IEA AUTUMN STATEMENT BRIEF: SUMMARY

Government spending

- The government's Spending Review will be far from comprehensive. With the triple-lock for state pension increases and NHS, per-pupil funding for schools, international aid and the defence budget all protected, the overwhelming majority of government spending has been ring-fenced from cuts.

- Rather than salami-slicing remaining departmental budgets to hit arbitrary savings targets, the government should rethink its functions from first principles.

- The spending review should take account of changing demand patterns and relative prices in certain sectors and should not maintain arbitrary targets for spending as a percentage of national income in others. It should take into account the long-term effects of ageing on health and pensions spending. Capital spending decisions should prioritise projects with the highest economic return.

The tax credits fiasco

- The government's proposed tax credit changes should be abandoned. They significantly increase marginal tax rates for the low-paid. Delaying implementation or other minor changes to the reforms will not change this.

- Instead, the government should overhaul the system. It should replace tax credits with a negative income tax based on household income with the amount of tax-free income based on tax allowances which would be transferable within households. This would end the discrimination against family formation inherent within the current system. Consideration should be given to increasing the conditionality of benefits with more stringent work requirements.

The tax system

- The Autumn Statement should make plans to simplify the tax system and make it more economically rational. The government should not put forward changes to the system of pension tax relief except that the tax-free lump sum should be abolished or severely restricted. Property taxation should be completely overhauled, with the long-term aim of abolishing council tax, business rates and stamp duty, and replacing them with a Land Value Tax on commercial land and a tax on imputed rent for residential property.

- Personal tax thresholds should rise by the higher of inflation or earnings growth in the coming years after a number of years of under-indexation. Further increases in tax thresholds at the lower end should focus on raising the starting threshold for national insurance contributions. The withdrawal of the personal allowance above £100,000 should be abolished as should the higher rate of income tax.

- The VAT base should be broadened to include VAT at the full rate on domestic energy consumption. Other extensions of the VAT base should be implemented in the long run. This change and the restricting of the tax-free lump sum for pensions would facilitate all the tax reductions above plus a number of measures that would considerably simplify the tax system.

Decentralisation

- The government should be ambitious in its fiscal decentralisation agenda. But rather than ad-hoc City Deals powers for spending, revenue raising and regulation should be devolved to all local authorities.

the Paragon initiative

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ASSESSING THE SPENDING REVIEW

The centrepiece of this year's Autumn Statement will be the Spending Review which accompanies it. In the explanatory document released alongside this year's July budget, the government said the review would deliver £20 billion of departmental expenditure cuts, which, combined with savings to working age welfare (£12 billion) and tax avoidance, evasion and compliance crackdowns (£5 billion), would deliver the overall £37 billion planned consolidation for the parliament.[1] In order to achieve this, departments have been asked to put forward proposals to cut real resource budgets by 25 per cent and 40 per cent by 2020.

It is worth noting at the outset that this review is far from 'comprehensive'. The government has pledged to increase the NHS budget in England by £10 billion in real terms by 2020/21 from 2014/15, after having protected NHS spending through the last parliament. It will continue with the triple-lock state pension policy, which is estimated to now be costing £6 billion per year already relative to if the level of the state pension had risen in line with earnings over the past five years.[2] It has committed to protect per-pupil funding for schools and to meet its commitment to spend 0.7 per cent of GNI on international development aid. Going further on the ring-fencing in this parliament, it has pledged to increase the defence budget by 0.5 per cent per year in real terms.

Given these huge areas of spending are ring-fenced, inevitably cuts in 'unprotected' areas are very deep indeed. Over the last parliament, for example, real spending on health rose by 4.5 per cent; international services by 26 per cent; and the huge social protection budget (which includes pensions) by 4.4 per cent. This coincided with cuts in real spending on housing and community amenities of 22.3 per cent, transport 11 per cent, and public order and safety 15.4 per cent.[3] In effect, the government has sought to continue this broad approach in this parliament, with many of the more traditional functions of the state cut whilst the welfare functions of the state (other than working-age welfare) are protected. Whilst it's difficult to disentangle exactly how much of government spending is protected overall, all of these protected policies plus the large debt interest payment bill mean that the vast majority of government spending has thus been ring-fenced from cuts.

