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Economic Bulletin

A FIRST STEPS BUDGET

- "For spoilers ahead of the Autumn Statement later this year, you could do worse than to look at anything coming out from the Centre for Policy Studies."
- Welcome steps on corporation tax, national insurance, deregulation and welfare
- More to do on planning reform, aviation capacity, energy policy and fiscal sustainability
- 16 policy wins for the Centre for Policy Studies

1. INTRODUCTION

"Productivity is the challenge of our time. It is what makes nations stronger, and families richer." This first line of the Productivity Plan unveiled by the Government last Friday demonstrates why it was, in effect, the second half of the Budget outlined by the Chancellor last Wednesday. In our previous Economic Bulletin, we highlighted OBR figures which demonstrated the importance of improving productivity with respect to deficit reduction, GDP growth and living standards. Whilst it is welcome that the Government is now taking seriously the need to raise

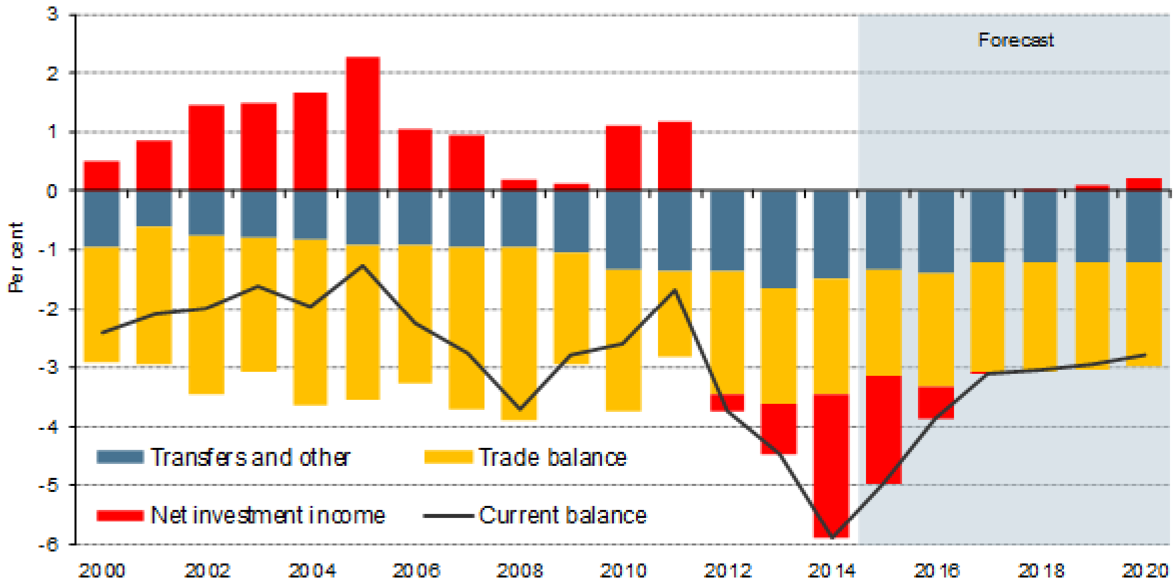
Britain's poor productivity, the reforms announced in the Budget and the Productivity Plan are only the first steps to restoring productivity growth.

2. GROWTH

The macroeconomic outlook is similar to what it was at the pre-election March Budget, with GDP expected to grow at 2.4% in most years of the Parliament. However, there are a few important changes in the composition of growth; real GDP growth in the year to Q 2014 has been substantially upgraded from 2.7% to 3.4% which is the result of stronger private investment and consumption. Yet in Q1 2015, net trade exerted a strongly negative influence on GDP. In March, net trade was expected to reduce real growth in Q1 2015 by 0.1 percentage points but by July this was 0.6 percentage points.

Net trade is already forecast to subtract from growth every year of this Parliament with the seemingly inexorable decline in the UK's export market share. The current account deficit fell to 5.8% of GDP in Q1 2015 from 6.4% in Q4 2014, although it is still at historically high levels. Persistent Eurozone weakness will damage UK export volumes which may make even the OBR's current forecasts far too optimistic.

