Background to the 2012 Budget

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This note sets out the background to the 2012 Budget which will take place on 21 March. The Office for Budget Responsibility (OBR) will publish revised forecasts for the economy and public finances on the same day.

The Library will publish a special edition of Economic Indicators on 20 March – the day before the Budget.

A separate note will be published shortly after the Budget summarising the main points.

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1 Introduction

"The days of un-funded giveaways are over – and they're not coming back in this Budget. Everything has to be paid for." Speech by the Chancellor of the Exchequer 6 March 2012

The Chancellor will present the Budget against a background of a fragile economic recovery. Most economic commentators expect 2012 to be another tough year for the UK economy. The OBR is currently forecasting growth of 0.7% this year and independent forecasters just 0.4%. The economy contracted by 0.2% in the last quarter of 2011. Unemployment is 150,000 higher than a year ago.

There are, however, some reasons for cautious optimism. While inflation is still well above its 2% target, it has fallen sharply in the last few months. This will lessen the squeeze on real incomes. There has been a recent improvement in some business surveys and signs of a pick up in the US economy in recent months. The Governor of the Bank of England has said "much of this year, there is likely to be a "zigzag" pattern of alternating positive and negative quarterly growth rates."[1]

The Budget is not expected to include significant changes in the overall levels of taxation or public spending. The Chancellor has made it clear that any tax cuts or spending increases must be funded by offsetting measures. The Budget is, however, expected to contain a number of tax changes. The Coalition is committed to real terms increases in the income tax personal allowance each year. An announcement on the level of the allowance in 2013/14 is expected. A real terms increase will, however, have to be paid for. There has been speculation that the Budget may contain proposals to reduce tax relief on pensions for high earners, action to close tax loopholes, and a more general shift in the personal tax system towards taxing property and wealth more severely. The Chancellor is also expected to comment on the 50p rate of income tax which has been the subject of a review by HM Revenue and Customs.

An announcement is also expected on child benefit for higher rate taxpayers. The Government has indicated its intention to remove child benefit from families containing a higher rate taxpayer from 2013. There has been widespread criticism of the design of this policy and the Budget may contain more detail on how it will operate.[2]

[1] Inflation Report Press Conference, 15 February 2012

[2] This issue is not considered further in this note. For more information, see Child Benefit for higher rate taxpayers, Library Standard Note SN05732, 3 November 2010. See also Mike Brewer and Robert Joyce, Withdrawing Child Benefit from better off families: are there better options? Chapter 11 of IFS Green Budget 2012

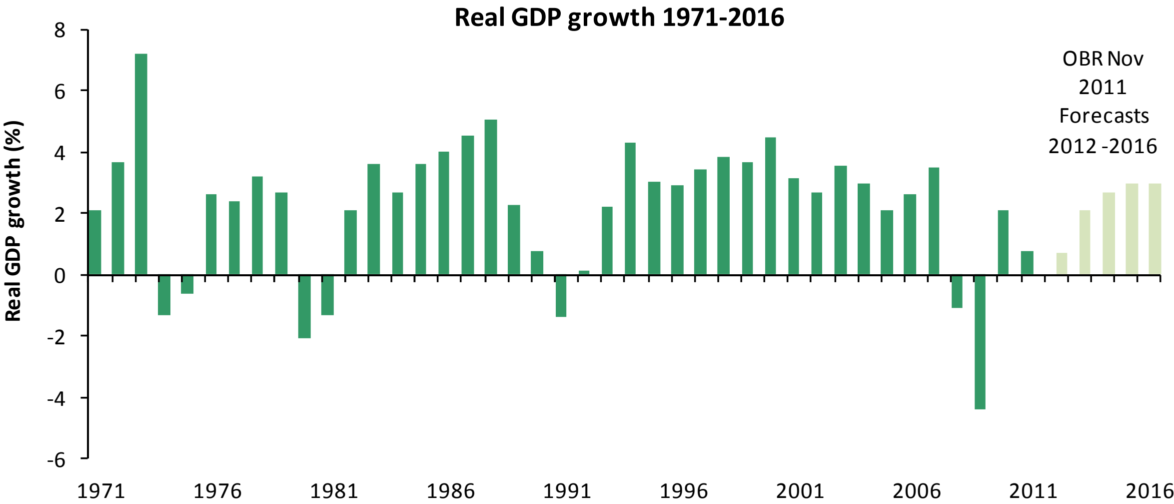
2 The UK economy

2.1 GDP

The economy has recovered slowly since 2009 when GDP fell by 4.4%. Although the economy grew by 2.1% in 2010, growth in 2011 is (provisionally) estimated to have been only 0.8%. Growth in 2011 was much lower than the OBR had forecast in last year's Budget and independent forecasts made at that time. According to the OBR, the main reason for lower than expected growth in 2010 and 2011 was higher than expected inflation squeezing household consumption. The OBR said:

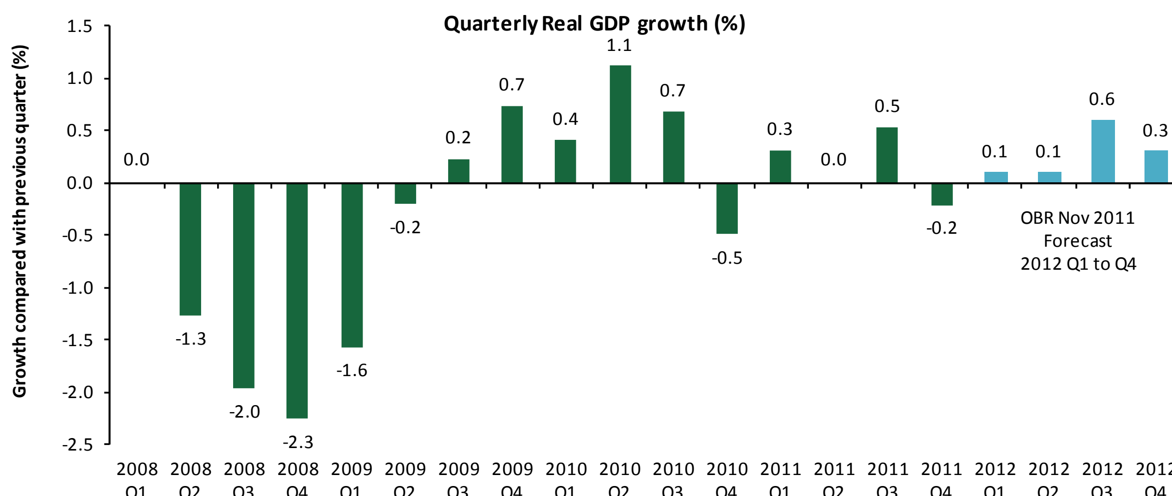
> The economy has grown less strongly this year than we forecast in March, primarily because higher-than-expected inflation has squeezed household incomes and consumer spending. Business and consumer surveys point to further weakness in the fourth quarter. On the assumption that the euro area struggles through its current difficulties, we expect the underlying momentum of the economy to pick up through next year, but with the headline measure of GDP broadly flat until the second half. Our central forecast is for 0.7 per cent growth in GDP in 2012, compared to the average external forecast of 1.2 per cent.[3]

Other factors, such as the problems in the Eurozone and access to credit, have also had an effect on growth. There is a political argument about whether public spending cuts have reduced growth.



Growth has fluctuated considerably from quarter to quarter. Before the 0.2% fall in output in Q4, 2011, the economy grew by 0.5% in Q3, 2011.

[3] OBR, Economic and fiscal outlook, November 2011, para 1.1



The table below shows contributions to estimated GDP growth in each of the last four quarters by expenditure component of GDP.

Contributions to growth (quarter-on-quarter), of the expenditure components of GDP

	2011 Q1	2011 Q2	2011 Q3	2011 Q4
Final Consumption Expenditure				
Households	-0.3	-0.3	-0.1	0.3
Non Profit Institutions Serving Households	-0.1	0.0	0.0	0.0
General Government	0.0	0.1	-0.1	0.2
Gross Capital Formation	-0.6	0.4	0.9	-1.2
of which Gross Fixed Capital Formation	-0.1	0.1	-0.1	-0.4
Exports	0.5	-0.6	-0.2	0.7
Imports	-0.7	-0.3	0.1	0.1
Net trade	1.2	-0.4	-0.3	0.6
Real GDP growth	0.3	0.0	0.5	-0.2

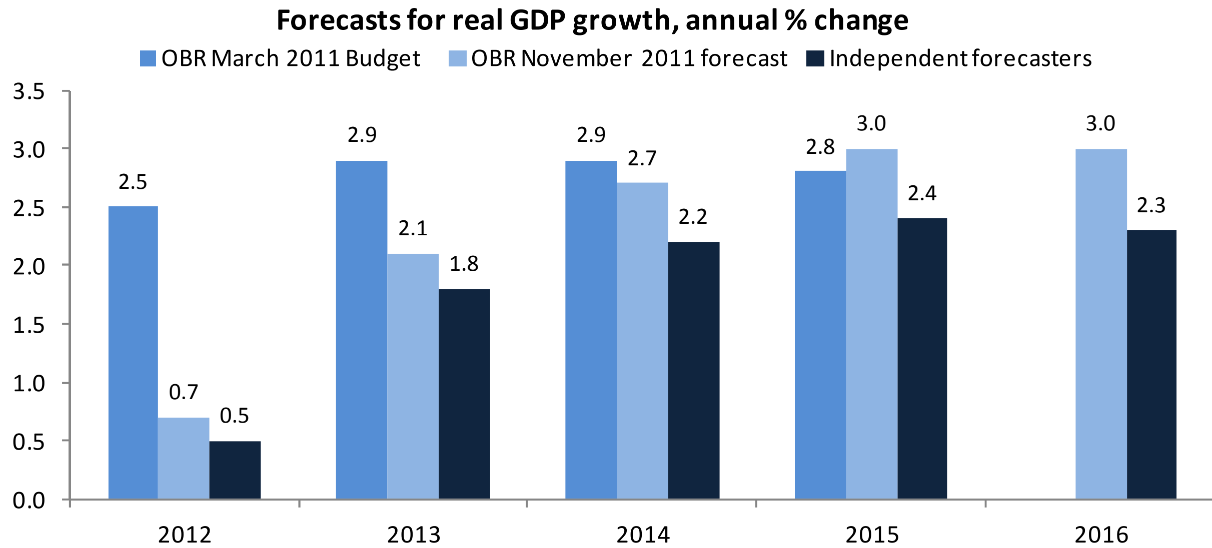
Source: ONS, Statistical bulletin: Second estimate of GDP - 4th quarter 2011

The latest estimates of GDP for Q4, 2011 suggest that net trade made a positive contribution to GDP growth, despite an overall fall in real GDP.

2.2 Growth forecasts

The OBR expect the economy to grow by 0.7% in 2012. Growth of 0.1% is forecast for both Q1 and Q2, 2012 before picking up in the second half of the year. Higher growth (2.1%) is forecast for 2013. In the medium term, the OBR expects growth of 2.7% in 2014 and 3.0% in 2015 and 2016.

The chart below compares the OBR's November 2011 forecast with the latest average independent forecast and the OBR's March 2011 forecast. In each of the next three years, the OBR's November 2011 forecast was lower than its March 2011 forecast but higher than the average independent forecast.



The table below shows the extent to which independent forecasters have downgraded the growth outlook for the UK economy. This time last year, independent forecasters were expecting growth of 2.1% in 2012. They are now forecasting 0.4%.[4]

Forecasts of GDP growth in 2012 (%)	
OBR	
Pre - Budget 2010	2.8
Post-Budget 2010	2.8
Nov-10	2.6
Mar-11	2.5
Nov-11	0.7
Average of independent forecasts	
Jan-11	n/a
Feb-11	2.1
Mar-11	2.1
Apr-11	2.1
May-11	2.1
Jun-11	2.1
Jul-11	2.0
Aug-11	2.0
Sep-11	1.8
Oct-11	1.5
Nov-11	1.2
Dec-11	0.6
Jan-12	0.4
Feb-12	0.4

Source: HMT, *Forecasts for the UK Economy: a comparison of independent forecasts*; OBR

[4] The chart shows the average of independent forecasts covering the period up to 2016. This figure is based on a smaller sample of forecasters and therefore gives a slightly different figure for 2012 (0.5%) than the larger sample which provide short term forecasts. The larger sample gives the 0.4% figure.

The OECD's latest forecasts for the UK, published in November, are for growth of 0.5% this year and 1.8% in 2013.[5] The OECD places the UK fifth out of the G7 for growth in 2012 and fourth in 2013. The IMF forecasts growth of 0.6% in 2012 and 2.0% in 2013.

