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BUDGET 2012

BRIEFING

AN

ECONOMIC STIMULUS

FOR THE UK

THE CHANCELLOR'S CHOICES

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Institute for Public Policy Research

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IDEAS to
CHANGE POLICY

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The case for an economic stimulus

The UK's economic recovery remains fragile, despite recent improvements in retail sales and business confidence. Unemployment is at a 17-year high and continues to rise, while the economy contracted in the final quarter of 2011 and the Office for Budget Responsibility (OBR) is forecasting a growth rate of just 0.7 per cent for 2012. The Coalition government is sticking to its deficit reduction programme but lacks a convincing plan to secure stronger growth and job creation.

As the chancellor prepares to deliver the 2012 budget, he should consider the arguments for a temporary economic stimulus through increased infrastructure spending or tax cuts to boost consumer spending. In the US, Barack Obama's payroll tax cut contributed to a 2.2 per cent increase in consumer spending last year – by contrast, consumer spending in the UK shrank by 0.8 per cent.

The chancellor has a number of options for delivering an economic stimulus, including tax cuts, increases to tax credits, and infrastructure spending. Choosing the most appropriate stimulus mechanism involves an assessment of the potential 'multiplier effect' – the additional economic activity likely to be generated. Other factors that need to be considered include the upfront cost to government and the ease with which the measures can be reversed. In an era of fiscal constraint, there is a strong argument for an explicitly temporary stimulus that is at least partly funded by raising taxes elsewhere – specifically on individuals who are least likely to adjust their spending as a result.

This paper considers the potential effectiveness of alternative economic stimulus measures against these criteria. It also assesses the distributional effects of each alternative – that is, how the measures might affect families with higher and lower incomes. Although the primary goal of a stimulus is not to reduce inequality or transfer resources from the better-off to the less affluent, an open debate about alternative approaches requires an understanding of where the gains are likely to be greatest across individuals and households. All other things being equal, there is a strong argument for a stimulus that is progressive, that is, one that benefits less affluent families more than better-off families. Distributional effects are calculated using the IPPR tax–benefit model; costings are based on government estimates.

Income tax and national insurance

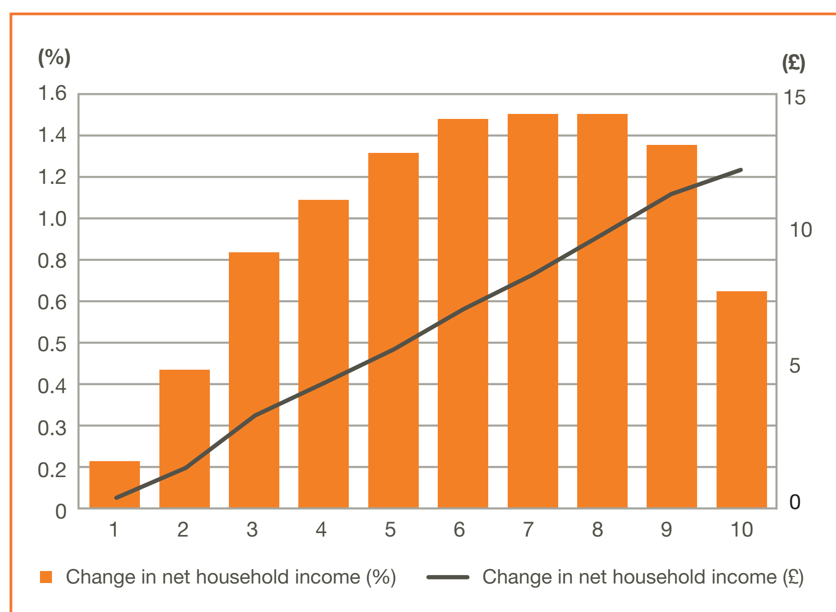
The Liberal Democrats, together with a number of Conservative MPs, have been lobbying the chancellor to use this month's budget to move more quickly towards achieving the Coalition's aspiration of a £10,000 personal allowance for income tax. Since the Coalition was formed in May 2010, the chancellor has announced two above-indexation increases in the threshold, which is due to rise to £8,105 in April. The Coalition is committed to raising the personal allowance to ease the burden on low-earners by reducing their income tax bill (and taking some of them out of income tax altogether). But in the run-up to the budget, this has been discussed as a stimulus measure as well.

