June 2010 Budget: a summary

Standard Note: SN/EP/5605

Last updated: 23 June 2010

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This note provides an initial summary of the main points of the June 2010 Budget and the reaction to it. Further information is available in a separate Library note, Background to the June 2010 Budget (SN/EP/5577).

Some of the key measures announced in the Budget were:

- Fiscal consolidation measures worth £40 billion a year by 2014/15, in addition to those announced by the previous government
- The new "fiscal mandate" – the Government's objective for fiscal policy
- An increase in VAT to 20% from January 2011
- An increase in the income tax personal allowance to £7,475 from April 2011
- A new levy on banks' balance sheets
- An increase in the rate of capital gains tax for higher rate taxpayers from 18% to 28%
- A number of reforms to corporation tax including cutting the main rate from 28% to 24% by April 2014
- A two year pay freeze for public sector workers earning over £21,000
- £11 billion savings from welfare reform by 2014/15
- A freeze in the level of child benefit for three years to fund increases in Child Tax Credit
- An increase in the Basic State Pension by the highest of earnings, prices or 2.5% from April 2011

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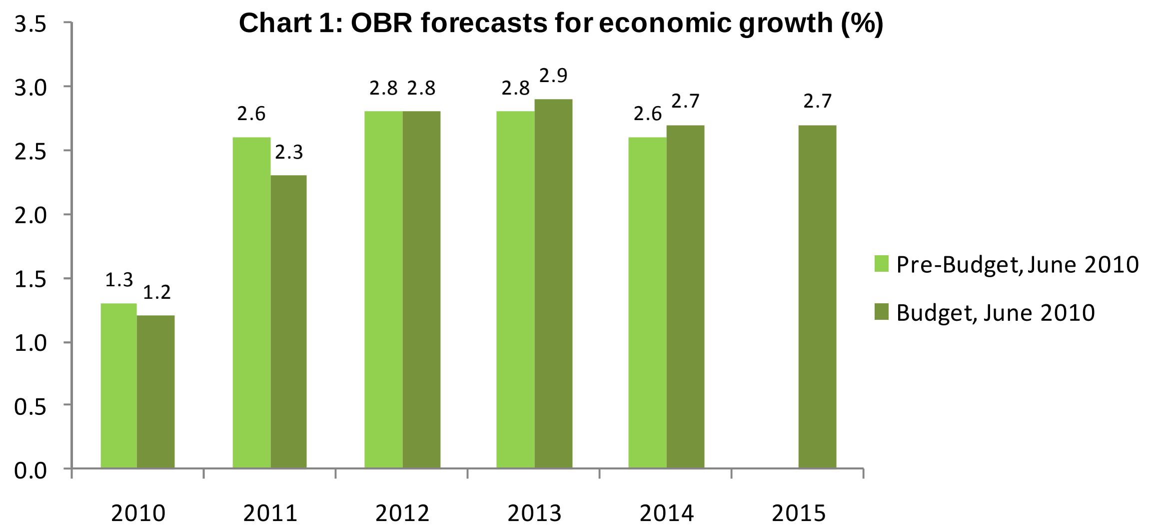
1 Introduction

George Osborne delivered the first Budget of the new Conservative-Liberal Democrat coalition government on 22 June 2010. The Budget set out a number of spending cuts and tax increases over a five year period to address the UK's large budget deficit. By 2014/15, 80% of the fiscal consolidation measures set out in the Budget will have been delivered through cuts in spending and 20% by tax increases. The Budget also set out the Government's fiscal policy objectives (its "fiscal mandate"). It is the first Budget to use the economic and fiscal forecasts prepared by the independent Office for Budget Responsibility (OBR).

2 Economic forecasts

The Budget contained the revised economic forecasts of the OBR. The new OBR forecasts for growth in 2010 and 2011 are lower than those published by the OBR on 14 June (see chart 1 below). In 2013 and 2014, the new growth forecast is higher.