OECD/IMF forecasts for real GDP growth, %

	OECD		IMF	
	2012	**2013**	**2012**	**2013**
UK	0.5	1.8	0.6	2.0
Canada	1.9	2.5	1.7	2.0
France	0.3	1.4	0.2	1.0
Germany	0.6	1.9	0.3	1.5
Italy	-0.5	0.5	-2.2	-0.6
Japan	2.0	1.6	1.7	1.6
US	2.0	2.5	1.8	2.2
EU27	...	...	-0.1	1.2
Euro area	0.2	1.4	-0.5	0.8
Total OECD	1.6	2.3	...	...
World	...	...	3.3	3.9

Sources: OECD, *Economic Outlook,* No 90, November 2011
IMF, *World Economic Outlook update*, January 2012

The OECD's *Economic Outlook* commented on the UK economy:

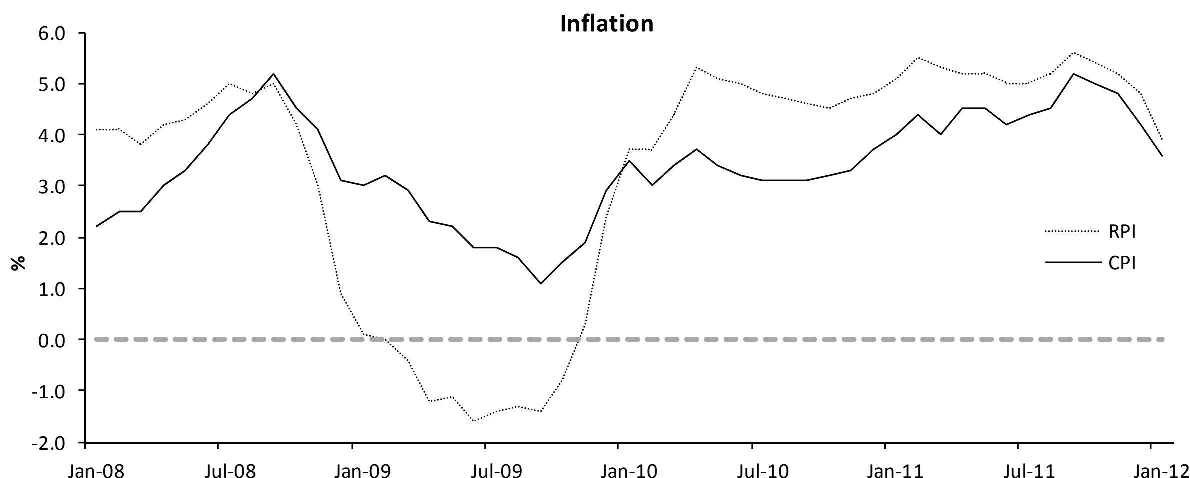
> Weak international demand, continued retrenchment among households and needed fiscal consolidation has halted the recovery. Growth will start to pick up during 2012 as exports and household consumption recover, with further strengthening in 2013. Unemployment is rising and will reach 9% in 2013, while inflation is presently peaking as anticipated and is expected to fall below the 2% target in 2013 as temporary effects from VAT hikes and commodity prices wane. Monetary policy is supportive, with the Bank rate at 0.5% and quantitative easing being resumed. Further expansions of quantitative measures are warranted. The ambitious fiscal consolidation has bolstered credibility and helped maintain low bond yields, leaving room for automatic stabilisers to work fully to cushion the slowdown.[6]

2.3 Inflation

Following a period of (RPI) deflation in 2009, inflation has risen to high levels on both the retail prices index (RPI) and the consumer prices index (CPI) measures, before falling back as the impact of the increase in the standard rate of VAT has subsided:

- RPI inflation reached 5.6% in September 2011 – its highest value since June 1991 - it fell to 3.9% in January.
- CPI inflation peaked at 5.2% in September 2011 before falling back to 3.6% in January (see chart below).

[5] OECD, *Economic Outlook*, November 2011
[6] OECD, *Economic Outlook*, November 2011, p 99



Inflation has been well above the Bank of England's 2% CPI target. The OBR forecast that CPI inflation will fall over the next few years. It forecasts 2.7% inflation in 2012 (compared with 4.5% in 2011), 2.1% in 2013 and 2.0% in 2014. The OECD forecasts CPI inflation in the UK of 2.7% this year (higher than in the other G7 countries) and 1.3% next year.

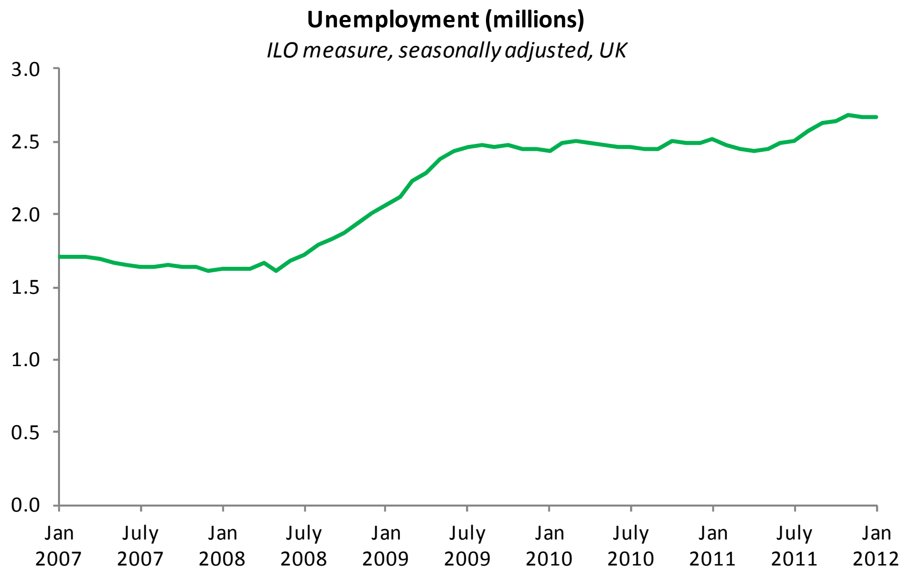
OECD forecasts for inflation, %

	2012	2013
UK (CPI)	2.7	1.3
Canada	1.6	1.4
France	1.4	1.1
Germany	1.6	1.5
Italy	1.7	1.1
Japan	-0.6	-0.3
US	2.4	1.4
Euro area	1.6	1.2

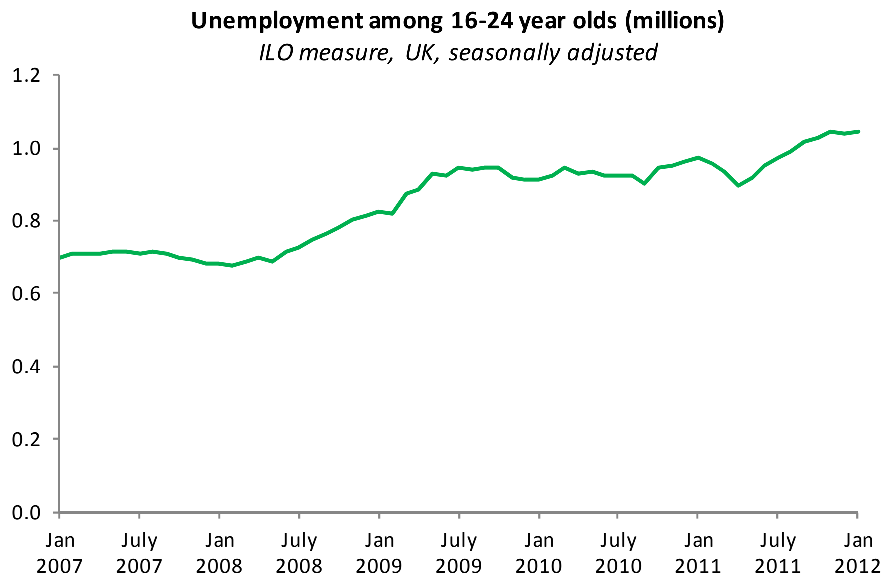
Source: OECD, *Economic Outlook,* November 2011

2.4 Unemployment

Unemployment has risen to 2.67 million in the three months to January 2012, an increase of 28,000 compared with the previous quarter and 148,000 higher compared with a year earlier. This represents 8.4% of the economically active population; the unemployment rate has not been higher since 1995.



The number of unemployed young people aged 16-24 rose above one million during summer 2011 and has remained there since. In the three months to January 2012, there were 1.04 million 16-24 year olds unemployed, an increase of 68,000 compared with a year earlier. Excluding those in full-time education, unemployment in this age group was up by 42,000 over the same time.



The overall unemployment rate in the UK is the third highest of the G7 countries. It is lower than France and Italy but higher than the US, Canada, Germany and Japan.

International comparisons of unemployment

OECD Harmonised unemployment rates

%, January 2012 (except where stated)

UK	8.4	(a)
Canada	7.4	(b)
France	10.0	
Germany	5.8	
Italy	9.2	
Japan	4.6	
US	8.3	(b)
Euro area	10.7	
Total OECD	8.2	

Notes: (a) Nov 2011, (b) Feb 2012

Source: OECD

The OBR's latest forecasts from November 2011 expect the unemployment rate to rise from an average 8.1% in 2011 to 8.7% in 2012, before falling slightly to 8.6% in 2013. In subsequent years the OBR forecasts unemployment to fall at a faster pace to 8.0% in 2014, 7.2% in 2015 and 6.2% in 2016.

The OECD's forecasts of unemployment are shown in the table below. In the UK, unemployment is forecast to increase from 8.1% in 2011 to 8.8% in 2012 and 9.1% in 2013. This would mean UK unemployment being the second highest in the G7 in 2013, below France. UK unemployment would remain below that of the Euro area average.

OECD forecasts for unemployment, %

	2012	2013
UK	8.8	9.1
Canada	7.3	7.2
France	9.7	9.8
Germany	5.7	5.5
Italy	8.3	8.6
Japan	4.5	4.4
US	8.9	8.6
Euro area	10.3	10.3
Total OECD	8.1	7.9

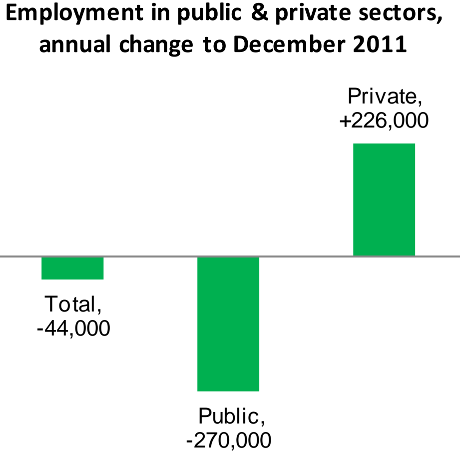
Source: OECD, Economic Outlook, Nov 2011

2.5 Employment

The number of people in employment increased by 9,000 over the last quarter but fell by 44,000 over the last year, to 29.12 million in the three months to January 2012. The employment rate for those aged 16-64 was 70.3%, unchanged from the last quarter and down 0.2 percentage points from a year before.

Employment in the public sector fell by 37,000 in the last quarter and declined by 270,000 over the previous year to 5.94 million in December 2011, its lowest level since June 2003.

Private sector employment increased by 45,000 in the last quarter and rose by 226,000 over the previous year to 23.17 million in December 2011.



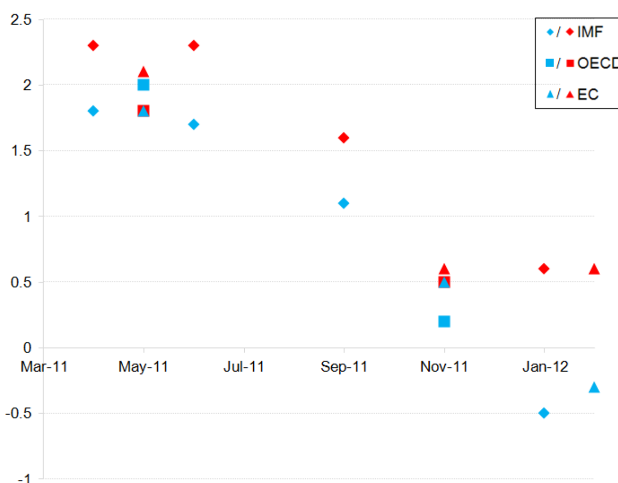
In November, the OBR forecast that general government employment would fall by 500,000 between 2010/11 and 2014/15.[7] Latest data show that general government employment fell by 208,000 between Q1 2011 and Q4 2011.

[7] Public sector excluding public corporations

3 Risks from the eurozone

3.1 Developments since the Autumn Statement

Since the Autumn Statement, the outlook for the eurozone has deteriorated still further, and major forecasters are now projecting a mild recession for the area as a whole in 2012. However, two significant actions have alleviated fears about the cohesion of the currency union in recent weeks.



Firstly, the drawn-out negotiations over a second assistance package for Greece have come to a close. The country will write-off €107 billion in sovereign debt owed to private creditors, and will receive up to €130 billion in loans from the IMF and eurozone on favourable terms, in return for committing to a programme of further public sector austerity and structural reform.[8] The Greek agreement is discussed in more detail in the Library Standard Note *The eurozone crisis – rescuing Greece*; some of the issues raised by the agreement are covered in the following section.

Secondly, the European Central Bank has supplied the financial system with an exceptional level of liquidity, in the form of low-interest (1%) 3-year loans, known as longer-time refinancing operations (LTROs). Over 800 financial institutions collectively borrowed €1 trillion under the scheme, bringing the size of the ECB's balance sheet to €3 trillion.[9] Three UK banks, HSBC, Barclays and Lloyds, together borrowed around €26 billion. The LTROs are intended to deal with a drying-up of lending between banks, and avert what the ECB euphemistically refers to as a 'tail risk', namely a credit crunch. They have been accompanied by rule changes that allow banks to use a broader range of collateral to borrow from the ECB. As well as restoring confidence to the financial sector, it is also hoped that the funds will stimulate demand among banks for peripheral eurozone bonds, especially in Italy and Spain, thereby reducing these countries' borrowing costs.[10] It is also possible that the LTROs will improve lending conditions in the 'real' economy, as the funds are lent on to businesses to finance investment.

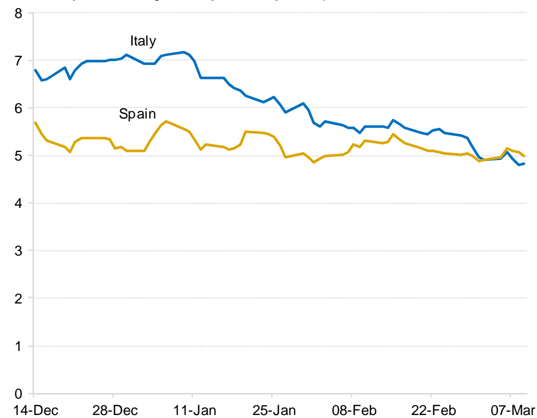
[8] Not all of the €130bn is going to the Greek government. €23-40bn will be used to recapitalise Greek banks, and €35bn as 'sweeteners' for private sector creditors involved in the debt write-off. There is also a further €34bn left over from the previous agreement.

