so often the case in economics, common sense is not necessarily a good guide to policy. First, it is not obvious that the medium-term objective of balancing the budget is optimal; the debt/GNP ratio could be stabilised (if this were desired) with the steady-state PSBR running at 1.5 per cent of GDP. Second, there is nothing necessarily optimal about the fiscal stabilisers either. These are the arbitrary by-product of the particular structure of the tax system in any given year, and are not designed to produce the optimal degree of output stabilisation.

As we gain experience of life inside the ERM, it may become obvious that budgetary policy needs to become more active in order to compensate for the loss of monetary policy flexibility. If so, then instruments should be developed which are more flexible than the annual Budget process. Furthermore, in order to reassure the markets that short-term PSBR swings were compatible with long-term borrowing and debt objectives, the Treasury should publish estimates of the fiscal stabilisers, the PSBR including and excluding these stabilisers, and the debt/GDP path over the medium term. These should be subjected to Select Committee scrutiny.

This article also makes an attempt to estimate the extent of the fiscal stabilisers built into the current budgetary structure, using the Treasury's equations linking the PSBR to economic activity. The results suggest that the full operation of the stabilisers would take the PSBR up to £12 billion in 1991/92 and to £20 billion in 1992/93. The Red Book estimates for the PSBR are considerably lower than this, especially on the expenditure side. This implies *either* that the Budget estimates for the PSBR are too low *or* that the fiscal stabilisers are not in fact being allowed to come through in full.

Tax Policy and the 1991 Budget

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I. INTRODUCTION

Prior to this year's Budget, the almost universal expectation was that the Chancellor would not attempt to make any major changes to the tax system. The possible exception to this appeared to be some moves to appear 'green', perhaps by using the tax system to discourage the use of motor vehicles, particularly large ones.

In the event these expectations were confounded. Not only did we see a sharp increase in central government taxation at the expense of local government, funded by the first rise in the VAT rate since 1979, but also a long-overdue widening of the base for National Insurance contributions to company cars and the restriction of mortgage interest relief to the basic rate. Also announced were increases in company car scale charges, increases in child benefit and the freezing of the married couple's allowance.

Here we try to assess the impact of these changes both from the point of view of distributional objectives and from the point of view of economic efficiency. Initially each change is assessed in isolation before an attempt is made to look at the Budget as a whole.

II. BENEFITS IN KIND

Since Nigel Lawson's Budget of 1988, in which he doubled company car scale charges, the announcement of an increase in the taxation of company cars has become a regular feature of Budgets. The Government came to power pledged to reduce the tax advantages of benefits in kind and has acted decisively.

In 1988 Mr Lawson claimed that 'a typical company car may be taxed on only a quarter of its true value'. The combination of increases in company car scale charges (the imputed value of the car on which tax is paid) since then, including the 20 per

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cent increase announced this year, suggests that company cars now come close to being taxed on their true value. Until now, however, a large incentive to provide company cars (or indeed, many other benefits in kind) has existed because the other major tax on income, National Insurance contributions (NICs), was not levied on them. The result was that to give an employee an extra £100 of take-home pay cost £167.35 in 1990/91 if paid in cash,[1] since income tax and employee and employer NICs are levied on the gross increase in salary. If the employer offered a benefit in kind valued at £100, however, the cost would have been only £133.33 since only income tax was payable on its value.

In 1988 NICs were imposed on payment in gilts. This year, the Chancellor announced that employer NICs will be imposed on company cars and free fuel provided by companies. This change will come close to eliminating the large incentive previously felt by employers to provide cars rather than cash. This was an incentive which distorted companies' decisions about how payment should be made, and encouraged provision of company cars on a scale unparalleled in other countries.

This change, however, has not *entirely* eliminated the tax advantages enjoyed by company cars. For although the Chancellor announced that from July 1992 company cars will be subject to employer NICs at a rate of 10.4 per cent, he made no provision for the imposition of employee NICs. This omission has rather more to do with the structure of NICs, however, than it does with taxation of benefits in kind.

