IEA SUBMISSION TO THE BUDGET

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Institute of
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SUMMARY

- Even though growth has picked up significantly in the last three quarters, the UK's economic and fiscal challenges remain much the same.

- A significant amount of fiscal consolidation will still be needed in the next Parliament, and the general election is likely to create considerable uncertainty over the likelihood of further tax rises and the medium-term commitment to deficit reduction.

- Structural factors, such as new regulation in the financial and energy sectors, the increase in the size of the state, high levels of debt, demographic trends, and the reversal of huge pre-crisis credit growth are likely to mean that we are unlikely to see significant "catch-up" growth in the medium-term relative to levels of GDP extrapolated from a pre-crisis trend line.

- In our view, the best means of closing the deficit and creating the conditions for economic prosperity would be a significant reduction in government expenditure, reviewing not just the scale of state spending but also the scope of government, and allowing a significant reduction in taxation. Our publication, *Sharper Axes, Lower Taxes* outlined how this could be achieved.

- Our more pragmatic, shorter-term suggestions for this Budget highlight policies which meet declared government aims: to reduce the budget deficit, to make the tax system more coherent,

to reduce the burden of regulation, and to improve the framework of government for long-term fiscal responsibility.

- Free bus travel, free TV licences and the winter fuel allowance should all be abolished. This would save around £4 billion per year.

- Means-tested pensioner benefits should be increased by 1% per year for the next three years, in line with government policy for means-tested working age benefits.

- Legislation should be introduced requiring thresholds for inheritance tax, stamp duty and all income tax thresholds to be increased annually by the higher of wage inflation and retail price inflation.

- A wealth tax or mansion tax should be ruled out. Stamp duty should be reformed away from the current slab structure, and eventually abolished. Council tax for homes worth £1 million or more should be replaced with a tax on imputed rent. Net revenues from the tax on imputed rent should be used to reduce stamp duty.

- An exemption to employment law should be introduced such that new firms and small businesses are able to treat a certain number of employees as self-employed. Mandatory sunrise clauses between the announcement of a new rule or regulation and a company’s liability to comply with it should be introduced.

- The current all-encompassing Budgets and Autumn Statements should be abolished and replaced with a short statement outlining the changes to tax rates, allowances and borrowing required to meet public spending obligations. Other announcements should fall under the auspices of the relevant departments.

CONTEXT

The last three quarters have seen a significant recorded up-tick in economy activity, with economic prospects for 2014 looking much brighter than forecast last year. Even so, the UK still faces large fiscal and economic challenges.

The forecast contained within December's Autumn Statement suggested that the Government will borrow as much as £111.2 billion this financial year (ignoring one-off factors), with a forecast structural deficit of over 5% of GDP. In fact, the deficit actually observed at the end of the Parliament is likely to be close to that forecast under the Chancellorship of Alastair Darling in March 2010 (under much more optimistic growth assumptions and when the aim was to halve the deficit in this Parliament). This shows the scale of the repair job that remains.

Much of the early fiscal consolidation comprised tax hikes and cuts to capital expenditure. Given that a significant amount of the remaining consolidation focused on current expenditure has been "rolled" into the next Parliament, the prospect of a new government with a different approach is likely to create considerable uncertainty over the likelihood of further tax rises and the medium term commitment to deficit reduction as we get closer to the General Election. This is especially true given the trends of an ageing population and the upward pressure this will put on spending if the scope of government remains unchanged.

The public finances have disappointed relative to expectations since 2010 mainly because growth has been lower than forecast. Productivity growth has been especially disappointing. In September 2013, Congdon et al analysed why the UK sustainable growth rate has been low, and concluded that a combination of new regulation in the financial and energy sectors, the increase in the size of the state, high debt levels across all economic actors, demographic trends, the reversal of huge pre-crisis credit growth and several other factors have all contributed.[1] The persistence of many of these factors is likely to mean that even though growth has recently picked up, we are unlikely to see significant "catch-up" growth in the medium-term relative to levels of GDP extrapolated from a pre-crisis trend line.

1 Congdon, T et al (2013), Will flat-lining become normal?: An analysis of Britain's worst period of peacetime growth since the industrial revolution, Institute of Economic Affairs.