[9] *Consolidated financial statement of the Eurosystem, 9 Mar 2012*. The ECB's balance sheet shows its total assets (gold plus outstanding lending) and, equally, its liabilities (deposits etc.)

[10] At 1%, the interest rates on the LTROs makes it profitable for banks to use these funds to buy-up Spanish and Italian bonds. The ECB is prohibited by statute from financing governments directly (i.e. buying their bonds at auction), and the practice of buying them on secondary markets (i.e. from investors) has proved controversial. The LTROs are arguably a less legally questionable means for the ECB to contain rising government borrowing costs.

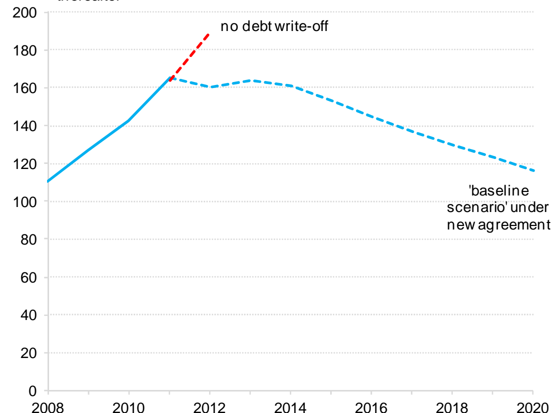
3.2 A turning point?

Together, these measures, along with data showing stronger than expected levels of output have restored a degree of confidence in the eurozone in recent weeks. Stock markets have risen considerably (France's CAC index by 8% and Germany's Dax by 13% since the start of the year), and indicators of economic sentiment more modestly. Most importantly, Italy's borrowing costs have been brought back to levels generally deemed to be sustainable, while Spain's have remained stable (see chart), indicating the contagion from Greece and Portugal to more substantial eurozone economies has been contained for the time being.



Source: Bloomberg

The foundations of any recovery remain fragile, however, and subject to a number of risks. The most significant of these is the Greek programme. The €100 billion debt write-off stops Greece's public debt burden from spiralling out of control, but its heavy debt servicing costs and rapidly-shrinking economy mean the effect is remarkably slight (see chart); that €100 billion barely turns the corner of Greece's debt trajectory is an indication of the extent of the country's problems. Even under the most optimistic assumptions, Greece will not reduce its debt burden below 120% GDP before 2020, and will remain one of the most indebted countries in the world for at least a generation. Though the country's position in the eurozone is safe for now, if its economy does not quickly see a return to growth under the new programme, the same pressures that caused the failure of the first agreement could resurface, and the cohesion of the currency union may once again be called into question. Moreover, with very little private sector debt left to write-off, any further reductions in Greece's debt burden are likely to involve restructuring of loans backed by eurozone governments. As well as the adverse fiscal consequences for the eurozone, any write-offs on these 'official' loans is likely to put strain on political relations between Member States.



Sources: European Commission and IMF

Secondly, even if the Greek programme stays on track, the political tensions that have plagued the response to the eurozone crisis could return. The fiscal compact has been interpreted by many as a quid pro quo for the ECB's LTROs; but commitment to the compact, and its compatibility with growth-orientated policies, is already under question. Francois Hollande, the frontrunner in the French presidential race, has announced his intention to renegotiate the compact were he to be elected, while the new Spanish prime minister has stated that the government will exceed the budget deficit target agreed by the

previous government. Ireland is obliged to put the Treaty to a referendum, and there could be difficulties in gaining parliamentary approval in Germany and the Netherlands.[11] In light of this, the ECB's president, Mario Draghi, has asserted participants' obligations in stark terms:

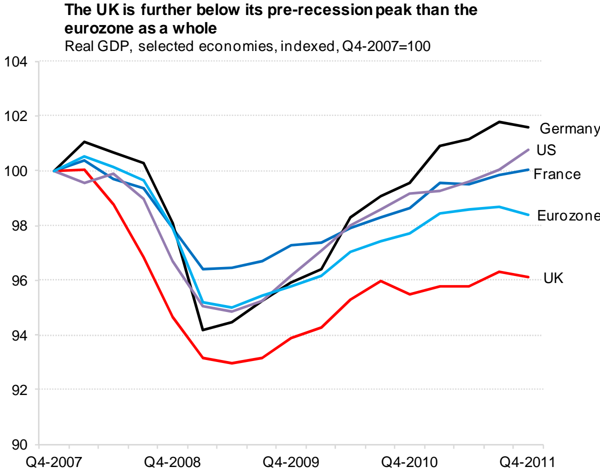
> all the [eurozone] countries [need] to have, in a sense, the will to be subject to a discipline that cannot be changed by any government whatsoever... these rules are the pillars of trust between countries

Thirdly, oil prices have risen in recent months, partly due to fears about the possible impact of EU sanctions imposed on Iran as a result of its uranium enrichment programme.[12] If tensions continue to escalate, prices could be pushed to a level that choke-off economic recovery.

Finally, the underlying causes of the eurozone crisis still remain. No government that has lost the ability to borrow on the open market (Greece, Portugal and Ireland) has thus far regained it: Ireland's borrowing costs have fallen over the past year, but at around 7% per year for 10-year loans, they remain unsustainably high.[13] Meanwhile, at 13%, Portugal's borrowing costs are entirely prohibitive. The fiscal austerity now being required across Europe does not address problems of anaemic growth and weak competitiveness in the eurozone periphery and imbalance across the currency union and may, according to some, make these problems worse.[14] The LTROs, while successful in preventing the crisis spilling over into the financial sector, are, according to some commentators, storing up problems for the future as banks will have to refinance their extensive borrowing in three years' time.[15] They have also resulted in banks' collateral being tied-up at the ECB, meaning the prospects for banks once again lending freely to each other is still more remote, since they have fewer assets against which borrowing can be secured.

Implications for the UK

Despite the focus on the eurozone's problems, the UK's economy has not outperformed the eurozone as a whole over the past two years, and its output remains further below the pre-recession peak (see chart). The Government has distanced itself politically from the currency union through its refusal to sign the 'fiscal compact' Treaty. However, the UK and the eurozone economies for the time being will remain closely intertwined: strong links with the eurozone through trade and the financial sector mean that, were the eurozone crisis to continue or worsen, it could further stifle the UK's faltering recovery.



Source: OECD.stat database

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[11] *Concerns rise over eurozone fiscal treaty*, FT 14 March 2012

[12] Other political developments in the Middle East, and rising demand from emerging economies and Japan (which is turning to oil as an alternative to atomic power in the wake of the Fukushima disaster) are also placing upward pressure on prices. For a summary, see *Sanctions choke of oil output*, FT 14 March 2012

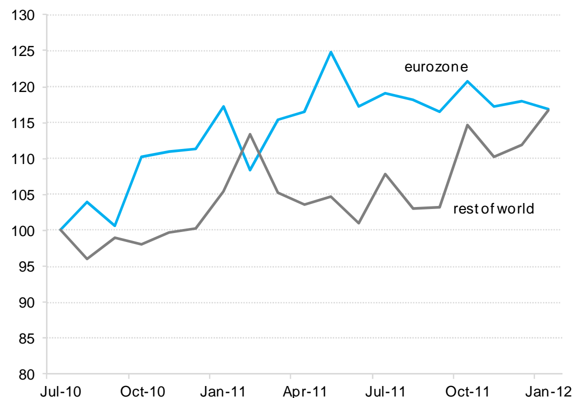
[13] These are the market yields on Ireland's and Portugal's 10-year sovereign bonds, which provide an indication of government borrowing costs. Source: Bloomberg

[14] See, for instance, Martin Wolf *The pain in Spain will test the euro*, 6 March 2012

[15] See, for instance, The Wall Street Journal Euro Crisis blog *Amidst the cheer, could the LTRO be storing up problems for later*, 29 February 2012

Trade

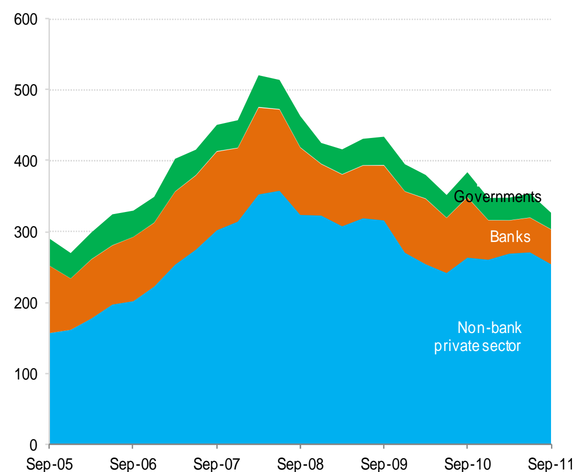
47% of total UK exports went to the eurozone in 2011. Exports to the eurozone have held up despite the crisis (see chart), largely because most go not to the beleaguered periphery, but to Germany, France and the Netherlands, which have performed far more strongly. Most forecasters expect trade to be the strongest driver of GDP growth in the UK in 2012, and so adverse developments there have the potential to return the UK to recession, particularly if the effects are felt in the eurozone 'core' that comprise the UK's key export markets. Demand for UK exports might also be affected were the euro to fall significantly against sterling, as might happen were the economic situation to deteriorate. In light of these risks, Ministers have begun to speak of cultivating 'alternative' export markets in emerging economies and the Commonwealth with a view to reducing the UK's reliance on the eurozone's fortunes.[16]



Source: UKtradeinfo

Financial sector

The UK's financial institutions are not heavily exposed to peripheral eurozone sovereign debt: total outstanding lending to the Greek, Irish, Portuguese, Italian and Spanish governments stood at $23 billion at the end of September 2011, down from $40 billion two years before. UK banks have also scaled back their exposure across other sectors too (see chart). Nonetheless, in the event of full eurozone break-up, the financial linkages between the eurozone and the UK would, in the view of many, precipitate a banking crisis in the UK and the requirement for urgent recapitalisation, possibly using public funds. Even without full-scale collapse, the risk and realisation of losses on lending that might follow from a severe recession in the eurozone could limit banks' capacity to lend to the domestic economy.



Source: Bank of England database

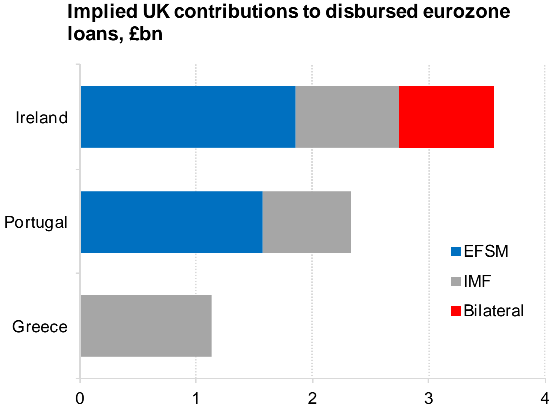
Direct fiscal links

The extent to which the UK government is implicated in the eurozone 'bail-outs' has attracted much interest in the past. The UK is a participant in the more minor of the two eurozone loans facilities, the European Financial Stabilisation Mechanism (EFSM), which has lent money to Portugal and Ireland. The UK has also extended bilateral loans to Ireland, and, along with the organisation's 186 other members, is part-liable for the IMF's lending to

16 See, for instance, speech by Mark Hoban MP, 8 December 2011

Greece, Ireland and Portugal.[17] Total 'exposure' through outstanding lending via these channels amounts to around £7 billion.

From June 2013, the entry into force of the European Stability Mechanism (ESM), backed by eurozone member states only, will mean that no *new* liabilities will be incurred by the UK via the EFSM after end June 2013. However, the longest-dated bond issued under the EFSM to date matures in April 2042, so technically the UK's 'liability' will continue at least until this point.



Sources: IMF; EC; HC Library calculations

[17] It is worth noting that the IMF's lending is 'senior' to that of other creditors; that is, in the event of default, the IMF gets paid back first.

4 The public finances

4.1 Background

The Government has put reducing the budget deficit at the heart of its economic policy. It argues that its programme of fiscal consolidation is necessary for the following reasons:

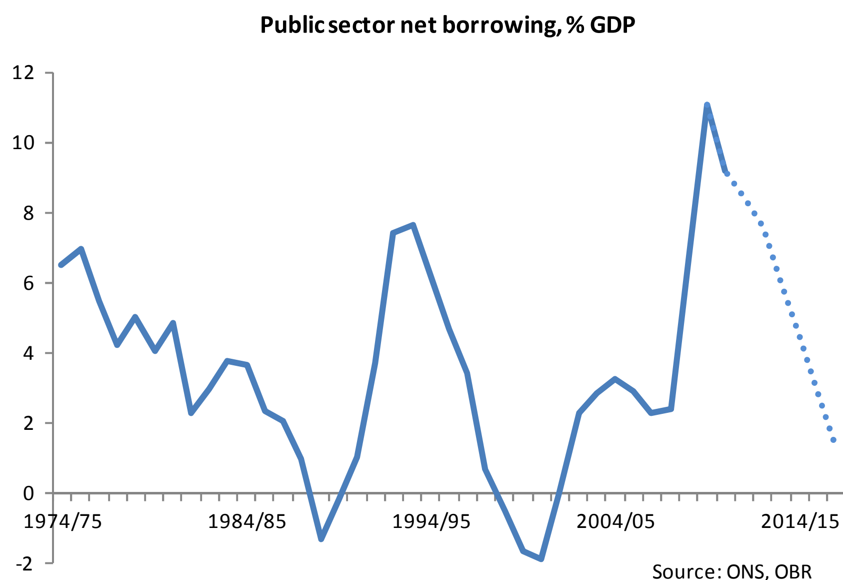
- To maintain market confidence and thus keep interest rates low and avoid the problems which have affected some Eurozone countries.
- To prevent government debt reaching high levels which harm economic growth
- To allow room for monetary policy (interest rates and quantitative easing) to support the economy.