Imposing employer NICs on company cars is expected to raise some £600 million in a full year. Imposing employee NICs would raise rather less than half of this figure. The main reason for this is that there is a ceiling for employee NICs above which no contributions are payable. There is no such ceiling for employers. Analysis of the 1988 Family Expenditure Survey indicates that around half of employees with company cars had earnings above the ceiling. They would, therefore, not have been liable for extra NICs even had the Chancellor imposed employee NICs on company cars. Indeed, the structure of NICs is such that, had this occurred, employees with earnings below the ceiling would effectively have been paying more for their company car than would their better-paid colleagues with earnings above the ceiling. The Chancellor presumably did not consider this to be a desirable state of affairs. It is a problem with the NIC system which still needs urgent attention.

One of the most frequent reasons given for the maintenance of the ceiling on employee NICs is its relationship to the 'contributory principle'. That is, the principle which is supposed to relate benefits received to contributions made. It is particularly relevant to SERPS (the State Earnings-Related Pension Scheme). Those who 'contract out' of SERPS do not receive the earnings-related pension but pay a lower rate of NICs; this lower rate also applies to their employers on those contributions paid in respect of earnings between the NI floor and the ceiling. The employer rate is reduced from 10.4 per cent to 6.6 per cent for employees who are contracted out. No provision, however, appears to have been made for this with the imposition of employer NICs on company cars at a flat rate of 10.4 per cent. This

[1] Assuming that the employee is below the NI ceiling and is contracted in to SERPS.

seems to be in direct contradiction to the avowed relationship between NICs paid and the level of the pension received.

One further change to the taxation of benefits in kind which has received an extraordinarily disproportionate amount of attention from the press was the simplification of the arrangements for taxing mobile telephones not fitted in cars and the bringing into tax of telephones which are fixed in cars. Part of the reason for the attention given to this has been a simple misunderstanding of what has happened. Mobile phones not fitted in cars have always been subject to tax as a benefit in kind where they are provided by employers and available for personal use without full reimbursement by the employee. All the Chancellor has done has been to simplify their taxation by standardising the amount on which tax should be paid, in respect of a mobile phone, at £200 a year, rather than the present practice requiring a detailed assessment of the benefit to be made in each case. Bringing into tax telephones which are fixed in cars simply ensures that a significant benefit in kind is taxed in precisely the same way as other benefits in kind.

III. MORTGAGE INTEREST TAX RELIEF

Imposing employer NICs on company cars greatly reduces an important non-neutrality in the tax system. Limiting mortgage interest relief (MIR) to the basic rate is a small but important step in the same direction. Like the changes to car taxation, it is also a change which will have its greatest impact on those on high incomes.

Restricting MIR to the basic rate means that the 860,000 higher rate taxpayers with mortgages will no longer be able to claim tax relief of 40 per cent on the interest on the first £30,000 of their mortgage. Like basic rate taxpayers they will now receive tax relief at just 25 per cent. At an interest rate of 13.75 per cent this change will yield £420 million in a full year at a cost to higher rate taxpayers with a mortgage of £30,000 or more of £11.90 per week in lost tax relief.

This change follows a period since 1983 when the ceiling on mortgage interest relief has not been raised, despite the large increases in house prices over the period. It seems unlikely that this ceiling will be raised again, and the restriction of relief to the basic rate seems to indicate a positive move against MIR. The abolition of higher rate mortgage interest relief emphasises the Government's eagerness to avoid another house price boom such as that we saw in the late 1980s.

Mortgage interest relief is a regressive tax relief in that it provides the greatest benefits to the richest sections of the population, and at a high cost. This partly reflects the fact that people on higher incomes are more likely to have large mortgages but also, until now, the fact that higher rate taxpayers enjoyed more relief than others. Table 1 shows the cost of MIR in 1989/90 and the average relief to people on different levels of income. The increase in relief as incomes increase is clear, but in future years will be mitigated somewhat by the restriction of relief to the basic rate.