Commenting on its revised growth forecasts, the OBR said:

> In the near term, economic activity is weaker than in the pre-Budget forecast. On the demand side this reflects Budget measures which restrain government spending and real household disposable income, holding back consumer demand. In 2010 as a whole GDP is forecast to rise by 1.2 per cent followed by 2.3 per cent in 2011 (against 1.3 per cent and 2.6 per cent in the pre-Budget forecast). From 2012 onwards GDP growth recovers as prices and wages adjust and monetary policy continues to support demand. Compared with the pre-Budget forecast, growth is stronger from 2013 onwards as the economy adjusts back towards potential output. By the end of the forecast the adjustment is still not quite complete, so that the output gap is slightly larger in 2014 than it was in the pre-Budget forecast [...].[1]

The OBR also commented on the problems of comparing its new forecast for the economy with that published earlier in June:

> As noted at the time, the pre-Budget forecast's use of market expectations to derive the path of interest rates probably resulted in an upward bias to that forecast. The

1 HM Treasury, Budget 2010, HC 61, June 2010 para C.18

> market may have been expecting lower interest rates as a result of additional fiscal tightening in the Budget. If that tightening had not occurred then interest rates would probably have been higher and economic activity lower in the pre-Budget forecast. As a result, the pre-Budget forecast does not provide a firm basis for comparison to produce an estimate of the effects of the Budget measures on the economy.[2]

The OBR also revised its forecast for ILO unemployment up. The unemployment rate is forecast to be 0.1 percentage point higher than the OBR's Pre-Budget forecast in 2011 and 0.2% higher in 2012-14.

3 Fiscal mandate

The Budget also announced the Government's new objective for tax and public spending. The previous government's fiscal framework had focused on fiscal rules (the golden rule and the sustainable investment rule) and, more recently, the requirements of the Fiscal Responsibility Act. The new Government's objective is set out in its "fiscal mandate":

> to achieve cyclically-adjusted current balance by the end of the rolling, five year forecast period.[3]

For this Budget, the end of the forecast period is 2015/16. In addition, there is a target that public sector debt as a percentage of GDP be falling by 2015/16.

A number of features of this mandate are of interest. First, the measure used is the current budget balance. This does not include investment spending. Higher investment spending will not count against this target. Secondly, the cyclically-adjusted measure is used. This means that the unadjusted current balance may fluctuate with the economic cycle, thereby allowing some flexibility for fiscal policy. Third, unlike the previous fiscal rules which were assessed over the economic cycle, the new mandate is forward-looking. According to the Budget, the old rules could be too backward-looking, especially at the end of the economic cycle. Finally, under the old fiscal rules, the government determined the start and end dates of the economic cycle over which the rules were assessed. The new mandate will be assessed by the OBR. The OBR will report on whether the Government's policy is consistent with a better than 50% chance of meeting the mandate. In the June 2010 Budget, the OBR said:

> We judge that the Government's policy is consistent with a greater than 50 per cent chance of achieving the fiscal mandate set for 2015-16. Our forecast also shows that there is a greater than 50 per cent chance of achieving the fiscal mandate in 2014-15, a year ahead of the date set in the Government's mandate.[4]

4 Public finance forecasts

The chart below shows that the deficit will be reduced by a combination of rising tax revenue and falling public spending. Public spending falls from a peak of 47.5% of GDP in 2009/10 to 39.8% in 2015/16. Taxation revenues increase from 36.6% of GDP in 2009/10 to 38.8% in 2014/15.

