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What's the damage?

A low earner impact assessment of deficit reduction options

Structure of report

1. Economic context

2. Low earners

3. Consolidation principles and process

4. Impact assessment of specific options

1. Economic context

Fiscal aggregates: UK 2006-07 - 2014-15

	Annual budget deficit	Annual structural deficit	Annual structural current deficit	Public sector net debt
As proportion of GDP				
2005-06	2.9%	2.8%	1.0%	35.3%
2006-07	2.3%	2.3%	0.4%	36.0%
2007-08	2.4%	2.6%	0.5%	36.5%
2008-09	6.1%	5.8%	3.2%	44.0%
2009-10	10.3%	8.4%	5.2%	53.8%
2010-11	11.1%	7.3%	**4.6%**	63.6%
2011-12	8.5%	5.3%	3.4%	69.5%
2012-13	6.8%	4.1%	2.5%	73.0%
2013-14	5.2%	3.1%	1.8%	74.5%
2014-15	4.0%	2.5%	1.2%	74.9%
£ billion (2009-10 prices)				
2005-06	42	41	15	517
2006-07	£32	£32	£6	£506
2007-08	£34	£37	£7	£513
2008-09	£86	£82	£45	£619
2009-10	£145	£118	£73	£756
2010-11	£156	£103	**£65**	£894
2011-12	£120	£75	£48	£977
2012-13	£96	£58	£35	£1,026
2013-14	£73	£44	£25	£1,047
2014-15	£56	£35	£17	£1,053

Source: HMT, *Public Finances Databank*, 27 May 2010

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1. Economic context

- Highest level of borrowing as share of GDP since WWII
- Global problem, but UK position deteriorated more than most
- Source of borrowing is collapse in tax revenues, not increase in spending
- Considerable uncertainty over actual size of the problem and prospects for economy

1. Economic context

- Borrowing costs currently low by historic standards
- Sharp increase could create unsustainable debt cycle
    - Could happen if investors think government is going to default
    - Could be triggered by insufficient demand for gilts (post QE)
    - Or by downgrading of UK credit rating
    - Or ‘contagion’
- In any event, borrowing costs likely to rise because of size of funding needed
- Need ‘credible plan’ to reassure markets, and to get the job done

1. Economic context

Coalition government

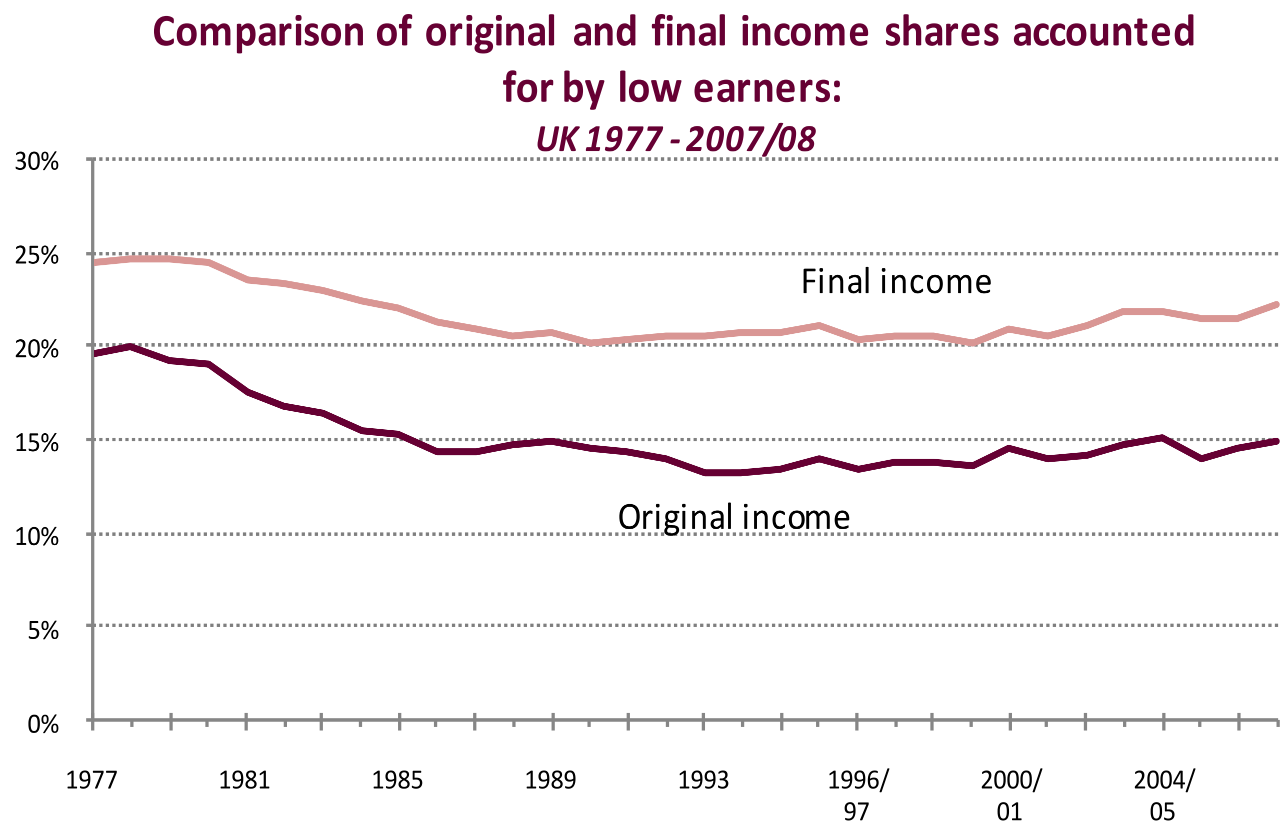
- “significantly accelerate” the reduction of the structural deficit over the course of a Parliament, with the main burden of deficit reduction borne by spending cuts rather than increased taxes

