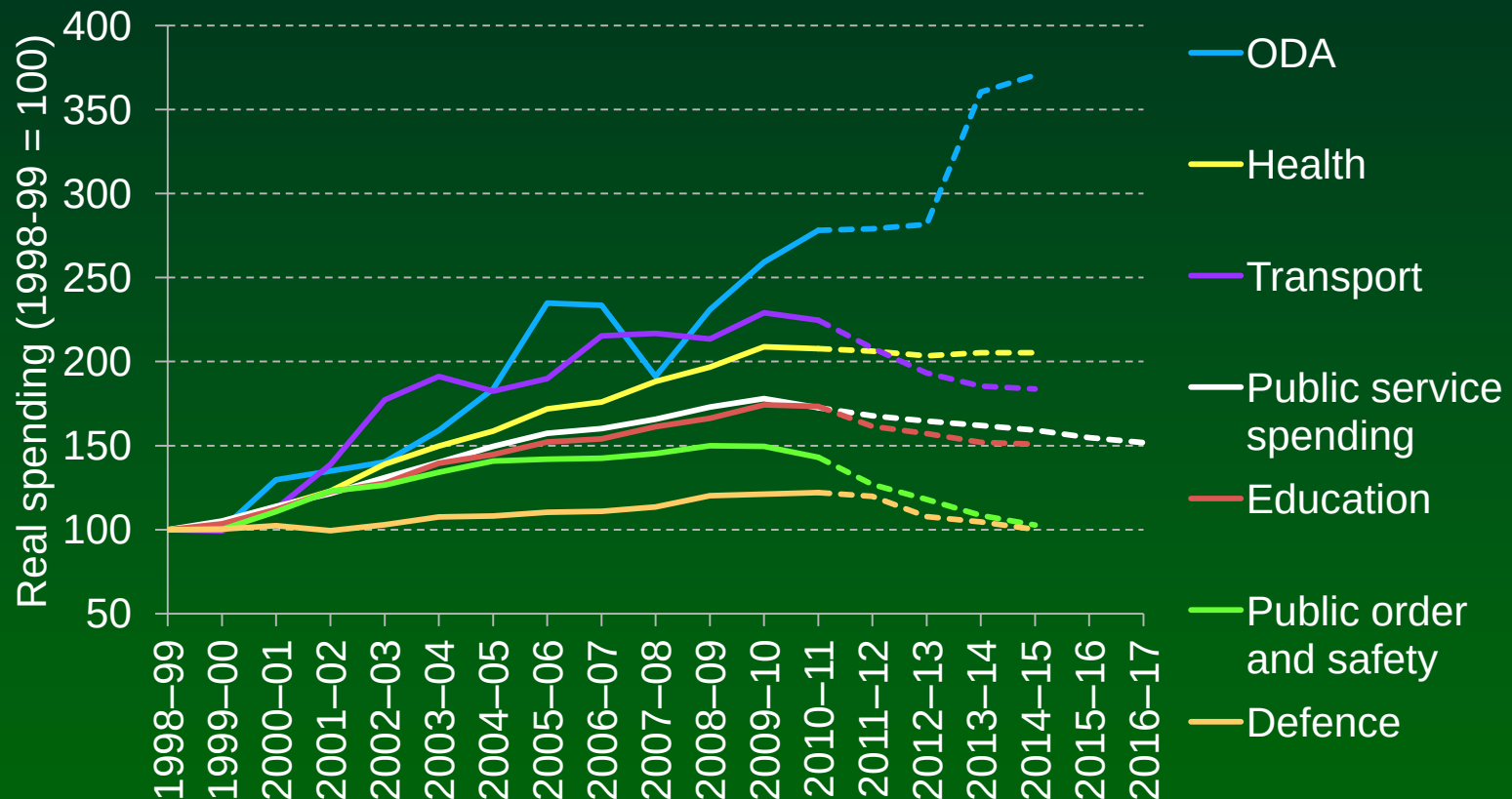
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Can the tight spending plans be delivered?

- How tight will they feel?



This year's public finances

- Current budget deficit and public sector net borrowing
 - PSNB: £124.2 billion (8.2% of national income)
 - CB deficit: £95.6 billion (6.3% of national income)
- £2.9 billion lower than forecast by the OBR
- Current spending: £3.3 billion lower than forecast by OBR
 - expect underspend by central government departments

And over the medium term

- Current budget
 - strengthens from 6.3% of national income deficit in 2011–12 to 0.4% surplus by 2016–17
 - 0.6ppt from increasing tax burden as share of national income
 - 6.2ppt from lower spending as share of national income
- Public sector net borrowing
 - falls from 8.2% of national income to 0.6% of national income
- Borrowing in 2016–17
 - 0.6% of national income (£9 billion) lower than forecast by the OBR
 - (compares to 1.6% of national income increase in OBR's forecast for underlying borrowing in 2016–17 between March and November 2011)