In an attempt to reduce the effects of the restriction of MIR to the basic rate on

TABLE 1

The Cost of Mortgage Interest Tax Relief

Range of total income (lower limit) (£)	*Number of tax units benefiting from MIR (thousands)*	*Cost of MIR (£ million)*	*Average relief (£)*
0	450	190	420
5,000	1,660	970	580
10,000	2,320	1,520	660
15,000	2,030	1,480	730
20,000	1,210	980	790
25,000	660	570	860
30,000	550	650	1,180
40,000	420	570	1,360
Total	9,300	6,900	740

Source: *Inland Revenue Statistics 1990.*

the incomes of higher rate taxpayers the Chancellor over-indexed the basic rate limit; that is, the point at which taxpayers start paying the higher rate of income tax. It went up from £20,700 of taxable income to £23,700, £1,000 more than was necessary just for indexation. This £1,000 real increase saves a higher rate taxpayer less than £3 per week, against the potential loss of nearly £12 from the restriction of interest relief to the basic rate.

In the remainder of this article we use the IFS tax and benefit model[2] to compare the impact of components of the actual Budget to that of a Budget in which all elements of the tax system had been uprated in line with inflation over the last year.[3]

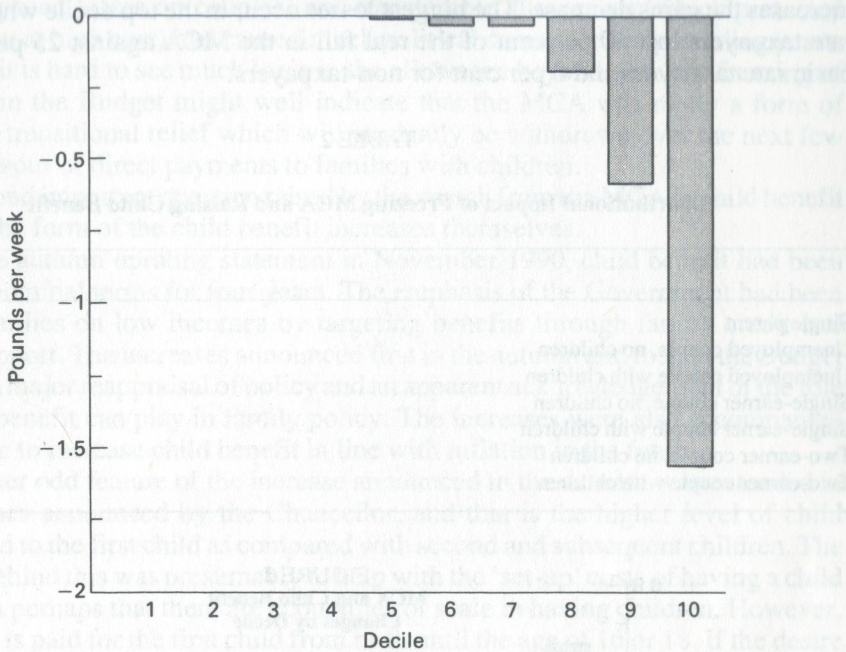
Shown in Figure 1 are the distributional changes in pounds per week by decile of equivalised household income of the MIR/basic rate limit changes alone. As one might expect only those in the richer half of the income distribution are affected and the losses increase to reach their peak in the top decile with an average loss of over £1.50 per week.

Restricting reliefs and allowances to the basic rate is a policy tool which the Government might consider in other circumstances. Just as mortgage interest relief was more valuable to higher rate taxpayers, so are personal tax allowances more valuable to them. Any increase in allowances benefits higher rate taxpayers by 40 per cent of the increase while benefiting basic rate taxpayers by 25 per cent. This fact makes increasing allowances more expensive than would otherwise be the case

[2] This is a computer model which can calculate the effects of various changes to the tax and benefit system on the incomes of a representative sample of 7,000 households drawn from the Family Expenditure Survey (see Johnson, Stark and Webb (1990)).

