6. Green Budget public finance forecasts

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Summary

- Smaller-than-expected falls in tax revenues and lower spending growth over the year to date suggest that the government will need to borrow £10.4 billion, or 0.7% of national income, less in 2009–10 than it forecast in the 2009 Pre-Budget Report.
- But our relative optimism diminishes thereafter. If the economy were to evolve broadly as the Treasury predicted in the PBR, we forecast that borrowing would be just 0.3% of national income (or £4 billion in today's terms) lower than the PBR 2009 forecast in 2014–15.This narrowing gap reflects the fact that we would expect weaker growth in tax revenues for a given economic outlook than the Treasury.
- We forecast that the current budget deficit would fall from 8.8% of national income in 2010–11 to 2.9% of national income in 2014–15 under this scenario. Of this 5.9% of national income reduction in the current budget deficit, 4.4 percentage points would come from a fall in current spending as a share of national income and 1.5 percentage points from an increase in the tax burden. With slightly lower borrowing over the next five years, we forecast that public sector net debt would peak at a slightly lower level (76.0% of national income) than the Treasury forecast.
- But if the economy were to evolve along the Barclays central scenario, we forecast that the current budget deficit would be 2.5% of national income larger in 2014–15 than in our baseline scenario. Even under their 'optimistic' scenario for the macroeconomy, our fiscal forecasts suggest borrowing would persist at a higher level than forecast by the Treasury. Meanwhile, under the Barclays 'pessimistic' scenario for the macroeconomy, most of the borrowing expected this year would be permanent.
- There is already a sizeable tightening of 1.6% of national income between 2009–10 and 2010–11 from the unwinding of the fiscal stimulus package. We suggest that no further significant tightening is implemented in 2010–11, given the likely fragility of the nascent recovery and the fact that monetary policy remains very loose.
- The government plans a 4.1% of national income (£57 billion) fiscal tightening between 2010–11 and 2015–16. By increasing this to 5% of national income (or an additional £13 billion), our baseline forecast would show the structural current budget deficit eliminated by 2015–16. Aiming to complete the repair job within one five-year Parliament would be more credible than the government's eight-year plan. It would also likely comply with the Conservatives' stated target for borrowing.
- It is very uncertain what policy settings would deliver the levels of borrowing that the government or the Conservatives want to achieve over the next few years. Both parties' plans might be more credible and sensible if they amounted to a challenging but achievable plan for tightening over the next five years, including an explanation of how they might need to change if the economy, the underlying health of the public finances or investor sentiment departed significantly from current expectations.

6.1 Introduction

This chapter presents the IFS Green Budget public finance forecasts and discusses them in the context of the government's new Fiscal Consolidation Plan, aimed at ensuring the public finances return to a sustainable position over the next five years. Section 6.2 presents the 2010 Green Budget forecasts for 2009–10 and 2010–11, using as a baseline the assumption that the economy evolves largely as the Treasury predicted in the December 2009 Pre-Budget Report (PBR), but where, as we shall see, tax revenues are slightly stronger than the PBR suggested. Section 6.3 looks at the medium-term prospects for the public finances (up to 2014–15), largely based on the same underlying economic assumptions. Section 6.4 compares our baseline forecasts with forecasts based on the alternative macroeconomic assumptions outlined by Barclays in Chapter 4. Finally, Section 6.5 concludes with what these projections imply for the 2010 Budget judgement.

6.2 Short-term projections

In 2008–09, receipts came in £13.1 billion lower than the Treasury had forecast in its PBR in November 2008 and about £6.5 billion lower than we forecast in the January 2009 IFS Green Budget, as shown in Table 6.1. The out-turn for total spending was £5.3 billion lower than forecast by both the Treasury and us, the result of current spending being £4.2 billion lower and investment spending being £1.1 billion lower than forecast (in both cases). This lower-than-expected spending slightly offsets the shortfall of receipts relative to both the Treasury's PBR forecast and our Green Budget forecast. However, the out-turn for the current budget deficit was still £8.9 billion larger than the Treasury's PBR 2008 forecast and £2.3 billion larger than our January 2008 Green Budget forecast. This resulted in borrowing being £7.9 billion higher than the Treasury forecast and £1.2 billion higher than we forecast.

Table 6.1. Comparison of forecasts for government borrowing, 2008–09

£ billion	**HM Treasury PBR forecast, November 2008**	**IFS Green Budget forecast, January 2009**	**Estimate, PBR, December 2009**
Current receipts	545.5	538.9	532.4
Current expenditure[a]	586.7	586.7	582.5
Surplus on current budget	–41.2	–47.8	–50.1
Net investment	36.5	36.5	35.4
Total managed expenditure	623.2	623.2	617.9
Public sector net borrowing	77.6	84.3	85.5

a. In line with the National Accounts, depreciation has been included as current expenditure.

Notes: Figures for net investment and net borrowing in 2008–09 from PBR 2009 are shown net of the impact of various capital transactions between the nationalised banks and other parts of the public sector (which amounted to £9.9 billion in 2008–09). Furthermore, the figure for net borrowing excludes the income received by the public sector from private sector banks as a result of public sector interventions in the financial sector (amounting to £0.8 billion in 2008–09) – see table B18 of PBR 2009. These measures of public sector net investment (PSNI) and public sector net borrowing (PSNB) are shown here as they are the most comparable metrics to those forecast in PBR 2008 and the 2009 Green Budget.

Sources: Out-turn figures for 2008–09 from HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/prebud_pbr09_index.htm. Forecasts from HM Treasury, *Pre-Budget Report 2008*, November 2008, http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm, and table 6.2 of R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2009*, IFS Commentary 107, http://www.ifs.org.uk/publications/4417.