Budget judgement: medium-term

- Forecasts more optimistic than OBR
 - **but** risks skewed to the downside
 - and longer-term pressures of ageing population loom
- So no significant medium-term net giveaway in the March Budget
- Revenue-neutral changes to tax and benefit system should be made that would boost economic growth
- Government should hold Spending Review by autumn 2013
 - in light of evidence on impact of cuts over this SR period
 - revise plans for 2014–15
 - set out spending plans for 2015–16 and 2016–17
 - (taking advantage of any fiscal good news then)

Budget judgement: short-term

- Some fiscal stimulus done in Autumn Statement 2011
 - revenue neutral but slightly growth enhancing reallocation of spending
 - no attempt to offset short-term rise in borrowing resulting from weaker economic outlook

Budget judgement: short-term

- Some fiscal stimulus done in Autumn Statement 2011
- Case for taking this significantly further stronger than a year ago
 - short-term economic outlook has worsened
 - risk of monetary policy being tighter in response is now much lower
- But still not clear cut
 - £740 billion of new debt to be issued over next five years
 - important that interest rates on government borrowing remain low
- Any stimulus measures should be: **Timely, Targeted, Temporary**
 - temporary VAT cut; temporary cut to employers' NICs
 - investment spending boost

Particular policies

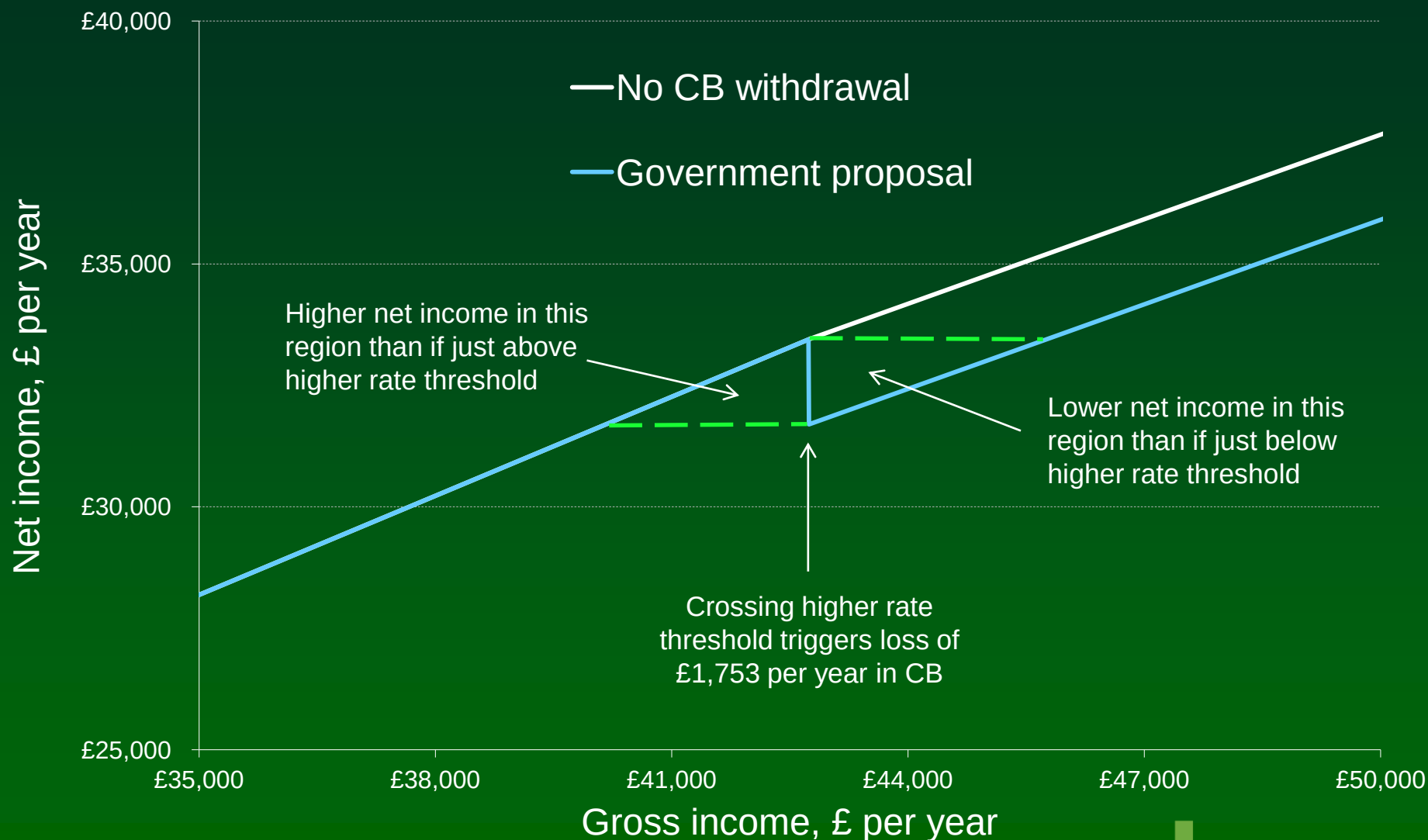
- Child benefit withdrawal
- Raising the personal allowance
- 50p tax rate
- Mansion tax
- “Tycoon tax”
- Pensions tax relief
- Devolution of corporation tax

