



ASI Response to the Emergency Budget

Introduction

The Adam Smith Institute (ASI) broadly welcomes the government's emergency budget, delivered on June 22, 2010. In particular, the fiscal consolidation proposed by chancellor George Osborne, which would eliminate the structural current deficit by the end of a five-year parliament, is a very positive step.

Income Tax

The government's ambition to significantly raise the personal income tax allowance, starting with a £1000 rise from April 2011, is praiseworthy and accords with one of the ASI's long-running campaigns.

Corporation Tax

Moreover, the progressive reductions in the headline rate of corporation tax proposed by the budget, coupled with the wider reform of the corporate tax system, will undoubtedly improve the UK's international competitiveness and help to drive the country's economic recovery.

Public Spending

It is, however, worth noting that the public spending reductions outlined in the budget are not as severe as some have claimed. Many commentators have confused cuts to spending *increases* planned by the previous government, with actual reductions in public expenditure.

In real terms (assuming 2 percent a year inflation), we can say the following things about what will happen to public spending over the five fiscal years to 2014/15, on the basis of the emergency budget:

- **Total managed expenditure (TME) will be reduced by £15.5bn, a cut of 2.2% over the period.** Within TME, capital expenditure will account for most of the decrease, falling by £18bn – a 30.3% cut. Current spending, meanwhile, will continue to rise modestly – by 2.6bn or 0.4%.
 - However, as part of TME, debt interest payments will rise significantly to 2014-15, climbing by 14.9bn (34.4%). Looking at TME excluding debt interest therefore gives a more realistic picture of what will happen to public spending. **On this basis, it will be cut by £30.4bn by 2014-15, a fall of 4.6%.**
 - This is a significantly smaller real terms spending reduction than the one outlined in the ASI's recent report 'The Party is Over', which called for cuts of 3% a year excluding debt interest, amounting to more than £90bn of cuts spread over five years.
- This disparity between the government's plan and the ASI's, both of which aim to eliminate the budget deficit over a five-year period, is explained by two factors:
- Firstly, the ASI's goal was to eliminate public sector net borrowing (PSNB) by the end of the current parliament, whereas the government is only aiming to eliminate the structural current deficit – a more lenient target, which will still leave the government borrowing approximately £34.2bn in 2014-15.
 - Secondly, the ASI's modelling assumed no changes to the 2009-10 tax system, whereas the coalition government has both largely accepted tax increases planned by the previous government (such as the introduction of a 50p top rate of tax), and introduced several tax increases of its own.

Tax Rises

The ASI believes that, as George Osborne put it in his speech, Britain's fiscal crisis is not the result of us being under-taxed. Rather, it is the result of overspending. As such, the fiscal black hole should be plugged entirely with spending cuts. Tax rises are neither necessary nor desirable.

Capital Gains Tax

The government's changes to the Capital Gains Tax regime, while not as bad as they might have been, remain misguided. In particular, the fact that there is no indexation for inflation will mean people paying a 28% tax on worthless paper gains. This is clearly unfair.

Furthermore, the CGT rises may yet prove counter-productive. Whether the higher rate of capital gains tax will raise the revenue that the government expects is open to debate, but international evidence (which indicates a revenue-maximising CGT rate of 10 percent) suggests that their forecasts may be overly optimistic.

Moreover, the £600m the government expects to get in increased *income tax* revenues as a result of the CGT hike is almost certain not to materialise. The government's calculations seem to suggest that nearly half of all current capital gains (equivalent to all investments held for eight years or less) represent tax avoidance – people switching income to capital to take advantage of a lower tax rate. This is plainly outlandish: previous ASI research has shown that only 5% only of capital gains revenue is accounted for by assets possibly affected by such switching.

Value Added Tax

The ASI was also disappointed to see the main rate of VAT raised to 20%, effective from January 2011. There *is* something to be said for VAT as a tax: it raises large sums of revenue very effectively and creates fewer economic distortions than direct taxes. But it is nonetheless regressive, and on the government's own figures will impact even the poorest households in a way that is not compensated for by the rise in the personal allowance.

Raising VAT to 20% is also unnecessary. Had the government decided to implement the £11bn in health spending cuts advocated by the ASI, rather than guarantee

the Department of Health annual real terms rises in its budget, they could have forgone the additional £14.5bn the VAT rise is set to bring in and still eliminated the UK's structural current deficit in the 2014-15 fiscal year.

Ring-fenced and Unprotected Departments

Implementing cuts in health spending is not unthinkable, especially given that the NHS has, more than any other policy area, been the subject of enormous profligacy over the last 10 years, with its budget more than doubling in real terms, while productivity fell. Even Sir David Nicholson, the chief executive of the NHS, has called for efficiency savings of between £15bn and £20bn to be made.

Outside health and international development spending, the budget suggests significant cuts will be made over the next four years to non-protected departments, with their departmental expenditure limits falling by an average of 25 percent compared with the previous government's plans.

Re-booting Government

For these cuts to be implemented effectively, it is vital that the government does not simply take a salami-slicer approach, imposing across-the-board cuts from the top down, and instead looks to fundamentally reform the role and activities of the state in these areas.

The ASI has previously advocated streamlining central government, with the number of government departments reduced to just 12. However, this is not just about changing the names above the door; it is about radically refocusing government on core priorities, and completely abolishing marginal, outdated or unnecessary programmes.

Welfare Reform

Finally, the government's budget proposals on benefits and tax credits, though largely welcome from the point of view of bringing public spending under control, will tend to increase marginal rates of taxation for people moving back into work, and as such create significant additional disincentives to paid employment. This must be dealt with by the government as a matter of urgency, and a far-reaching overhaul of the benefits and tax credits system undertaken as soon as practically possible.