Summary

• This briefing deals with selected chapters in the latest IFS Green Budget (available here), focusing in particular on the prognosis for the UK economy, the public finances, and incomes growth. Also dealt with are chapters on business rates, housing, and policies to help the low paid.

• This briefing will be of particular interest to members and officers in all authorities concerned with finance and strategic planning.

• Based on the latest revisions by the ONS, GDP growth for 2013 was 1.9 per cent, the strongest performance of the UK economy since 2007. GDP is forecast to grow by an average of 2.6 per cent between 2014-18.

• Despite the improvement in GDP growth, real average earnings are shown to remain broadly flat between 2013-15 and to rise slowly thereafter. However, they do not rise above their 2009-10 position until 2018-19, and then only slightly. Overall, living standards are highly unlikely to recover their pre-crisis levels by 2015–16.

• Recovery from recession has been slower than in previous economic downturns, and hence the current programme of fiscal contraction is unusually deep and protracted.

• Of the total planned contraction in spending, nearly half (46 per cent) is planned to have been achieved by the end of 2013–14. A large proportion of the cuts to planned spending is still to come. Only 36 per cent of the cuts to planned spending excluding social security and debt interest payments will be in place by the end of 2013–14.

• Current plans imply that central government departmental spending will be cut by 10.5 percent (an average of 3.6 per cent per year) over the three years 2016–17 to 2018–19. However, spending settlements between departments have not been made beyond 2015–16, and therefore it is not yet clear which public services will bear the brunt of the extra spending cuts planned between
The Institute for Fiscal Studies has produced a “Green Budget” for the past 32 years, usually published about a month before the Chancellor’s Budget Statement (scheduled this year for 19 March). It is meant to provide a detailed and independent analysis of the public finances and Budget policy options.

The 2014 Green Budget has a wide scope, comprising eleven chapters spread across 273 pages. Coverage in this briefing is necessarily selective, and focuses on the key issues of public finances and taxation, current UK economic prospects, and incomes.

Also covered are current policies and proposals for helping the low paid, the Institute’s opinions on policies for business rates, and housing, the last of which because it presents recent data on the government’s Help to Buy scheme. Not included are chapters on early care and education, private pensions, and energy prices. Energy prices and plans for the introduction of tax-free childcare have been dealt with comprehensively in earlier briefings.

**The UK economic outlook**

Based on the latest revisions by the ONS, GDP growth for 2013 was 1.9 per cent, the strongest performance of the UK economy since 2007. Most of this improvement was driven by consumption spending, despite a real contraction in personal incomes, with the additional expenditure financed through a sharp reduction in personal saving. The reduction in the ratio of savings to incomes from 7.2 per cent in 2012 to 4.9 per cent in 2013 is thought to have been driven by an upswing in confidence as unemployment began falling and by low interest paid on savings deposits. Another related factor was a recovery in house prices and mortgage transactions, both boosting consumer confidence and stimulating expenditure related to house buying on things like furniture and white goods.

The savings-to-income ratio had fallen to a low of just over 2 per cent in 2007-08 before rising sharply during the recession, probably as a precaution against unemployment. By contrast, the debt-to-income ratio had risen throughout the late 1990s and 2000s to a peak of nearly 160 per cent in 2008 before falling during the recession. It is expected to continue falling throughout the forecast period to 2017, but will remain much higher than in the early 2000s.
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There is limited scope for households to further reduce savings, but as the fall in the savings ratio levels out, consumer spending is expected to realign more closely with real income growth. Real wage growth will be supported by lower inflation, but will nonetheless be slow (see below).

The slowdown in consumer spending is anticipated to be offset by business investment, forecast to increase by 5.4 per cent in 2014 and 7 per cent in 2015. A strengthening of exports is indicated by business surveys which reported a clear improvement throughout 2013.

