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ARE (FISCAL) RULES MADE TO BE BROKEN?

As the election approaches, the tax debate is hotting up. The government has been rejecting claims by many independent commentators that taxes may soon have to rise again, while the Conservatives have been trying to demonstrate that they would be able to cut them.

Much hinges on the Chancellor's rules restricting how much the Government can borrow. These are the sustainable investment rule and the (at present) more constraining golden rule. Both have to be met over the course of an economic cycle. The Treasury believes that the current cycle will end in Spring 2006. Whether the rules are met or not over this period will be important for the Chancellor's pride, but whether they are on course to be met over the next cycle is more important for the future path of taxes.

The golden rule states that the government should only borrow to fund investment and that the remainder of government spending – namely current spending – should be paid for out of government receipts. The Treasury judges compliance with the golden rule by looking at the current budget, which is the difference between government receipts and current spending. If the cumulative sum of the current budget over the economic cycle is positive (measured as a share of national income), the golden rule is met. From the mid 1970s to the mid 1990s the

golden rule would have been missed, so to meet it in future implies higher taxes and/or lower current spending than we have seen on average over the twenty years before new Labour came to power.

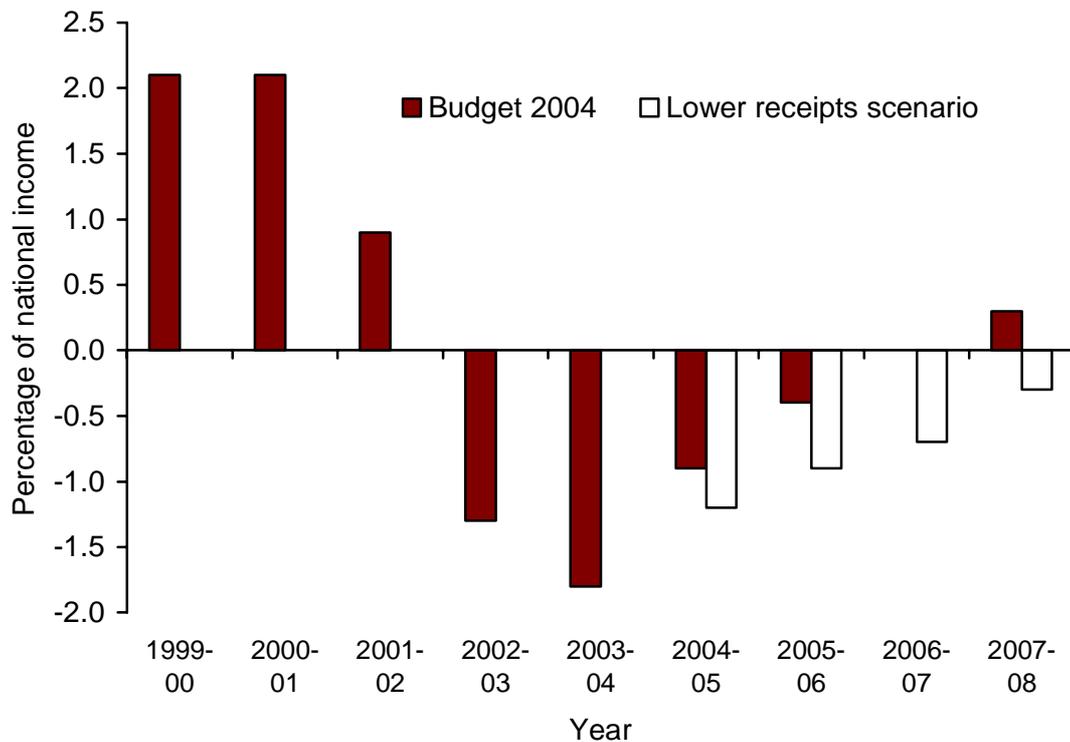
So how do the public finances look now? In the Budget the Treasury estimated that the current economic cycle comprises the seven financial years from 1999–2000 to 2005–06. The solid bars in figure 1 show the outturns of current budget since the beginning of the cycle until last year (2003–04) and the Treasury's forecasts until the end of the cycle. These add up to a total surplus on the current budget of 0.7% of one year's national income. So if these forecasts are achieved, the rule will have been met over this cycle.

However, forecasting the public finances is inherently very difficult. If the Treasury's forecasts are as accurate in the future as they have been in the recent past, with two years of the cycle to go, we estimate that the Budget forecast implied that there was only a 59% chance of the golden rule being met without spending cuts or further tax increases. This compares to a 74% chance at the time of Budget 2003 and an 82% chance at the time of Budget 2002. So even on his own forecasts the Chancellor now has significantly less margin for error.

These probabilities assume that an overoptimistic forecast is just as likely as an overly pessimistic one, but the Treasury has been overoptimistic three years running. Prior to the Budget, the January 2004 IFS forecast was less optimistic about the expected surplus on the current budget, in large part due to lower expected revenue forecasts. The hollow bars (labelled lower receipts scenario) in figure 1 show a revised profile for the current budget based on our lower revenue projections. For

example, in the current year 2004–05 our forecast was for receipts to be 0.3% of national income lower than the Treasury expected. Information on the path of receipts over the first seven months of this financial year suggests, if anything, a slightly larger shortfall than this. Under the lower receipts scenario, the expectation would be for the golden rule to be narrowly missed over the current economic cycle by a total of 0.1% of national income.

Figure 1. Current budget surpluses and deficits since the Treasury’s estimate of the start of the current economic cycle.



Source: HM Treasury; IFS calculations.

But there are other sources of uncertainty. There is evidence that the spare capacity in the economy has been used up more quickly than the Treasury predicted and that the economic cycle could end a year earlier than was forecast in the March Budget. Were this to be accepted by the Treasury then it

would be able to exclude the current budget deficit forecast for 2005–06 when calculating whether or not the golden rule is met over the current cycle. This would make the golden rule more likely to be met over the current economic cycle. Indeed, even under the lower receipts scenario the expectation

is for a surplus on the current budget over the period from 1999–2000 to 2004–05.

While this might seem like very welcome news for the Chancellor, such a situation would be less encouraging over the medium term. Government borrowing naturally rises when the economy is weak, so if the cycle ends earlier because the economy is stronger than expected that would imply that the underlying position of the public finances is worse.

Next month's Pre-Budget Report (and the Budget that will follow in the Spring) are likely to be difficult for the Chancellor. He must persuade people that his forecasts are realistic and that they do not mask the need for spending cuts or, more likely on the basis of previous performance, further tax increases after the next election. If the less optimistic forecasts shown in figure 1 do materialise then meeting the golden rule over the *next* economic cycle would be difficult. Were the next cycle to begin in 2005–06 and only run for three or four years (the last economic cycle is believed by the Treasury to have only lasted for two years) then meeting the rule would be made even more difficult.

This may all make the current state of the public finances difficult territory for the current Chancellor. But it will also be difficult for the opposition parties to capitalise on Mr Brown's difficulties since they will have to explain whether they wish to subscribe to the current fiscal rules and, if so, whether they would choose to cut spending or increase taxes.

The Liberal Democrats propose increasing taxes to pay for an increase in public spending of a similar magnitude.

So, as with the government, the less optimistic scenario for tax receipts would imply that they would need further tax increases to both continue to meet the golden rule and finance their spending plans. The plans set out by the Conservatives involve cuts to public spending over the period from 2006–07 to 2011–12. While these cuts in public spending might, if delivered, enable the Conservatives to expect to meet the golden rule under the less optimistic path of tax revenues without the need for any further tax increases, their scope to cut taxes would be reduced.

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