For more details on the components of these forecasts and out-turns, see Appendix A.

Borrowing in 2009–10

Table 6.2 provides an overview of the December 2009 PBR and the February 2010 Green Budget baseline projections for receipts, spending and borrowing in the current financial year. The 2010 Green Budget baseline forecast for 2009–10 is that receipts will be £7.2 billion higher and current spending £3.2 billion lower than PBR 2009 expected. Therefore our baseline forecast is that the current budget deficit in 2009–10 will be £10.4 billion lower than forecast in the December 2009 PBR, i.e. that the current budget deficit will be £117.7 billion rather than the £128.1 billion forecast by the Treasury.

Table 6.2. Comparison of forecasts for government borrowing, 2009–10

£ billion	**PBR, December 2009**	**Green Budget, February 2010**	**Differences**
Current receipts	498.1	505.2	+7.2
Current expenditure[a]	626.2	623.0	–3.2
Surplus on current budget	–128.1	–117.7	+10.4
Net investment	49.5	49.5	0.0
Total managed expenditure	675.7	672.5	–3.2
Public sector net borrowing	177.6	167.2	–10.4

a. In line with the National Accounts, depreciation has been included as current expenditure.
Source: PBR forecasts from HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/prebud_pbr09_index.htm.

We assume the public sector net investment in 2009–10 is the same as forecast in the PBR. As a result, the smaller current budget deficit translates directly to a forecast for a lower level of headline borrowing: we forecast that public sector net borrowing in 2009–10 will be £167.2 billion, which is £10.4 billion below the £177.6 billion forecast in the PBR. Consequently, we expect net gilt issuance this year to be £10.4 billion lower than forecast by the Treasury in PBR 2009, at £214.7 billion rather than at £225.1 billion.[1]

Receipts and spending in 2009–10

Between the April 2009 Budget and the December 2009 PBR, the Treasury revised up its forecast for receipts in 2009–10 by £2.1 billion. The most significant changes were upwards revisions to receipts of value added tax (VAT) of £3.5 billion, stamp duties of £2.5 billion and a fall in forecast receipts of National Insurance contributions (NICs) of £2.9 billion. Total managed expenditure (TME) was revised upwards by £4.3 billion, within which there was a £5.7 billion upwards revision to public sector net investment. The latter was in large part brought about by £3.0 billion of grants from central government to public sector banks (which score as public sector spending under the Treasury's new measures of the fiscal aggregates 'excluding financial interventions', which treat the nationalised banks as if they were still in the private sector). With the forecast for spending increasing by more than the forecast for receipts, the forecast level of borrowing was also revised upwards. However, this revision, of just £2.2 billion from

[1] Net gilt issuance is higher than public sector net borrowing for various reasons, including the impact of net lending to the private sector and the financing of the Asset Purchase Facility. The relationship between PSNB and gilt issuance is outlined in detail in tables B21 and B22 of the 2009 PBR. We assume here that a £10.4 billion increase in PSNB also leads to a £10.4 billion increase in gilt issuance.

Table 6.3. Comparison of Green Budget and HM Treasury forecasts for government borrowing, 2009–10 and 2010–11

£ billion	2009–10		2010–11	
	PBR Dec. 2009	*Green Budget Feb. 2010*	*PBR Dec. 2009*	*Green Budget Feb. 2010*
Income tax (net of tax credits)	134.2	137.5	138.2	143.4
National Insurance contributions (NICs)[a]	94.8	95.9	98.1	97.0
Value added tax (VAT)	67.2	70.0	74.2	81.6
Corporation tax (net of tax credits)	33.4	33.1	40.1	34.4
Petroleum revenue tax	1.2	1.2	1.6	1.6
Fuel duties	26.4	26.4	28.0	28.1
Capital gains tax	2.5	2.5	2.6	2.6
Inheritance tax	2.2	2.2	2.3	2.3
Stamp duties	7.4	7.4	9.3	10.1
Tobacco duties	8.8	8.8	8.9	8.9
Spirits duties	2.6	2.6	2.6	2.6
Wine duties	2.9	2.9	3.0	3.0
Beer and cider duties	3.5	3.5	3.5	3.5
Betting and gaming duties	1.4	1.4	1.4	1.4
Air passenger duty	1.9	1.9	2.3	2.3
Insurance premium tax	2.3	2.3	2.3	2.3
Landfill tax	0.9	0.9	1.2	1.2
Climate change levy	0.7	0.7	0.7	0.7
Aggregates levy	0.3	0.3	0.3	0.3
Customs duties and levies	2.6	2.6	2.5	2.5
Total HM Revenue and Customs	**397.0**	**404.1**	**423.1**	**429.8**
Vehicle excise duties	5.7	5.7	6.1	6.1
Business rates	23.7	23.7	24.6	24.6
Council tax[b]	24.8	24.8	25.8	25.8
Other taxes and royalties[c]	16.4	16.4	19.2	19.2
Net taxes and NI contributions[d]	**467.6**	**474.7**	**498.8**	**505.5**
Accruals adjustments on taxes	1.3	1.3	1.7	1.7
Less Own resources contribution to EU budget	–3.7	–3.7	–4.6	–4.6
Less PC corporation tax payments	–0.2	–0.2	–0.2	–0.2
Tax credits adjustment[e]	0.7	0.7	0.8	0.8
Interest and dividends	4.4	4.4	4.7	4.7
Other receipts[f]	28.1	28.1	29.2	29.2
Current receipts	**498.1**	**505.2**	**530.3**	**537.1**

a. 2009–10 includes revenues from the bank payroll tax.
b. PBR figures are based on stylised assumptions rather than government forecasts, as council tax increases are determined annually by local authorities, not by the government.
c. Includes VAT refunds and money paid into the National Lottery Distribution Fund.
d. Includes VAT and the traditional 'own resources' contributions to the EU budget.
e. Tax credits that are scored as negative tax in the calculation of 'net taxes and NI contributions' but expenditure in the National Accounts.
f. Includes gross operating surplus and rent; net of oil royalties and business rates payments by local authorities.
Sources: PBR forecasts from HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/prebud_pbr09_index.htm; this table is similar to table B10 on page 181. Authors' calculations.