[3] 9.3 per cent for the tax components.

FIGURE 1
Higher Rate and MIR Changes by Decile



and can be the unintended consequence of changes which are designed specifically to help poorer taxpayers. The logic which led the Chancellor to claim that it was unjust that higher rate taxpayers should gain more from mortgage interest tax relief than basic rate taxpayers might also lead him to feel the same with respect to income tax allowances.

IV. A BUDGET FOR CHILDREN?

Only one real change was made to income tax allowances in the Budget — the freezing of the married couple's allowance (MCA). This was combined with an increase in child benefit of £1 for the first child and 25p for subsequent children.[4] The parts of income-related benefits payable in respect of children were increased by the same amount as child benefit.

Table 2 and Figure 2 show the distributional effect of this joint change, the table by family type and the figure by income decile. As is clear, families without children lost from the change whilst families with children gained. Furthermore, it was a broadly progressive change with gains in the bottom deciles and losses increasing

[4] From October the rates of benefit will be £9.25 and £7.50 respectively.

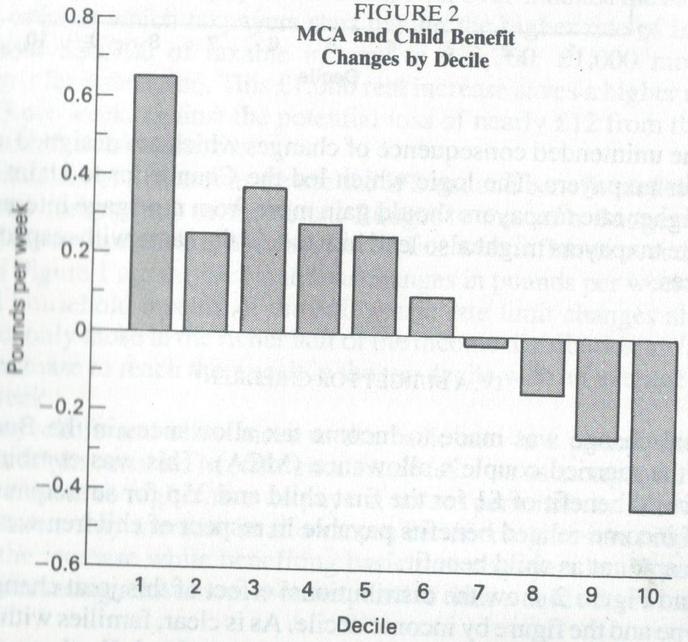
towards the richest decile. The gains are largest at the bottom because there are no taxpayers there losing from the freezing of the MCA. As the number of taxpayers increases the gains decrease. The biggest losses occur in the top decile where higher rate taxpayers lost 40 per cent of the real fall in the MCA against 25 per cent for basic rate taxpayers and 0 per cent for non-taxpayers.

TABLE 2

Distributional Impact of Freezing MCA and Raising Child Benefit

	£ per week
Single parent	1.18
Unemployed couple, no children	–0.16
Unemployed couple with children	1.31
Single-earner couple, no children	–0.71
Single-earner couple with children	0.83
Two-earner couple, no children	–0.85
Two-earner couple with children	0.65

FIGURE 2
MCA and Child Benefit Changes by Decile



The changes to child benefit and the MCA raise two important questions about the tax and benefit system.

The first concerns the role of the MCA. The MCA was introduced by Chancellor Lawson as part of the 1990 move to independent taxation, essentially as a cheap and

simple way of stopping widespread losses amongst married couples. It is hard not to sympathise with him about this: proposals for both pure independent taxation (which imposed losses on couples) and transferable allowances (which protected couples, but at high cost) had caused much political damage in the preceding years. However, it is hard to see much logic in the allowance beyond this. The freezing of the MCA in the Budget might well indicate that the MCA was really a form of souped-up transitional relief which will gradually be withdrawn over the next few years in favour of direct payments to families with children.