Several IEA publications and pieces written by IEA authors have criticised the way that these spending reviews have been undertaken. Rather than determining what the overall level of spending should be and salami-slicing unprotected departments to achieve an arbitrary target, our publication *Sharper Axes, Lower Taxes* outlined how the government should reassess all areas of spending on a broad 'functions' of government basis, working through programme by programme, and fundamentally rethinking what government should do from first principles.[4]

It is particularly perverse to ring-fence large areas of spending irrespective of need. For example, it may well be that because of an ageing population and unforeseen growing demands, spending on healthcare has to increase to maintain the same quality of service provision. But to 'protect' the budget in that case (in real terms) need not necessarily be the same thing as protecting the service.

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[1] HM Treasury: A Country That Lives Within Its Means

[2] FT article: UK pension triple lock costs extra £6bn a year, says report

[3] Authors' calculations based on function analysis from HMT Public Expenditure Statistical Analyses (PESA) 2015.

[4] Booth et al. (2011) *Sharper Axes, Lower Taxes*. London: Institute of Economic Affairs.

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Governments should seek to work out what services they should provide and then work out whether it is wise for them to be protected, bearing in mind both changing demands and, importantly, relative prices in that sector. The effective inflation rate in health in particular tends to be much higher than the overall headline inflation rate, for example.

It is particularly unclear what the economic rationale is for 'as a proportion of GDP' targets for different areas of spending too. They can lead to perverse circumstances, as in international aid, where faster-than-expected economic growth leads to the department desperately trying to find projects to spend the money on.[5] In defence too, it does not really make sense to spend more or less on defence depending on the ups and down of GDP growth. Surely what should be the real driver of spending is how much spending is necessary to provide national security given current challenges and threats?

IEA authors have also been critical of the failure to address the long-term drivers of the future debt challenge - namely long-term promises on health and pensions spending associated with an ageing population.[6] Even though many of these upward pressures on spending occur well into the next decade, taking steps now to effect policy change on the eligibility for pensions (further planned increases in the retirement age, for example), linking the state pension with just earnings or prices and taking steps to improve NHS productivity could have profound implications for the public finances over the next 50 years. Given that it is ultimately this long-term debt-to-GDP outlook which matters in terms of fiscal sustainability, we would benefit from our politicians being much more forward-looking on what is driving this debt path.

Finally, the government has said that it will spend £100 billion on capital investment over the next five years. Some capital spending can be growth-enhancing. However, the government should choose the projects that have the greatest economic return. Sadly, the evidence currently arising on the spiralling cost of HS2 (which has a very poor cost-benefit ratio compared with other schemes) and the huge problems associated with the energy sector remind us that often politicians make decisions on infrastructure which can undermine the UK economy relative to feasible alternatives.[7]

We will judge the spending review then on: a) whether the government rethinks functions and programmes; b) whether the decisions take into account shifting demand patterns and relative prices; c) whether the spending review maintains arbitrary targets for spending in certain areas; d) whether the spending review improves or worsens the long-term debt-to-GDP outlook and e) whether, from here on, capital spending decisions appear to be made on the economic returns of the projects.

TAX CREDITS

In our immediate response to the post-election Budget, we explained that the cuts to tax credits and the introduction of the National Living Wage (NLW) was a reflection of poor economic analysis.[8] There were three main problems with the way the Chancellor went about the reforms, which saw him lower

[5] IB Times: UK rushes £1bn extra in foreign aid spending in just 2 months to hit target
[6] Booth, P. and Bourne, R. (2014) *Defusing the Debt Timebomb*. London: Institute of Economic Affairs.
[7] The Times: High-speed rail cost rises by a third
[8] IEA Reaction to the Budget 8 Jul 2015

the income threshold above which tax credits would be withdrawn and increase the rate at which they were withdrawn above that.