- set out a plan for deficit reduction in an emergency Budget, to be published on 22 June

- hold a full Spending Review, reporting in autumn, which will follow a “fully consultative process” involving all tiers of government and the private sector

2. Low earners: *squeezed*

Low earners' share of total original and final income in UK has declined in last 30 years



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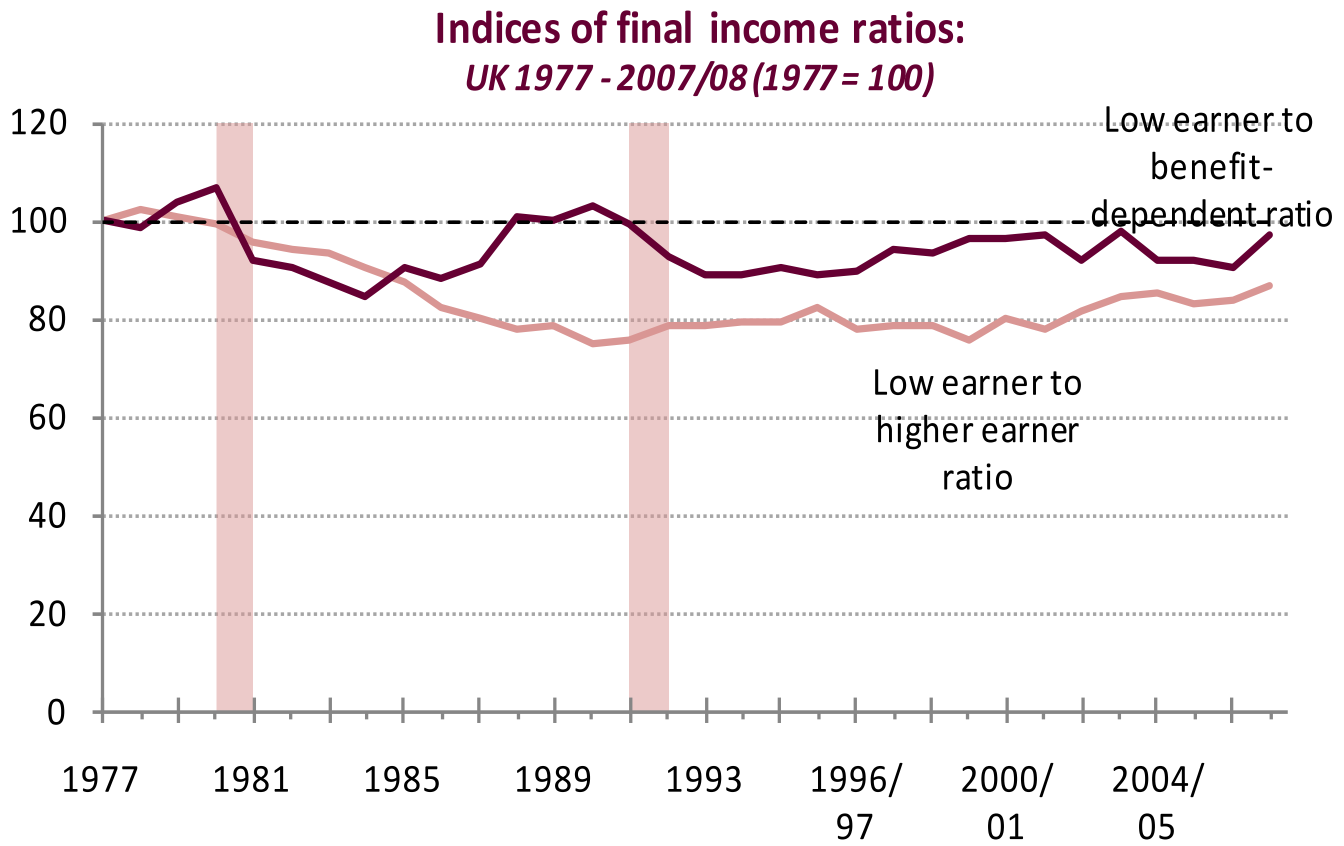
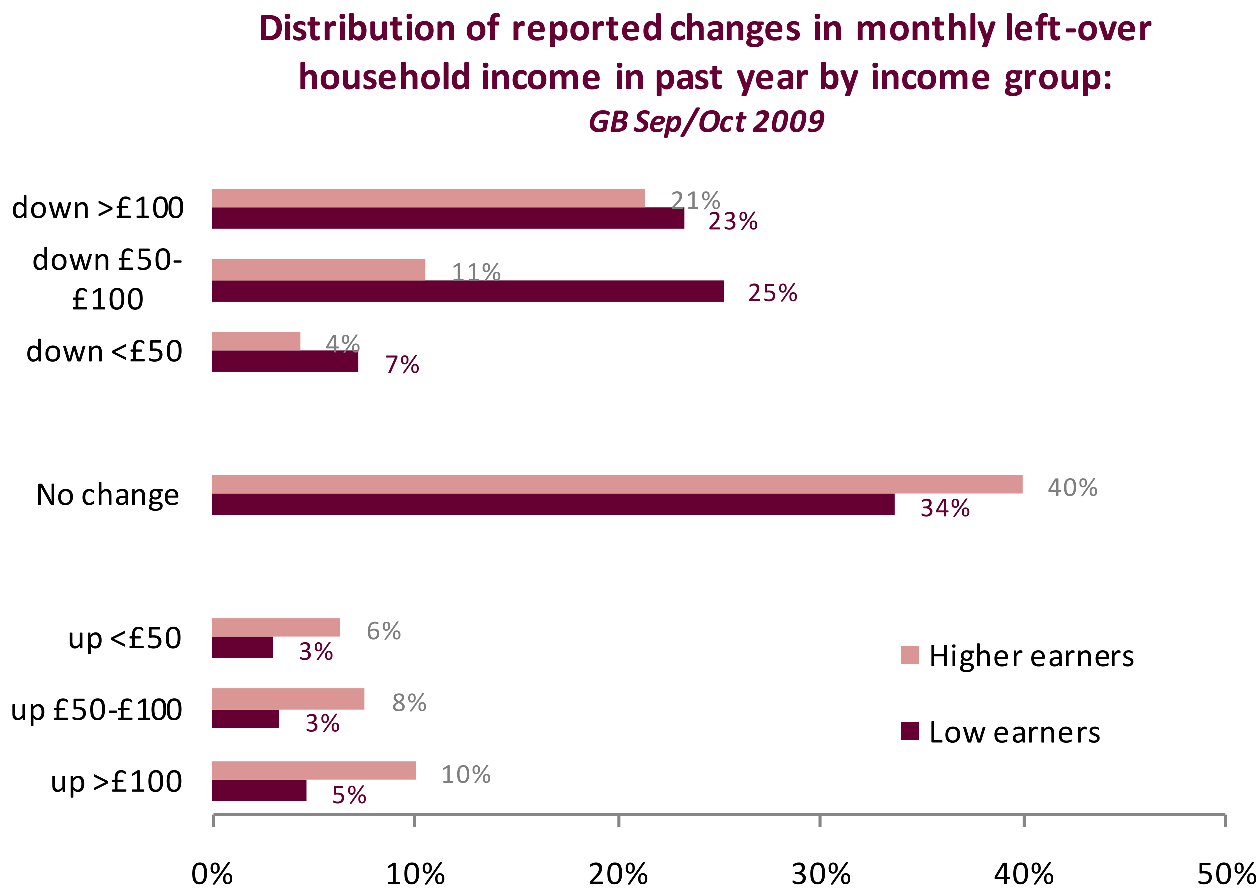
2. Low earners: *squeezed*