The second important question raised by the switch from the MCA to child benefit relates to the form of the child benefit increases themselves.

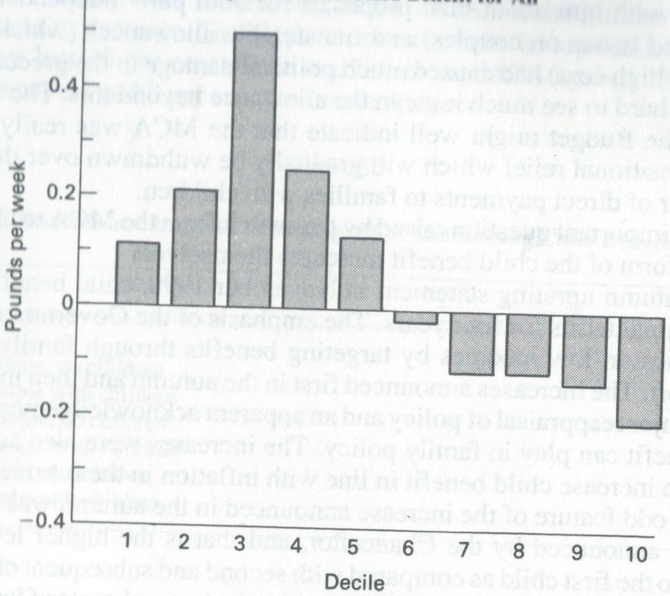
Until the autumn uprating statement in November 1990, child benefit had been frozen in nominal terms for four years. The emphasis of the Government had been to help families on low incomes by targeting benefits through family credit and income support. The increases announced first in the autumn and then in the Budget represent a major reappraisal of policy and an apparent acknowledgement of the role that child benefit can play in family policy. The increases were also accompanied by a pledge to increase child benefit in line with inflation in the future.

One rather odd feature of the increase announced in the autumn was extended in the increases announced by the Chancellor, and that is the higher level of child benefit paid to the first child as compared with second and subsequent children. The thinking behind this was presumably to help with the 'set-up' costs of having a child — the idea perhaps that there are economies of scale in having children. However, the money is paid for the first child from birth until the age of 16 or 18. If the desire is to help families cope with the initial costs of buying cots, clothes and so on, a grant at birth would be better targeted. If it is particularly desired to help families where one parent stays at home to look after the children then money would be better directed by increasing child benefit for younger children (see, for example, Johnson, Stark and Webb (1989), Parker and Sutherland (1991) and Willetts (1991) for more detailed discussion of these points).

As Figure 3 shows, money would in fact be better targeted if the same amount of child benefit (£8.50) were paid in respect of all children. (This would cost the same as paying £9.25 for first and £7.50 for subsequent children.) This partly reflects the fact that larger families tend to be poorer. Favouring families with just one child means, on average, favouring richer families with children.

In sum, the switch of resources away from the married couple's allowance towards child benefit is a reasonable and progressive policy. However, the Government does not appear to have given serious thought to its policy towards the family and towards helping children. There would be scope for radical change if the married couple's allowance were abolished altogether, or gradually reduced, and much thought should be given to how the money should be spent.