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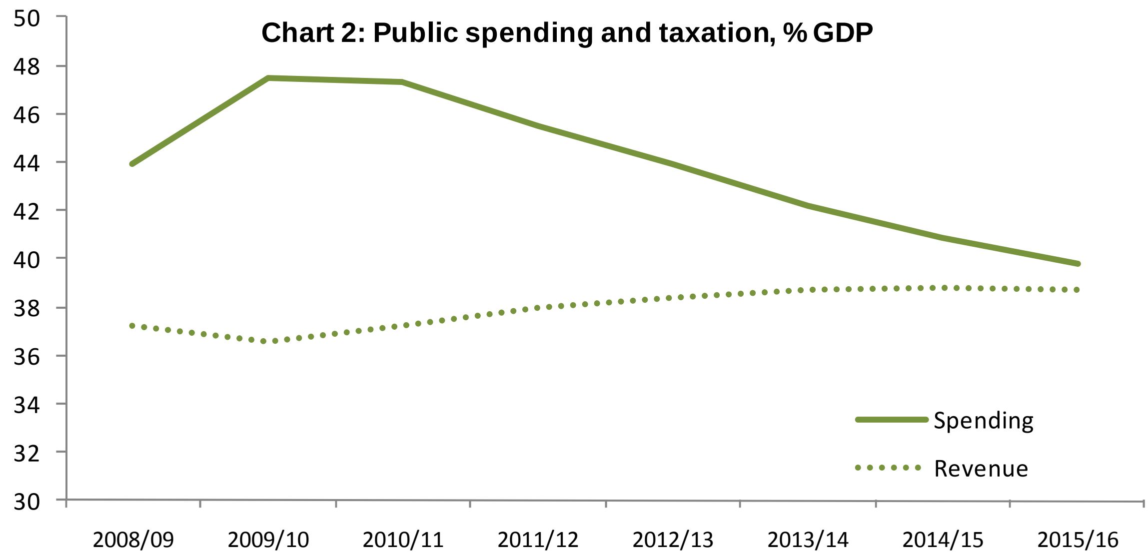
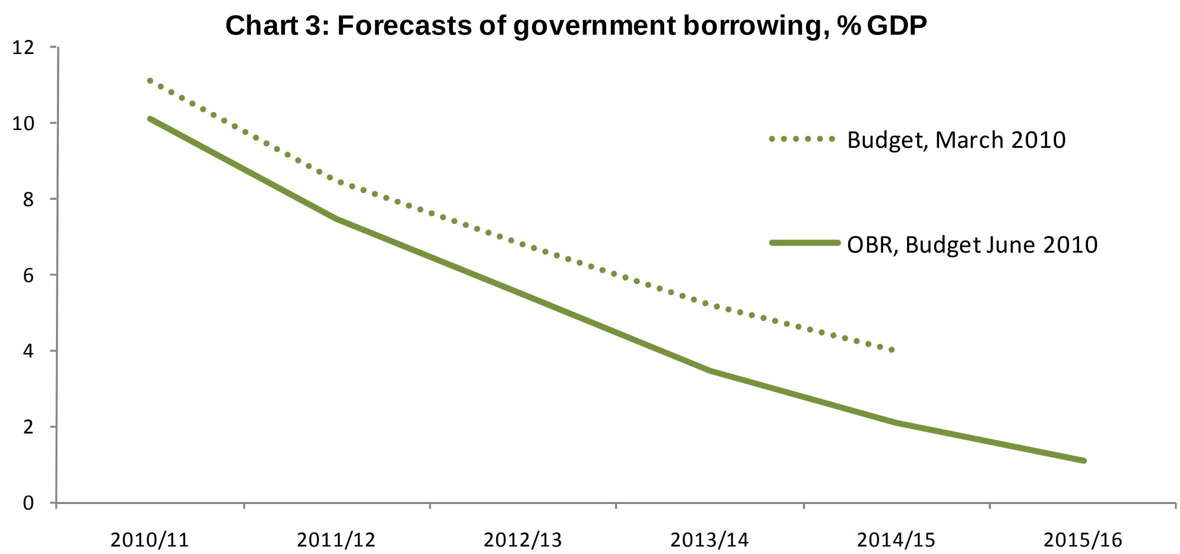
[2] HM Treasury, Budget 2010, HC 61, June 2010 para C.11
[3] HM Treasury, Budget 2010, HC 61, June 2010 para 1.15
[4] HM Treasury, Budget 2010, HC 61, June 2010 para C.9