Low earners become poorer relative to higher earners and benefit-dependent households over same period



2. Low earners: *exposed*

Low earners suffered more than other groups during recession because of vulnerability of work and lack of savings safety net



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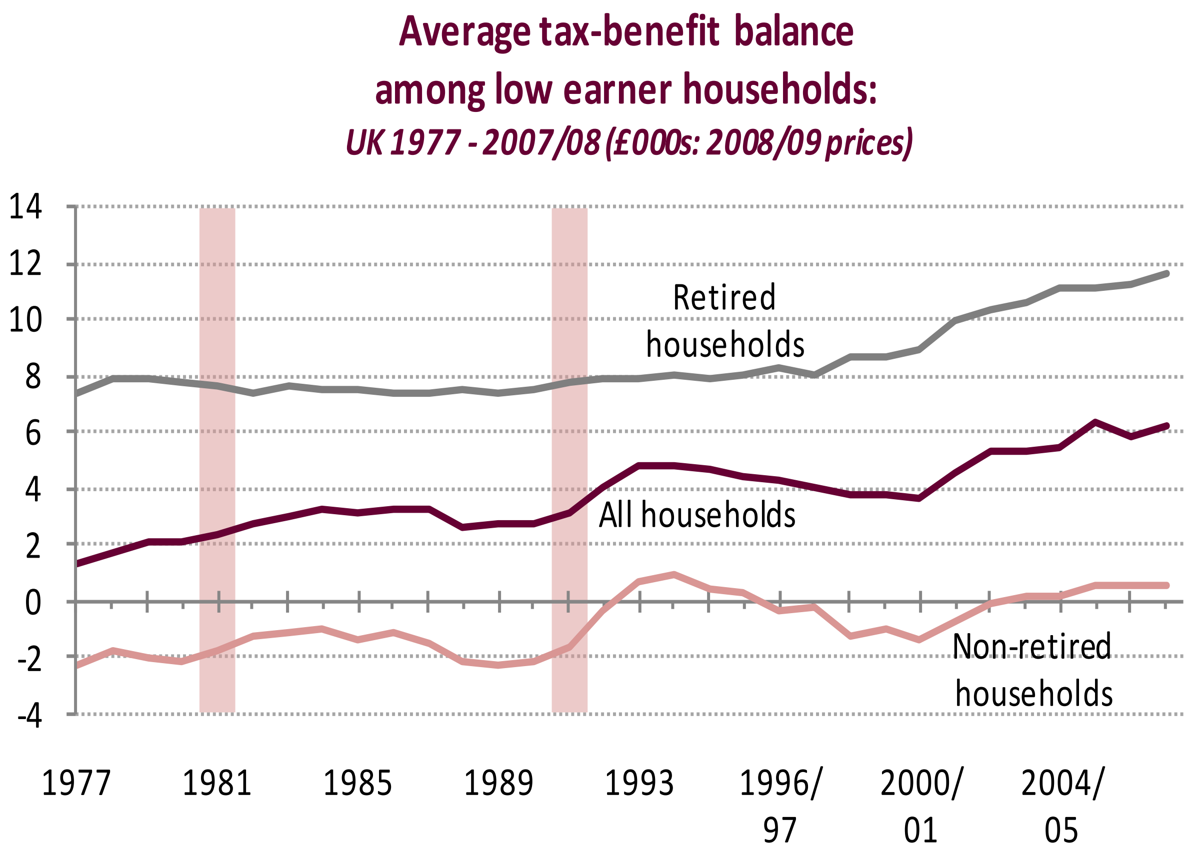
2. Low earners: *overlooked?*