Figure 1 (over) shows the distributional impact at the household level of increasing the personal allowance to £10,000 this year, while keeping the higher rate threshold (the point at which an individual starts paying the higher rate of income tax) the same, at £42,475. In this scenario, basic rate taxpayers earning more than £10,000 a year and higher rate taxpayers earning less than £100,000 gain £379 a year, or £7 a week.[1] Families with no

1 People earning less than £8,105 gain nothing because they pay no income tax; people earning between £8,105 and £10,000 gain a proportion of £379. At earnings of £100,000 the personal allowance starts to be withdrawn at

one in work or with no one earning enough to pay income tax gain nothing from a higher personal allowance, and they tend to be the poorest families. Pensioner households also see no benefit because pensioners already have a personal allowance above £10,000. On average, families in the eighth-richest income decile (where the average income is £659 a week) would gain £10 a week while families in the second income decile (where the average weekly income is £270) would only gain £1.

Figure 1
Increasing personal allowance to £10,000 in April 2012, distributional effects



The gains for the richest families could be significantly reduced if the higher-rate threshold was also lowered. The impact of this change is shown in figure 2 (over), and affects primarily the richest 20 per cent of families.[2] Increasing the personal allowance is expensive but the cost is reduced considerably by removing the gains from higher-rate taxpayers. A personal allowance of £10,000 introduced in April 2012 would cost around £9 billion; this could fall to around £6 billion if the higher rate threshold was also lowered, although this would draw more people into the 40-per-cent-tax band. This is likely to be difficult politically. It would also increase the number of families who would lose child benefit under current plans to remove the payment from families with a higher-rate taxpayer. The cost of raising the personal allowance is gross – the net cost would be lower if the reform increased economic activity, thereby boosting tax revenues.

Rather than moving to a £10,000 allowance in a single step, the chancellor might decide to continue a gradual approach. Increasing the threshold to £9,000 this April would cost approximately £3 billion, if the higher-rate threshold was also lowered. Every basic rate taxpayer earning more than £9,000 would gain £179 a year, or £3 a week.

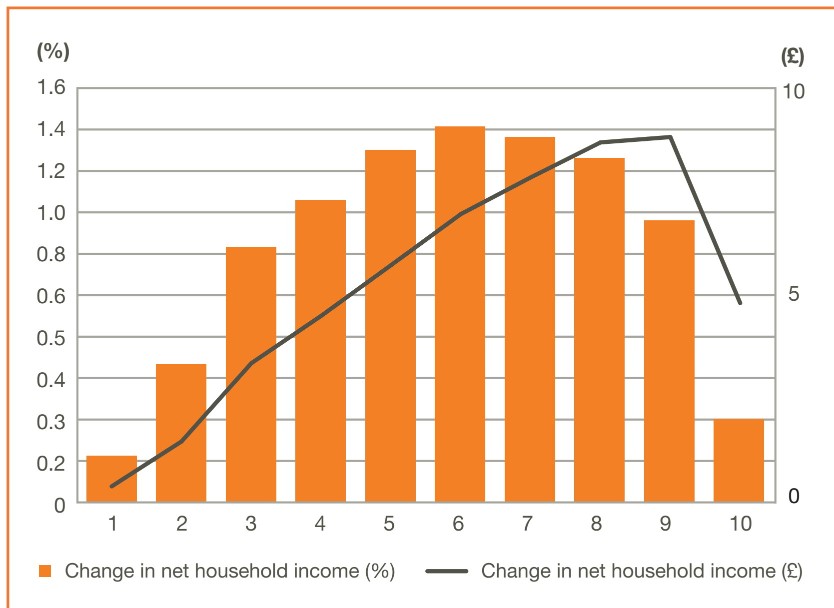
Instead of raising the threshold for tax, the chancellor could cut the basic rate of income tax or the main rate of national insurance contributions (NICs). This approach is better suited to a temporary stimulus: governments find it easier to vary tax rates than tax-free allowances. However, cutting income tax rates is more regressive than raising the threshold

a rate of 50%, so that people with earnings above £120,000 have no personal allowance and so make no gain.

2 In this scenario, the personal allowance is £10,000, the basic rate limit (the amount of income eligible for income tax at 20%) is £30,508 and the higher rate threshold (the personal allowance plus the basic rate limit) is £40,580.

because the cash value of the cut increases with earnings, whereas a higher threshold gives the same amount to the majority of taxpayers (except those earning between the old and new thresholds and those high earners who have had their allowance tapered away).