The first is that these two policy areas affect very different groups: tax credits apply to relatively poor households; minimum wage rises to individuals who earn low hourly wage rates. As we have explained in previous research, many of those who earn on or around the minimum wage are second-earners or young people who reside in relatively affluent households.[9] Therefore, it was never the case that the NLW introduction would compensate those losing from the tax credit changes, even ignoring the fact that the NLW would be introduced in a more staggered way and could itself have potential unemployment effects for low-income workers. The package was always going to make many households worse off – an almost inevitable consequence when one is cutting so significantly from the tax credit bill.

The second problem was that the Chancellor justified the reforms by implying that the proliferation of tax credits over the past decade had in effect been subsidising employers, and that the National Living Wage was needed as a corrective to this. Whilst an argument can certainly be made that the high marginal tax rates that tax credits create might deter productivity growth and hence wages, Osborne's more populist line seems to be backed by little evidence, despite having almost become received wisdom in public debate.[10]

The third problem is that the specific proposals outlined by Osborne actually significantly raised effective marginal tax rates on low-earners. On top of the fact that many families will be financially worse off (some by as much as £1,000 a year); the incentive for many to move into work has fallen, and so has the incentive to earn more, as the interaction of tax credit withdrawal and taxes on income mean that effective marginal tax rates are now 80 per cent – rising to 93 per cent for some households given other credit elements. This is a significant disincentive to work.

The government was right to highlight the need to reduce tax credit spending in principle. It has expanded to a huge £30 billion, ensnaring 4.6 million families. Tax credits are complex, with arbitrary work hour requirements encouraging many to remain in part time work. They have steep withdrawal rates meaning that, combined with taxes on income, many already face marginal tax rates as high as 73 per cent. A lack of clarity as to the aims of the credits (do they aim to give poor people money or encourage people to work?) mean the child tax credit comes with no work requirements at all, and for many part-time workers credits act as more of a wage substitute than a wage supplement.

But the specific reforms outlined by Osborne in fact make one of the worst features – that of high marginal tax rates - worse. The proposed alternative from Frank Field – whilst protecting financially the lowest paid, would worsen incentives even more than Osborne's proposals higher up the income scale. Delaying the rollout instead does not change the fundamental problems outlined above. And the proposal suggested in the press to increase withdrawal rates within the new Universal Credit rollout would similarly undermine the whole rationale for that reform.

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[9] Bourne, R. and Shackleton, J.R. (2014) *The Minimum Wage: Silver Bullet or Poisoned Chalice?* London: Institute of Economic Affairs.

[10] IEA Blog: Do tax credits subsidise employers? 17 June 2015 and The Economist: Credit where taxes are due 4 June 2015.

Instead, the government should completely think again on this policy. A complete overhaul of tax credits towards a negative income tax with generous transferable allowances, including child allowances, would be preferable to tinkering with thresholds and withdrawal rates within the existing system. Moving towards this system with the aim of saving the same amount of money as Osborne seeks to save would still make many households worse off. But the advantages of more fundamental reform would be avoiding the very high marginal tax rates many families currently face and ending the discrimination against family formation inherent in the tax and benefit system.

If the government thinks that this sort of fundamental overhaul is infeasible, but seeks to save money broadly within the existing system, then a far less economically damaging means of saving money (from a labour supply perspective, not a 'how much money do people have' one) would be blending the unconditional transfers into working tax credit, and raise the minimum number of working hours required to obtain them. This would move us towards a system much more geared towards supporting those on low pay but in full-time work.

We will judge any announcement on tax credit changes then on whether it changes the fundamental problem of high marginal tax rates that would be faced by the low-paid and moves towards ending discrimination against family formation in the tax and benefit system.