The Opposition argues that the Government's deficit reduction programme is harmful to growth.

4.2 The budget deficit

Recent trends

The budget deficit peaked at 11.1% of GDP (£156 billion) in 2009/10 in the wake of the recession and financial crisis.[18] This is an extremely high level in both historical terms and by international standards. It fell to 9.2% of GDP (£136 billion) in 2010/11.



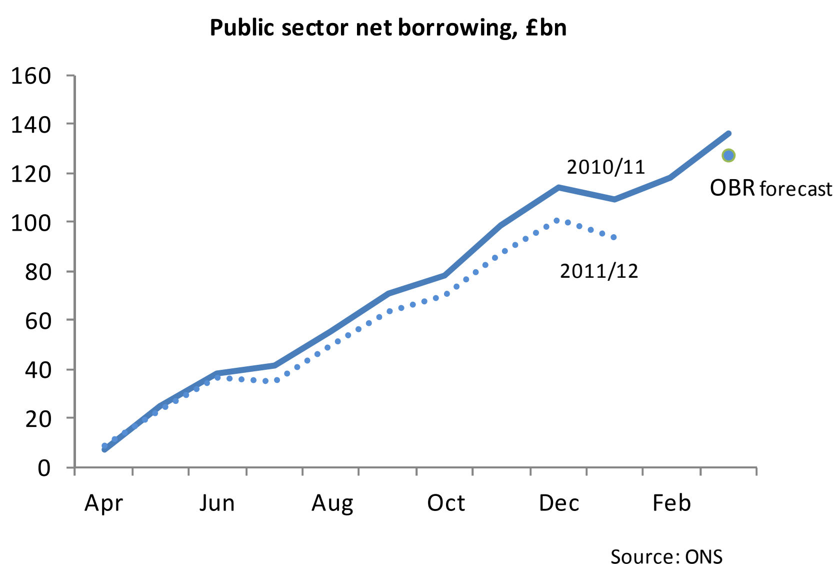
The deficit is forecast to fall to 8.4% of GDP (£127 billion) in 2011/12. Over the first ten months of 2011/12, the deficit was £93.5 billion: 14.4% lower than in the same period of 2010/11 (see chart below). The Institute for Fiscal Studies (IFS) cautioned against extrapolating these figures and warned that any lower than forecast borrowing this year might not continue in the future:

> A simple extrapolation of the data over the last ten months suggests that borrowing is on course to come in at around £116bn. This is lower than the £127.1 billion forecast by the OBR in the November 2011 Economic and Fiscal Outlook and lower than the

[18] The borrowing and debt figures in this note exclude the temporary effects of measures to help the financial sector.

£124.2bn forecast in our IFS Green Budget earlier this month. However it is important to bear in mind that borrowing over the next two months might not follow the pattern seen over the previous ten. In particular, VAT receipts may be expected to slow and spending may be expected to accelerate.

The Chancellor would no doubt be pleased if borrowing this year were to come in lower than the OBR forecast. However the composition of this lower borrowing suggests that it is unlikely to feed through into lower than currently forecast borrowing in future years.[19]



Forecasts for the budget deficit

The OBR forecasts that the budget deficit will fall steadily from £127 billion this year to £24 billion in 2016/17. As a share of GDP, this is a fall from 8.4% to 1.2%.

Public sector net borrowing

	Outturn £bn	OBR forecast £bn	IFS forecast £bn	Outturn % GDP	OBR forecast % GDP	IFS forecast % GDP
2006/07	30.9	..	..	2.3	..	..
2007/08	34.0	..	..	2.4	..	..
2008/09	96.5	..	..	6.8	..	..
2009/10	155.8	..	..	11.1	..	..
2010/11	135.8	..	..	9.2	..	..
2011/12	..	127	124.2	..	8.4	8.2
2012/13	..	120	121.1	..	7.6	7.7
2013/14	..	100	97.8	..	6.0	5.9
2014/15	..	79	74.6	..	4.5	4.3
2015/16	..	53	44.0	..	2.9	2.4
2016/17	..	24	12.3		1.2	0.6

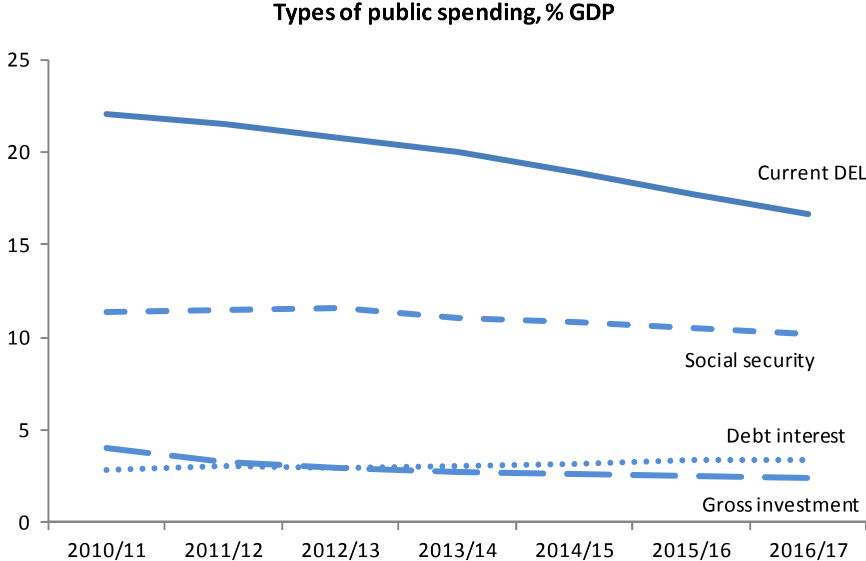
Sources: ONS, Public sector finances Statistical Bulletin, January 2012
OBR, Economic and fiscal outlook, November 2011, Table 4.27
IFS Green Budget 2012, Table 4.2 and 4.3

[19] IFS, IFS analysis of today's public finance figures, 21 February 2012

The IFS forecast a slightly lower level of borrowing, reaching £12 billion or 0.6% of GDP by 2016/17.

Most of the forecast reduction in the deficit is due to spending restraint rather than increases in taxation. The chart below shows public spending and revenue as a share of GDP. Spending is forecast to fall from a peak of nearly 48% of GDP in 2009/10 to 39% in 2016/17 – a fall of nearly nine percentage points. Revenues are forecast to increase from 36.5% of GDP in 2009/10 to 37.8% in 2011/12 and remain at this level for rest of the forecast period.

The chart below shows forecasts for different types of public spending as a share of GDP.



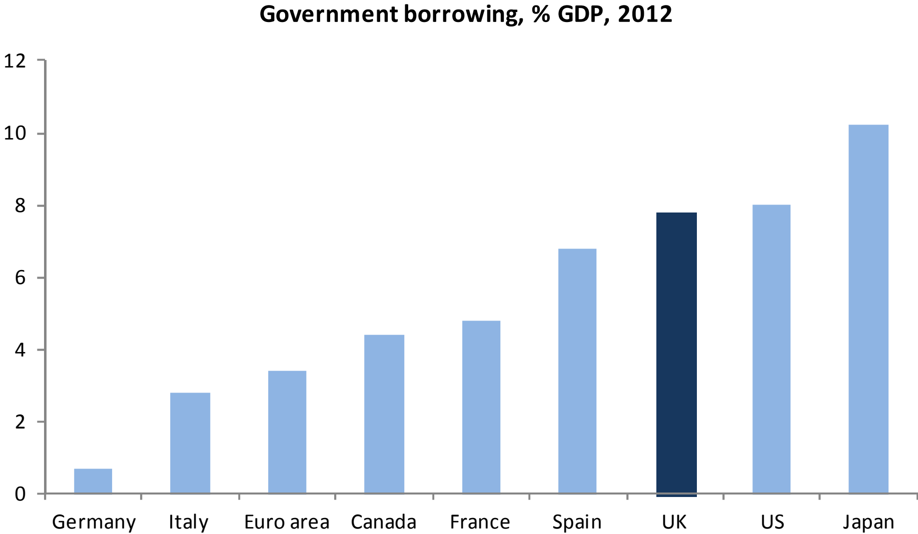
Current Departmental Expenditure Limit (DEL) spending is forecast to fall by 5.4 percentage points between 2010/11 and 2016/17.[20] Social security spending falls by 1.2 percentage points. Debt interest is forecast to increase from 2.9% of GDP to 3.4%. Gross investment is forecast to fall from 4.0% of GDP to 2.4%.

The Autumn Statement announced that public spending in 2015/16 and 2016/17 would fall in line with the reductions already in place for the Spending Review period. Speaking the day after the Autumn Statement, Paul Johnson, Director of the IFS commented:

> Yesterday the Chancellor had to pencil in two more years of substantial spending cuts to deal with most, but not quite all, of this additional problem and is now just on course for meeting his mandate.
>
> That will extend to six years the period for which total spending will have been cut year on year. One begins to run out of superlatives for describing quite how unprecedented that is. Certainly there has been no period like it in the UK in the last 60 years. The scale of the additional cuts is itself substantial. In 2016-17 spending is now planned to be £15 billion less, in real terms, than in 2014-15. That is even after the dramatic reductions seen in this parliament. Relative to a world in which spending stayed the same relative to national income the cut in the first two years of the next parliament is bigger still – nearer £30 billion.
>
> Of course the Chancellor has not told us anything about where those spending cuts will come from – those are decisions for a future spending review.[21]

International comparisons

The IMF forecasts that UK government borrowing will be 7.8% of GDP in 2012. This is higher than all other G7 countries except the US and Japan. Estimates for a wider range of countries are in Appendix 2.



[20] DEL spending is departmental spending set in spending reviews. It covers administration and programme costs which can be reasonably be planned in Spending Reviews. DEL is split between current and capital spending. Besides DEL, there is also Annually Managed Expenditure (AME) which is less predictable than DEL spending. Social security and debt interest payments fall within AME.

[21] IFS Commentary on Autumn Statement 2011 and OBR forecast, Opening remarks Paul Johnson, 30 November 2011

Government borrowing, % GDP

	2008	2009	2010	2011	2012	2013
UK	**4.9**	**10.4**	**9.9**	**8.6**	**7.8**	**6.5**
US	6.7	13.0	10.5	9.5	8.0	6.4
France	3.3	7.6	7.1	5.7	4.8	4.4
Germany	0.1	3.2	4.3	1.1	0.7	0.1
Italy	2.7	5.3	4.5	3.9	2.8	2.3
Spain	4.2	11.2	9.3	8.0	6.8	6.3
Japan	4.7	10.8	9.3	10.1	10.2	8.8
Canada	-0.1	4.9	5.6	4.9	4.4	3.6
Euro area	2.2	6.5	6.3	4.3	3.4	2.9

Source: IMF Fiscal Monitor Update, January 2012

4.3 The structural deficit

A distinction is often drawn between the "cyclical" and "structural" elements of the budget deficit:

- Cyclical elements of the deficit refer to the effect of the economic cycle on the level of government borrowing. In a recession, government borrowing tends to increase as tax receipts are reduced and spending on unemployment benefit increases. The reverse happens when the economy is growing strongly. These effects are sometimes known as the economy's "automatic stabilisers".

- Structural elements of the deficit refer to underlying or persistent elements of government borrowing which are unrelated to the economic cycle. The structural deficit is measured by cyclically-adjusted measures of borrowing.

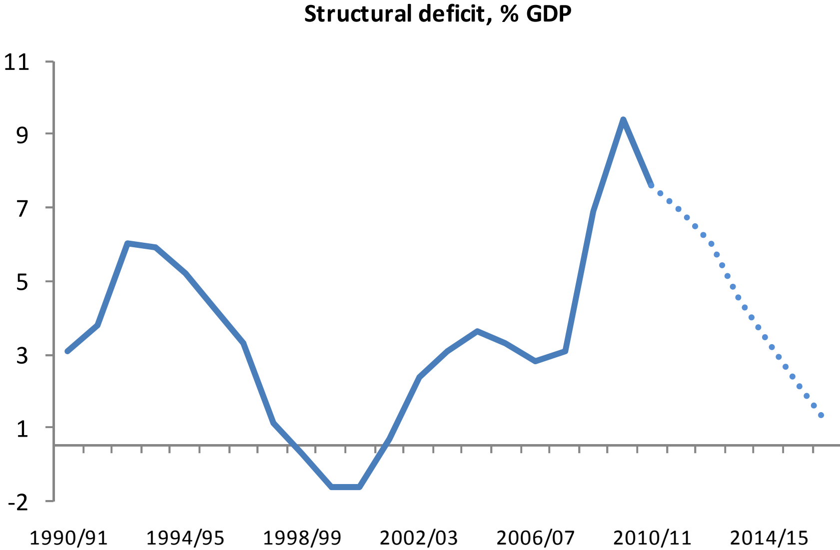
The distinction is important as the "headline" borrowing figures may mask underlying trends unless the economy's position in the economic cycle is taken into consideration. Estimating how much of the deficit is cyclical and how much is structural is far from easy. This requires an assessment of where the economy is in the economic cycle. It can be difficult to determine where the economy is in relation to its "trend" level of output. This is particularly the case when the economy is coming out of recession as it requires a calculation of how much of the lost output is purely cyclical and how much is permanent. These problems mean that estimates of the structural deficit need to be treated with a degree of caution.