KEY RECOMMENDATION

It remains our view that the best means of closing the deficit and creating the conditions for economic prosperity would be a significant reduction in government expenditure, reviewing not just the scale of state spending but also the scope of government. Our publication *Sharper Axes, Lower Taxes*, for example, provided a genuinely comprehensive review of state expenditure, which would facilitate a substantially lower tax burden.[2] Coupled with other supply-side measures including a significant deregulatory agenda, we believe the recommendations contained within that paper could greatly improve the UK's growth prospects.

The remainder of this submission seeks to outline a range of practicable policies from our previous work which the government should consider given current policy debates and the forthcoming 2014 budget. These all relate to declared government aims: to reduce the budget deficit, to make the tax system more coherent, to reduce the burden of regulation, and to improve the framework of government for long-term fiscal responsibility.

2 Booth, P et al (2011), Sharper Axes, Lower Taxes, Institute of Economic Affairs.

MEASURES TO REDUCE GOVERNMENT SPENDING AND THE BUDGET DEFICIT: PENSIONER BENEFITS

Over the past 15 years, there has been an enormous increase in government provision for old age. By and large, this has been protected by this government: not only have we seen the introduction of the triple-lock for the state pension, but we have also seen the government introduce provision for more state funding of long-term care by implementing a variant of the Dilnot Commission recommendations. Though longer-term steps have been taken to mitigate the effects of an ageing population through bringing forward increases in the state pension age and a commitment to link this state pension age to longevity, the existing elderly seem to have been identified for special treatment in terms of sharing the burden of fiscal consolidation.[3] In light of the declared need to cut welfare spending by £12 billion in the first two years of the next Parliament, maintaining the existing non-means-tested pensioner benefits now look indefensible.[4]

Free bus travel is an exceptionally poorly targeted way to transfer income to older people, and it also leads to significant economic distortions. It only helps those fit enough to travel without help and with reliable bus services nearby, it distorts decisions on the mode

3 Gov UK (2013), Reviewing the state pension age
4 George Osborne pledges £12bn cuts in Government welfare spending after next general election, Daily Telegraph (2013).

of transport used by pensioners, it prevents the bus companies themselves from innovating and developing their own pricing structure, and it creates economic distortions through the taxes raised to finance it.

Likewise, free TV licenses for over 75s, whilst less distortionary from an economic perspective, also do nothing to help those with impaired vision or who do not want to watch television. At the same time, it provides benefits to families, who may be very young but contain one elderly relative living with them.

The winter fuel allowance, whilst notionally a payment towards fuel costs, is really just a tax-free cash payment to those over 60. It has no actual link to the weather or temperature and thus the need to use fuel, and in fact lies outside of the main tax and benefit system. This means it requires its own administration and application process.

Many means-tested working age benefits and tax credits are being increased by the government by 1% per year for three years from 2013/14.[5] This means their value will increase by less than the rate of inflation through to 2015/16. It seems entirely reasonable to us that the same should apply from 2014/15 for means-tested pensioner benefits (i.e. those administered through the pension credit system). This is particularly reasonable when one considers the increase in means-tested benefit levels in recent years and above inflation increases in the basic state pension.

- **Free bus travel, free TV licenses and the winter fuel allowance should all be abolished. This would save around £4 billion per year.[6]**

- **Means-tested pensioner benefits should be increased by 1% per year for the next three years, in line with government policy for means-tested working age benefits.**

5 Gov UK (2012), Autumn Statement 2012 policy decisions table
6 More detailed explanation on this subject can be found in Booth, P et al (2011), Sharper Axes, Lower Taxes, Institute of Economic Affairs.