Figure 1: Current account balance as a share of GDP



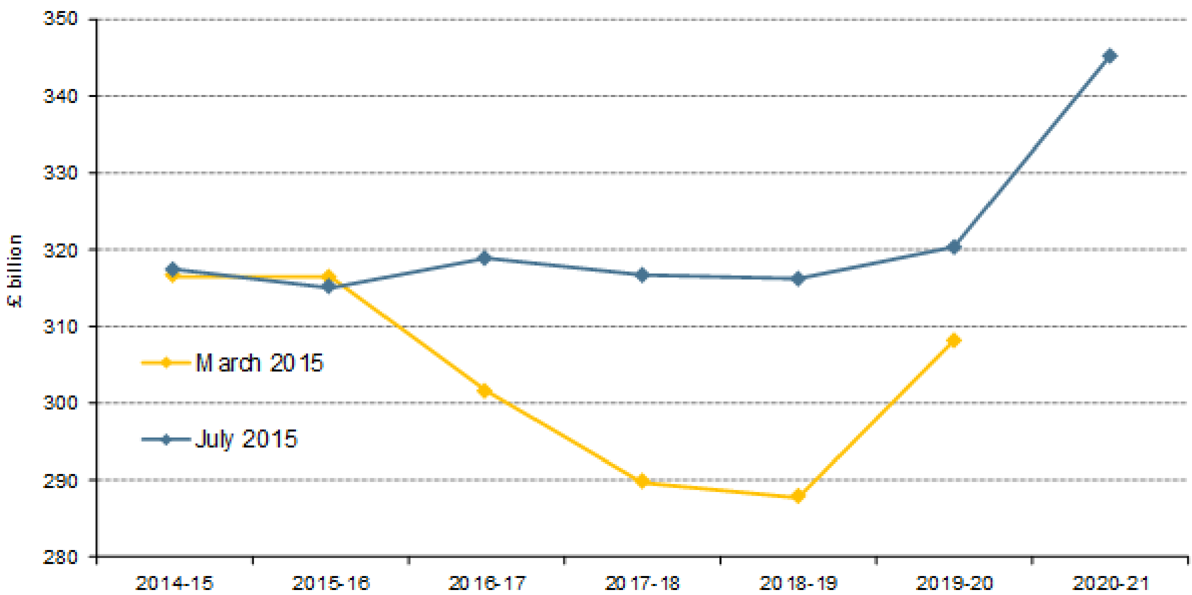
3. BORROWING

The outlook for borrowing is mixed. Whilst the budget deficit will now only return to surplus in 2019/20, a year later than forecast in March, public sector net debt will fall slightly more than anticipated at the pre-election budget. This means that the deficit is expected to fall from 3.2% of GDP in 2015/16 to reach a small surplus of 0.4% of GDP in 2019/20. Over the same period, public sector net debt is expected to fall from 80.3% of GDP to 71.5% of GDP. It is worth remembering that at the Emergency Budget in June 2010, the OBR forecast that this year, the deficit would be only 1.1% of GDP and public sector net debt only 67.4% of GDP.

It does now seem that the national debt is set to fall as a proportion of GDP, although, it is disappointing that the date for a return to a balanced budget has again been pushed back. In large part, this is because of the smoother path of spending that the Government now plans over the coming years; something we argued for at the previous Budget. In March, the Government planned for a reduction in Resource Department Expenditure Limits (RDEL) ie day to day spending on public services from £316.4bn in 2015/16 to £287.9bn in 2018/19 before seeing a sharp increase in 2019/20 to £308.2bn. The Government now plans for RDEL to stay largely flat in nominal terms over the Parliament and reaching £320.3bn in 2019/20.