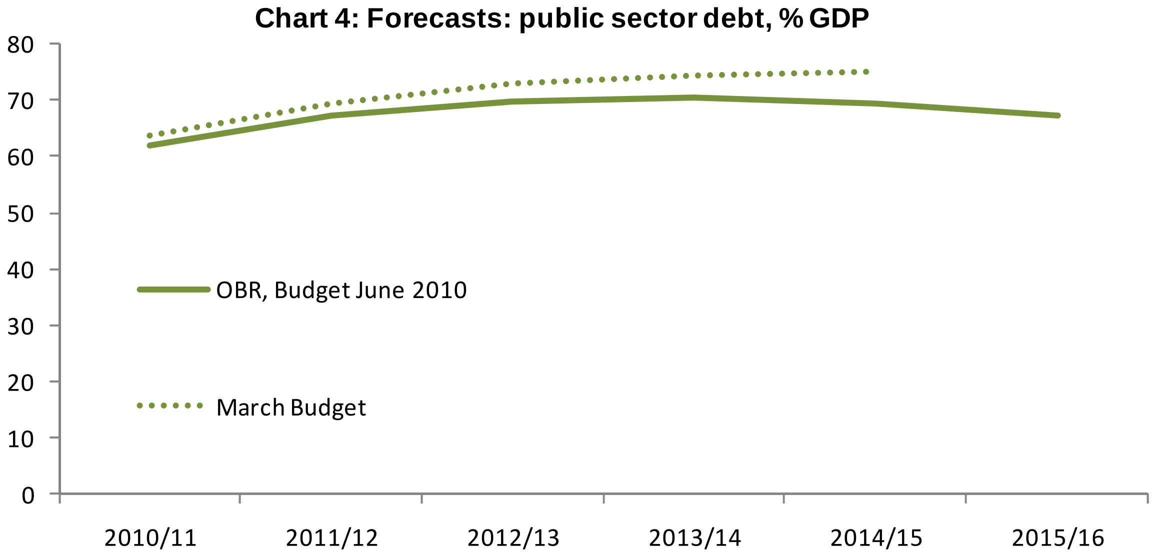
4.1 Government borrowing

The OBR produced revised forecasts for the public finances taking the Budget measures into account. These show government borrowing falling more quickly than was forecast in the March Budget. On the OBR's forecasts, borrowing will be 10.1% of GDP this year falling to 2.1% in 2014/15 and 1.1% in 2015/16. In the March Budget, the forecast was for borrowing to fall to 4.0% of GDP by 2014/15 (see chart below).



4.2 Government debt and debt interest payments

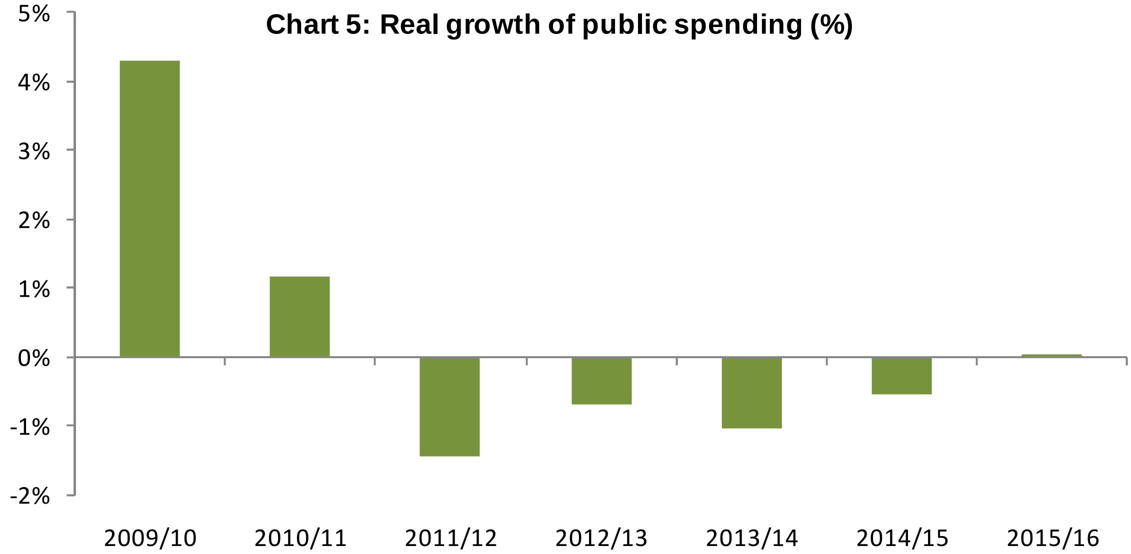
The OBR also updated its forecasts for government debt. The OBR forecast that debt would fall from 61.9% of GDP this year before peaking at 70.3% in 2013/14 and then falling to 67.4% of GDP in 2015/16. On this forecast, debt starts to fall as a share of GDP in 2014/15 – a year ahead of target. By comparison, in the March Budget, debt was forecast to rise every year until 2014/15 (see chart 4 below).



The OBR's Budget forecast is that debt interest payments will increase from £30.9 billion in 2009/10 to £63.0 billion 2014/15 and £66.5 billion in 2015/16. The OBR's Pre-Budget forecast, based on the policies of the previous government, was that debt interest would reach £67.2 billion by 2014/15.