All of this points to steady growth in the medium term as business investment and exports make up for slowing consumption spending. GDP is forecast to grow by an average of 2.6 per cent between 2014-18. Base interest rates are not expected to rise until 2015, despite the likelihood of the threshold unemployment rate of 7.0 per cent signalled by the Bank of England being passed during 2014. However, recovery has been slower than in previous recessions: following the recession of the early 1990s, GDP was 12 per cent above its previous peak by this stage, while the recovery of the early 1980s saw GDP around 6 per cent above its previous peak by this stage. The forecast in this report suggests that GDP will not regain its previous peak until mid-2014, a total of more than six years. Three factors explain the slowness of recovery: the severity of the UK’s fiscal tightening (the largest contributory factor), tight credit conditions, and the crisis in the eurozone, which weakened demand for exports.

Downside risks to the growth forecasts ensue from the UK’s high level of household indebtedness which could impact on consumption spending, particularly if interest rates rise earlier than expected. An early rise in interest rates could in turn be triggered by a house price bubble. The recovery could also be stifled by a renewal of the eurozone crisis, which would both dampen export performance and damage the UK’s financial sector.

Public finances: the long road ahead

It is usual to expect a loss of output (national income) in a recession to be temporary, with economic growth being higher than normal in the initial stages of recovery as the economy absorbs spare capacity and ‘bounces back’ to catch up with its pre-recession trend level. The increase in public spending as a share of national income (as a consequence of lower tax receipts and higher spending on social security) would therefore normally be expected to correct itself. However, much of the decline in national income as a consequence of the financial crisis is now widely thought to be a permanent rather than a temporary downgrade, meaning that the level of UK GDP will not recover to what it would have been (its ‘trend’ level) in the absence of the banking crash (it has been shown above how slow the current recovery is in comparison with previous cycles). Hence the current programme of fiscal contraction is especially severe and protracted. The IFS notes that disagreements between the major parties about deficit reduction focus on the precise timing and composition of the tightening rather than a need for one.
In 2008–09 and 2009–10, the net effect of policy was to increase borrowing, because tax cuts and spending increases were used to stimulate the economy during the recession. From 2010–11 the net effect of new policies was to reduce borrowing, and these reductions in borrowing are projected to increase each year up to 2018–19.

The composition of the planned tightening is currently heavily weighted towards spending cuts. Only 14 per cent of the overall tightening is planned to come from tax increases, while 71 per cent of the overall tightening is from lower than planned non-interest spending, with the remaining 15 per cent coming from lower debt interest (strictly speaking, lower-than-otherwise debt interest, because the real amount will continue growing until the end of the forecast period, 2018-19).

Of the total planned tightening, nearly half (46 per cent) is planned to have been achieved by the end of 2013–14. Virtually all of the tightening from tax increases has already been implemented, but a large proportion of the cuts to planned spending is still to come. Only 36 per cent of the cuts to planned spending excluding social security and debt interest payments (which therefore comprises mainly spending on public services) will be in place by the end of 2013–14. Of the cuts to benefits announced by the government, 58 per cent of the forecast spending reduction will be delivered by the end of 2013–14.

In 2017–18 the total stock of debt is projected to be 78.4 per cent of national income. Such a high level of public debt requires a high servicing cost, which in 2018-19 the IFS estimates will be more than is currently spent on schools. It also means exposure to movements in interest rates, and little room for manoeuvre in the event of other uncertainties, adverse shocks and calls on public finances such as that implied by population ageing or a decline in North Sea revenues.

The Chancellor has indicated that he wants all of the additional tightening to come from reduced spending rather than increased taxes, confirming that he aims to reduce spending further. Even with the additional cuts in spending signalled by the Chancellor, the IFS does not expect total debt to fall below the previous Labour government’s ceiling of 40 per cent of national income until the 2030s. It is nonetheless expected to rise again after 2030 because of population ageing.

Spending settlements between departments have not been made beyond 2015–16, and therefore it is not yet clear which public services will bear the brunt of the extra spending cuts planned between 2016–17 and 2018–19. The IFS goes into some considerable detail in exploring the various options.