£175.4 billion to £177.6 billion, would be considered very small in a normal economic environment, let alone in one as volatile as it is presently.

The 2010 Green Budget forecast for receipts in 2009–10 is £7.2 billion higher than the Treasury's 2009 PBR projection. Table 6.3 shows the forecast for receipts in 2009–10 (and also that for 2010–11) broken down into the constituent taxes. For most taxes, we expect revenues in 2009–10 to be in line with the Treasury's PBR forecast.

In 2009–10, there are three significant exceptions to this: income tax, VAT and NICs. In all of these cases, we forecast higher revenues than the 2009 PBR. (In the case of corporation tax, we forecast that receipts will be £0.3 billion lower than the PBR.)

The IFS Green Budget baseline forecast is that income tax revenues in 2009−10 will be £3.3 billion higher than the Treasury forecast. Our relative optimism is based on the fact that over the first nine months of this financial year, these receipts do not appear to have fallen quite as sharply as forecast by the PBR for the year as a whole (although it is difficult to get a complete picture as the monthly data include receipts of capital gains tax, which are, unsurprisingly, expected to fall very sharply). In our income tax forecast, we also make an allowance for the bank payroll tax depressing income tax receipts in the remaining months of the year. However, we still forecast that overall income tax receipts will be slightly higher than forecast in the PBR.

Considerable uncertainties regarding income tax receipts this year remain, much of which should be resolved when receipts in January are known. This is because January is the month in which PAYE income tax on financial sector bonuses is typically paid and also because the deadline for self-assessment income tax payments for 2008–09 was 31 January. The former is likely to boost receipts relative to January 2009 (notwithstanding the impact of the bank payroll tax mentioned above), as many financial sector firms have been more profitable in 2009 than they were in 2008 when the financial crisis struck. However, self-assessment income tax payments are likely to depress receipts due to the impact of the recession in 2008–09 compared with 2007–08. (Details of receipts in January are scheduled to be published by the ONS on 18 February 2010.)

The Treasury forecasts that VAT receipts will be £67.2 billion in 2009–10. A simple extrapolation of the trends over the first nine months of this financial year would suggest that these receipts are on course to be just £65.8 billion. However, this fails to take into account the 13-month cut in the main rate of VAT from 17½% to 15% that ran from 1 December 2008 to 31 December 2009. Not only will this have depressed receipts in the first nine months of 2009–10 but it will also have lowered the base level of receipts in the last four months of 2008–09. Taking these effects into account, we estimate that growth in underlying receipts over the year to date would put VAT receipts on course to come in at £70.8 billion in 2009–10. As both our forecasting model and the PBR forecast suggest lower receipts than this, we forecast that VAT receipts will come in at £70.0 billion. This is still £2.8 billion higher than forecast in the PBR.

The IFS Green Budget baseline forecast is that NICs receipts in 2009−10 will be £95.9 billion, which is £1.1 billion higher than the £94.8 billion forecast by the Treasury in the PBR. The PBR forecast implied that NICs receipts would fall over the last five months of 2009−10 relative to the same months in 2008−09. However, in the two months of data that have been published since the PBR (relating to November and December 2009), they have actually risen slightly. Taking this into account – and also adjusting NICs receipts over the remainder of this financial year upwards to account for receipts of the bank payroll tax – we forecast that NICs receipts will come in higher than the Treasury has forecast. (The Treasury has chosen to include the revenues from the bank payroll tax in NICs receipts; note that the introduction of this tax has a direct positive impact on receipts and also, to the extent to which bank bonuses are reduced, an indirect negative impact on employer and employee NICs.)

As discussed above, we assume that public sector current spending in 2009–10 will be £3.2 billion below the Treasury's forecast from the December 2009 PBR. This is because, so far this financial year, current spending by central government has not grown as quickly as the PBR forecast for the year as a whole. Over the first nine months of this financial year, central government spending has been running 5.8% above the level seen in the same months last year, while the PBR forecast implies an increase over last year's level of 7.4% for the year as a whole.[2] Were central government current spending to continue to grow at the rate seen so far this year, it would come in £8.7 billion below the 2009 PBR forecast. Therefore, our forecast of a £3.2 billion shortfall does assume some pick-up in spending growth in the final three months of 2009–10. It is also the case that the November 2008 PBR forecast for current spending in 2008–09 (which in last year's Green Budget we assumed would be accurate despite the fact that spending growth over the year to date had been relatively low) turned out to be an overestimate (as shown in Table 6.1).

We assume that the Treasury's PBR forecast for public sector net investment of £49.5 billion is accurate. Therefore we forecast that TME will be £672.5 billion, which is £3.2 billion lower than the PBR forecast of £675.7 billion.

Borrowing in 2010–11

The 2010 IFS Green Budget forecast for 2010–11 is also for lower borrowing and a smaller current budget deficit than forecast in the December 2009 PBR. However, the difference between the forecasts is smaller than for 2009–10. We forecast that receipts will be £537.1 billion, which is £6.8 billion higher than the PBR forecast (slightly smaller than the £7.2 billion higher receipts forecast for 2009–10), as shown in Table 6.4.