4.3 Public spending

The Government has said that the bulk of the fiscal consolidation will come through spending cuts rather than tax increases. Total public spending is forecast to grow by 1.2% this year before falling in real terms in each of the following three years.



In his Budget statement, the Chancellor explained the impact on departmental budgets:

> We have inherited from the previous Government spending plans to cut departmental budgets by £44 billion a year by 2014-15. This implies an average real reduction for unprotected Departments of 20%—not that this was ever said, or a single pound of cuts to programmes even identified. Because the structural deficit is worse than we were told, my Budget today implies further reductions in departmental spending of £17

> billion by 2014-15. We have committed to providing the NHS with real increases throughout the Parliament, and we will honour our international aid obligations to the poorest in the world. Once these are taken into account, the Budget figures imply that other Departments will face an average real cut of around 25% over four years. Clearly, if we can find any additional savings to social security and welfare beyond those that I will outline shortly, then that will greatly relieve the pressure on these Departments and that 25% figure.
>
> Of course, not all Departments will receive the same settlement. I recognise, for example, the particular pressures on our education system and on defence. Final departmental settlements, and the final split between departmental expenditure and annually managed expenditure on welfare, will be set in the spending review. Rather than follow the usual practice of keeping the date of that review a secret until a few weeks before it happens, let me tell the House that it will be presented on Wednesday 20 October.[5]

5 Tax measures

The Budget announced a series of tax changes – mostly tax increases – to take effect over the next two years. It also confirmed some changes that will take effect from next year which had been announced by the previous government.

The most significant of the Government's *new* measures, with regard to the amounts of money they are estimated to raise, or cost, are:

- Increasing the standard rate of VAT from 17.5% to 20% from 4 January 2011. This is to raise £12.10 billion in 2011/12.

- Increasing the personal income tax allowance by £1,000 to £7,475 from April 2011. The basic rate limit – the point at which individuals become liable to pay income tax at the higher rate – will be reduced to ensure higher rate taxpayers do not benefit from the increased allowance. Taken together, these changes will cost £3.49 billion in 2011/12.

- Increasing the 'secondary threshold' – the point at which employers become liable to pay National Insurance contributions (NICs) on an employee's earnings – by £21 per week in real terms from April 2011. This change is in addition to reforms to the structure of NICs which the Labour Government had announced in its March 2010 Budget, discussed below. The higher secondary threshold is to cost £3.13 billion in 2011/12.

- A new bank levy on banks' balance sheets from 1 January 2011. This is projected to raise £1.15 billion in 2011/12, rising to £2.32 billion the following year.

- Increasing the rate of capital gains tax for higher rate taxpayers from 18% to 28%, as well as increasing the lifetime limit for Entrepreneurs Relief from £2 million to £5 million. These changes are to take effect from 23 June 2010, and taken together are to raise £725 million in 2011/12.

The Government also proposes a series of reforms to corporation tax over the next five years:

- Cutting the main rate of corporation tax by 1% each year over the period 2011/12 to 2014/15, from the current rate of 28% to 24% by April 2014.

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5 HC Deb 22 June 2010 c171

- Cutting the small profits rate of corporation tax by 1% to 20% from April 2011.
- Decreasing the rates of capital allowances from April 2012.
- Cutting the Annual Investment Allowance from £100,000 to £25,000 from April 2012.

Taken together, these changes are projected to cost £1.1 billion in 2012/13, rising to £1.3 billion by 2014/15.

Looking at all of the tax policy decisions in the June Budget, the changes are forecast to raise £6.26 billion in 2011/12.[6]

As mentioned the Government confirmed a series of tax measures which were announced by the Labour Government in its March 2010 Budget or earlier.[7] This includes major changes to the structure of NICs from April 2011:

- A 1% increase in both the main rate, and the additional rate, of NICs paid by employees, employers and the self-employed. (Initially the Labour Government had proposed a 0.5% increase in NIC rates in its 2008 Pre-Budget Report (PBR), but decided the increase should be double this in its PBR the following year.) Taken together these increases are to raise £9.02 billion in 2011/12.
- An increase in the 'primary threshold' – the point at which employees start to pay the main rate of NICs on their earnings – from April 2011 to compensate earners on lower incomes for the increase in NICs rates. (As with the increase in NI rates, this increase was announced in two stages in the 2008 and 2009 PBRs.[8]) This is estimated to cost £2.93 billion in 2011/12.