INDEXATION OF TAX THRESHOLDS

One of the more pernicious ways in which governments increase tax over time is through fiscal drag – thresholds not rising in line with inflation. There are many instances of this in the current UK tax system. The inheritance tax threshold, for example, has been frozen at £325,000 for the past six years, during which time the Retail Price Index has increased by around 25 per cent. Stamp duty land tax on a house bought for £250,000 has been 3% since 2003. In London during that time, the average house price has increased substantially from around £250,000 to £400,000, meaning that stamp duty is now a serious cost which hinders mobility for many ordinary working people. Meanwhile the level of income you can earn before higher rate tax (40%) became due fell by nearly one third relative to earnings between 1979 and 2010. This government has actually cut the amount of income you can earn before paying higher rate tax. On top of this, from now on the government has decided to increase the tax thresholds in line with increases in the CPI rather than the RPI. All of the above tax thresholds: inheritance tax, stamp duty, and all income tax thresholds, should be increased annually by the higher of wage inflation and retail price inflation.

- **From this year onwards, thresholds for inheritance tax, stamp duty and all income tax thresholds should be increased annually by the higher of wage inflation and retail price inflation.**

PROPERTY TAXATION AND THE HOUSING MARKET

Throughout this Parliament, there has been much discussion over both the taxation of property and the aim of increasing property ownership. The ‘mansion tax’ concept keeps arising in public discourse, and there has been much public debate about planning laws and the need for more homes to be built. Both issues are linked. Those who advocate a ‘mansion tax’ believe that the capital appreciation arising from house price inflation is ‘unearned’ wealth and thus deserves to be taxed with an annual charge. Meanwhile, anyone who has studied why UK property prices are so high can see that planning laws are extremely restrictive, and incentive structures are biased against development. An unresponsive supply means that increases in demand inevitably lead to higher and higher prices.

In *Redefining the Poverty Debate*, IEA author Kristian Niemietz argued persuasively that high house prices should be a key concern for those worried about the ‘cost of living’.[7] Though building new homes would not lead to lower prices straight away, a significant liberalisation of planning laws and incentive structures to encourage more development in areas of high demand is the only way to keep house prices under control in the longer term. Instead it has become fashionable to both encourage demand-side schemes to “get the housing market moving”, and at the same time to advance the idea of a ‘mansion tax’.

7 Niemietz, K (2012), Redefining the Poverty Debate – Why a War on Markets is No Substitute for a War on Poverty, Institute of Economic Affairs.

A mansion tax would in effect be a wealth tax which only operates on property, though it would take no account of an individual's mortgage position, or the number of properties an individual owns. It would be a particularly pernicious tax, as it would apply year-after-year. It would certainly be an obvious example of 'double taxation' and would amount to a significant policy attack on property rights per se. History suggests that a new tax would inevitably lead to the temptation for politicians to expand the base over time, not least through the threshold limit not keeping pace with house price inflation. For these reasons, there is no case for a mansion tax as proposed by the Liberal Democrats or the Labour party.

Nevertheless, there is a case for reform of property taxation. At the moment property is exempt from VAT and the owner occupier use of property (the imputed rent) is not taxed. This means renters (or landlords) pay tax on their property but owner occupiers do not. Meanwhile, because council tax is capped, those with large homes and in the South East get a relatively good deal. A key tax faced in the property market is instead imposed when people buy a property, in the form of stamp duty – almost universally regarded as a terrible tax which restricts labour mobility under an awful 'slab' structure, creating particularly perverse incentives. The government should seek to overhaul this tax as a matter of urgency and set out longer-term plans for its abolition.

In an ideal world we might also seek to abolish council tax entirely and replace it with a tax on the imputed rent from owner-occupied property. But the costs of evaluation here would be prohibitive. Instead, council tax should remain for properties worth under £1 million (where it represents a reasonable proxy for a tax on imputed rent), but be abolished for those worth £1 million or above.

In its place, high end properties would face a tax on imputed rent. The tax charge on imputed rent would be set such that the income tax charge would be equivalent to the current council tax charge for properties of £1 million in the particular borough. But then the tax rate would be the same, meaning that properties worth more than a £1 million would face a proportionally higher tax bill given the higher value of imputed rent. The net revenues from this tax change could then be used to cut stamp duty.[8]

- **There is no case for a mansion tax, or a wealth tax.**

- **Stamp duty is a bad tax. Ideally it would be abolished, but at the very least the ‘slab’ structure should be overhauled and replaced by a marginal rate structure.**

- **Council tax for homes worth £1 million or more should be replaced with a tax on imputed rent.**