This means that changes in the economy's trend or potential level of output can have significant consequences for the structural measures of borrowing. A downward revision to the level of trend growth means that more borrowing is structural. The OBR revised down its view of potential output in its November forecast:

> We have also revised down our estimate of the level of potential output in 2015-16 as set out in Chapter 3. This has important implications for the 'structural' or cyclically-adjusted measures of the deficit. It implies that less of the deficit will disappear automatically as the economy recovers, pushing up revenues and reducing spending.[22]

[22] OBR, Economic and fiscal outlook, November 2011, para 4.14

The structural deficit was around 2-3% of GDP immediately before the financial crisis. It increased to nearly 9% of GDP in 2009/10. The OBR forecasts structural borrowing of 6.4% of GDP this year. It is then forecast to fall to 0.6% of GDP by 2016/17.



The IFS forecasts for the structural deficit are similar to the OBR's for the next few years. The IFS forecast a slightly lower structural deficit in 2015/16 and 2016/17.

Structural deficit

Cyclically-adjusted public sector net borrowing

% GDP

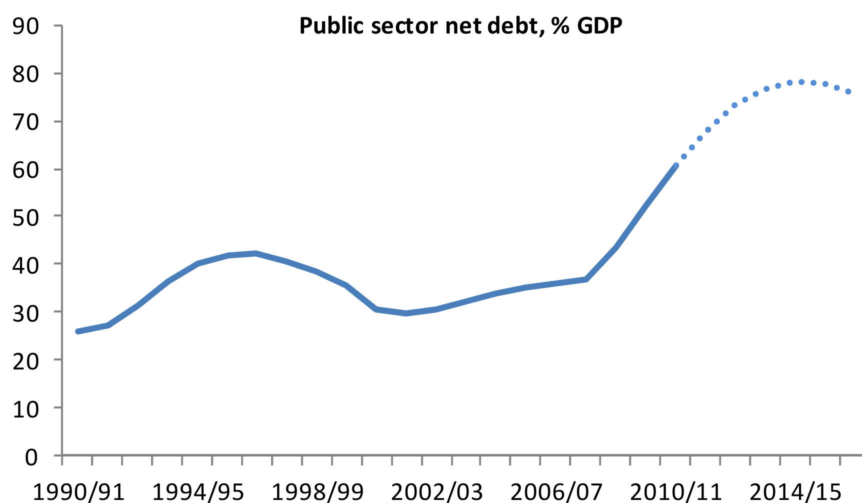
	Outturn	OBR forecast	IFS forecast
2006/07	2.3	..	..
2007/08	2.6	..	..
2008/09	6.4	..	..
2009/10	8.9	..	..
2010/11	7.1	..	..
2011/12	..	6.4	6.2
2012/13	..	5.5	5.6
2013/14	..	4.0	3.9
2014/15	..	2.8	2.6
2015/16	..	1.7	1.2
2016/17	..	0.6	0.0

Sources: HM Treasury, Public finances databank, , Table A1
OBR Economic and fiscal forecast, November 2011, Table 4.27
IFS Green Budget 2012, Table 4.3

4.4 Public sector net debt

Public sector net debt exceeded £1 trillion at the end of in 2011. The OBR forecast is that debt will reach £1,044 billion (67.5% of GDP) this year. Immediately before the financial crisis, public sector debt was around half this level: just under £500 billion or around 36% of GDP in 2006/07. The OBR forecasts that debt will continue to grow as a share of GDP until

2014/15 when it is forecast to reach 78%. It is then forecast to fall for the following two years. The IFS forecast is very similar to that of the OBR.



Public sector net debt

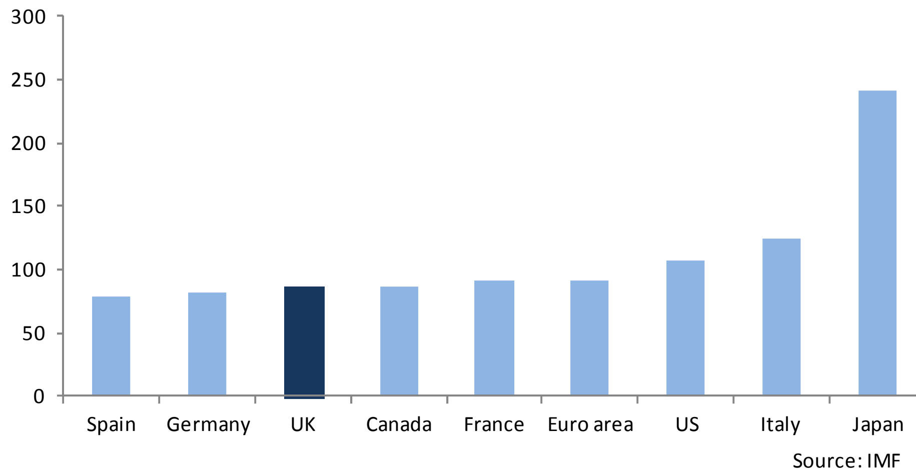
	Outturn £bn	OBR forecast £bn	Outturn % GDP	OBR forecast % GDP	IFS forecast % GDP
2006/07	497.8	..	35.9	..	..
2007/08	527.2	..	36.7	..	..
2008/09	606.8	..	43.5	..	..
2009/10	760.3	..	52.5	..	..
2010/11	905.3	..	60.5	..	..
2011/12	..	1,044	..	67.5	67.4
2012/13	..	1,182	..	73.3	73.3
2013/14	..	1,300	..	76.6	76.6
2014/15	..	1,397	..	78.0	77.8
2015/16	..	1,470	..	77.7	77.1
2016/17	..	1,515	..	75.8	74.7

Sources: ONS, Public sector finances Statistical Bulletin, January 2012
OBR, Economic and fiscal outlook, November 2011, Table 4.27
IFS Green Budget 2012, Table 4.3

Debt interest payments are forecast to increase from £47.6 billion in 2011/12 to £65.5 billion in 2016/17.

The UK's level of public sector debt is low compared with other G7 economies. As the chart below shows, the UK's level of debt is similar to that of Germany, France and the Eurozone but below the US, Italy and Japan.[23] Estimates for a wider range of countries are in Appendix 2.

[23] The chart shows a gross measure of debt whereas the OBR and IFS figures for the UK are for net debt.



Government gross debt, % GDP

	2008	2009	2010	2011	2012	2013
UK	**52.5**	**68.4**	**75.1**	**80.8**	**86.6**	**90.3**
US	76.1	89.9	98.5	102.0	107.6	112.0
France	68.3	79.0	82.4	87.0	90.7	93.1
Germany	66.7	74.4	83.2	81.5	81.6	79.8
Italy	105.8	115.5	118.4	121.4	125.3	126.6
Spain	39.9	53.6	60.8	70.1	78.1	84.0
Japan	196.2	216.3	219.0	233.4	241.0	246.8
Canada	71.1	83.6	85.1	85.5	86.7	84.7
Euro area	69.8	79.4	85.3	88.4	91.1	92.5

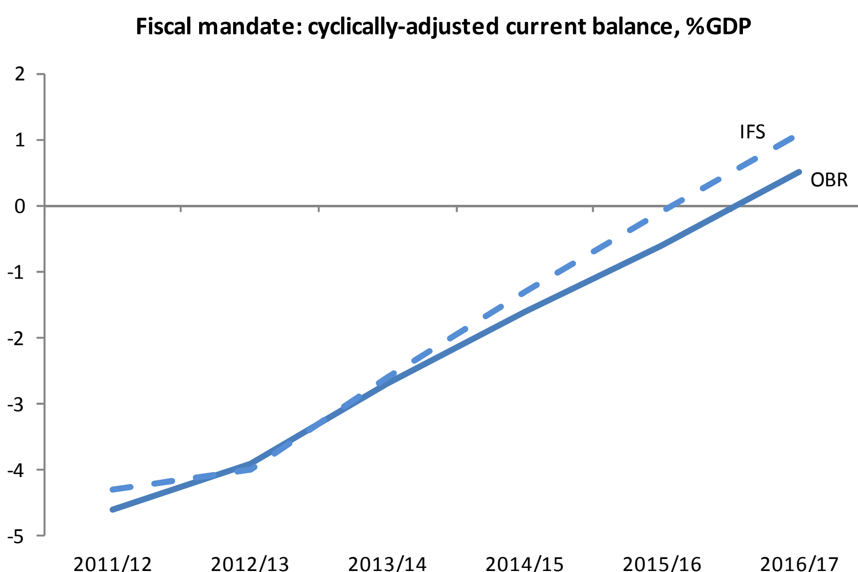
Source: IMF Fiscal Monitor Update, January 2012

4.5 The fiscal mandate

The Government announced its "fiscal mandate" in the June 2010 Budget. The mandate requires the cyclically-adjusted current budget to be balanced by the end of a rolling five year period, currently 2016/17. A cyclically-adjusted (or "structural") measure is used as this removes the effect of the economic cycle and thus gives a better indication of the underlying state of the public finances. The mandate also gives some protection to capital spending as the current balance excludes net investment spending.

The OBR assesses the Government's chances of meeting the fiscal mandate. The borrowing target will be met on the basis of the OBR's November forecast, as shown in the chart below.[24] On the OBR's forecast, the cyclically-adjusted current balance moves into a surplus of 0.5% of GDP in 2016/17 compared with a deficit of 4.6% in 2011/12. The IFS's Green Budget forecasts are slightly more optimistic, showing a surplus of 1.1% of GDP in 2016/17.

[24] In the chart, negative figures indicate a deficit, positive figures a surplus.



The Government also has a supplementary target for public sector debt. This requires public sector net debt to fall as share of GDP at the fixed date of 2015/16. According to the Treasury, this target ensures that the public finances are restored to a sustainable path. This target is met on both the OBR and the IFS forecasts.

In its November assessment of the Government's chances of meeting its fiscal rules, the OBR noted that the Government would have had a less than 50% chance of meeting the rules without the additional policy measures announced in the 2011 Autumn Statement.[25] The Government has also lost some room for manoeuvre compared with the OBR's March 2011 forecast. In March, the OBR forecast that the Government was on target to meet its fiscal targets a year early. This is no longer the case on the OBR's latest forecast published in November. The main reason why the borrowing target is no longer met early is the downward revision to the level of potential GDP.

[25] OBR, Economic and fiscal outlook, November 2011, para 5.2

4.6 The balanced budget multiplier

Not all fiscal changes are created equal

The forthcoming Budget will take place in the context of two fundamental and seemingly competing policy objectives: to increase the rate of economic growth while sticking to a credible programme of austerity to reduce the fiscal deficit.

A major tax cut or additional spending programme would, all other things being equal, be expected to boost aggregate demand and increase economic growth. However, it would act to increase the deficit.

However, not all taxes and areas of Government spending have the same impact on the wider economy. Some expansionary fiscal policy changes can have a greater positive effect on aggregate demand than an accompanying contractionary policy of the same value. The Chancellor can therefore stimulate the economy without any net cost to the Exchequer. This theory is known as the **balanced budget multiplier**.

This concept has led to economists considering how the Budget might juggle tax and spending decisions to promote growth. A target for potential tax increases is money that would otherwise be removed from economic circulation. Saving is the archetypal example. In the short run, money saved is money not consumed and therefore acts, all other things being equal, to reduce economic growth. Taxing saving is likely to have a limited contractionary effect. Hence pensions tax relief and ISAs have been in the crosshairs.

Such measures could be combined with spending increases or tax cuts of equivalent value that provide a large boost to aggregate demand. Government investment in infrastructure is widely held to have substantial knock-on, or “multiplier”, effects on the wider economy. For example, a major infrastructure scheme would generate construction demand, in turn creating jobs locally and increasing demand in other industries through supply chain effects. Newly employed builders would spend their earnings in shops, and so on.

An alternative is tax cuts for individuals or businesses with high propensities to spend or invest. A common example is tax cuts for those on low incomes. Such people have a high marginal propensity to consume. Give someone on a low income an extra £10 and they are likely to spend it, while a person on a high income may save some or all of it.

Of course, such policy decisions are highly political as well as economic. The impact of all fiscal changes is uncertain, they have (often unwanted) wider and long-term impacts and cost money to administer. However, the Chancellor is not left with a simple choice between reducing the deficit and promoting growth.

5 Personal taxation : prospects for reform

It is an annual tradition that in the days before the Budget many commentators will make predictions of the content of the Chancellor's speech.[26] There has been a considerable amount of speculation over the 2012 Budget, in part due to press reports of the views of even some senior members of the Coalition Government as to what it should include.[27] It has been suggested that this trend threatens an end to the process known as 'Budget purdah' – where draft proposals for tax changes are kept secret and public discussion by Ministers about an upcoming Budget is strictly avoided.[28]

Clearly there are very good reasons for secrecy in this area – where advance notice of tax changes risks 'forestalling' – actions by taxpayers to avoid the consequences of any change in law, undercutting its purpose. In its first Budget the Coalition Government published a paper on tax policy setting out a number of proposals to strengthen "predictability, stability and simplicity in the tax system"[29] – and an illustration of this new approach has been the department's practice in publishing most of the annual Finance Bill in draft for consultation. However, the IFS for one has argued that while this is welcome, "we start from a rather poor position. There has been a long tradition of governments failing to state a strategy in the field of tax policy. Chancellors have taken rather a delight in producing rabbits from hats rather than setting out longer-term directions."[30]

The most famous example of a breach in Budget purdah was in 1947 when the then Chancellor Hugh Dalton revealed key details of the Budget in a conversation with a member of the press lobby minutes before delivering the speech. Some details were published in an afternoon edition of The Star newspaper before Dalton got to this point in his statement and although a Select Committee inquiry went on to find no evidence of Stock Market traders profiting from the leak, Dalton resigned the next day.[31]

Barring an indiscretion of Dalton-esque proportions, Members, journalists and the public at large will have to wait for Budget day itself to know for certain. That said there are two aspects of personal taxation which the Chancellor is anticipated to address: the level of the personal tax allowance, and the future of the additional 50p rate of income tax.