TAX REFORM

Each budget or Autumn Statement seems to, on net, further complicate the tax system. Tax reform is a key potential supply side policy which has been under-examined in terms of the potential beneficial impact on economic growth. In previous submissions to budgets and autumn statements, we have emphasised that the process of these events actually leads to under-scrutinised and hence bad tax policy. There have been numerous rumours flying around about what tax changes might be included in this year's statement, primarily in the area of pensions, which could make the tax system more incoherent still. It is also argued below that housing is in an area ripe for more fundamental tax reform.

Pensions: there have been rumours again that the government might decide to fundamentally alter the system of pensions tax relief at the Autumn Statement, moving towards a new single equalised relief rate for all income levels (in effect, a policy of restricting tax relief for some and paying subsidy to others). Though it looks increasingly likely that any change such as this would be announced in the budget rather than at this time, we continue to argue that this would be a deeply misguided change, and potentially unworkable in practice. It is wrong in principle because the purpose of both the ISA and pension fund tax systems is to ensure that the returns from saving are tax-free. An equalised rate could lead to someone paying a higher tax rate on their pension than the relief rate they obtained as they saved for it. Though the opposite can indeed occur, this often facilitates income-smoothing and makes the tax system fairer over an individual's lifetime. As we explained in our last budget note, there are also enormous practical problems with equalising tax relief in terms of potential avoidance mechanisms.[11] For these reasons, the system of tax relief should be maintained. The estimated £4 billion tax-free pension lump sum relief available from pension funds does remain an unjustified anomaly in the UK tax system, however, which should be abolished. The savings could be used to

[11] IEA Budget Submission 2015.

reduce or abolish other damaging taxes such as stamp duty, inheritance tax and capital gains tax. In our previous note, we outlined some pragmatic means of mitigating against the Chancellor being accused of changing the goal posts retrospectively in this area.

Property taxation: taxation of housing, commercial property and land is ripe for fundamental reform in the UK. Though the government overhauled the economically damaging 'slab' system of stamp duty, the tax remains highly distortive and a deterrent to labour mobility, with very high marginal rates now on expensive properties. There has been widespread discussion of the iniquities of the council tax system and the failure to update property valuations. Meanwhile, there is currently ongoing discussion about the future of business rates. Our recent *Federal Britain* paper suggested that taxation in this area should be wholly decided by local authorities who should be free to experiment.[12] In his party conference speech, George Osborne suggested that the government was moving in this direction with more powers for councils to vary business rates and collect and keep their own revenues. Though devolving all these decisions to local authorities and allowing variation should be the long-term aim, economic theory can guide us in terms of how land, property and business property taxes should operate. Transactions taxes are highly distortionary, so the long-term aim should be to abolish stamp duty entirely. Taxation of land is efficient, but as the Mirrlees Review makes clear, the current system of business rates combines an efficient tax on land with a damaging tax on business property.[13] Instead, they should be replaced with a land value tax applying to all commercial land. Finally, council tax and stamp duty should be abolished entirely and replaced with a tax on imputed rent from owner-occupied property. Any changes to the taxation of property should be judged against this sort of agenda.

Personal income taxes: over the course of the last five or six years, there has been a very significant increase in the income tax personal allowance, but little in the way of simplifying the combined income tax and national insurance marginal rate structure, nor attempts to apply consistency in terms of how tax thresholds are uprated. We have long argued that the neutral position for the uprating of thresholds should be that they rise in line with earnings growth or nominal GDP growth, but after years of under-indexation of thresholds, there is a case for a temporary 'double-lock' such that all personal tax thresholds rise by the higher of inflation or earnings growth in the coming years to prevent further fiscal drag. Further increases in allowance thresholds at the lower end should now focus on raising the starting national insurance threshold to align it more closely to the income tax personal allowance. Meanwhile, the significant marginal rate anomaly occurring above £100,000 as the personal allowance is withdrawn should be removed from the system entirely. Unless we are going to move towards a more contributory system again using the national insurance system, steps should be taken to integrate income tax and national insurance entirely with a single tax on income.