6 Public spending measures

The emphasis in the Government's deficit reduction plan is on spending cuts rather than tax increases. By 2014/15, the spending measures announced in the Budget will yield £31.9 billion compared with £8.2 billion from tax measures (a ratio of 80:20).[9]

By 2014/15, around a third of the spending measures relate to welfare payments. Examples include:

- Switching to CPI indexation for benefits, tax credits and public service pensions from April 2011 (saving £5.8 billion by 2014/15 – the largest single saving of the spending measures).[10] The chart below shows how the RPI and the Rossi index (which is used to uprate certain benefits) have generally been higher than the CPI over the last decade.

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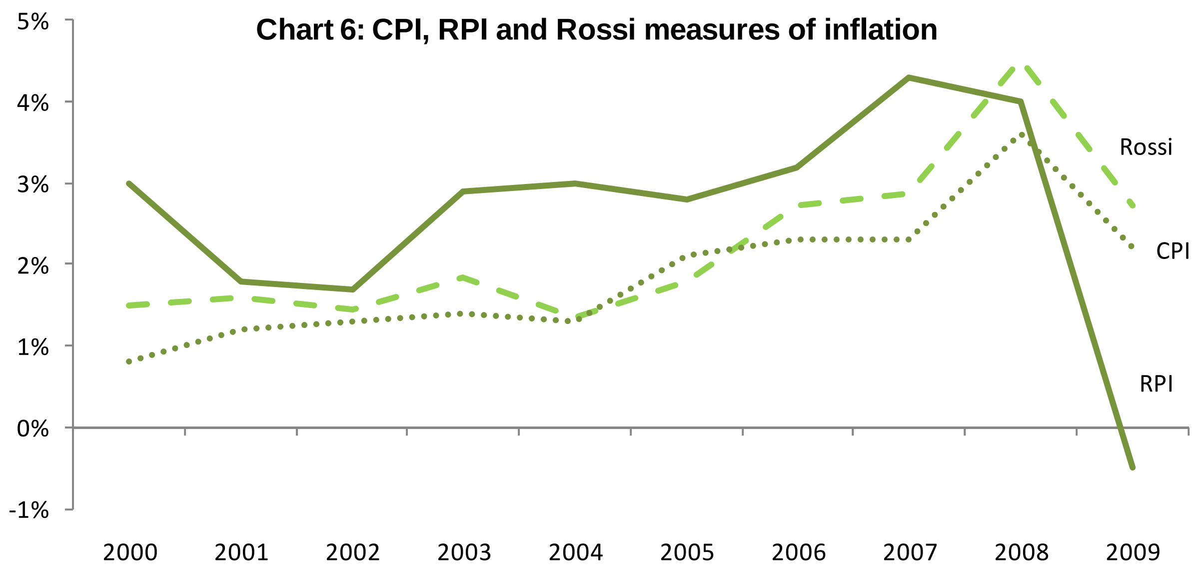
[6] HM Treasury, Budget 2010, HC 61 June 2010, Table 2.1, page40. HM Revenue & Customs' series of Budget Notes give details of the individual tax measures in the Budget; they are collated here: http://www.hmrc.gov.uk/budget2010/notes-pdf.htm

[7] A full list with costings is set out in the Budget report (Table 2.4, page 55). These are projected to raise £7.42 billion in 2011/12.

[8] Initially the primary threshold was to rise from April 2011 to align it with the personal allowance. In 2008/09 the allowance had been increased by an *extra* £600, as compensation for the abolition of the 10p starting rate of income tax. In the 2009 PBR the Government proposed a further increase in the threshold, to mitigate the impact of the higher 1% increase in NI rates, set for 2011/12.