Figure 2
Increasing personal allowance to £10,000 + lowering higher-rate threshold to £40,580 in April 2012, distributional effects



This is clear from figures 3 and 4, which demonstrate the distributional impact of cutting the basic rate of income tax to 18 per cent and of cutting the main rate of employee NICs to 10 per cent. It is also difficult to directly restrict the gains to high-earners, although this could be done by lowering the higher-rate threshold or by raising the upper earnings limit. Cutting the basic rate of income tax would provide a direct stimulus of around £8 billion, while a 2-percentage-point cut in national insurance would deliver a direct stimulus of £7 billion.

Figure 3
Cutting basic rate of income tax to 18%, distributional effects

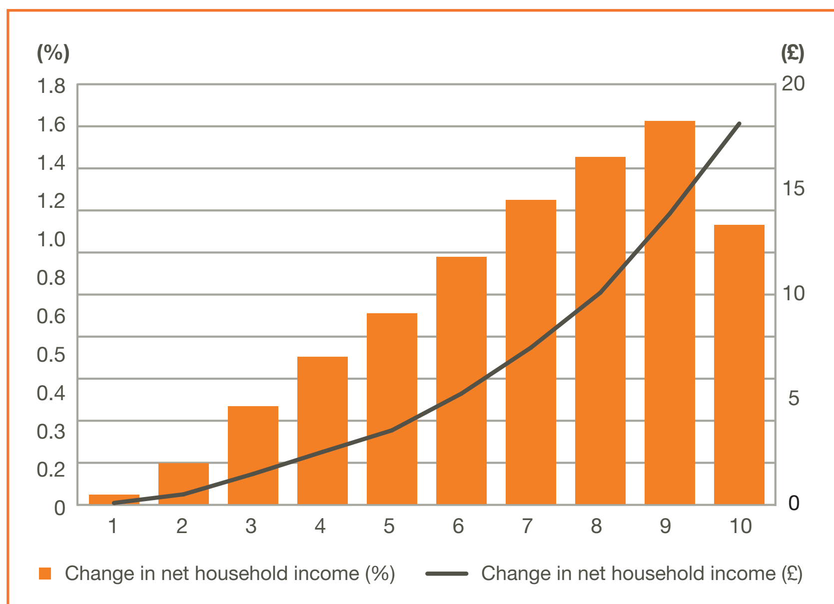
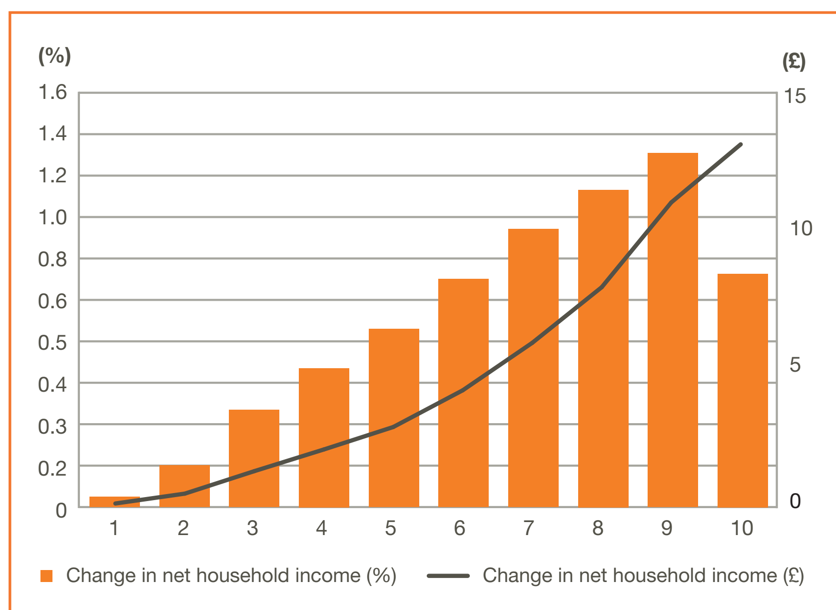


Figure 4
Lowering main rate of Class 1 employee national insurance contributions to 10%, distributional effects



The OBR has estimated the 'multiplier effect' (the additional economic activity generated) of key tax and spend reforms. Of the measures assessed by the OBR, changes to rates and thresholds in the income tax and national insurance systems have the weakest multiplier effect, at 0.3. This means that every £1 of tax revenue foregone by the exchequer generates 30p in additional GDP in the short run.