VAT base: there has been discussion recently of further narrowing the VAT tax base, with a campaign arguing that tampons and sanitary products should be zero-rated. This sort of campaign is inevitable when the VAT system has so many exemptions and lower rated products depending on whether the item is considered 'essential'. Economically, it is highly inefficient however to in effect 'subsidise' certain products using tax exemptions. The VAT base should be as broad as possible across products, and campaigns like this resisted. In fact, we should instead be looking to broaden

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[12] Booth, P. (2015) *Federal Britain: The case for decentralisation*. London: Institute of Economic Affairs.

[13] Mirrlees Review Chapter 16: The Taxation of Property and Land.

the VAT base. It is unclear, for example, why domestic energy is VAT exempt, and then a host of taxes to internalise the costs of fuels imposed later. Significant tax expenditures such as this make little sense. Instead we should seek to broaden the VAT base, and either lower the rate or lower the tax burden on the working poor.

We will judge reforms to the tax system according to whether they simplify or complicate the existing tax code, and are sensible on grounds of economic efficiency.

FISCAL DECENTRALISATION

The government has correctly identified that the UK is over-centralised, with too much power over spending, taxes, and regulations reserved in Westminster. In an attempt to mitigate this, and recognising that different areas have different needs, the government has begun a process of decentralising powers, particularly to cities through City Deals. The focus of these deals are primarily about spending and regulatory powers, though the Chancellor's recent announcement of the decentralisation of business rate retention to local authorities suggests there may be an appetite for tax decentralisation too.

Our research into fiscal decentralisation suggests that devolving tax raising powers alongside spending powers is crucial to decentralisation engendering better economic outcomes.[14] Areas should be responsible for raising the money they spend as much as possible – this encourages efficiency, the building of larger tax bases through pro-growth policies, and enables more innovation in the tax-public service packages that areas are able to offer.

It has been rumoured that new City Deals – in particular, one for Liverpool, might be announced at the Autumn Statement. Though in favour of decentralisation, we are sceptical that City Deals are the way to go. Those areas involved in City Deals often have greater freedom as to how they spend government grants. However, they are also able to borrow for the purposes of spending more on areas where less spending would previously have taken place – thus taking economic power from the private sector and increasing the power of local government relative to the private sector. Furthermore, many of the powers that are being given to local authority areas under City Deals involve increased regulation of areas of economic life that had been deregulated under previous governments. City Deals also often involve moving powers from lower levels of local government to more distant levels: for example, in the Leeds City Deal, five local authorities are going to move to a combined authority model. At the moment, there is also no genuine attempt under this programme to decentralise revenue raising in any meaningful sense. The asymmetric nature of this type of decentralisation also lends itself to rent-seeking behaviour, where particular areas, local authorities or cities lobby the government for preferential grants or powers.

The UK is ripe for significant fiscal decentralisation. But, as the analysis in *Federal Britain* made clear, this should be carried out symmetrically using existing local authorities as the basis of passing down powers. In the long-term responsibility for the following should be transferred from national government to the local level: environmental policy; working-age welfare; education and health; granting of permissions for and regulation of natural resource exploitation; lifestyle regulation; policing; and housing and planning. Local authorities could join together to provide some functions,

[14] Booth, P. (2015) *Federal Britain: The case for decentralisation*. London: Institute of Economic Affairs.

such as policing, where local geography or other circumstances make that desirable. In addition, there should be complementary reforms to promote autonomy for individuals, families and civil society institutions, especially in relation to health and education. Except for working-age welfare, which would be largely financed by government grant but administered by local government, all local government functions would be financed entirely by local revenue streams. These would come from user charges and from some combination of the following, to be determined at local level: taxes modelled on the current council tax; land value taxes; taxes on business property; natural resource levies; consumption taxes; variation in income taxes; and tourist taxes.

We will judge efforts to decentralise further powers in the UK primarily on whether tax-raising powers are decentralised alongside spending powers.

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