The government’s current fiscal consolidation implies cutting total public spending from 46.3 per cent of national income in 2010–11 to 38.2 per cent by 2018–19. Given current growth forecasts, this would be achieved if total spending were cut in real terms by 3.8 per cent over the eight-year period. Social security and tax credit spending is forecast to increase by 8.5 per cent (assuming there are no further cuts to social security after 2015–16, although the Chancellor has expressed a desire for...
a further £12bn). The real increase in social security between 2010–11 and 2015–16 is being driven by increases in spending on pensioner benefits; over the following three years, the increase is driven by both an increase in spending on pensioner benefits and non-pensioner benefits such as Housing Benefit.

Total public spending, less that on debt interest payments and social security, is forecast to fall by 13.8 per cent between 2010–11 and 2018–19. Within that, departmental spending (or (DEL) is projected to fall by 20.4 percent. This is because other areas of spending (such as locally financed spending by local authorities and net public service pension payments) are projected to increase.

Current plans imply that departmental spending will be cut by 10.5 percent (an average of 3.6 per cent per year) over the three years 2016–17 to 2018–19, leaving departmental spending just over 20 per cent below its 2010-11 level. These departmental cuts have been spread unevenly because of ‘protection’ for health, schools, and overseas aid. Unprotected DEL, under current plans, will fall by 36.6 per cent between 2010-11 and 2018-19.

If the government wanted to slow the pace of cuts, and only cut departmental spending at the same rate as over the period 2010–11 to 2015–16 (an average of 2.3 per year), it would need an additional £12bn of benefits cuts or tax increases, similar to the amount that George Osborne has indicated he would like via additional welfare cuts after the next General Election. If the government wanted to freeze departmental spending in real terms between 2015–16 and 2018–19, it would need an additional £33bn in real terms to be raised from lower benefit spending and/or higher taxation.

However, these scenarios are complicated by the cost of additional policies that the government has announced with no indication of how they will be funded. Some of these are existing policies that only start to cost money from 2016–17 onwards, including the contracting out into defined benefit pension schemes, which will increase employer NICs in the public sector by £3.3 billion per year, the Dilnot reforms to social care funding (costing around £1.0 billion per year) and the new tax-free childcare scheme (costing an additional £0.4 billion per year from 2016–17 – see below). Others are policies announced in the 2013 Autumn Statement for which additional money was made available up to 2015–16, including the extension of free school meals and abolishing the cap on higher education student numbers.

### Income growth

Real average household incomes since the recession have fallen to their lowest levels for the best part of a decade. When using the RPI, the estimates presented in this report indicate that median incomes are more than 2 per cent lower in 2014 than they were in 2001–02. When using the CPI deflator, real incomes appear higher now than in 2001–02, yet lower than in 2004–05. When deflated by the CPI, average incomes began to fall in 2008–09, whilst when deflated by the RPI, they continued to
The difference is due to the fact that mortgage interest payments, which are included in the RPI, but not the CPI, fell dramatically in 2009.

According to the CPI measure, median real household income fell by 5.1 per cent between 2007–08 and 2011–12. The falls in median real incomes were 5.8 percent using the RPI measure between 2009–10 and 2011–12.

Median income in 2013–14 deflated by the CPI is projected to be 6.2 per cent lower than its pre-crisis peak. When incomes are deflated by the RPI, median income in 2013–14 is 7.9 per cent lower than its pre-crisis peak and below its level throughout the 2000s. Projections indicate that median incomes continue to fall in 2012-13 before stabilising, or rising very slightly in 2013-14 according to the CPI.

Falling real earnings were the most important reason for the falls in living standards over the period 2007-08 and 2011-12, and this was true across the distribution. Whereas middle and high-income households tend to rely on employment income, those towards the bottom of the distribution get more of their income from benefits and tax credits. Income from benefits and tax credits was actually higher in 2011–12 than in 2007–08. Because pensioners get most of their incomes from index-linked state and private pensions and little from earnings, their position was better protected than those of working age.