Low earners are on cusp of state support, so withdrawal of state during consolidation risks falling disproportionately on the group



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3. Principles and process

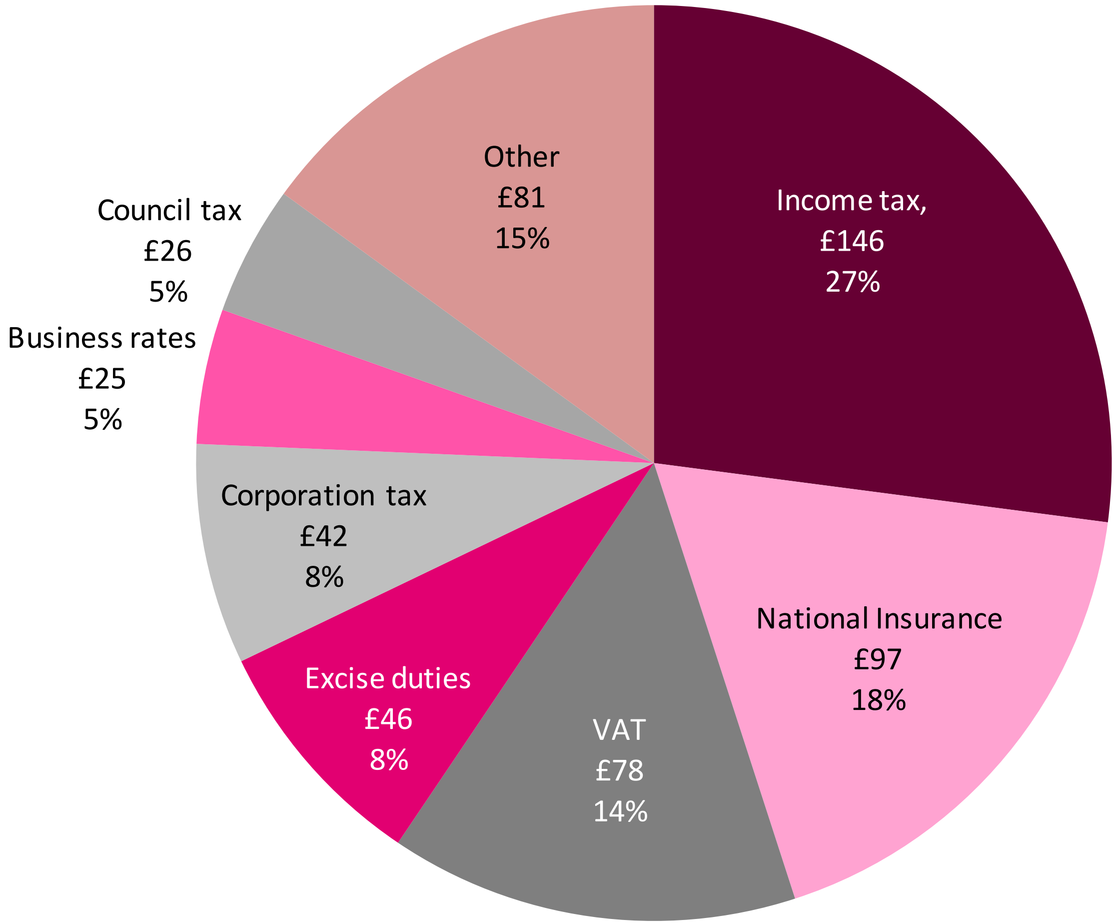
- Recovery nascent, deficit pressing: solutions potentially conflicting, but hopefully reinforcing
- Risks on both sides are real – and unpredictable. No objective way of determining which is more pressing, instead a judgement call about which consequences are worse
- Low earners more likely to be disproportionately affected by return to recession, so pace of tightening should be contingent on state of economy (formal tests)
- Consolidation needs to be carefully considered and presented as a single package, with clear trade-offs (distributional assessment)
- Strategic review should be based on three criteria: ***fairness***, impact on ***growth*** and ***sustainability*** of deficit reduction