On the spending side, we assume that the government keeps to its plans for spending on public services and, since our baseline scenario is that the economy evolves as the PBR predicts, we assume that the PBR forecasts for spending on social security benefits and tax credits prove accurate. Since we are forecasting a lower level of borrowing in 2009–

Table 6.4. Comparison of forecasts for government borrowing, 2010–11

£ billion	**PBR, December 2009**	**Green Budget, February 2010**	**Differences**
Current receipts	530.3	537.1	+6.8
Current expenditure[a]	667.2	666.7	–0.5
Surplus on current budget	–136.8	–129.6	+7.2
Net investment	39.5	39.5	0.0
Total managed expenditure	706.6	706.2	–0.5
Public sector net borrowing	176.3	169.1	–7.2

a. In line with the National Accounts, depreciation has been included as current expenditure.
Sources: As for Table 6.2.

[2] For IFS analysis of the monthly ONS/HM Treasury press releases on the public finances, see http://www.ifs.org.uk/publications/browse?type=pf.

10, we take this into account when forecasting debt interest payments and thus current spending is forecast to be £0.5 billion lower than the December 2009 PBR forecast, reflecting lower spending on debt service. As with 2009–10, we assume that the Treasury's forecast for public sector net investment is accurate.

Taken together, this leads to the IFS Green Budget forecasts for the current budget deficit and public sector net borrowing being £7.2 billion smaller than forecast in the PBR.

Receipts and spending in 2010–11

The December 2009 PBR revised up current receipts in 2010–11 by £1.8 billion relative to the forecast made in the April 2009 Budget. The Treasury revised upwards its estimate of receipts from taxes on capital and corporate profits – stamp duties, capital gains tax, inheritance tax and corporation tax – and revised down its estimate of revenues from NICs and some other more minor revenue sources, such as interest and dividends.

On the spending side, there was also a relatively small upwards revision to current expenditure of £2.2 billion between the April 2009 Budget and the December 2009 PBR. Within this, there was a £1.1 billion increase in the departmental reserve, a £1.4 billion reduction in estimated social security spending and a £1.5 billion increase in estimated debt interest costs. The PBR also revised up planned net investment spending by £3.3 billion to £39.5 billion, from the £36.2 billion that had been forecast in the Budget.

Overall, the change to forecasts of receipts (up by £1.8 billion) and spending (up by £4.9 billion) led to the forecast for total borrowing being increased by £3.1 billion. Further details of the changing outlook for the public finances between the April 2009 Budget and the December 2009 PBR can be found in Chapter 2.

Relative to the Treasury's forecast from the 2009 PBR, the 2010 Green Budget forecast for 2010–11 is that receipts will be £6.8 billion higher and spending £0.5 billion lower. The latter difference entirely reflects the lower debt interest payments that will be required to service the smaller borrowing that we forecast will be necessary in 2009–10 (discussed above).

As shown in Table 6.3, the five biggest discrepancies between the January 2010 Green Budget forecast and the December 2009 PBR forecast for receipts in 2010–11 are (in diminishing order of magnitude) for receipts of VAT, corporation tax, income tax, NICs and stamp duties.

We forecast that VAT revenues will be £7.4 billion above the PBR forecast, which arises from our model suggesting much higher growth in these receipts between 2009–10 and 2010–11 than the Treasury predicts (in 2009–10, our forecast is just £2.8 billion higher than the Treasury's PBR forecast). The Treasury's forecast of growth in cash receipts of just £7.0 billion between 2009–10 and 2010–11 (from £67.2 billion to £74.2 billion) looks particularly pessimistic given that its own estimate is that the temporary VAT cut will have depressed revenues by £7.8 billion in 2009–10 while having no direct impact on receipts in 2010–11.[3]

[3] Source: Table A2 of Budget 2009. Another factor influencing VAT receipts in 2009–10 and 2010–11 is the Fleming judicial ruling. In Budget 2009, the Treasury included an allowance for repayments of £2.7 billion in 2009–10 and £2.1 billion in 2010–11. (Figures are from HM Treasury, *Impact on VAT Receipts of Fleming Judicial Ruling*, Response to Freedom of Information request, 28 July 2009, http://www.hm-treasury.gov.uk/foi_fleming_ruling.htm.) While the 2009 PBR states (in paragraph B67 on page 183) that the offset for 2010–11 is now greater than in 2009–10, this seems unlikely to explain the low growth in VAT receipts forecast by the PBR.

Our forecast for corporation tax receipts (which, due to the timing of tax payments, are dependent on both lagged and contemporaneous corporate profits) is on the basis that, in our baseline forecast, nominal-terms corporate profits are assumed to fall by 7.4% in 2009–10 and to grow by just 1.8% in 2010–11 (in line with Barclays' 'optimistic' forecast). Since this growth rate is below that implied by the Treasury's forecast for growth in underlying corporation tax receipts, the 2010 Green Budget baseline forecast for corporation tax receipts in 2010–11 is £34.4 billion, £5.7 billion below the 2009 PBR forecast. Further detail on the outlook for corporation tax receipts under our forecasts and the Treasury's forecast is given in Figure 6.2 below and the accompanying discussion.

As real-terms incomes grow between 2009–10 and 2010–11, the gap between our forecast for income tax receipts and the Treasury's grows from £3.3 billion in 2009–10 to £5.2 billion in 2010–11.

Though we have forecasted the same level of stamp duty revenues in 2009–10 as the PBR, we are £0.8 billion more optimistic about stamp duty revenues in 2010–11. This is based on the Treasury's assumption that house prices grow by 5% and share prices grow in line with money GDP. We further assume that the volume of property transactions increases by 37.5% during 2010–11.[4]

In contrast, we forecast that receipts of NICs will be £1.1 billion lower than the PBR forecast for 2010–11, with this being despite the fact that we predict that these receipts will be £1.1 billion higher in 2009–10 than the PBR forecast. The relatively low growth in cash NICs receipts between 2009–10 and 2010–11 forecast by both ourselves and the Treasury in part reflects the negative impact of the removal of the temporary bank payroll tax.