Average real earnings (as measured by total employee compensation minus employers’ National Insurance Contributions, divided by the total number of employees) continued to fall in 2012–13, but are forecast by the OBR to be flat in real terms in 2013–14 and to increase thereafter. Based on the OBR’s December 2013 forecasts and using the CPI measure, real average earnings are shown to remain broadly flat between 2013-15 and to rise slowly thereafter. However, they do not rise above their 2009-10 position until 2018-19, and then only slightly. Overall, living standards are highly unlikely to recover their pre-crisis levels by 2015–16.

Although the downward pressure on income from earnings is easing, there is increased pressure from reductions in benefit and tax credit income, which is reflected in the estimates for incomes across the distribution between 2010–11 and 2013–14. As falls in real earnings come to a halt, and the effect of benefit cuts increases, estimated falls in incomes are larger in the bottom half of the income distribution than in the top half.

Inflation indices like the RPI and CPI are calculated by averaging the price changes of different goods and services in the economy, with each good ‘weighted’ according to its importance in the budget of an average consumer. However, the spending patterns of rich and poor households differ from the average in ways that could cause them to experience higher or lower inflation than average rates. Therefore considerable attention is given in this study to how the inflation experiences of different income groups have varied in recent years.

Two questions were set:
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1. Are there significant differences in the spending patterns of low- and high-income households?
2. Have prices changed differently for goods that are disproportionately consumed by low- or high-income households?

Spending patterns vary systematically across the income distribution. People in low income households (bottom quintile) spend more of their budget on food, rent and energy, while individuals in the highest quintile spend more on recreation, transport and mortgage interest payments. The bottom quintile spent 17.2 per cent of its budget on food, compared with 9.4 per cent for the top quintile.

Inflation rates are calculated for the poorest and richest income quintiles by using each income group’s budget shares as the weights in the calculation. The average rate of inflation experienced by low-income households over the period 2008–09 to 2013–14 was 3.4 per cent, compared with 2.4 per cent for high-income households. This has caused the average price level faced by households in the bottom quintile to rise by 7.1 percentage points more than that faced by households in the top quintile since 2007–08, with the difference especially large in the wake of the recession. A large part of the difference was driven by the impact of the reduction in mortgage interest costs in 2009, which reduced the inflation rates of the top quintile by an average of 0.6 percentage points, compared with just 0.2 percentage points for the bottom quintile. Food and energy price inflation made much larger contributions to the inflation rates of those in low-income households. Transport and education had a slightly larger impact on the inflation experience of the rich.

When all incomes are deflated by a uniform CPI, the fall in real incomes between 2007–08 and 2013–14 was 6.3 percentage points smaller at the 10th percentile (lowest) than at the 90th percentile (highest). But when differences in the inflation rates experienced by low and high-income households are taken into account, households at the 10th and 90th percentiles suffered very similar percentage declines in their real incomes – falls at the 90th percentile have only been 0.7 percentage points larger. Unless the difference in inflation rates is reversed over the coming years, this finding suggests that low-income households may end up seeing the largest falls in living standards, as cuts to benefits and tax credits continue, even when real earnings start to recover.

Policies to help the low paid

It is noted that all the main parties have set out proposals to help the low paid. Tax reductions for the poorest paid have been targeted, and it is thought that both the Conservatives and the Liberal Democrats might pledge further increases in the personal tax allowance for the next Parliament. Labour has proposed to reintroduce a 10 per cent starting rate band of income tax and to provide financial incentives to firms to pay the Living Wage. George Osborne has stated there is scope for an above-inflation increase in the National Minimum Wage.
In this section of the IFS report, tax and benefit policies designed to help the low paid are analysed along with policies aimed at increasing the pre-tax pay of the low paid.

In-work poverty is concentrated in low-paying sectors and occupations and is more strongly linked to low hourly pay than to low hours of work. For hourly pay, the level of the Living Wage (currently £8.80 per hour in London and £7.65 an hour in the rest of the UK) is chosen as the appropriate threshold for determining whether hourly pay is low because this is the level of hourly pay that the Labour Party has said it plans to incentivise employers to pay.