Tax credits

An alternative way of delivering an economic stimulus by boosting consumer spending power is through the tax credit system. The Coalition has demonstrated a clear preference for helping low-earners through the income tax system rather than through tax credits. The chancellor has frozen the value of the main elements of the working tax credit and reduced support for childcare costs.[3] Many low-earning families will have benefited from an increase in the income tax threshold last year but lost out because of the cuts to tax credits.

Figure 5 (over) shows how family incomes would change if the main elements of working tax credits, rather than being frozen, were to rise in line with CPI inflation in April. Families in the 6th and 7th income deciles gain most in proportionate terms from an increase in the income tax personal allowance, but it is families in the 3rd and 4th deciles who gain most from an increase in working tax credits. The poorest 20 per cent of families do less well because they are less likely to be in work. The government estimates that freezing the main elements of the working tax credit will save £680 million in 2012–13.

Figure 6 (over) compares the distributional impact of an illustrative above-indexation increase in working tax credits and increasing the personal income tax allowance to £10,000, which would each cost around £6 billion.[4] An increase in working tax credits delivers a substantially higher increase in the average spending power of the poorest half of families compared to the same amount of money spent on an increase in the personal allowance.

3 The basic, lone parent, couple and 30+ hour element have been frozen for April 2012, and some of these elements have been frozen for subsequent years. Support for childcare through the childcare element has been reduce from 80 to 70 per cent of eligible costs.

4 As noted above, the higher-rate threshold must also be lowered in order to reduce the cost of raising the personal allowance threshold to around £6 billion.

Figure 5
Increasing main elements of working tax credit in line with CPI inflation in April 2012, distributional effects

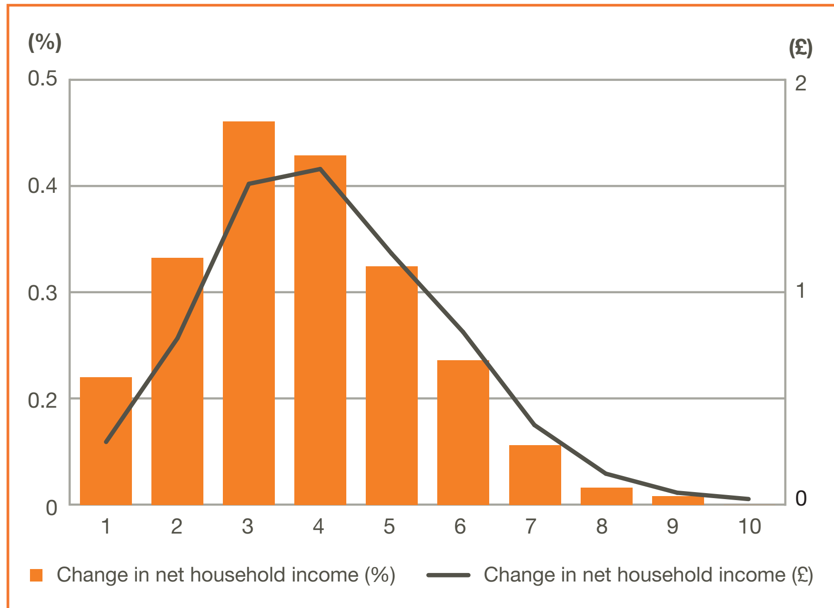
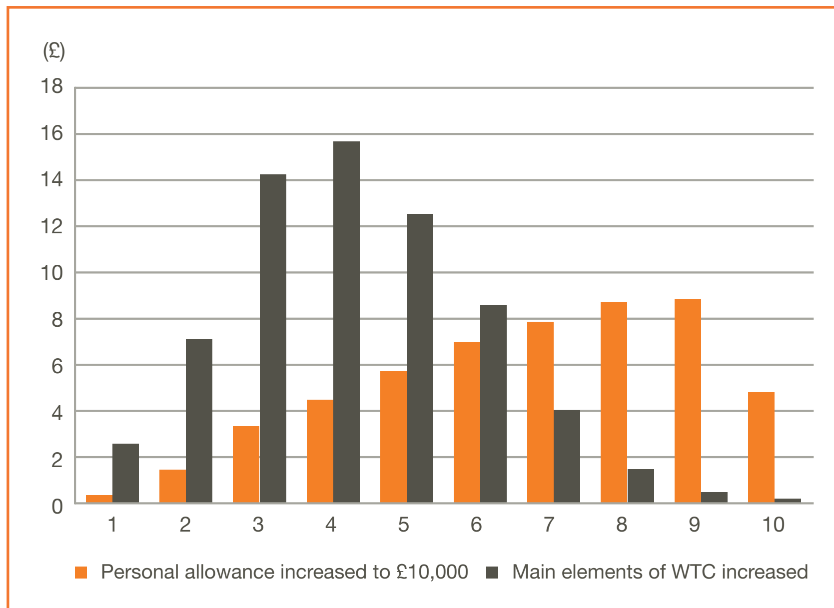