6.3 Medium-term prospects

Over the medium term, we expect the near-term gap between the PBR 2009 forecast and our Green Budget baseline forecast to narrow slightly (Tables 6.5 and 6.6). The Green Budget forecasts the current budget deficit will be £7.2 billion – or 0.5% of national income – smaller than the PBR in 2010–11. This gap reduces in nominal terms to £6 billion – or 0.3% of national income – in 2014–15. These differences are likely to be small relative to the uncertainties around both forecasts, judging from both past forecasting performance and also the fact that the current outlook is more uncertain than usual.

The Fiscal Responsibility Bill, once legislated, will commit the government to reducing public sector net borrowing every year from 2009–10 to 2015–16, to borrow at most half the 2009–10 level in 2013–14 and to have debt peaking as a share of national income no later than 2015–16. The subsidiary Fiscal Responsibility Order 2010 sets a target of borrowing no more than 5.5% of national income for 2013–14. These are all projected to be met under the Green Budget baseline (as they are in the PBR) – this is despite the fact that our forecast for lower borrowing this year makes the target for halving the deficit by 2013–14 slightly more onerous: it requires borrowing to be at most 5.9% of national income in 2013–14 rather than 6.3% of national income under the PBR forecasts.

[4] This is based on authors' calculations using HMRC data available at http://www.houseprices.uk.net.

Over the coming five years, we expect the current budget balance to improve from a deficit of 8.8% of national income in 2010–11 to a deficit of 2.9% by 2014–15. Of this 5.9% of national income forecast improvement (£83 billion in today's terms), 4.4% of national income (£62 billion) comes from a forecast fall in current spending and 1.5% of national income (£21 billion) from a forecast increase in the tax burden. Over the same period, the PBR has the same reduction in current spending, and a 0.2% of national income (£3 billion) larger forecast increase in the tax burden.

We assume that current spending grows – after economy-wide inflation – at the same rate after 2010–11 as assumed in PBR 2009 – however, as mentioned in Section 6.2, from a slightly lower baseline in 2010–11. As a result, current spending is very marginally (just £0.5 billion, and therefore nearly always lost in the rounding of Table 6.5) lower in every future year under our baseline scenario than under the PBR 2009 forecasts. For public sector net investment, we assume that spending is the same in each year going forwards as forecast in PBR 2009. These assumptions (as is also the case with the Treasury's own forecasts from PBR 2009) lead to spending falling as a share of national income between 2010–11 and 2014–15. As described in Chapter 8, given realistic assumptions about social security, debt interest and other 'annually managed expenditure', these plans would necessitate real cuts to public service spending departments, in particular those areas that the government did not pledge to 'protect' in PBR 2009. The same is true of our baseline forecast.

Table 6.5. Medium-term public finance forecasts under Pre-Budget Report 2009 assumptions – £ billion

£ billion	**2009–10**	**2010–11**	**2011–12**	**2012–13**	**2013–14**	**2014–15**
Green Budget forecasts						
Current budget						
Current receipts	505.2	537.1	580	618	658	699
Current expenditure[a]	623.0	666.7	687	708	730	752
Surplus on current budget	**–117.7**	**–129.6**	**–107**	**–89**	**–71**	**–53**
Capital budget						
Net investment	49.5	39.5	29	26	22	23
Public sector net borrowing	**167.2**	**169.1**	**136**	**115**	**93**	**76**
HM Treasury forecasts						
Current budget						
Current receipts	498.1	530.3	576	617	656	694
Current expenditure[a]	626.2	667.2	687	708	730	753
Surplus on current budget	**–128.1**	**–136.8**	**–111**	**–91**	**–74**	**–59**
Capital budget						
Net investment	49.5	39.5	29	26	22	23
Public sector net borrowing	**177.6**	**176.3**	**140**	**117**	**96**	**82**
Difference in borrowing forecasts (GB–PBR)	–10.4	–7.2	–4	–2	–3	–6

a. In line with the National Accounts, depreciation has been included as current expenditure.
Sources: Authors' calculations. Treasury forecasts from HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/prebud_pbr09_index.htm; this table is similar to table B13 on page 189.

Table 6.6. Medium-term public finance forecasts under Pre-Budget Report 2009 assumptions – % of national income

% of national income	2009–10	2010–11	2011–12	2012–13	2013–14	2014–15
Green Budget forecasts						
Current budget						
Current receipts	35.9	36.5	37.6	37.8	37.9	38.0
Current expenditure[a]	44.2	45.3	44.5	43.3	42.0	40.9
Surplus on current budget	**–8.4**	**–8.8**	**–6.9**	**–5.4**	**–4.1**	**–2.9**
Capital budget						
Net investment	3.5	2.7	1.9	1.6	1.3	1.2
Public sector net borrowing	**11.9**	**11.5**	**8.8**	**7.0**	**5.4**	**4.1**
Public sector net debt	**54.9**	**64.2**	**70.3**	**74.0**	**75.6**	**76.0**
HM Treasury forecasts						
Current budget						
Current receipts	35.3	36.0	37.3	37.7	37.8	37.7
Current expenditure[a]	44.4	45.3	44.5	43.3	42.1	40.9
Surplus on current budget	**–9.1**	**–9.3**	**–7.2**	**–5.6**	**–4.3**	**–3.2**
Capital budget						
Net investment	3.5	2.7	1.9	1.6	1.3	1.3
Public sector net borrowing	**12.6**	**12.0**	**9.1**	**7.1**	**5.5**	**4.4**
Public sector net debt	**55.6**	**65.4**	**71.7**	**75.4**	**77.1**	**77.7**
Difference in borrowing forecasts (GB–PBR)	–0.7	–0.5	–0.3	–0.1	–0.1	–0.3

a. In line with the National Accounts, depreciation has been included as current expenditure.
Sources: Authors' calculations. Treasury forecasts from HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/prebud_pbr09_index.htm; this table is similar to table B14 on page 189.