In this study, there is an estimated 29 per cent of employees paid below the Living Wage in their main job in 2011–12. This is slightly higher than other estimates produced, for example, by the Resolution Foundation (see related briefings). Lower weekly earnings are strongly associated with working fewer hours, but there is a strong association between low hourly pay and low hours of work. Low pay does not necessarily translate into low family income, and there is a substantial minority of families where someone is low-paid, but low-paid work is not the main source of earnings, for example, where a partner has higher earnings. However, families for which low pay is the main source of earnings are found predominantly in the lower and lower-middle of the family income distribution. A Resolution Foundation report (see related briefings) is referred to, in which it is indicated that a substantial number of people stay for a long time in low-paid employment.

In April 2014, the current Government will raise the income tax personal allowance to £10,000. It has been widely reported that a commitment to increase the personal allowance to £12,500 may be an election pledge for both the Conservatives and the Liberal Democrats. The Liberal Democrats have explicitly linked this commitment to an aspiration to take all minimum-wage workers out of income tax, and £12,500 is roughly the annual earnings of an individual working full time at the National Minimum Wage (NMW).

Although such an increase would probably be implemented over a period of time, for illustrative purposes, the effects of increasing the personal allowance to £12,500 in April 2014 is modelled. Workers (about 17 per cent) who pay no income tax will benefit little from a further increase to the personal allowance. The workers who would gain most in percentage terms from this further increase are those in the lower-middle of the individual earnings distribution. All those with incomes between £12,500 and £120,000 will have their income tax liability reduced by £500 (the personal allowance is gradually withdrawn as taxable income rises above £100,000).

However, working couples, who tend to be relatively far up the family income distribution, can gain double the amount that one-earner families can gain. The families that gain the most from a £12,500 personal allowance are those in the upper-middle of the overall income distribution. Overall, 69 per cent (£8.4bn) of the £12.2bn per year giveaway would go to working families in the top half of the income distribution, and a further 16 per cent (£1.9bn) would go to non-working families (mostly pensioners). Only 15 per cent (£1.9bn) would go to working families in the lowest income half of the population. Many with incomes slightly above £10,000 (the current allowance) will lose, under Universal Credit (UC) and Council Tax Support.
(CTC), some of the gains because of reduced in-work benefits. Low-paid workers whose family receives both UC and CTS will typically keep no more than 28p from a £1 reduction in income tax.

Ed Miliband has announced that a future Labour government would seek to reintroduce the 10 per cent starting rate of income tax. This proposal is received with even less enthusiasm than the proposal to raise the personal allowance. Assuming that the 10 per cent rate applies to incomes between £10,000-£15,000, the effect of the two proposals on most of the income distribution is almost identical. The only difference would be a 10 per cent rate rather than zero for those earning between £10,000-£12,500, although, as we have seen in the case of a higher allowance some of this would in any case be lost through reductions in in-work benefits under the UC and CTS regimes.

Consideration is given to the ‘make work pay’ contract announced by Labour in 2013. Under this proposal, employers that increase the wages of all their workers to the Living Wage or higher and become accredited Living Wage employers in the first year of a Labour government would receive a tax rebate for one year, equal to 32p for every £1 increase in wages up to the level of the Living Wage. This 32p is equal to the basic rate of income tax plus employee NICs. It is argued that this would raise revenue in its first year in operation, as more would be raised from employer NICs and less would be spent on in-work benefits. After the first year, the government would also benefit from the higher income tax and employee NIC if these higher wages persisted. This would mean a gain to the exchequer of around 50p, on average, for every £1 increase in wages. There will also be additional spending, meaning higher VAT and excise duty revenues. The proposal is given short shrift by the IFS, mostly on the grounds that it incentivises employers to reduce or freeze pay in the run-up to the policy, increase pay to the level of the Living Wage when the policy is in place, and then subsequently reducing or freezing pay after pocketing the temporary tax rebate. Employers might also respond by raising the pay of some employees whilst not employing others. Finally, there could be substantial deadweight effects, in that the tax rebate could be claimed by employers who would have raised wages anyway.