This means that whilst RDEL was planned to undergo real terms cuts of 5.8% and 5.4% in 2016/17 and 2017/18, it will now only see real terms cuts of 0.5% and 2.4% in those years. Equally, in the last year of the Parliament, RDEL will see a real terms cut of 0.8% compared to the 4.3% real terms increase which had been outlined in March. Whilst the smoother spending profile makes much more sense, it is disappointing that the result is ultimately a bigger state than had been previously considered necessary. Total public spending will rise from £742.3bn this year to reach £804.4bn in 2019/20 which will be 36.3% of GDP; this is up from the 35.2% of GDP which had been planned at the Autumn Statement.

Figure 2: Day to day spending on public services



4. TAX CHANGES

There were a number of welcome tax changes in the Budget including a further increase in the Personal Allowance to £11,000 which is in effect an annual £1 billion tax cut. Despite criticism of raising the income tax free threshold from the Left and the Right, it remains a powerful tool which does indeed help lower and middle earners. Increasing the Personal Allowance to

£12,500 would see the poorest 40% of workers gain the biggest percentage point cuts in their effective marginal tax rates which would boost work incentives. Increasing the national insurance threshold should be the next task.

Further cuts in corporation tax from 20% to 18% are to be welcomed as well as cuts to employer national insurance through an increase in the Employment Allowance to reach £3,000. Reducing the burden of the bank levy by gradually cutting the rate from 0.21% to 0.1% and ensuring that it does not apply to the international balance sheets of UK headquartered banks is a positive step. However, whilst the Government understandably wants to ensure that the financial sector pays its way, there is a danger that the new 8% corporation tax surcharge on banks will damage the investment capacity of Challengers which would reduce competition.

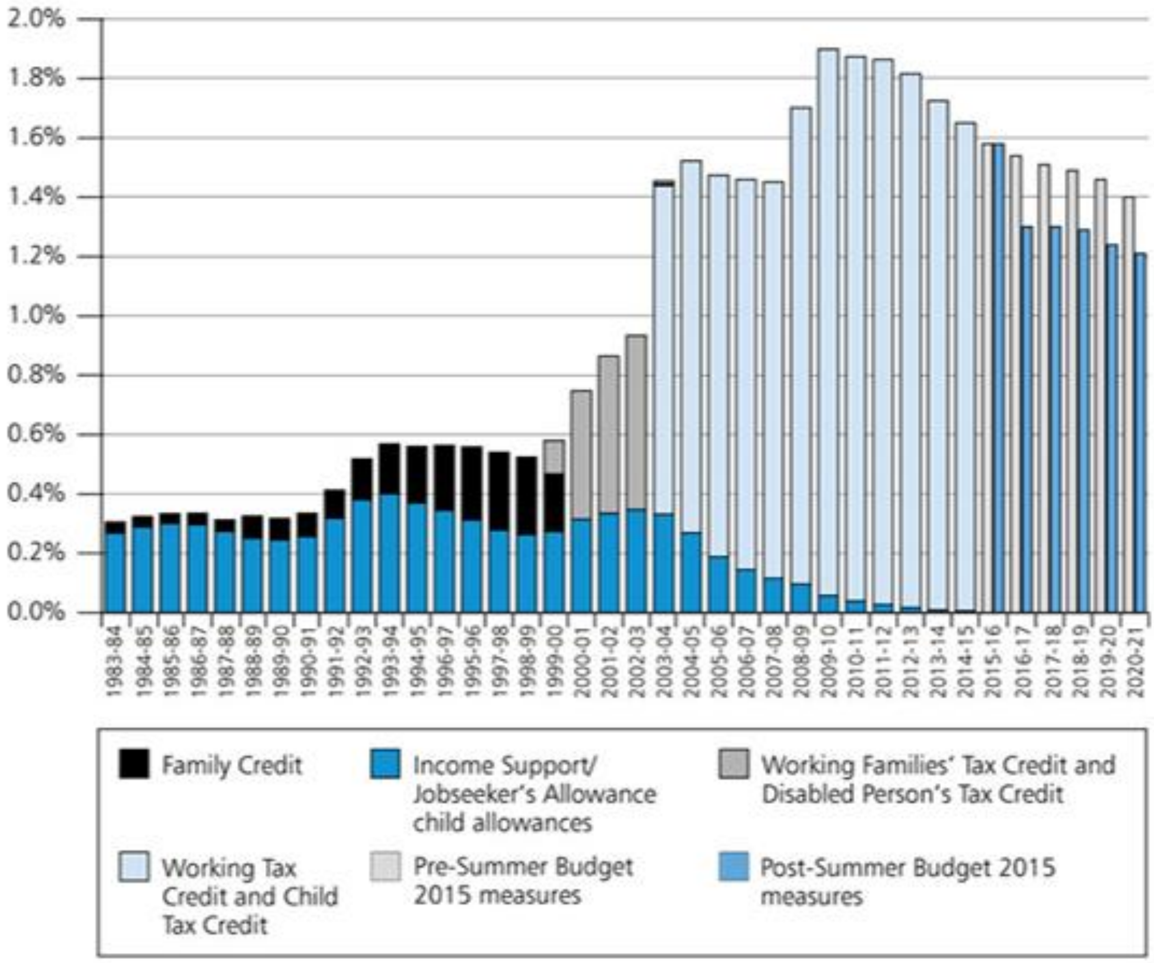
Fixing the Annual Investment Allowance at a permanent level of £200,000 is a vast improvement on what had been a constantly vacillating allowance by reducing business uncertainty and boosting investment. The Chancellor also delivered a significant and inexpensive boost for the Sharing Economy by increasing the Rent-a-Room Allowance to £7,500. Whilst we applaud the Government's intention to reduce the burden of inheritance tax, a better way of doing so would have been to implement a thorough simplification of the tax by abolishing a number of inefficient reliefs to fund a sharp reduction in the rate from 40% to 20% as suggested in our recent paper, How to Cut Inheritance Tax.