Figure 6
£10,000 personal allowance or £6 billion increase in working tax credits in April 2012, distributional effects



The OBR estimates that changes to tax credits and benefits are associated with a multiplier effect of 0.6, higher than for a cut in direct taxes. This suggests that £1 of increased tax credit spending will deliver a greater stimulus than £1 of tax cuts. More generous working tax credits also increase work incentives for low-earners and for unemployed people likely to move into low-wage jobs, which could help to boost employment rates.

However, some features of the tax credit system are likely to reduce its effectiveness as a mechanism for delivering a quick and temporary economic stimulus. Take-up of working tax credits is only 61 per cent, falling to just 27 per cent for adults with no children.[5]

5 HM Revenue and Customs (2011) *Child Benefit, Child Tax Credit and Working Tax Credit Take-up Rate 2009-10*, London

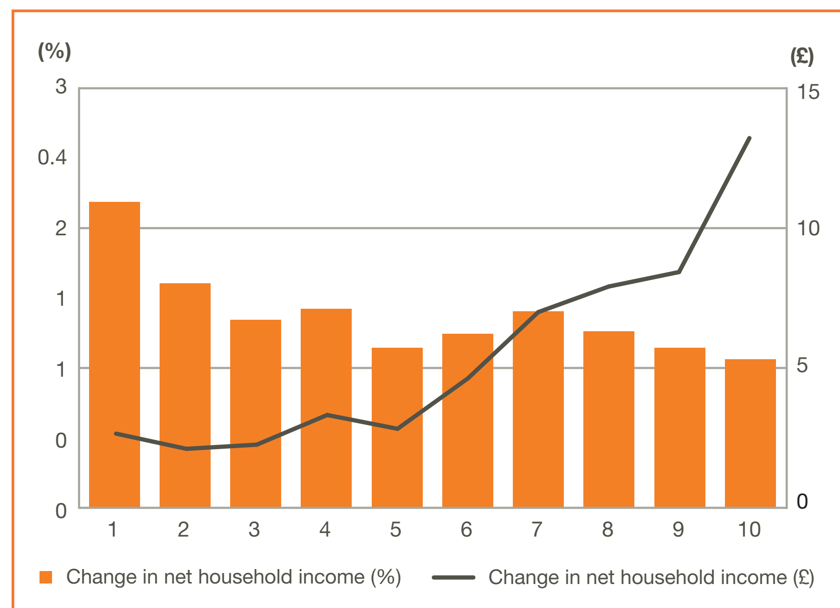
Lower take-up reduces the stimulus effect and means that the charts above overestimate the impact of an increase in tax credits on weekly income. In addition, some households that would benefit from a boost in their spending power are not eligible for working tax credits, including single adults under 25 and people who work too few hours to qualify (although some of these people would not gain from an increase in the personal allowance either because their earnings are already below the tax threshold).

A substantial rise in the value of tax credits also draws more (higher-earning) families into the tax credit system, increasing the extent of means testing. This has administrative costs, but it also reduces incentives for these newly eligible families to increase their earnings, because their entitlement to tax credits increases their marginal effective tax rate.[6] Moreover, as with increases in personal allowances, increases in tax credits could be hard to reverse, making them less effective as a mechanism for delivering a *temporary* stimulus. Tax credits also have less salience with the public and the media than personal taxes, so the Coalition may feel it would secure less political capital from increasing tax credits relative to lowering tax thresholds or cutting rates.

VAT

Rather than boosting incomes, the Coalition could opt to deliver a temporary stimulus by directly lowering the cost of consumption, for example by cutting VAT. This is the option preferred by the Labour party, which makes it very unlikely that the Coalition will adopt it. However, cutting VAT has the advantage of being quick and simple for the government to implement, and easy to reverse. A temporary VAT cut would not only pump extra resources directly into the economy but also provide an additional stimulus by lowering the purchase price of goods today relative to some point in the future, which should motivate consumers to spend sooner rather than later. The OBR estimates that the multiplier associated with a VAT cut is similar to that of direct tax cuts, at around 0.35. The distributional effects of cutting VAT to 17.5 per cent are shown in figure 7.