Having been unenthusiastic about the proposals of the three main parties, the IFS makes some proposals of its own. The first of these is raising the employee NIC threshold (currently at £7596) in tandem with the income tax threshold to £11,000. The effect is higher for all people in work across the income distribution, although it would cost the same. However, as with the gains in raising the personal allowance, the effects are similar in that the very lowest earners see only a small gain because some are already below the NIC threshold whilst others will lose some in-work benefits. As with raising the personal allowance, the effects are less progressive at the level of the family, for similar reasons.

Another proposal, which appears to be most favoured, is to increase the allowances currently planned for UC by 20 per cent. This has the advantage of being targeted at low income earners, and also at low income families, because the family (or household) is the relevant unit for assessment. Of the 3.8 million families that gain, 3.3. are in the bottom half of the income distribution, despite costing £10bn less than
the tax policies discussed earlier. It also has the advantage of improving incentives for people whose earnings are the lower end of the income distribution.

On 'pre-tax distribution' it is noted first of all that the value of the NMW has fallen in real terms between 2008-2013, although the main adult rate has actually risen by a small amount relative to median hourly pay because of the general squeeze on earnings. The IFS analysis shows that the potential gains from an above-average increase in the NMW would be substantially higher among the lower and middle parts of the income distribution, although cautions are expressed on the negative employment effects of too rapid a rise in the NMW.

**Business rates**

Business rates raised £26.1bn in 2012–13, slightly less than the £26.3bn raised from council tax and around two-thirds of the £40.4bn raised from corporation tax. It is shown that tax raised from non-domestic properties in the UK is substantially higher than in many other OECD countries. Businesses have raised concerns over the burden of business rates, and the responses by government and other possible options for reform is the topic of this section.

The latest revaluation for business rates came into effect in April 2010, based on property values in April 2008. In England and Wales there are currently 1.9 million non-domestic properties with an aggregate rateable value of £61.7bn. In 2013–14, the multiplier for high-value properties (i.e. those with a rateable value over £18,000) is 47.1% in England (outside Greater London), meaning that a property with the mean rateable value of £32,923 will owe £15,507 a year in business rates.

Since 2010, English local authorities have had the ability to levy a supplementary business rate in order to pay for economic development projects. The only authority to do this is the Greater London Authority, as a contribution to funding the Crossrail project. This power is now subject to a vote among businesses that would be liable to pay the supplement.

The multiplier is usually increased each April in line with the RPI. In revaluation years, the multiplier is adjusted so that average bills before any transitional relief increase at the point of revaluation in line with RPI inflation: bills increase by more (less) than the RPI for properties that have seen above (below) average rises in value since the last revaluation.

Since bills increase in line with RPI inflation regardless of economic circumstances, revenue from business rates do not follow economic cycles. This is one reason why businesses have concerns about the tax: while other liabilities shrink broadly in line with profits and payroll, firms that continued to occupy the same premises still have to pay, in real terms, as much as before an economic downturn in business rates. Business complaints, along with other recent changes, provide the prompts for a brief review of business rates in the Green Budget.
The IFS examines five main changes to business rate policy, mostly as applied to England:

- The delay of the revaluation of rateable values from 2015 to 2017.
- A below-RPI increase in the multiplier in 2014 (England and Wales).
- The doubling of small businesses rate relief.
- Discounts and reliefs available to occupiers of retail premises.
- Business rates retention.

The commentary on these changes is framed within a broader critique of the basic principle of business rates, namely, that it is a tax on a productive input with the distortionary effect of skewing activity away from property development and property-intensive activities. A tax on land value would be preferable, because its effects are only in making land less valuable to its owners, whilst not discouraging any new activity.

Recent business rates policy are criticised for, variously, being unclear in their aims, ineffective, and potentially distortionary. Treating retail premises differently from other premises is criticised for adding complexity to the business rates system, whilst it is unclear how temporary relief can assist the aim of restoring high streets. Delaying revaluation avoids sharp changes in bills in the short term only at the expense of even sharper changes later. Announcing temporary reliefs and then repeatedly extending them on an ad hoc basis, it is argued, creates uncertainty as to how long the reliefs will last and eventually it becomes difficult to rescind what was originally a short-term policy.