5.1 Income tax personal allowance

All individuals are entitled to a personal allowance which they can set against their liability to income tax. Income tax legislation requires that the personal allowance – as well as the other main tax allowances and tax thresholds – should rise each year in line with inflation, unless Parliament determines otherwise.[32] Over the last twenty years the general pattern

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[26] For a general description of the Budget and the legislative process for implementing the measures set out in the speech see, *The Budget and the annual Finance Bill*, Library standard note SN/BT/813, 10 May 2011.

[27] For example, "Boost taxes on rich, says Clegg" & "The Chancellor's choice", *Financial Times*, 26 January 2012 & 13 March 2012

[28] "The Budget starter list (the usual starting point for the budget process listing all the options potentially on the table) normally carries a Treasury SECRET classification. This time, it is all over the press cuttings. And no one needs to be calling in the police for a leak enquiry" *The strange death of Budget purdah*, blog post by Jill Rutter at the Institute of Government, 12 March 2012

[29] HM Treasury/HM Revenue & Customs, *Tax policy making: a new approach*, June 2010 p3

[30] "Defining a tax strategy", in *The IFS Green Budget 2011*, February 2011 p222. In their 2012 Green Budget the IFS recalled their appeal for "a comprehensive strategy for the tax system as a whole", remarking, "we still await one" ("Tax reform and growth", in *The IFS Green Budget 2012*, February 2011 p179).

[31] *Report from the Select Committee on the Budget Disclosure*, 11 December 1947 HC 20 1947-48

[32] see, *Direct taxes : rates and allowances 2011/12*, Library Research paper 11/30, 6 April 2011 pp3-4

has been for the allowance to be increased in line with this rule, or by more than inflation.[33] In the Coalition Agreement the Government stated that setting the personal allowance at £10,000 was a long-term objective, and that making increases in the allowance each year would be given priority over other tax cuts. The allowance has been increased in two successive tax years: by £1,000 to £7,475 for 2011/12, and by a further £630 to £8,105 for 2012/13 – at a combined cost of nearly £5 billion a year.[34]

Increasing this allowance by £100 above inflation costs around £490 million a year, so that further steps toward £10,000 would cost considerable amounts of money.[35] To mitigate the cost of the last two increases in the allowance, the Government made two reductions in the basic rate threshold – the point at which taxpayers start to pay the 40% higher rate. Clearly one option would be to make further reductions in this threshold, so that higher rate taxpayers saw no benefit from an increased personal allowance. The IFS has estimated that this would cut the Exchequer cost of moving to a £10,000 allowance from £5.3bn to £3.3 billion in 2015/16. However, cutting the basic rate threshold increases the number of individuals who are higher-rate taxpayers, and – under current policy proposals – increases the number of families who would lose child benefit from January 2013.[36] The IFS go on to note that a £10,000 allowance would be of no benefit for those whose incomes are not high enough to pay income tax anyway – which is more than a third of the adult population.

5.2 The 50p tax rate

Mr Osborne is also expected to address the future of the 50p additional rate paid by individuals on incomes above £150,000, which was introduced from April 2010. When first proposed by the Labour Government in its 2009 Budget, the 50p rate was anticipated to raise £1.3 billion in 2010/11, rising to £3.05 billion in 2011/12. 275,000 individuals were projected to pay the 50p rate in 2010/11, compared to the total taxpayer population of 30.5 million.[37] In his Budget last year, Mr Osborne underlined his view that the 50p rate "would do lasting damage to our economy if it were to become permanent" and said he had asked HM Revenue & Customs to review "how much revenue it actually raises."[38]

Over the last few months, there has been a great deal of debate over the 50p rate, much of it in response to a letter published in September 2011 in the *Financial Times*, signed by several leading economists, arguing that the 50p rate should be dropped "at the earliest opportunity as part of a package of measures to stimulate growth."[39] The deadline for individuals completing their tax returns for 2010/11 was 31 January 2012, so the department will have had several weeks to process this data. It is worth underlining that as detailed as this may be, this can, at best, be a partial guide to how much the higher rate might raise in

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[33] HL Deb 7 January 2010 c121WA. HM Revenue & Customs give historical details on the structure and parameters of income tax at: http://www.hmrc.gov.uk/stats/tax_structure/menu.htm

[34] The combined cost of these two increases is estimated to be £4.6bn in 2012/13, rising to £5.1bn by 2015/16: HC 836 March 2011 (Table 2.1 – item 22 & Table 2.2 – item ad).

[35] This £490m figure is for 2011/12: HMRC *National Statistics: Tax Expenditures & Ready Reckoners* – Table 1.6: Direct effects of illustrative changes, December 2011. These estimates ignore behavioural changes, so that calculations which involve multiplying these estimates need to be treated with some caution.

[36] The IFS estimate that cutting the basic rate threshold this way would see around 600,000 more higher rate taxpayers, and about 200,000 more families with children losing child benefit because an adult in that family had become a higher rate taxpayer: "A £10,000 personal allowance", *IFS Observations*, 8 March 2012.

[37] HC Deb 22 April 2009 c244; HC 451 March 2010 p140 (Table A11 : item l); HMRC, *Income Tax Liabilities Statistics*, April 2011 p16

[38] HC Deb 23 March 2011 c957. See also, HC Deb 14 September 2011 c1191W

[39] "Letters: Government must abolish 50p tax rate to grow UK economy", *Financial Times*, 7 September 2011 – see also, "Debate goes on in wake of 20 economists' letter to the FT : Q&A", 8 September 2011

future years – not least because of the other factors at play in the wider economy affecting the remuneration of those on the highest incomes.[40]

5.3 Revenue raising measures

Clearly further increases in the personal allowance, or a cut in the additional rate of tax, would have serious revenue implications. In turn this has lead to much speculation about the ways in which the Chancellor might raise significant sums of money – most often in relation to the tax treatment of pensions and pension saving.[41] This is explored in a little more detail below. Further to this, there has been also been debate that the Chancellor should look to reform the nature of personal taxation, seeing a shift from taxing income to taxing wealth: possibly through changes in existing taxes on property (council tax or stamp duty) or in the form of new taxes (such as the proposal made for a 'mansion tax' in the Liberal Democrats' 2010 election manifesto) or wealth more generally.[42]

Personal taxation: prospects for reform – the case of pensions tax relief

Generally contributions made by an individual into their pension are not treated as part of their income for tax purposes.[43] (Contributions do not qualify for relief from National Insurance contributions in this way). In effect, individuals will receive tax relief on their contributions at their marginal tax rate. A number of commentators have argued that this means higher rate tax payers benefit disproportionately from the current system of tax relief. The main limits that apply are the annual allowance and the lifetime allowance (£50,000 and £1.8 million in 2011/12, respectively).

In Budget 2009, the Labour Government said that those on the highest incomes already benefitted disproportionately from tax relief on pension contributions and that this would be exacerbated by the introduction of the new 50p tax rate from April 2010. To address this, it proposed to restrict the tax relief on contributions to people with incomes over £150,000, with effect from April 2011. Following consultation, it introduced reforms in the *Finance Act 2010.* Representatives of the pension industry were concerned at the complexity of the approach adopted and argued that it would have been better to use one of the existing levers in the system – for example, by reducing the annual allowance.

In the June 2010 Budget, the Chancellor announced that he would work with industry on alternative ways of raising the same revenue, potentially by reducing the Annual Allowance. In October 2010, he announced that the annual allowance would be reduced to £50,000 from April 2011 and the lifetime allowance to £1.5 million from April 2012. Legislation to implement this change was included in the *Finance Act 2011*. More recently there has been speculation as to whether the Government might consider further reductions in the value of tax relief on contributions,[44] in part as a way to increase revenues from the 50p rate, though in their 2012 Green Budget the IFS suggested that limiting the value of the tax-free lump sum, paid on retirement, was an alternative:[45]

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40 The debate is examined in depth in, *Income tax: the new 50p rate*, Library standard note SN00249, 3 February 2012

41 For example, "High earners' pension relief targeted", *Financial Times*, 14 February 2012

42 See, for example, "Leader: Wealth of the Nation", *Times*, 24 February 2012 & "Editorial: George Osborne's taxing trade-offs", *Financial Times*, 7 March 2012

43 A basic explanation of the tax treatment of pensions and pension saving is given in, *Tax and private pensions*, Library standard note SN00625, 14 February 2012.

44 For example, "Laws joins call to cut pension tax relief", *Financial Times*, 21 February 2012

45 "The 50p income tax rate: what is known and what will be known?", *The 2012 Green Budget*, Institute for Fiscal Studies February 2012 p194

> Further restrictions to tax relief on pension contributions, perhaps by restricting relief to the basic rate, might also increase revenue.[46] But this would introduce a set of different problems and inequities and would not, in general, be desirable in the context of wanting an efficient and equitable tax system. A better way of reducing the generosity of the tax treatment of private pensions might be to limit the total amount that can be taken as a tax-free lump sum on retirement.[47]

Some basic statistics on the cost of pensions relief are given below. More details on these issues are given in two Library notes: *Restricting pension tax relief* and *Pension lump sums*.

Pensions tax relief statistics

Provisional data on the cost to the Exchequer of pensions tax relief have been published up to 2010/11.[48] This pre-dates reductions in the annual and lifetime allowances. The table below shows data since 2007/08:

[46] Restricting tax relief to the basic rate would significantly weaken the incentive for higher-income individuals to save in a pension, particularly if this were not accompanied by only taxing pension income at the basic rate. It would also be administratively difficult for those in defined-benefit schemes. For a fuller discussion of this policy, see S. Adam, M. Brewer, J. Browne and D. Phillips, 'Taxes and benefits: the parties' plans', *IFS Briefing Note 100*, 2010.

[47] Current total pension contribution limits mean that up to £375,000 can be taken as a tax-free lump sum on retirement. Income taken in this way escapes income tax both at the point it is earned and at the point of withdrawal. Reducing this limit would neither penalise saving as opposed to immediate consumption nor significantly reduce the attractiveness of saving for a pension.

[48] HMRC table PEN6

Cost of tax relief: registered pension schemes[1]
£ million at current prices to nearest £100 million

	2007-08	2008-09	2009-10[p]	2010-11[p]
Relief for				
Occupational Scheme Contributions				
By Employees	4,400	4,200	3,800	4,000
By Employers	15,100	14,100	15,600	16,500
Personal Pension Scheme Contributions				
By Employees	1,900	2,000	1,800	1,800
By Employers	2,500	2,500	2,500	2,900
Contribution to PPs and RACs by self employed	1,300	1,000	800	800
Total contributions	*25,200*	*23,800*	*24,500*	*26,000*
Investment income of funds[2]	5,600	6,000	7,300	6,800
Total reliefs	**30,700**	**29,700**	**31,800**	**32,900**
Less tax liable on				
Pension payments[3] and fund surplus refunds to employers	9,200	8,700	8,500	9,000
Total	**21,600**	**21,000**	**23,300**	**23,900**

PP = Personal Pension; RAC = Retirement Annuity Contract; p = provisional

1. The cost of tax relief is calculated as the tax that w ould be paid if comparing the pensions tax regime for registered pension schemes w ith the tax regime w e have for most other forms of saving.
2. The cost of relief on investment income is for both Occupational and Personal Pensions schemes funds; it is not possible to provide reliable estimates distinctly. The estimate assumes relief at the basic rate of tax. Estimates of relief for capital gains realised by pension funds are not included because of estimation difficulties.
3. Assuming that pension payments represent the top slice of taxable income.
Source: HMRC National Statistics table PEN6

- HMRC estimates that the overall cost of pensions tax relief was approximately £24 billion in 2010/11. This takes into account the £9 billion tax paid on pension payments.
- Pension contributions by employees, employers and the self-employed received combined relief of £26 billion in 2010/11.

It is important to bear in mind that the cost of a relief is unlikely to be the same as the potential yield from its removal. The removal of a relief would have behavioural effects as individuals changed their saving and investment decisions in response.

The Government estimates that its reductions in the annual and lifetime allowances will raise around £4 billion per year in a steady state compared with the pre-existing relief structure.[49]

Relief on contributions by income band
Estimates of the proportion of tax relief on pension contributions have been published in response to PQs.[50] These are shown in the table below:

[49] For example, HC Deb 14 Oct 2010 c25-6WS
[50] HC Deb 18 Jul 2011 c541W and HC Deb 20 Feb 2012 c643W

Tax relief on pension contributions by income band

Estimated percentage of total

Income bands	2009-10	2010-11	2011-12	2012-13
£0-£19,999	8	7	7	6
£20,000-£44,999	31	29	31	30
£45,000-£74,999	27	26	31	32
£75,000-£99,999	8	7	8	8
£100,000-£149,999	8	8	8	8
over £150,000	18	22	15	15
All	100	100	100	100

Sources: HC Deb 18 Jul 2011 c541W and HC Deb 20 Feb 2012 c643W

- In 2010/11, individuals with incomes of over £150,000 accounted for around 22% of tax relief on pension contributions. By 2012/13 this proportion is expected to fall to around 15%, partly reflecting the reductions in the annual and lifetime allowances.
- The proportion of tax relief on pension contributions accounted for by people with incomes over £45,000 is expected to stay almost constant at just over 60% over the four year period.