3. Principles and process (tax)

- Three options:
  - increase rates
  - introduce new taxes
  - reform existing
- **Growth**: land/wealth taxes are least-bad, followed by consumption taxes, then direct taxes, then corporate taxes
- **Fairness**: direct tax (income and wealth) increases are most progressive, indirect (consumption) are least, corporate taxes less clear – prices, wages and profits
- **Sustainability**: tackling the big three and maintaining mandate

3. Principles and process (tax)

Government revenues by type:
£ billions, 2010-11 projections



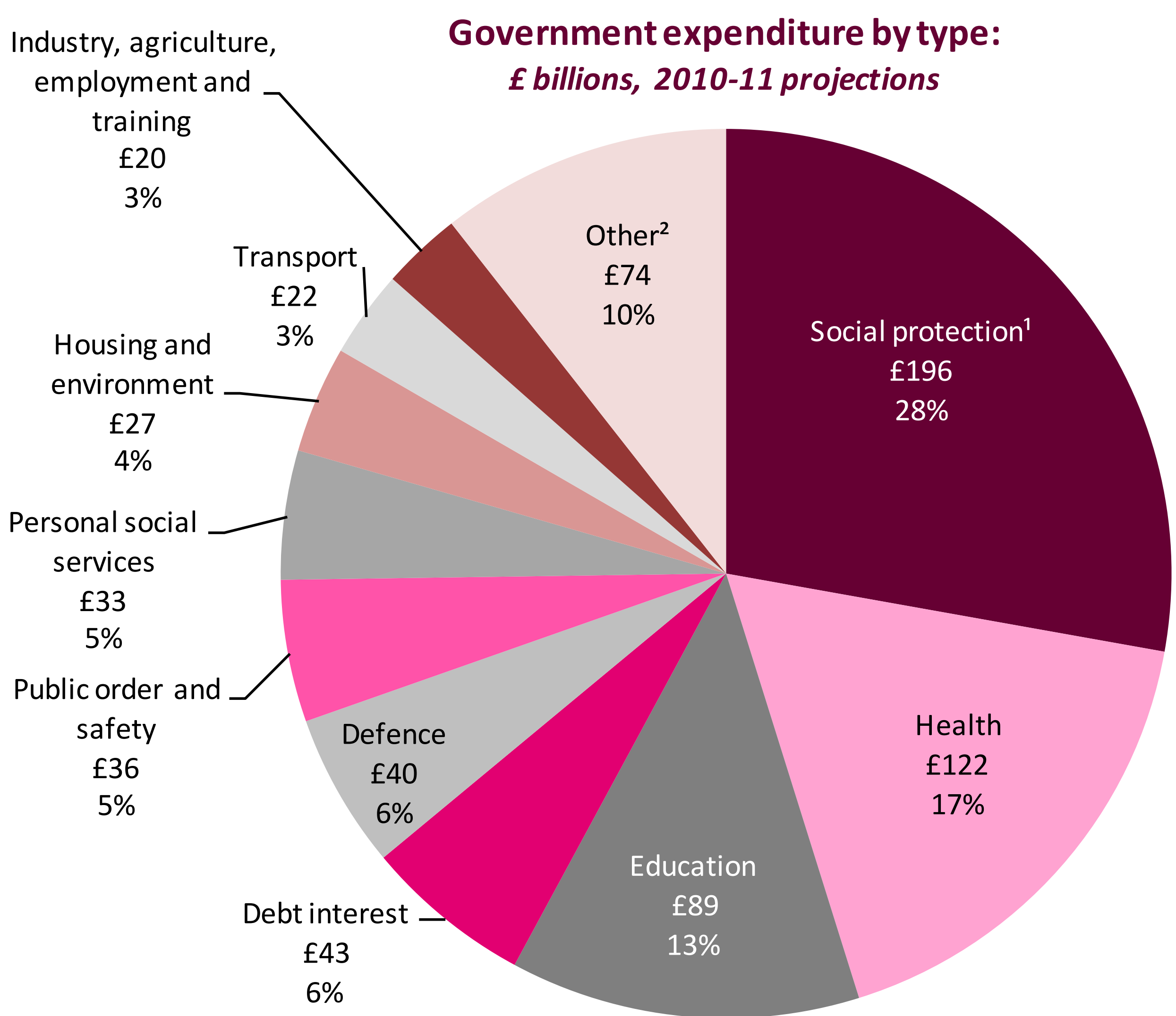
3. Principles and process (spending)