[9] HM Treasury, Budget 2010, HC 61 June 2010, Table 1, page 4

[10] HM Treasury, Budget 2010, HC 61 June 2010, Table 2.1, page 40



- The introduction of an objective medical assessment for Disability Living Allowance (saving £1.1 billion by 2014/15)
- Various reforms to housing benefit (saving £1.8 billion by 2014/15)
- Various reforms to tax credits (saving £3.2 billion by 2014/15)
- Freezing rates of child benefit from 2011/12 for three years (saving £975 million by 2014/15)
- A two year pay freeze for public sector workers from 2011/12, except for those earning less than £21,000 who will receive an increase of at least £250 a year. This will save £3.3 billion a year by 2014/15.

Some spending measures introduced in the Budget will increase expenditure. For example, from April 2011, the child element of the Child Tax Credit will increase by £150 above CPI indexation and in April 2012 it will increase by £60 above indexation at a cost of nearly £2 billion by 2014/15.

7 Links to further information

HM Treasury, June 2010 Budget: http://www.hm-treasury.gov.uk/2010_june_budget.htm

Chancellor's Budget Statement to House of Commons:
http://www.publications.parliament.uk/pa/cm/cmtoday/cmdebate/03.htm#d2e1643

IFS analysis: http://www.ifs.org.uk/projects/330

House of Commons Library Economic Indicators Research Paper, June 2010:
http://www.parliament.uk/briefingpapers/commons/lib/research/rp2010/RP10-039.pdf

House of Commons Library Standard Note (SN/BT/4680)
http://www.parliament.uk/briefingpapers/commons/lib/research/briefings/snbt-04680.pdf

8 Selected press/IFS comment

1. “Editorial : Budget 2010: George Osborne's national gamble”, *The Guardian*, 23 June 2010
2. “Budget 2010: If Osborne's gamble pays off, it is Thatcherism's finest hour”, *Guardian.co.uk*, 22 June 2010
3. “Editorial: Osborne makes good on his promises”, *Financial Times*, 23 June 2010
4. “Behind those words are far deeper cuts”, *Financial Times*, 23 June 2010
5. “Leader: Austerity Rules; George Osborne's first Budget was bolder than 'unavoidable'”, *Times*, 23 June 2010
6. “Chainsaw massacre is delayed”, *Times*, 23 June 2010
7. “Editorial : A brave Budget that pulls Britain back from the brink”, *The Daily Telegraph*, 23 June 2010
8. “He made it all sound relatively painless. It is not”, *The Daily Telegraph*, 23 June 2010
9. “Weighing the risks”, *Stephanomics blog*, 22/23 June 2010

10 Robert Chote, Director of IFS, Post Budget Presentations: Opening Remarks, 23 June 2010

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The new Budget forecasts suggest that the financial crisis and the economic damage associated with it opened an additional structural hole in the public finances of around 5.8% of national income or £86 billion a year in today’s terms. This additional structural deficit would be impervious to economic recovery and would put public sector debt on an unsustainable path if left unaddressed.

George Osborne inherited an outline fiscal consolidation plan from Labour that would have filled about 70% of this hole by 2016–17. The measures he announced yesterday will make the consolidation more than half as big again and will accelerate its pace. This should be sufficient to fill the hole by 2014–15 and a year later to do so with 0.9% of national income to spare. This is also sufficient, perhaps not surprisingly, to meet the new fiscal rule that the Government has set itself, and by a similar margin. Yesterday’s measures should reduce total public sector borrowing over the course of this Parliament by 17% compared to the total implied by the plans in Labour’s last Budget.

Mr Osborne has long argued that international experience recommends dividing a fiscal consolidation 80:20 between spending cuts and tax increases. The measures announced by Mr Osborne yesterday split 80:20 by 2014–15 and 85:15 by 2015–16. But because the larger package of measures he inherited from Labour split roughly 70:30, the total consolidation only gets up to 74:26 in 2014–15 and 77:23 in 2015–16. Mr Osborne has in effect compromised between his desired ratio and that of the Liberal Democrats, who in their manifesto were looking for less reliance on spending cuts. But the Coalition is clearly relying more than Labour said it would have done on spending cuts and also much more than the last Conservative government to confront a similar repair job did. The Clarke and Lamont budgets of 1993 aimed for a roughly 50:50 split between spending and tax.

This degree of reliance on spending cuts implies some very tough decisions. The Government has identified welfare cuts worth £11 billion by 2014–15. More than half come from indexing benefits to an inflation rate that tends to be lower than the ones currently used. Mr Osborne implicitly assumes that recipients were overcompensated for increases in the cost of living in

the past, an argument that is open to debate. The rest comes largely from the four biggest working-age benefits and tax credits, a mixed bag of reforms with no consistent objective beyond the desire to save money.