FIGURE 3
Impact of Same Child Benefit for All



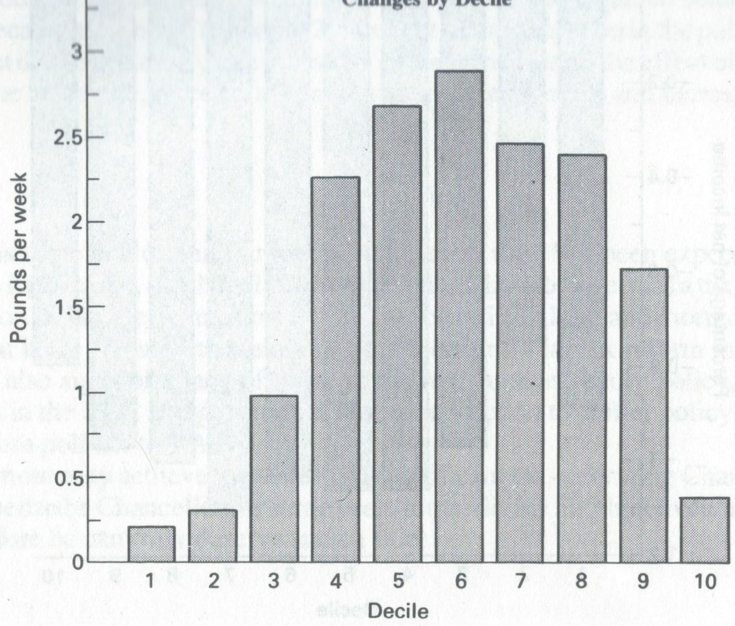
V. THE POLL TAX AND VAT

The most dramatic change in the Budget was the shift from local to central taxation which saw £140 taken off poll tax levels and 2.5 per cent added to the VAT rate, taking it to 17.5 per cent. This was the first increase in the VAT rate since the combining of a standard rate of 8 per cent and a higher rate of 12.5 per cent to a single 15 per cent rate in 1979. Here we make no attempt to enter the debate about the desirability in itself of taxes being raised centrally as opposed to locally; instead we evaluate the impact of the change on people's incomes and its distributional effect.

Figure 4 shows the effect of the two changes by income decile. There are two caveats which must be attached to these results. In the IFS tax and benefit model no account is taken of behavioural changes which may have been occasioned by the increases in VAT. It is assumed that people continue to spend the same amount of money on the same goods. Secondly, up to one third of VAT is paid by businesses rather than by households. We make no attempt to model the effect this will have on households as a result of firms passing on this extra cost in price rises. This explains why a broadly revenue-neutral change results in all groups gaining in our diagram.

The overall effect is clearly for the largest gains to be enjoyed by those in the middle of the income distribution, with much smaller gains for the poorest and richest deciles. The smaller gains in the poorest deciles result from the action of the benefit system. People on income support only pay 20 per cent of the poll tax and

FIGURE 4
Poll Tax/VAT
Changes by Decile



will therefore only gain 20 per cent of the £140, or £28 per year, from the reduction in poll tax. Meanwhile those on the highest incomes spend more money on VATable goods whilst gaining the same amount as the rest of the population from the decrease in the poll tax.

Much discussion has centred around the progressivity or regressivity of VAT because of this increase. Figure 5 shows people's increases in VAT payments as a proportion of their net incomes as a result of the 2.5 per cent increase. It shows a picture which is broadly progressive, but slightly regressive at the very top of the income distribution. The very poorest households tend to spend only a relatively small proportion of their incomes on goods on which VAT is levied, most of their expenditure going on goods such as food and heating on which VAT is not charged. Further up the income distribution people spend more on VATable goods, but the proportion tails off towards the top as a greater part of income is saved. Thus, although VAT is not a particularly regressive tax, neither is it anything like as progressive as income tax.

VI. THE OVERALL PICTURE

Having looked in some detail at the impact of the Budget changes separately, we now bring all the changes together. We also include the effects of the increases in excise duties on petrol and tobacco, not previously mentioned.