The Government's reforms to vehicle excise duty, insurance premium tax, the taxation of dividends, capital gains tax and the climate change levy amount to a cumulative £17.4bn tax rise between now and 2019/20. Whilst these measures are likely to hit higher income deciles proportionately more, we should be in no doubt that these are serious tax rises which all have the potential to damage output growth. Nevertheless, many of these taxes are in need of reform. For example, the Government's measures to replace the dividend tax credit with a £5,000 dividend allowance and reducing the number of vehicle excise duty bands are useful, simplifying proposals.

5. WELFARE REFORM

The broad aims of the Government in reforming welfare are laudable, yet there are some problems with the specific measures which it has outlined. The substantial growth in the tax credit bill to reach approximately £30 billion has meant that it cannot be ignored in a comprehensive deficit reduction strategy. Whilst there is evidence that much of the gain from tax credits flow to employees, they have been more of an attempt to ease the symptoms, by topping up low pay, instead of resolving the real problem of low productivity amongst both firms and workers. There is of course evidence elsewhere which suggests that the tax credits system has not been effective at promoting a stronger work ethic amongst people who are stuck in chronically low paid work whilst creating high marginal tax rates.

Figure 3: Expenditure on tax credits and equivalents as percentage of GDP



The biggest component of the welfare savings by 2019/20 is the extension of the freeze in working age benefits, which we argued for before the election and which is expected to save £3.9bn in 2019/20 (and a cumulative £7.2bn). However, the other cuts in welfare spending seem to be piecemeal rather than forming a coherent strategy to reform the system. Some measures such as ending the automatic entitlement of 18 to 21 year olds to receive housing benefit, reducing the benefit cap, limiting future claims on child tax credits to fewer than three children and making higher income social housing tenants pay market rents are sensible and equitable and should help to boost work incentives and encourage greater personal responsibility.