Turning to spending on public services, Mr Osborne pointed out that, in the absence of further welfare cuts, spending on public services outside the protected areas of the NHS and overseas aid would need to be cut by 25% in real terms by the end of the parliament – with schools and defence likely to do better than average and other departments worse. What is striking is the extent to which protecting the NHS in particular intensifies the squeeze elsewhere. Applying the squeeze evenly across Whitehall would require 14% cuts rather than the 25% plus that the least favoured departments now face. In total, the cut in central government public services spending as a share of national income now planned by the Coalition will more than reverse the entire increase we saw under Labour. We are looking at the longest, deepest sustained period of cuts to public services spending at least since World War II.

On the tax side, yesterday's package added up to an £8 billion net tax increase in 2014–15, but this comprised roughly £20 billion of tax increases offset by roughly £12 billion of tax cuts. When Mr Osborne said that "the years of debt and spending" made the £13 billion increase in VAT unavoidable you might just as well say it was his desire to cut other taxes that made it so.

In terms of their contribution to the efficiency and effectiveness of the tax system, yesterday's changes were a mixed bunch of positive reforms, backward steps and missed opportunities. For example: Perhaps the most welcome change was the decision to rethink the last Government's complex, unfair and inefficient plans to limit pension contributions relief for high earners. The Coalition now has a better approach than was in any of the three main party manifestos.

The increase to increase the standard rate of VAT rather than shrink the UK's unusually extensive range of zero and reduced rates and exemptions means that the VAT system will now do more to distort people's spending decisions, so that they can buy fewer of the goods and services they want for every pound they spend.

The cuts in the headline corporation tax rate are welcome, but the cuts in the small profits rate and the generosity of capital allowances are less welcome. This is not a simplification.

The National Insurance break for start-ups looks complicated, potentially prone to avoidance and oddly targeted.

And, finally, the much-debated changes to Capital Gains are a step in the right direction in narrowing the gap between CGT and income tax rates. But this was a missed opportunity to move to a more coherent treatment of saving in the tax system, although at least the Chancellor resisted the siren voices calling for the reintroduction of taper relief.

Turning to the distributional impact of the Budget, Mr Osborne and Mr Clegg have been keen to describe yesterday's measures as "progressive" in the sense that the rich will feel more pain than the poor. That is a debateable claim. The Red Book includes a formal distributional analysis of the impact those tax and benefit spending measures where it is relatively easy to identify the households affected in 2012–13. It suggests that higher income households are indeed hit harder than lower income households, although the very lowest-income 10% are also hit relatively hard.

The Budget looks less progressive – indeed somewhat regressive – when you take out the effect of measures that were inherited from the previous Government, when you look further into the future than 2012–13 and when you include some other measures that the Treasury has chosen not to model. Conversely, looking at the impact of the Budget on households with different income levels overstates how regressive it is in comparison to an analysis based on households with different spending levels, which should give a better guide to their lifetime living standards. The main reason is that the VAT increase looks regressive when viewed against snapshots of income, but progressive when viewed against households' spending. That said, perhaps the most important omission in any distributional analysis of this sort is the impact of the looming cuts to public services, which are likely to hit poorer households significantly harder than richer households.

To conclude, let me that say that whatever you may think of the substance of yesterday's policy announcements, the new Government is certainly to be congratulated on the transparency with which it has presented them. In particular, the Budget policy costing document released by the Treasury online yesterday provides far more information than we have ever received before on the details of each policy change, the way it is expected to affect behaviour, and what it will raise or cost. This comes on top of the Office for Budget Responsibility's decision to publish many more of the economic assumptions upon which official public finance forecasts are based. Both are long overdue and should increase both the understanding of and trust in fiscal policy decisions.

The Treasury said yesterday that these innovations would complement a new approach to tax policy making, promoting predictability, stability and simplicity, for example through a commitment to ensure that the majority of tax changes are confirmed and available in draft form three months before the tax year. We will need to see a couple more budgets at least to judge whether these noble aims are being lived up to. But it is not immediately obvious that yesterday's announcements promoted simplicity in themselves or set out a long-term strategic vision for the tax system.