The new system for business rates retention has been dealt with in earlier briefings (see related briefings). There is lengthy reprise in the IFS document of how the new system will work. Broadly, the aim of the business rates retention scheme is to provide local authorities with a stronger incentive to promote business development by allowing them to keep a fraction of the revenue from new developments. There is a system of tapers, ceilings, and floors to dampen down the effects of excessive gains and losses and equalise the distribution of resources between authorities with large and growing businesses bases and those with smaller and possibly declining business bases. In 2020 the system will be ‘reset’ and baseline funding levels adjusted to account for any changes in circumstances. Details of that reset have not been determined. It is argued that letting local authorities keep a fraction of the revenue from new developments until funding allocations are ‘reset’ in 2020 (and every 10 years thereafter) means that they have a relatively strong incentive to encourage development at the start of a cycle but much weaker incentives as the reset point approaches.

There is lengthy consideration of how this alters the incentives confronting local authorities. It is noted, however, that CLG has estimated the impact of the business rates retention scheme on national income (available here). The main effect is through an easing of restrictions in the planning system leading to an increase in the supply of business premises and a reduction in costs for business. Its central
estimate is that the scheme will boost national income by £10.1 billion over the period 2013–14 to 2019–20.

In summary, business rates retention increases the incentives of local authorities to promote business development, but these incentives are dampened by the mechanisms put in place to ensure that large disparities in available resources do not arise. To some extent, it is argued, this trade-off is inevitable. The effectiveness of the scheme will depend in part on how responsive local authorities are to the new incentives. If the government wanted to promote a more substantial change in the incentives faced by, and therefore in the behaviour of, local authorities, it would probably require a larger shift in the appropriate degree of resource equalisation. Alternatives put forward by the IFS, however, involving returning to local authorities any growth in business rates in excess of a national average appears to involve even more complexities and problems.

Under the 2011 Localism Act, Local authorities in England and Wales have had, since April 2012, almost complete discretion to offer business rates discounts of any size for any property or properties, at their own expense. In principle, this is a sweeping power and a major step towards localisation: the government’s impact assessment for the policy noted that, in principle, Local authorities could decide to abolish business rates entirely. However, reports suggest that in 2012–13 only 18 out of 326 local authorities in England offered any such discounts, with a tiny collective value of £2.5 million. This suggests that there was negligible appetite among Local authorities to pay for reductions in business rates – although this first year of the policy was before the introduction of business rates retention, so there would now be more incentive than there was then for Local authorities to offer discounts to encourage property development in the area.

There is a discussion of alternative policy options, of which a Land Value Tax (LVT) is the preferred option, despite the acknowledgement of formidable administrative and political complications. Others include:

- Changes to small business relief
- Scaling back or removing exemptions and reliefs;
- Changing how the multiplier is uprated between revaluations
- Going further in allowing local government to keep more of any additional revenues, and in giving local government more say over rates or structures.

Currently, lower rates of tax are charged on properties with lower rateable values, through a combination of different multipliers for small and large properties and explicit small business rates relief schemes. One option for reform would be to change the relationship between rateable value and the tax rate. The essential argument against differential treatment is that lower business rates for properties with low rateable values is a distortion towards activities involving more low-value properties and fewer high-value properties than commercial considerations would normally dictate.
Although the case for exemptions for charities is (with qualifications) acknowledged, there is no case, it is argued, for exempting agricultural property from business rates. The current three-month exemption for empty properties, it is argued, creates an uncomfortable dilemma between creating an incentive to demolish empty properties (once empty properties become taxed) or a disincentive to use properties (when the exemption applies). There is no remedy for this other than a move to a land tax.

More frequent valuation would mean that multipliers would no longer have to be uprated each year in line with (RPI) inflation. The tax on property would also be a better reflection of current economic realities.

One option for greater localisation would be to increase the share that local authorities can keep, or the period for which they can keep it. The other main option for localisation would be to give local authorities more control over the tax rate. As noted above, local authorities in England and Wales already have almost unlimited powers to reduce tax rates, but little power to increase tax rates, other than to levy a supplementary business rate. Easing some of the restrictions on the supplementary business rate might, it is argued, be a good way forward.