6 Appendix 1: Economic and public finance data since 1979

Economic data, 1979-2016

	Real GDP growth %	Inflation RPI % (a)	Inflation CPI % (b)	ILO Unemployment thousands (a)	ILO Unemployment % (a)
1979	2.7	13.4	..	1,432	5.4
1980	-2.1	18.0	..	1,833	6.8
1981	-1.3	11.9	..	2,609	9.6
1982	2.1	8.6	..	2,875	10.7
1983	3.6	4.6	..	3,081	11.5
1984	2.7	5.0	..	3,241	11.8
1985	3.6	6.1	..	3,151	11.4
1986	4.0	3.4	..	3,160	11.3
1987	4.6	4.2	..	2,940	10.4
1988	5.0	4.9	..	2,445	8.6
1989	2.3	7.8	5.2	2,082	7.2
1990	0.8	9.5	7.0	2,053	7.1
1991	-1.4	5.9	7.5	2,530	8.9
1992	0.1	3.7	4.3	2,822	9.9
1993	2.2	1.6	2.5	2,929	10.4
1994	4.3	2.4	2.0	2,676	9.5
1995	3.1	3.5	2.6	2,436	8.6
1996	2.9	2.4	2.5	2,296	8.1
1997	3.4	3.1	1.8	1,988	6.9
1998	3.8	3.4	1.6	1,788	6.2
1999	3.7	1.5	1.3	1,727	6.0
2000	4.5	3.0	0.8	1,587	5.4
2001	3.2	1.8	1.2	1,489	5.1
2002	2.7	1.7	1.3	1,529	5.2
2003	3.5	2.9	1.4	1,490	5.0
2004	3.0	3.0	1.3	1,426	4.8
2005	2.1	2.8	2.1	1,467	4.9
2006	2.6	3.2	2.3	1,674	5.4
2007	3.5	4.3	2.3	1,654	5.3
2008	-1.1	4.0	3.6	1,783	5.7
2009	-4.4	-0.5	2.2	2,394	7.7
2010	2.1	4.6	3.3	2,479	7.8
2011	0.8	5.2	4.5	2,560	8.1
2012	0.7	2.8	2.7	2,800	8.7
2013	2.1	3.0	2.1	2,700	8.4
2014	2.7	3.2	2.0	2,500	7.8
2015	3.0	3.7	2.0	2,200	6.8
2016	3.0	3.9	2.0	1,900	5.9

Sources: ONS (series ABMI, CZBH, D7G7, MGSC, MGSX)
OBR Economic and fiscal outlook, November 2011, Table 3.1 and Economy Supplementary tables

Notes: (a) outturns are calendar years, forecasts are Q4
(b) CPI estimated before 1997

Public finance data: 1979/80 to 2016/17

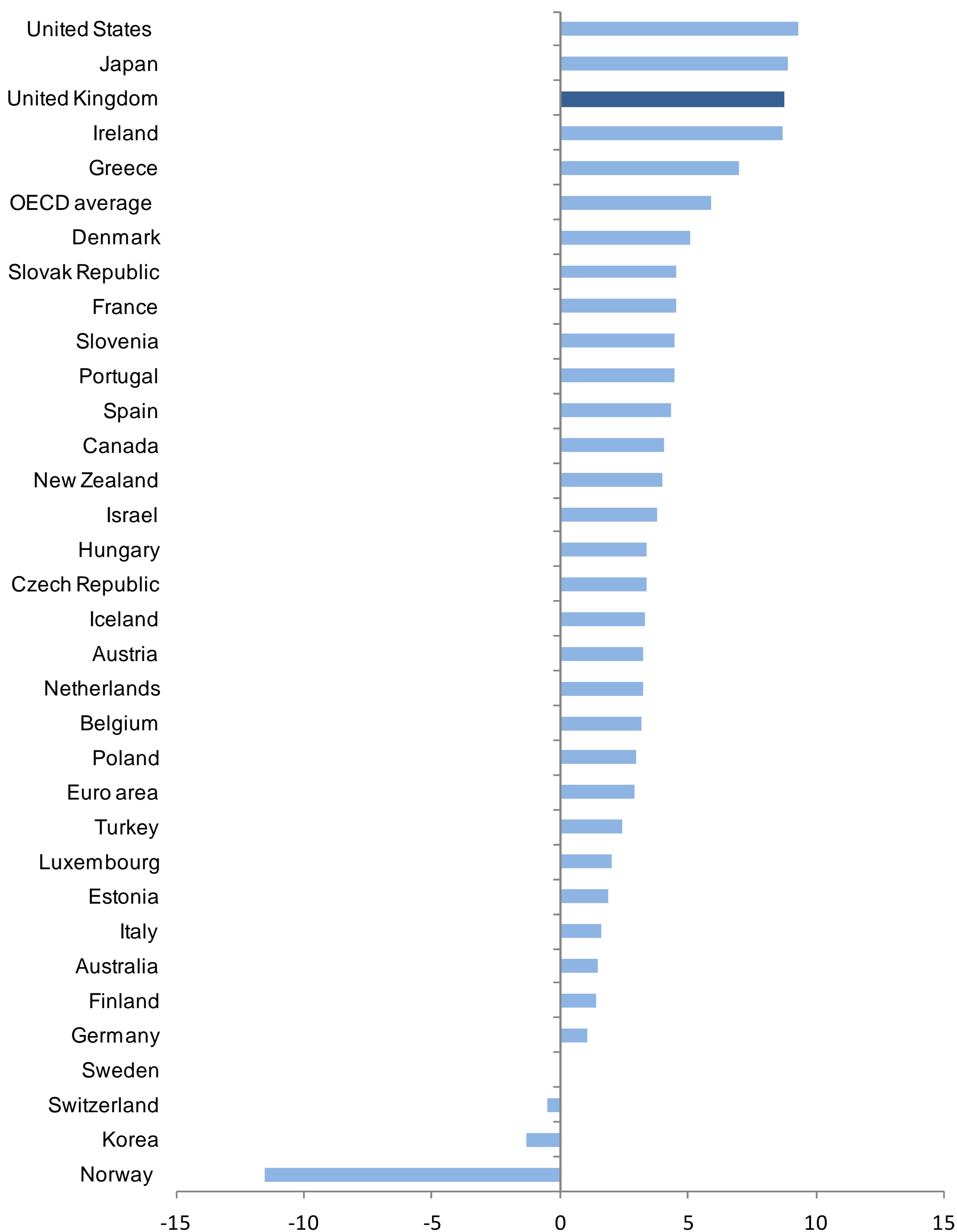
	Public sector net borrowing (a)		Structural borrowing (b)	Public sector net debt (a)		Debt interest payments (c)	
	£ billion	% GDP	% GDP	£ billion	% GDP	£ billion	% GDP
1979/80	8.5	4.1	4.0	98.2	44.0	7.6	3.6
1980/81	11.5	4.8	3.4	113.8	46.1	9.2	3.8
1981/82	6.0	2.3	-1.5	125.2	46.1	11.2	4.3
1982/83	8.5	3.0	-1.4	132.5	44.8	12.1	4.2
1983/84	11.7	3.8	0.0	143.8	45.1	13.2	4.2
1984/85	12.3	3.7	0.6	157.2	45.1	14.7	4.4
1985/86	8.8	2.4	0.6	162.7	43.2	16.6	4.5
1986/87	8.1	2.0	1.9	167.8	40.9	17.2	4.3
1987/88	4.4	1.0	2.2	167.4	36.6	18.4	4.2
1988/89	-6.3	-1.3	1.3	153.9	30.4	19.0	3.9
1989/90	-1.0	-0.2	2.6	152.2	27.5	19.8	3.7
1990/91	5.8	1.0	2.6	151.3	26.0	19.5	3.4
1991/92	22.6	3.7	3.3	166.1	27.2	17.5	2.9
1992/93	46.7	7.4	5.5	201.9	31.4	18.4	2.9
1993/94	51.0	7.7	5.4	249.8	36.5	20.1	3.0
1994/95	43.3	6.2	4.7	290.0	40.1	22.8	3.2
1995/96	34.7	4.7	3.8	322.1	41.9	26.1	3.5
1996/97	27.1	3.4	2.8	347.2	42.4	27.6	3.5
1997/98	5.8	0.7	0.6	352.0	40.5	29.2	3.5
1998/99	-4.5	-0.5	-0.2	350.7	38.4	28.7	3.2
1999/00	-15.5	-1.6	-1.1	344.4	35.6	25.0	2.6
2000/01	-18.3	-1.9	-1.1	311.1	30.7	26.0	2.6
2001/02	-0.2	0.0	0.2	314.3	29.7	22.0	2.1
2002/03	25.1	2.3	1.9	346.0	30.8	20.9	1.9
2003/04	33.0	2.9	2.6	381.5	32.1	22.3	1.9
2004/05	39.8	3.3	3.1	422.1	34.1	23.9	2.0
2005/06	37.4	2.9	2.8	461.7	35.3	25.8	2.0
2006/07	30.9	2.3	2.3	497.8	35.9	27.6	2.0
2007/08	34.0	2.4	2.6	527.2	36.7	30.0	2.1
2008/09	96.5	6.8	6.4	606.8	43.5	30.3	2.1
2009/10	155.8	11.1	8.9	760.3	52.5	30.2	2.1
2010/11	135.8	9.2	7.1	905.3	60.5	42.8	2.9
2011/12	127	8.4	6.4	1044	67.5	47.6	3.1
2012/13	120	7.6	5.5	1182	73.3	47.1	3.0
2013/14	100	6.0	4.0	1300	76.6	50.5	3.1
2014/15	79	4.5	2.8	1397	78.0	56.1	3.2
2015/16	53	2.9	1.7	1470	77.7	61.7	3.3
2016/17	24	1.2	0.6	1515	75.8	65.5	3.4

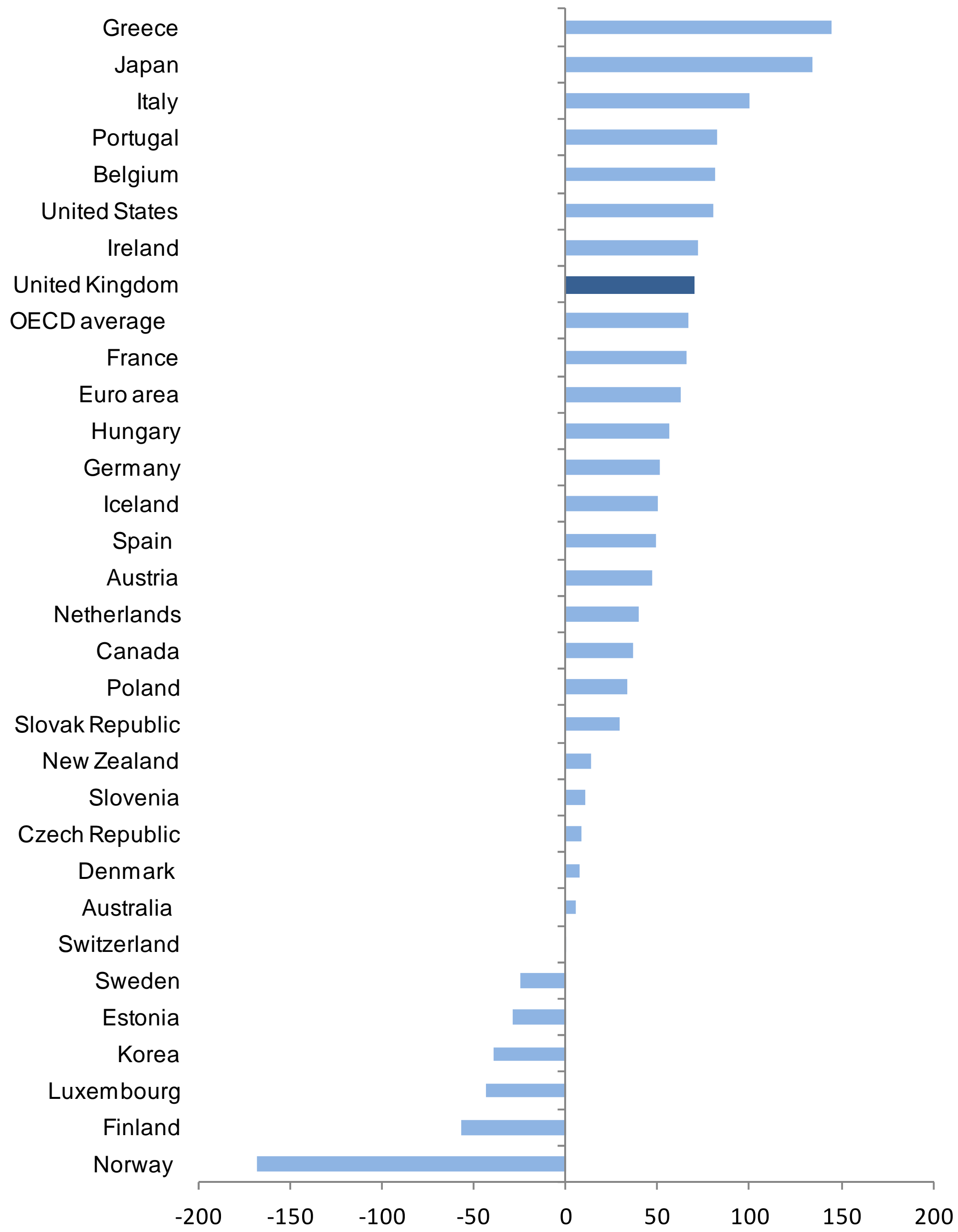
Sources: ONS, HM Treasury Public finances databank A1, OBR Economic and fiscal outlook, November 2011, Table 4.27

Notes: (a) borrow ing and debt figures exclude temporary effect of financial sector interventions
(b) cyclically-adjusted public sector net borrow ing
(c) central government gross debt interest payments

7 Appendix 2: International comparisons of government borrowing and debt

The charts below are taken from the December 2011 edition of the OECD's Economic Outlook. Data for other years are in Annex tables 27 (borrowing) and 33 (debt).