On the receipts side, the Green Budget forecast is for receipts to grow slightly less quickly over the medium-term than forecast in the December 2009 PBR, although – as Section 6.2 outlined – from a slightly higher base. Over the period from 2009–10 to 2014–15, we forecast that in nominal terms receipts will grow by 6.7% a year on average; in contrast, the PBR forecasts that they will grow by 6.9% a year on average. This compares with assumed average annual growth in nominal national income of 5.5% a year. The next subsection discusses the composition of receipts in more detail.

Taking together our forecasts for total spending and receipts, we forecast that borrowing will be slightly lower in 2009–10 and 2010–11 than PBR 2009 forecast, but then fall less quickly than the PBR forecasts suggest. By 2014–15, we forecast that borrowing will be 0.3% of national income (or £4 billion in today's terms) lower than the PBR 2009 forecast.

As a result of slightly lower borrowing over the medium term, our baseline forecast is that public sector net debt will increase slightly less quickly than PBR 2009 suggested, reaching (and peaking at) 76.0% of national income in 2014–15, compared with the PBR 2009 forecast of it reaching a peak of 77.7% in 2014–15.

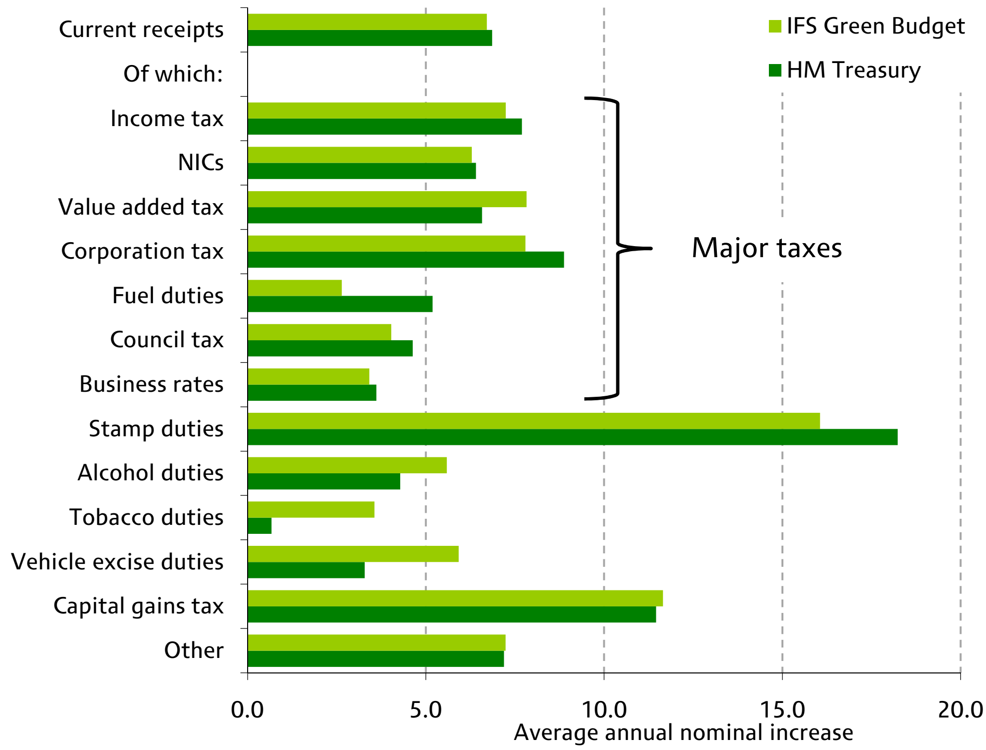
Breakdown of medium-term revenue projections

Figure 6.1 shows the average annual nominal growth rate for each major component of tax revenues under the Green Budget projection over the period from 2009–10 to 2014–15. These are compared with the Treasury's December 2009 projections.

Overall, the Green Budget projection is for slightly lower growth in tax (and non-tax) revenues from a slightly higher base (as detailed in Table 6.3). In terms of the major taxes, between 2009–10 and 2014–15 the Green Budget forecasts weaker growth in income tax and – in particular – fuel duties and corporation tax, somewhat offset by stronger growth in VAT than the PBR 2009 forecast. (In terms of the other 'major taxes', our model also forecasts that revenues from NICs, council tax and business rates will grow slightly less quickly than projected by the PBR.)