- Avoid salami-slicing
  - Cuts easiest rather than most appropriate
  - Creates divisions/rivalries across departments
  - No consideration of distributional impact

- Zero-based review based on two-stage process
  - Priority in each area (fairness – political judgement)
  - Government effectiveness (value for money - objective)

- Opportunity for reform
  - For example, joining up silos by learning lessons of Total Place

Principles for cutting spending



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4. Impact assessment

- Process will hurt everyone, but low earners have been squeezed in the good times, exposed in the bad and are at risk again. Need special consideration to avoid further exposure

- Not complete insulation from pain, but avoid disproportional hit

- Presentation of consolidation plan as single package, with distributional assessment, would make treatment clear

4. Impact assessment

Low earners unaffected, or significantly less affected than other income groups

Low earners little affected, or less affected than other income groups

Low earners slightly less affected than other income groups

Broadly neutral distributional impact/not possible to make an assessment

Low earners slightly more affected than other income groups

Low earners quite affected, or more affected than other income groups

Low earners significantly affected, or significantly more affected than other income groups

4. Impact assessment

Achieving public service efficiencies	*up to £20bn*
Increasing capital gains tax rate	*~ £3.2bn via alignment with income tax rates*
Implementing public service resource transfers	*na*

Increasing National Insurance Upper Earnings Limit	*~ £4.2bn via raising to £100k a year*
Removing personal allowance for higher rate income tax payers	*~ £4.1bn*
Restricting pension contribution tax relief	*~ £4.1bn via restricting relief to 20%*
Introducing ad-valorem tax on properties over a certain threshold	*£3-£4bn via average 0.5% levy on properties above £500k*
Charging capital gains tax at death	*~ £0.2bn*
Raising inheritance tax rate	*~ £0.01bn via 1 percentage point increase*
Increasing the number of lifetime gifts covered by inheritance tax	*na*

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4. Impact assessment

Increasing income tax rates	*~ £5.5bn via 1p increase in all rates*
Cutting public sector pay	*~ £5.5bn via freezing wages for two and a half years*
Increasing National Insurance rates	*~ £5.0bn via 1 percentage point increase in employee or employer rates*
Charging capital gains tax on primary residence	*up to £5bn*
Extending VAT to financial services	*up to £2.8bn*
Cutting low cost home ownership programmes	*up to £2bn*
Charging higher interest on student loans	*up to £1.2bn*
Reducing inheritance tax threshold	*~ £0.03bn via cut to £320k*
Cutting capital gains tax threshold	*~ £0.02bn via £500 cut for indlviduals and £250 cut for trustees*
Introducing local income tax	*could replace £24.4bn raised via council tax or go further*
Introducing ad-valorem tax on all properties	*could replace £24.4bn raised via council tax or go further*