FIGURE 5
Impact of VAT Increase

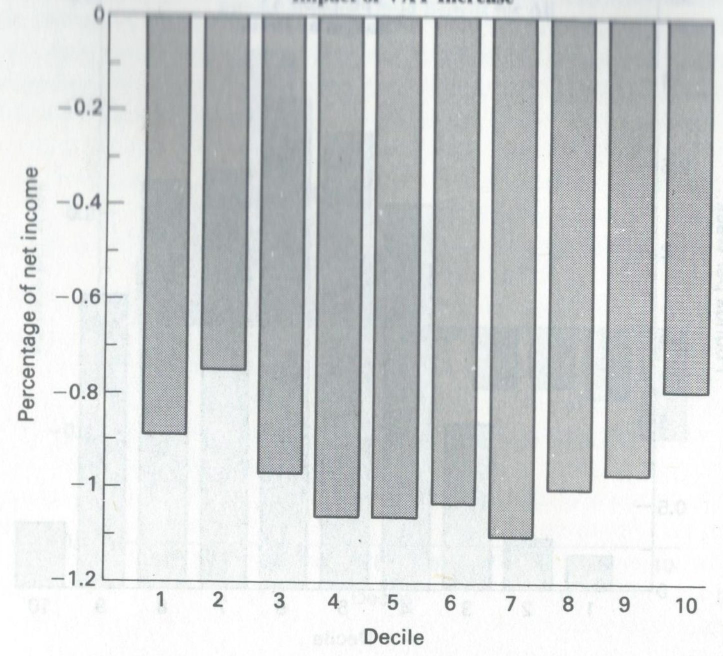
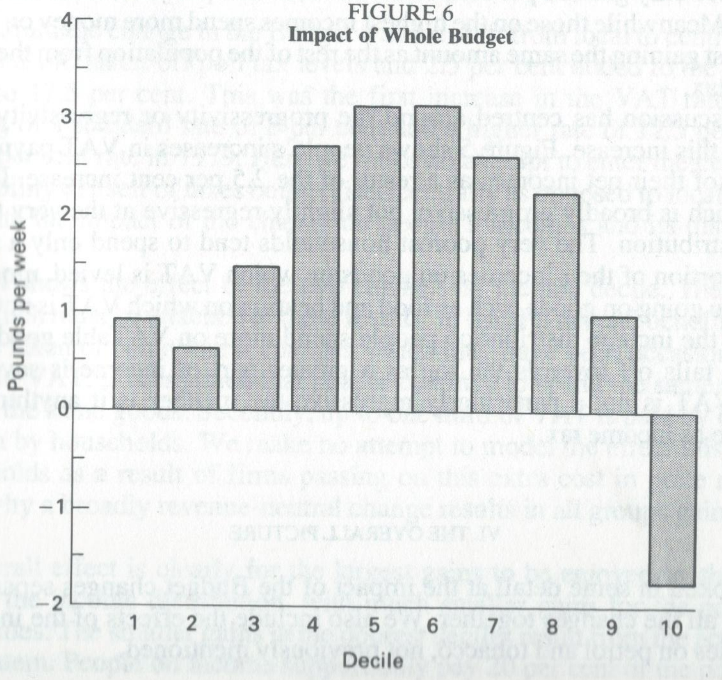


FIGURE 6
Impact of Whole Budget



As Figure 6 clearly shows, those who have gained most from the Budget are those in the middle of the income distribution. The poorest have gained somewhat less, mainly because they benefit by only 20 per cent of the reduction in the poll tax, while the richest decile is the only one to lose on average, reflecting the effect of restricting MIR to the basic rate, increasing company car scale charges, and increasing VAT.

VII. CONCLUSION

There was more to Norman Lamont's first Budget than had been expected, and he has made it plain that, like Nigel Lawson, he would like to be seen as a tax-reforming Chancellor. There are signs, most notably on benefits in kind and mortgage interest relief, that he is prepared to make difficult decisions with tax reform in mind. Yet there are also signs of a lack of strategy in areas such as family policy, where the measures in the 1991 Budget are in direct contradiction to earlier policy, and in the switch from poll tax to VAT.

Mr Lamont may achieve the status of a significant tax-reforming Chancellor, but he will need to be Chancellor for some years more, define his objectives, and achieve them, before he can truly deserve such a title.

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