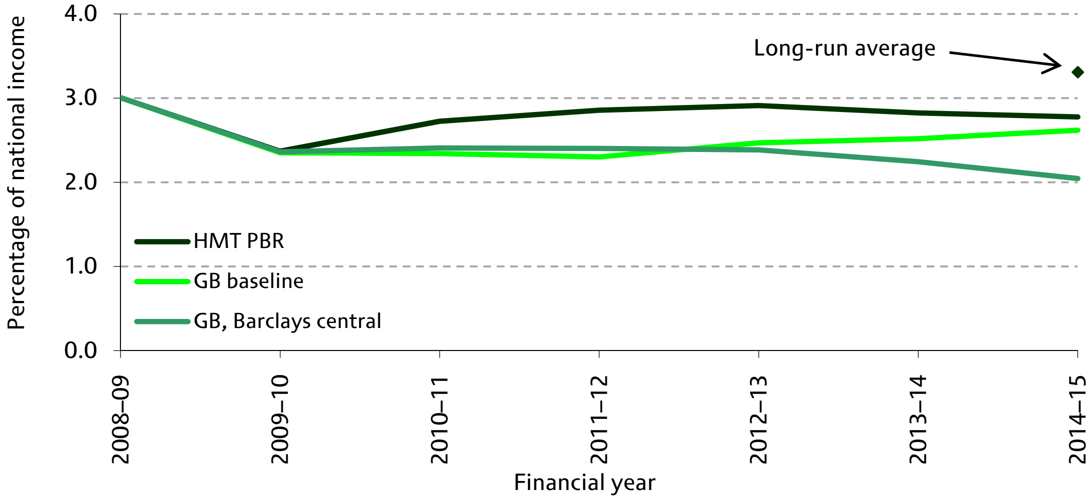
With other taxes, there are more significant differences in the average annual growth in tax receipts between that implied by our model and that forecast by the PBR. In particular, our model predicts much lower growth in revenues from stamp duties and much higher growth in revenues from alcohol duties, tobacco duties and vehicle excise duties. But these taxes make up a relatively small part of revenues – each of them individually is forecast by the Treasury and ourselves to raise less than 4% of total revenues in 2014–15 – and therefore these differences in growth rates are relatively unimportant in explaining differences in projections for overall receipts.

Figure 6.1. PBR and IFS forecasts for revenue growth, 2009–10 to 2014–15



Notes: Income tax net of income tax credits; corporation tax net of company tax credits. Taxes ranked in descending order by amount that the December 2009 PBR forecasts they will raise in 2014–15, with all taxes that are forecast to raise less than capital gains tax (£4.3 billion in 2014–15) included in 'other'.
Sources: Authors' calculations. Treasury forecasts from HM Treasury, *2009 Pre-Budget Report: The Economy and Public Finances – Supplementary Material*, December 2009, http://www.hm-treasury.gov.uk/d/pbr09_chartstables.pdf.

Figure 6.2. Forecasts for corporation tax receipts under HM Treasury and Green Budget assumptions



Notes: Corporation tax includes petroleum revenue tax. The Green Budget baseline forecast assumes that corporation tax receipts as a share of national income move back towards their long-run average level – equal to 3.3% of national income – and, if they continued on this path, would eventually reach this level by 2017–18. We have adjusted this average long-run level to include an assumption that the financial sector, which has traditionally paid relatively large amounts of corporation tax revenues compared with its share in national income, will decline by one-eighth as a share of total output. In addition, we have taken into account the decline in North Sea corporation tax revenues that is forecast in the PBR. The Barclays central scenario assumes that corporation tax revenues grow in line with corporate profitability, as forecast by Barclays.
Sources: Authors' calculations. Treasury forecasts from HM Treasury, *2009 Pre-Budget Report: The Economy and Public Finances – Supplementary Material*, December 2009, http://www.hm-treasury.gov.uk/d/pbr09_chartstables.pdf.

Figure 6.2 provides more detail on the differences in outlook for revenues from corporation tax over the medium term. The PBR forecasts that these receipts will fall from 3.0% of national income in 2008–09 to 2.4% of national income in 2009–10. After this, receipts are forecast to climb to 2.9% by 2011–12, before falling slightly to 2.8% of national income by 2014–15.

The IFS baseline forecast assumes instead that corporation tax revenues grow in line with Barclays' 'optimistic' forecast for corporate profits growth in 2010–11 and 2011–12, before moving back towards the long-run average level of corporate taxation as a share of national income, adjusted downward for the assumption that the financial sector (which, at least prior to the financial crisis, has tended to generate a relatively large share of revenues compared with its size[5]) will comprise a smaller share of national income going forwards. However, we assume that corporate taxation would still be somewhat below this long-term average in 2014–15, as under the PBR macroeconomic scenario the UK economy would still be operating below its productive potential at this point.

A more pessimistic view of the outlook for corporation tax receipts is shown by the Barclays central forecast (discussed in more detail in Section 6.4). This suggests that corporation tax revenues will remain at about 2.4% of national income until 2012–13, before falling as a share of national income as corporate profits growth fails to keep pace

[5] Financial companies, excluding life assurance, paid 28% of mainstream corporation tax in 2007. Source: Table 11.2 of HMRC statistics, http://www.hmrc.gov.uk/stats/corporate_tax/menu.htm. Financial services were 7.6% of GDP in 2007. Source: ONS National Accounts Blue Book.

with growth in nominal national income. By the end of the medium-term forecast horizon, the forecast under the Barclays central scenario is for corporation tax receipts to be 0.7% of national income (or £10 billion in today's terms) lower than the PBR 2009 forecast.