General Government Net Debt, OECD countries % GDP, 2012
Greece
Japan
Italy
Portugal
Belgium
United States
Ireland
United Kingdom
OECD average
France
Euro area
Hungary
Germany
Iceland
Spain
Austria
Netherlands
Canada
Poland
Slovak Republic
New Zealand
Slovenia
Czech Republic
Denmark
Australia
Switzerland
Sweden
Estonia
Korea
Luxembourg
Finland
Norway
-200
-150
-100
-50
0
50
100
150
200

8 Appendix 3: Links to further information

HM Treasury

Budget 2012

Budget 2011

Autumn Statement 2011

Public finance databank

Forecasts for the UK economy: a comparison of independent forecasts

Office for Budget Responsibility

Economic and fiscal outlook, November 2011

Institute for Fiscal Studies

IFS Green Budget 2012

IFS Observations: A £10,000 personal allowance: who would benefit and would it boost the economy? By James Browne, March 2012

House of Commons Library

Economic Indicators Research Paper (an updated version will be published on 20 March – the day before the Budget)

(external users : http://www.parliament.uk/topics/Economic-situation.htm)

Restricting pension tax relief, Library standard note SN05901, 15 February 2012

Pension lump sums, Library standard note SN02181, 3 February 2012

Child benefit for higher rate taxpayers, Library standard note, SN05732, 3 November 2010

The eurozone crisis – rescuing Greece, Library standard note SN06232, 23 February 2012

Treasury Select Committee

http://www.parliament.uk/business/committees/committees-a-z/commons-select/treasury-committee/

9 Appendix 4: Tax measures in the Coalition Agreement

The Government set out its priorities for taxation in the Coalition Agreement, published in May 2010. On its overall approach this stated: "the Government believes that the tax system needs to be reformed to make it more competitive, simpler, greener and fairer. We need to take action to ensure that the tax framework better reflects the values of this Government."[51] In their first Budget in June 2010, the Government announced that it would introduce two Finance Bills in 2010: the first, in a matter of days, limited to its key priorities (such as raising the standard rate of VAT to 20%), the second, in the autumn, given over to a series of technical measures which the Labour Government had planned to introduce in the March 2010 Budget, but had decided to postpone until after the Election.[52] The first of these Bills had its second reading on 6 July and received Royal Assent at the end of that month.[53] Draft legislation for the second Bill was published at this time; the Bill had its second reading on 11 October, and received Royal Assent – as the *Finance (No3) Act 2010* – on 16 December.

Although HM Revenue & Customs have often published individual draft clauses to be included in a future Finance Bill, many tax practitioners have argued that far too little of the annual Bill is released in draft form, and the timetable for Parliamentary scrutiny for tax legislation is too short to avoid mistakes being made. Alongside the June 2010 Budget the Government published a paper on its approach to tax policy, proposing that in future nearly all of the Finance Bill would be realised in draft three months before formal publication, subject to certain exceptions.[54] In December 2010 the Treasury published a large amount of draft legislation constituting the majority of the clauses to be included in the Finance Bill after the 2011 Budget; in a statement the Exchequer Secretary David Gauke announced "this practice will become an established feature in the tax policy making cycle." Alongside the draft clauses the department published a series of 'tax information and impact notes', which, as the Minister explained, set out "for each draft clause, the proposed change, why we seek the change and what we expect the impacts to be."[55] In turn the Government published draft legislation for the 2012 Finance Bill on 6 December 2011,[56] and has confirmed that following the Budget on 21 March, the Finance Bill will be published a few days later, on 29 March.[57]

This table gives a checklist of tax measures in the Coalition agreement, indicates if they have been implemented in either of the Government's first two Budgets and if not, whether the Government has given some other indication of how and when this measure might be taken forward.

The Treasury collate details on its tax consultations, while HM Revenue & Customs have pages for each Budget and further updates.

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[51] HM Government, *The Coalition: our programme for government*, May 2010 p30

[52] *Budget 2010* HC 61 June 2010 para 2.118. The Budget report itemises these measures in section 2b (pp 54-60).

[53] The Committee considered the Bill on 12,13 & 15 July & gave the Bill its Third Reading on 20 July 2010. The *Finance (No2) Act 2010* received Royal Assent on 27 July.

[54] ie, straightforward changes to rates, allowances and thresholds; revenue protection measures; and areas where forestalling presents a significant risk (HM Treasury, *Tax policy making: a new approach*, June 2010 para 2.11).

[55] HC Deb 9 December 2010 c29WS; see also, HC Deb 15 March 2011 c5WS.

[56] HC Deb 6 December 2011 cc11-12WS. This draft legislation is collated here: http://www.hm-treasury.gov.uk/finance_bill_2012_consultation.htm

[57] HC Deb 10 January 2012 c1WS

Coalition agreement	Budget 2010 HC 61 June 2010	Budget 2011 HC 836 March 2011	Other developments
"We will announce in the first Budget a substantial increase in the personal allowance from April 2011, with the benefits focused on those with lower and middle incomes" p30	Personal allowance increased by £1,000 to £7,475 from April 2011, with reduction in basic rate limit (para 1.93-4).	Confirmation of £1,000 rise in personal allowance (para 1.127). Provision made in s3 of *Finance Act 2011*.	Not applicable.
"We will further increase the personal allowance to £10,000, making real terms steps each year towards meeting this as a longer-term policy objective. We will prioritise this over other tax cuts, including cuts to Inheritance Tax" p30		Personal allowance to be increased by £630 to £8,105 from April 2012, with corresponding reduction in basic rate limit (para 1.127). Confirmation that the inheritance tax nil rate band would remain frozen from 2011/12 to 2014/15 – a decision announced by the Labour Government in its March 2010 Budget (para 2.58).	Income tax rates and allowances for 2012/13 confirmed (including cut in basic rate limit by £630 to £34,370), and draft legislation published.
"The increase in employer National Insurance thresholds proposed by the Conservatives will go ahead in order to stop the planned jobs tax" p30	All rates of NICs to rise by 1% from April 2011, as proposed by Labour Government in March 2010 Budget, while employer threshold to rise by £21 a week in real terms (para 1.66).		Legislation to effect this change - the *National Insurance Contributions Act 2011* - received Royal Assent on 22 March 2011. For details see Library Research papers 10/76 & 10/83.
"We will … ensure that provision is made for Liberal Democrat MPs to abstain on budget resolutions to introduce transferable tax allowances for married couples without prejudice to the coalition agreement" p30	No mention made of transferable allowances in Budget, nor any consultation launched.	No mention made of transferable allowances in Budget, nor any consultation launched.	None

Coalition agreement	Budget 2010 HC 61 June 2010	Budget 2011 HC 836 March 2011	Other developments
"We will reform the taxation of air travel by switching from a per-passenger to a per-plane duty, and will ensure that a proportion of any increased revenues over time will be used to help fund increases in the personal allowance" p30	Confirmation the Government would "explore changes to the aviation tax system, including switching from a per-passenger to a per-plane duty" and any major changes to be "subject to public consultation" (para 1.123).	Decision not to proceed with a per-plane duty "given concerns over the legality and feasibility of this approach" (para 1.153-3). Consultation launched on options to simplify rate structure.	Announcement that current banding structure to be retained, though scope of tax to be extended to business jets from April 2013. Draft legislation published. For details see Library standard note SN05094.
"We will seek ways of taxing non-business capital gains at rates similar or close to those applied to income, with generous exemptions for entrepreneurial business activities" p30	Rate of CGT for higher rate taxpayers to rise from 18% to 28% from 23 June 2010, alongside increase in entrepreneurs relief (para 1.96). Legislation to effect this in s2 & sch1 to *Finance (No 2) Act 2010*.	Additional increase in entrepreneurs' relief from April 2011 (para 2.55). No further changes to tax rates. For details see Library standard note SN05572.	Not applicable
"We will make every effort to tackle tax avoidance, including detailed development of Liberal Democrat proposals" p30	Measures to tackle individual avoidance schemes in *Finance (No2) Act 2010*, and informal consultation on General Anti-Avoidance Rule (GAAR) launched (paras 2.110-6).	Strategy paper, *Tackling Tax Avoidance*, published; measures to tackle individual avoidance schemes (para 1.141-3). Ongoing work of expert study group to explore case for GAAR (HM Treasury press notice 04/11, 14 January 2011).	Recommendation of study group for a narrowly focused GAAR (HC Deb 21 November 2011 cc2-3WS). Government response to be in Budget 2012. Additional anti-avoidance measures for *Finance Bill 2012* (HC Deb 12 January 2012 c17WS, HC Deb 22 February 2012 c77WS & HC Deb 13 March 2012 c11WS)
"We will increase the proportion of tax revenue accounted for by environmental taxes" p31	No discussion or mention of specific tax increases to ensure this.	No discussion or mention of specific tax increases to ensure this.	Answer to PQ HC Deb 17 October 2011 c710W: "The Government are currently finalising their definition of environmental taxes. This will establish a baseline against which the Government's commitment to increase the proportion of revenue from environmental taxes can be measured."

Coalition agreement	Budget 2010 HC 61 June 2010	Budget 2011 HC 836 March 2011	Other developments
"We will take measures to fulfil our EU treaty obligations in regard to the taxation of holiday letting that do not penalise UK-based businesses" p31	Consultation to be launched for reform to rules to be implemented from April 2011 (para 2.85). Consultation launched in July (HC Deb 27 July 2010 cc80-82WS). Government response in December.	New tax rules for furnished holiday letting take effect from April 2011; letting and availability thresholds to be increased from April 2012 (para 2.42). Provision made in schedule 14 of *Finance Act 2011*. For details see Library standard note SN05250.	Not applicable.
"We will review the taxation of non-domiciled individuals" p31	Confirmation that Government "will review" this issue (para 2.30).	Reforms to be made from April 2012 – consultation forthcoming. No other substantive changes to be made "for the remainder of this Parliament" (para 1.133-6).	Consultation launched on both these changes and on a statutory definition of residence (HMT press notice 60/11, 17 June 2011). Draft legislation for reform on non-domicile taxation published, though provision for statutory residence test postponed until April 2013 (HC Deb 6 December 2011 cc13-14WS).
"We will introduce a banking levy and seek a detailed agreement on implementation" p9	New levy based on banks' balance sheets to be introduced from 1 January 2011 (para 1.63).	Levy rates to be amended from 2012 to offset cut in main rate of corporation tax (para 1.90). Provision for levy made in s73 & schedule 19 of *Finance Act 2011*.	Further change to levy rates for 2012 to offset expected yield shortfall announced in Autumn Statement (HC Deb 29 November 2011 c805). For more details see Library standard note SN05251.
"We will review IR 35, as part of a wholesale review of all small business taxation" p10	Confirmation that Government "remain committed" to doing this (para 1.69). New advisory body, the Office of Tax Simplification (OTS) established, and asked to present review of small business taxation in time for 2011 Budget.	Formal response to OTS report includes decision that IR35 rules to be retained as "abolition would put substantial revenue at risk"; HMRC to overhaul their administration of these rules (para 2.203).	IR35 Forum established in May 2011 to monitor department's approach. For more details see Library standard note SN05976. OTS publish final report on simplifying small business taxation in February 2012.

Coalition agreement	Budget 2010 HC 61 June 2010	Budget 2011 HC 836 March 2011	Other developments
"We will reform the corporate tax system by simplifying reliefs and allowances, and tackling avoidance, in order to reduce headline rates" p10	Series of reforms to corporation tax, including cut in main rate by 1% each year from 2011 to 2014 (para 1.61). Rate cut from 28% to 27% for 2011 by s1 of *Finance (No2) Act 2010*. Consultations on Controlled Foreign Company (CFC) regime and taxation of foreign branches.	Further 1% cut in main rate of corporation tax to 26% from April 2011; main rate to be 23% by 2014. New CFC rules to be introduced from April 2012 (para 1.74-5). Provision for cut in tax rate, and changes to rules on foreign branches in s4 & s48 of *Finance Act 2011*. For more details see Library standard note SN05945.	Further consultation and draft legislation for new CFC regime published.
"We will … refocus the research and development tax credit on hi-tech companies, small firms and start-ups" p10	Intention to consult so as "to review the taxation of intellectual property [&] the support R&D tax credits provide for innovation" (para 1.61). Consultation launched in November; HM Revenue & Customs publish evaluation of R&D credits in December (Research report 107).	Consultation ongoing on both R&D credits, and a 'patent box' regime (para 1.75). Further consultation documents published in June.	Autumn Statement announces that a new 'above the line' R&D credit to be introduced from April 2013 (Cm 8231 para 1.123). More details to be given in Budget 2012. Draft legislation for patent box regime published.
"We will review alcohol taxation and pricing to ensure it tackles binge drinking without unfairly penalising responsible drinkers, pubs and important local industries" p13	Informal consultation begun, to report in the autumn (para 1.120). Review published in November recommends two new duty rates for very high-strength and low strength beers.	New duty rates for high-strength and lower-strength beers from 1 October 2011 (para 1.155). Provision in ss14-15 of *Finance Act 2011*. Confirmation that duty rates on alcohol will rise each year by 2% in real terms to 2014/15 – inherited from Labour Government's March 2010 Budget (Table 2.2 : item bt). For more details see Library standard note SN01373.	None

Coalition agreement	Budget 2010 HC 61 June 2010	Budget 2011 HC 836 March 2011	Other developments
"We will examine the case for moving to a 'gross profits tax' system for the National Lottery" p14	Confirmation the Government "will review the taxation of the National Lottery" (para 2.99).	Informal consultation completed. Announcement that "no change will be made" (para 2.130).	Not applicable.
"We will work to bring Northern Ireland back into the mainstream of UK politics, including producing a government paper examining potential mechanisms for changing the corporation tax rate in Northern Ireland" p28	Government to "publish a consultation paper in autumn 2010, on rebalancing the Northern Ireland economy" which will, among other things, "examine mechanisms for changing the corporation tax rate" (para 2.108).	Consultation paper published just after Budget (para 1.109 & HC Deb 24 March 2011 c59WS).	Government response to report by Northern Ireland Affairs Committee: "no decision has yet been made on whether to devolve corporation tax. A decision will be taken following the conclusion of work developed by the joint ministerial working group, which is expected in summer next year" (*1st Special Report* HC 1767 2010-12, 30 January 2012 p2).