- **Net revenues from the tax on imputed rent should be used to reduce stamp duty.**

8 This is a reported ambition of the Welsh Conservatives, who have proposed raising the 1% starting threshold to £250,000 if they win power in the Welsh Assembly in 2016. http://www.bbc.co.uk/news/uk-wales-politics-26052659

REDUCING THE BURDEN OF REGULATION

Though the government has made some welcome reforms to the formation and extent of regulation across several areas, business has still had to contend with substantial change in the regulatory environment concerning financial services and banking, energy and the environment. For small businesses (particularly challenger businesses), regulation and employment law is also disproportionately challenging. This is because new ventures often lack the resources or expertise to deal with it and operate under substantial uncertainty over how their business will actually be structured in the medium-term.

During his work with the Red Tape Challenge, IEA Director General Mark Littlewood recommended two policy ideas which could allow businesses the flexibility to adapt to new regulations and changes to employment law.

First, an exemption from employment law based on an automatic right for some staff to be treated as self-employed could be introduced. This could apply for any one of: a certain period of time following a company's formation, for a certain number of staff within a business or operate with a turnover threshold, beyond which businesses would be ineligible.

Second, in addition to the wider rollout of sunset clauses, the government should seek to institute mandatory "sunrise" clauses, such that companies are given a set period of time between being informed of a regulation and being liable to comply with it. This would provide significantly more flexibility for businesses to adapt.

- **Provide an exemption from employment law to allow new firms and a certain number of employees to be treated as self-employed.**

- **Institute mandatory sunrise clauses between the announcement of a new rule or regulation and a company's liability to comply with it.**

FISCAL RESPONSIBILITY AND TRANSPARENT GOVERNMENT POLICY: ABOLISH THE ANNUAL BUDGET

The government should consider completely abolishing the budget, and much of the fanfare surrounding the mini-budget of the Autumn Statement. This would help to improve public scrutiny of tax rate and allowance changes, bring more focus on the reason for taxation (to raise the funds to meet public expenditure obligations), improve the process of new tax legislation, reduce uncertainty for households and businesses within the economy, and prevent the huge waste of resources currently devoted to analyse budget and Autumn Statement decisions.

Since 1997, the budget has moved far beyond its original purpose, morphing into a broad economic statement, far beyond the aspects of spending and tax rates and allowances. Measures are now often announced within it which should be outside of the remit of the Treasury. This creates a lot of uncertainty for businesses and households, creating a big bang of announcements, or worse, announcements of consultations, where individuals feel the need to pore over the details to find hidden effects on their businesses or household finances. Furthermore, new tax legislation pushed through Parliament in the Finance Act is often badly scrutinised, due to heavy whipping, guillotined debates and the combining of discussions about *tax policy* with discussion of *tax rates.* As if this isn't all bad enough, the political nature of the day creates strong incentives for interest groups to lobby government for changes to tax law in the build up to budgets, and the desire for politicians to claim good headlines leads to obfuscation of potentially important yet unpopular policies. This also creates the illusion that a ‘good’ budget is one where the Government has provided a raft of ‘goodies’ for various interest groups.

To improve the transparency of tax and spending decisions, and the quality of tax law, the Government should instead replace the Autumn Statement with a simple statement outlining its spending intentions for the next three years. The current version of the all-encompassing budget statement should then be replaced each March by a statement outlining the tax rates and allowances adjustments necessary to fulfil these public spending obligations and outlining any borrowing necessary. This would mean new tax policy, i.e. tax legislation, would instead have to be brought forward to Parliament by the Treasury and debated fully by both Houses and the relevant select committees, as with other legislation. Likewise, changes to welfare benefits, for example, would become a matter for the DWP within its budget, and put to Parliament and debated in the normal way.

This process would allow much better scrutiny of a smaller number of decisions on budget day, highlight the purpose of taxation and reduce the political incentives for obfuscation and lobbying whilst reducing economic uncertainty.

- **Abolish the current all-encompassing budget and replace it with a short statement outlining the changes to tax rates, allowances and borrowing required to meet public spending obligations.**

- **Abolish the current Autumn Statement and replace it with a statement outlining public expenditure.**

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