Child benefit withdrawal

- Child benefit costs £12 billion a year
 - worth £1,056 p.a. for first child, £697 for each subsequent one
- From January 2013, Government plans to remove from families containing higher rate taxpayer
 - HMT estimated saving of about £2.4 billion in 2013–14
 - will affect about 1.5 million families (average annual loss of £1,570)
- Will lead to many administrative challenges
- Policy creates a cliff edge
 - 170k families could increase net income by reducing taxable income
 - 200k families could get lower net income after rise in taxable income

The cliff-edge, illustrated

Budget constraint for example one-earner family with two children, 2013-14



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- Policy creates a cliff edge
 - 170k families could increase net income by reducing taxable income
 - 200k families could get lower net income after rise in taxable income
- And affects one earner couple much more than two earners
- These are major problems of efficiency and equity
 - why not use the tax credit system?



Personal allowance

- Currently stands at £7,475, due to rise by £630 (£210 more than inflation) in April 2012
- Nick Clegg has said that the coalition agreement's aspiration to increase it to £10,000 will be met before the next general election

Year £10,000 personal allowance introduced	Annual cost to the Exchequer
2012–13	£8.9bn
2013–14	£7.7bn
2014–15	£6.5bn
2015–16	£5.3bn

- Could reduce cost to £3.3bn by reducing higher rate threshold
 - would lead to 600,000 additional higher rate income taxpayers, 200,000 of whom would (effectively) lose child benefit

Perhaps not as progressive as you might think



Perhaps not as progressive as you might think



50p tax rate

- We really don't know what effect it will have on revenues or on behaviour
- Treasury's current estimate that it will raise £2.6 billion already assumes £4 billion lost to behaviour change
 - and that is on optimistic side
- HMRC have been asked to report on revenue effects for this budget
 - they won't yet be able to give a clear answer: change in receipts between 2009–10 and 2010–11 might give a distorted view of the long-run impact of the tax
- And of course it's not just revenue that matters

A mansion tax?

- Not likely to raise significant sums
 - Liberal Democrat manifesto proposed a 1% tax on the value of homes in excess of £2m: they estimated this would raise £1.7bn with 70,000 households affected so an average annual bill of £24k
 - only 126,000 Band H households in England: taking the highest value half and giving them an annual bill of £16k would only yield £1bn a year
- Higher tax on expensive properties may make some sense
 - council tax is still based on relative values in 1991 and is regressive because payments rise less quickly than the value of the property and the payments are capped
- But wider reform preferable
 - Mirrlees Review proposed replacing SDLT and council tax with a proportional domestic property tax based on up-to-date valuations



A tycoon tax?

- Aimed at those with very high incomes paying low amounts of tax
 - through taking income as capital gains and incorporation
- In 2009–10 16,000 individuals had income over £1 million
 - they paid an average of £860,000 in income tax which is an average rate of 34.8%
- Setting a minimum tax rate still requires the taxbase to be defined
- If particular reliefs and allowances are deemed too generous better to reform those directly
 - analogous to the benefits cap

Restricting tax relief on private pension contributions

- Private pension saving is relatively tax favoured for many individuals
 - in particular 25% of the fund can be taken as lump-sum tax free
- Annual limit on contributions is £50,000 (from April 2011) and lifetime limit on fund is £1.5m (from April 2012)
- Speculation £50,000 limit might be reduced
 - difficult to estimate revenue raised
 - losers would be lifetime rich and others wanting to make large contributions prior to retirement (self-employed selling their business)
- Pension relief is overly generous to wealthy individuals as up to £375,000 can be taken free of income tax
- Better to reduce the lifetime limit rather than the annual allowance
 - even better to limit generosity of tax-free lump sum



Devolution of corporation tax

- We expect a decision of devolution of corporation tax rate to Northern Ireland in 2012
 - if devolved, seems likely that Wales and (especially) Scotland would want the option to follow suit
- Uncertainty over the size of the effect on investment and whether sufficient to outweigh revenue losses (and associated spending cuts)
- Certain to be large administration and compliance costs
- Implementing devolution would at best be a calculated risk, with unknown long-term consequences for the UK tax system

Tax reform for growth

- Tax system remains complex and distortionary
- We can improve it in many ways which are good for welfare
 - stamp duty on property, uniform VAT
- We can improve it to promote growth
 - support work incentives for those we know are responsive (over 55s and mothers of school age children)
 - reform corporation tax so as to avoid taxing the “normal” return
 - replace business rates with a business land value tax
 - introduce congestion charging
 - rationalise environmental taxes
- Requires a long term strategy

Summary

- Apparent hole in the public finances has increased by £114 billion (7.5% of national income) since the start of the financial crisis
- Planned fiscal consolidation: 8.1% of national income (£123 billion) over the 7 years to 2016–17
 - including spending cuts on an unprecedented scale
- Borrowing this year and in medium term may end up a little below OBR forecasts
 - but great uncertainty and downside risks limit room for manoeuvre
- Chancellor also needs to get the micro-economics of tax and spending right
 - a spending review by Autumn 2013 is needed
 - as is a tax strategy



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