However, whilst the need to need to reduce welfare spending is clear, other measures such as increasing the tax credits taper rate from 41% to 48% and reducing income thresholds in tax credits and work allowances in Universal Credit might protect those on the lowest incomes but will certainly raise effective marginal tax rates and diminish work incentives for those slightly higher up the income scale. The new National Living Wage will partially, although clearly not entirely, offset the reduction in tax credits. Nevertheless, the focus on improving productivity instead of topping up low pay which is the direct result of poor productivity is right and by 2016/17, 50% of families with children will receive tax credits, down from 90% in 2010.

6. PRODUCTIVITY

One of the most important measures in the Productivity Plan was planning reform on brownfield sites. New sites for development will effectively be able to gain automatic planning permission in areas of disused industrial land, councils will be encouraged, effectively, to be less obstructive to development and height restrictions on building in London will also be relaxed. These are all important steps which will help to support housing construction and productivity growth. However, the Government could have gone further to simplify and consolidate existing planning laws as suggested in our recent report, Pink Planning.

On skills, it is welcome that the Government is taking the task of increasing the quantity and quality of apprenticeships so seriously. Apprenticeships will be an important driver of skills accumulation and productivity growth of the coming years but it is not clear if a new levy on bigger businesses is the best way to fund them especially with numerous questions remaining over how it will be implemented. Apprenticeships require reform to increase their quality in areas such as National Qualifications and performance metrics. The Productivity Plan could have gone much further on skills, as we suggested in Mind the Skills Gap, to develop the skills of older workers and remove remaining restrictions on Universities.

On deregulation more broadly, the Government's steps to enact swift reform of the Electronic Communications Code and to allow the development of taller mobile masts will provide a significant boost to the UK's digital infrastructure and broadband connectivity. The devolution of Sunday trading laws is also a sensible deregulatory measure. However, whilst the Government aims to reduce regulatory costs by £10bn this Parliament, this will be a much easier task if regulation emanating from the European Union is brought into the On-In-Two-Out rule.

One area in which the Productivity Plan was disappointing was its discussion of energy policy. Commitments to review and to consult are fine but some actions on energy policy can be implemented immediately to boost productivity. For example, shale gas extraction through fracking is being held back by a sea of expensive bureaucracy and nimbyism yet it is of national importance to allow the sector to grow. The Government should have outlined measures to ease significantly the planning process for exploratory drilling. The forecast tax revenue from the North Sea fields has collapsed and whilst there was a small increase in the investment allowance, the Government could have just given the sector a sharp boost by abolishing entirely one of the key oil and gas taxes such as the Supplementary Charge at a negligible cost.

7. CPS POLICY WINS

The Budget and Productivity Plan contained a number of policy wins for the Centre for Policy Studies. These include, fixing the Annual Investment Allowance, increasing the Rent-a-Room

Allowance, extending the freeze on working age benefits, extending the oil and gas investment allowance, reforming the Electronic Communications Code and deregulating mast height restrictions, increasing the Personal Allowance, committing to the 2% NATO defence spending target, the National Living Wage, cutting the corporation tax rate to 18%, reforming the dividend tax credit, simplifying vehicle excise duty, opening the higher education marketto new and alternative providers and privatising the Green Investment Bank amongst other measures. In particular, the radical idea put forward by the Chancellor to treat pensions like ISAs seems to have been inspired by CPS Research Fellow, Michael Johnson's recent paperThe Workplace ISA and the ISA Pension.

As one leading financial journalist has commented: "Either way, for spoilers ahead of the Autumn Statement later this year, you could do worse than to look at anything coming out from the Centre for Policy Studies."

8. CONCLUSION

Public spending as a proportion of GDP is falling and by 2020, the size of the state relative to the economy will have fallen by about a fifth compared to 2010. However, in this Budget, it is clear that the Government decided to be slightly less ambitious in shrinking the state than it was in March or at the Autumn Statement. Substantial challenges to the UK's long term fiscal sustainability remain especially with respect to the rising cost of pensions and weak public sector productivity.

This Budget contained a number of welcome measures but these should only be considered as the first steps. Planning reform must go much further, welfare reform must be more radical, energy policy must be more ambitious and the aviation capacity question must finally be resolved; perhaps through a free vote in Parliament.

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