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Assessing options

Reforming public sector pensions	*~ £9bn via increasing employer contributions to 7.5%*
Cutting transport spending	*~ £5bn on assumption that department will account for 10% of all cuts as in 2010-11*
Increasing standard rate of VAT	*~ £4.5bn via 1 percentage point increase*
Reducing limit on tax-free lump sum pension drawdown	*up to £3.2bn*
Increasing corporation tax rates	*~ £3.2bn via removal of small companies discount rate*
Increasing stamp duty land tax rates	*~ £3bn via 1 percentage point increases in all rates*
Increasing business rates	*~ £2.3bn via 1% increase in all rates*
Taxing universal benefits	*~ £1.2bn via taxing Child Benefit*
Reducing stamp duty land tax thresholds	*~ £0.4bn via £5k reduction in all thresholds and removal of zero-rate threshold*
Removing inheritance tax exemptions	*up to £0.35bn*
Increasing stamp duty rates on share transactions	*~ £0.3bn via 1% increase in rates*
Increasing vehicle excise duties	*~ £0.06bn via 1% increase in all rates*

Assessing options

Removing exemption of employer pension contributions from National Insurance	*up to £8.3bn*
Means-testing universal benefits	*~ £5.1bn via combining Child Benefit with Child Tax Credits*
Cutting spending on skills training	*up to £4.5bn*
Cutting National Insurance thresholds	*~ £0.7bn via cutting employer and employee thresholds by £2 a week*
Cutting generosity of maintenance grants for students	*up to £0.5bn*
Cutting income tax thresholds	*~ £0.3bn via cutting basic and higher rate limits by 1%*

Introducing a carbon tax	*~ £10bn via £21 per tonne CO2 charge and reductions in other environmental taxes*
Means-testing tax credits more aggressively	*~ £1.3bn via increasing main taper to 49%*
Cutting bus industry fuel grant	*up to £0.4bn*
Increasing air passenger duty rates	*~ £0.03bn via 1% increase in all rates*
Tightening benefit eligibility criteria	*na*
Increasing class sizes	*na*
Cutting public sector employment	*na*

Assessing options

Introducing VAT to zero-rated items	*~ £24.8bn via charging at standard rate of 17.5%*
Reducing long-term care funding	*up to £10bn*
Cutting all benefits values	*~ £4.1bn via freezing rates in cash terms*
Cutting universal benefits values	*up to £4bn via scrapping Winter Fuel Payments and freezing basic State Pension*
Increasing reduced rate of VAT	*~ £3.9bn via raising to standard rate*
Removing pensioner tax allowance	*~ £2.8bn*
Increasing council tax rates	*~ £2.5bn via 1% increase in all rates*
Cutting tax credits values	*~ £2.2bn via cutting various elements by £100*
Reducing investment in house building	*~ £1.5bn based on proportion of cuts in 2010-11 accounted for by housing*
Cutting Sure Start funding	*up to £1.3bn*

Assessing options

Increasing fuel duties	*~ £0.5bn via 1p per litre increase in main rate*
Capping university places	*~ £0.5bn for every 20,000 students denied entry*
Increasing alcohol and tobacco duties	*~ £0.2bn via 1% increase in duties*
Increasing the starting rate of tax for savings income	*~ £0.1bn*
Extending congestion charging and road pricing	*na*
Letting NHS waiting lists grow	*na*
Increasing user-charging in the NHS	*na*
Scaling back free nursery care	*na*
Charging for local authority services	*na*

4. Impact assessment

- Least bad options from the perspective of low earners are primarily tax-based – in particular, taxes on wealth and income
- Very few absolute spending cuts which suit the group more than other members of society
- Spending cuts are set to shoulder a larger share of the consolidation than tax rises, so important that Government prepared to introduce tax and spend measures that explicitly target higher earners
- More means-testing will place low earners at risk. Important to use compensating measures to help protect the most vulnerable members of society from tax rises, benefit cuts and user-charging, but Government must bear in mind the danger that this approach exposes the same group time and again

Conclusions

- In designing consolidation, the Government should have consideration for **growth**, **fairness** and **sustainability**

- Means exploring all possible progressive tax options, while having regard for keeping disincentives and distortions to a minimum

- Cuts are inevitable, but need to be intelligent
  - Ring-fencing programmes or personnel is not sensible because of the size of the problem
  - Current spend should not be protected at expense of investment in future growth
  - But, programmes that provide ladders to help individuals sustain economic independence (e.g. re-training) should be maintained/improved

- Consolidation plan should include distributional impact assessment
  - experiences will vary - household composition, location and life stage – so assessments should also have regard for sub-groups

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