Figure 7
Cutting VAT to 17.5 per cent, distributional effects



6 So long as a household receives tax credits, the 41 per cent taper rate effectively reduces net income by 41p for every £1 of additional gross earnings. This combined with income tax and NICs yields a marginal effective tax rate of 73 per cent. Basic rate taxpayers who are not eligible for tax credits have a marginal effective tax rate of 32 per cent (assuming no eligibility for other means-tested benefits).

The impact is largest in proportional terms for the poorest 20 per cent of families and broadly flat across the rest of the income distribution. However, the gain as a proportion of income is strongly regressive if families are placed in deciles on the basis of their expenditure rather than income.[7] There are good reasons to do this, because income is not always a good proxy for spending power – for example, many pensioners live on savings rather than income.

This stimulus would cost around £12 billion, making it much more expensive than the measures considered above. A cut of just 1 percentage point (to 19 per cent) would cost a little less than increasing the personal income tax allowance to £10,000, at about £5 billion.

Infrastructure spending

Rather than directly boosting the spending power of consumers, the Coalition could create a substantial stimulus by increasing infrastructure spending. The chancellor's deficit reduction strategy focuses on the cyclically-adjusted current balance, leaving him scope to increase capital spending. IPPR has previously recommended an increase in infrastructure spending of £10 billion in 2012/13 and subsequent years, focused on areas like social housing and transport.[8] Even with this additional spending, total public sector investment would still be lower in 2012/13 than in 2009/10. Extra infrastructure spending has the added advantage of increasing the UK's productive capacity over the long term.

The main downside to delivering an economic stimulus through increased capital spending is that it is not very quick, because projects take time to get up and running. However, the OBR estimates that infrastructure spending delivers the highest multiplier, at 1.0 – every £1 of investment delivers an extra £1 of GDP.

Paying for a temporary stimulus

Tax cuts or increases in tax credits would need to be funded eventually, even if they are only in place for one or two years. This should be done in ways that are least likely to dampen demand in the economy. All taxes take income from some part of the population and so potentially reduce demand. In the present circumstances, the aim should be to increase taxes on those who are least likely to adjust their spending as a result. One option that fits this criterion is a 'mansion tax' as proposed by the Liberal Democrats. A 1 per cent levy on properties worth more than £2 million has been estimated to raise £1.7 billion a year: the first few years of these tax revenues could be used to offset the cost of an immediate one- or two-year stimulus (although it would take at least a year to introduce such a tax). If tax cuts or extra tax credits are successful in boosting economic activity then other tax revenues will also be higher than would otherwise be the case. The overall goal should be to provide a fiscally neutral stimulus partly funded through increased economic activity and partly through higher taxes levied on those least likely to reduce their spending.

Summary

The table below summarises the pros and cons of the potential stimulus measures analysed in this paper, alongside the OBR estimates of multiplier effects. It is clear that no single measure ticks all the boxes in terms of delivering a quick, temporary, effective and progressive stimulus to UK consumers and the economy. If the chancellor is persuaded

7 See http://www.bbc.co.uk/news/business-12111507

8 Dolphin T (2011) *10 ways to promote growth*, London: IPPR. http://www.ippr.org/publications/55/8266/10-ways-to-promote-growth

that the UK economy requires a US-style emergency stimulus then he will have to carefully balance the potential consequences of each option, and it may be that a combination of measures delivers the best outcome for the UK economy.

Table 1
Summary of potential stimulus measures

Stimulus measure	Easy to reverse?	Estimated multiplier	Other points	Direct stimulus / cost
Raising personal allowance to £10,000	No	0.3	Relatively quick to implement; more progressive than cutting the rate	£6 billion*
Cutting income tax basic rate or main rate of NICs by 2 percentage points	Yes	0.3	Relatively quick to implement	£8 billion / £7 billion
Increasing tax credits	No	0.6	Low take-up; relatively progressive	£6 billion (illustrative)
Cutting VAT by 2.5 percentage points	Yes	0.35	Quick and simple for the government to implement	£12 billion (illustrative)
Increasing infrastructure spending	Yes	1.0	Adds to long-term productive capacity; slow to implement	£10 billion (illustrative)

* Cost also assumes that the higher-rate tax threshold is lowered.