Housing market trends and policies

The past year has seen a strengthening of the UK housing market. This has been welcomed as a sign of wider economic recovery, but has also raised concerns over the development of a house price bubble, and that rising prices might put homeownership beyond the reach of many.

The evidence presented in this report does not suggest that the features of a housing bubble are present in the UK housing market as a whole. This is because both nominal and real prices are still below both their previous peaks and the levels that would be predicted by longer-term trends. The main caveat is offered by the London market, where the proximity of nominal prices to their 2007 peak, a rising ratio of house prices to earnings, and a rising number of high mortgage offers relative to income present the greatest risks.

Some preliminary evaluation of Help to Buy is offered, although a challenge in evaluation is that of distinguishing between purchasers who would have bought a new home in the absence of the scheme from those who would not. On Help to Buy: Equity Loan, the available data indicates that most households purchasing under the scheme have above-average incomes, but lower incomes than typical house purchasers. Over half (54 per cent) of those purchasing through Help to Buy: Equity Loan have a total gross household income of less than £40,000, compared with 42 per cent of those borrowing to purchase a home in 2012. The official data also suggest that most purchases are at a level well below the upper limit of £600,000 and that the majority of users of the scheme are first-time buyers. Nonetheless, it is noted that in terms of enhancing affordability, it is somewhat surprising that the ceiling on prices was set at such a high level and that the scheme was not focused
explicitly on first-time buyers. On stimulating house-building, at which the Equity Loan Scheme is explicitly targeted, the assessment is less conclusive.

The Help to Buy: Mortgage Guarantee aims to address the reduction in the availability of high loan-to-value (LTV) mortgages since the onset of recession. Available data from the Bank of England suggests there has been an increase in the availability of high LTV loans and that this is associated with the availability of high LTV loans to participation in Help to Buy.

If the risk of a bubble becomes a major concern, it is argued that the government may want to consider two modifications to Help to Buy. A reduction in the cap on property values would, in addition to targeting the policy on first-time buyers, be likely to have the greatest impact on the London market. A more significant change would be to restrict the mortgage guarantee scheme to lending on new-build properties. At present, the implicit mechanism by which Help to Buy: Mortgage Guarantee will encourage greater housing supply is by raising house price expectations. Restricting the scheme to mortgages on new builds would mitigate the risk of providing a significant stimulus to demand without inducing an increase in supply, thereby driving up prices.

Additionally, the coalition government has sought to reinvigorate RTB sales via large increases in maximum discounts and in reducing the qualifying period before tenants become eligible for RTB from five to three years. Data available to date suggest that the reinvigorated RTB policy has succeeded in increasing sales of social housing. However, it is not clear whether this increase in sales will be matched by sufficient new social housing to maintain the current stock. The commitment to one-for-one replacement is that, on a national basis, each property sold under the revamped Right to Buy will be replaced by a property let at ‘affordable rent’. However, this commitment will not replace social housing on a like-for-like basis, and may still lead to additional pressure on social housing, given that ‘affordable rent’ is a new category of social housing.

Comment

Probably more so than in earlier Green Budgets, this edition gives an indication of what are likely to be the key issues in George Osborne’s last-but-one Budget before the 2015 election. However, the analysis offers little comfort to the three main parties, or, for that matter, to anyone else. Although it is likely that the economy is entering a growth phase, the 2.6 per cent average growth in GDP to 2019 compares badly to the 3.0 per cent annual average in the decade before the onset of the financial crisis, and earnings are not going to recover their pre-crisis levels until the end of the decade. Slower than expected economic growth between 2010-12 has meant that the elimination of the structural deficit has not proceeded as planned, and the programme of spending reduction will only be about halfway complete by the next General Election. Even with the £12b earmarked for cuts to further social
security benefits (which will fall on working age benefits), it seems unlikely that local
government will escape the further tightening of departmental budgets.

For more information about this, or any other LGiU member briefing, please
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