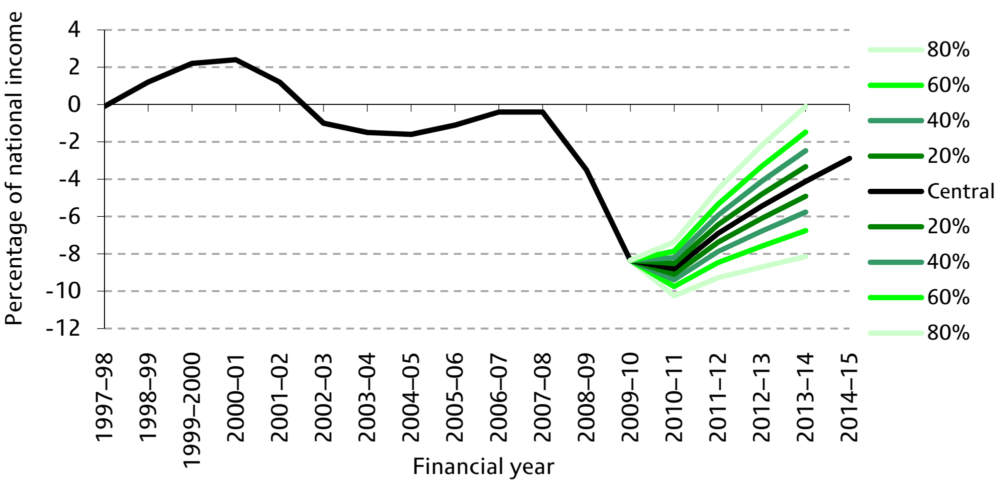
Therefore a key risk to the PBR forecast for corporation tax revenues over the next two years is that they will not grow as quickly as the Treasury predicts, as is suggested by the IFS Green Budget baseline forecast. However, a further risk to the IFS Green Budget baseline forecast is that from 2012–13, revenues may not recover and that they may follow a similar path to that implied by the Barclays central forecast (which shows a similar trajectory for corporation tax receipts as a share of national income from 2011–12 to that implied by the PBR forecast).

Uncertainties around the baseline Green Budget forecast

Public finance forecasts are, by their nature, uncertain and it is important to acknowledge this uncertainty when presenting them, in particular when interpreting point estimates for future deficits and debt. The further ahead forecasts are made, the larger the degree of uncertainty. Figure 6.3 presents a probabilistic fan chart for the Green Budget forecast for the evolution of the current budget over the next four years, with the forecast for 2009–10 taken as given. The fan chart assumes that the current Green Budget forecasts are expected to be right on average and that they are as accurate as the Treasury's forecasts have been in the past, but ignoring the very large forecast errors that have arisen recently as a result of the financial crisis. If the Green Budget forecasts were less accurate than the Treasury's, the fan charts would be wider, while if they were more accurate then the fan charts would be narrower. In addition, if the current forecasting environment is more difficult than normal – which seems likely as we recover from a deep recession and a financial crisis – then the fan charts would also be wider.

The black line in Figure 6.3 shows the central Green Budget forecast – it is assumed that there is a 50% chance that the outcome will lie above this line and a 50% chance that it

Figure 6.3. Probabilities of current budget balance outcomes (Green Budget baseline)



Notes: Central projections are taken from Table 6.6 and assume that the Green Budget projection for 2009–10 is correct. Methodology for computing fan charts taken from C. Emmerson, C. Frayne and S. Love, 'Updating the UK's Code for Fiscal Stability', IFS Working Paper W04/29, 2004, http://www.ifs.org.uk/publications.php?publication_id=3163.

will lie below, as the central forecasts are (by definition) assumed to be right on average. The darkest green lines on either side of the central forecast denote the range of outcomes within which there is a 20% probability that the outcomes will lie. As uncertainty increases with the time horizon, these lines fan out. To the extent that current economic circumstances make the outlook more uncertain than typical, the fans in this figure should be considered to be too narrow.

The central forecast for 2010−11 is for a current budget deficit of 8.8% of national income and Figure 6.3 indicates that there is a 20% probability that the actual outcome will be a deficit of between 8.5% and 9.1% of national income. In 2013–14, the central forecast is for a deficit of 4.1% of national income – but the greater uncertainties in forecasting four years in advance mean that we can only be 20% certain that the outcome will lie within the much larger range of –4.9% to –3.3% of national income.

The 40%, 60% and 80% lines bound the ranges within which there is a 40%, 60% or 80% probability that the outcome will eventually lie. Therefore, there is a 10% probability that the outcome will lie above the upper 80% line and a 10% probability that it will lie below the lower one. Under the Green Budget baseline forecast, there is an estimated 9% probability that, on unchanged policies, the current budget will be in surplus in 2013–14, but a 27% probability that it will be in deficit by more than 6% of national income.

A key conclusion of this analysis is that the difference between the central projections in the Green Budget and the PBR for budget balances and therefore for net debt is less significant than the uncertainty that lies around either, given past forecast performance.

6.4 Alternative macroeconomic assumptions

This section presents alternative forecasts under three different sets of macroeconomic assumptions from Barclays – a central scenario, an 'optimistic' scenario and a 'pessimistic' scenario.

Table 6.7 presents both the underlying economic growth and the assumed level of the economy relative to trend as well as public finance forecasts under the five sets of assumptions: the Treasury's PBR forecasts, the Green Budget baseline forecasts, the Green Budget forecasts under the Barclays central macro forecasts, the Green Budget forecasts under the Barclays 'optimistic' macro scenario, and the Green Budget forecasts under the Barclays 'pessimistic' macro scenario. More details on the three Barclays scenarios can be found in Chapter 4.

The Treasury forecasts that national income will shrink by 3½% in 2009–10. Positive growth returns in 2010–11, with growth forecast to be 2% in 2010–11 and then 3¼% in the following four years. Given the Treasury's estimate of the output gap, this path implies that the economy will not return to trend until well after the end of the forecast horizon in 2014–15.

The Green Budget baseline is largely based on the same underlying economic assumptions as the December 2009 PBR.

Under the first alternative Green Budget scenario (the Barclays central case), there is very slightly stronger real economic growth in 2009–10 and 2010–11. From 2011–12 onwards, the economy is forecast to grow less strongly, as it is estimated that the economy will already have returned to trend activity (and in fact would move slightly above trend in 2011–12).

Table 6.7. Public finance forecasts under various macroeconomic scenarios

	2009–10	2010–11	2011–12	2012–13	2013–14	2014–15
Treasury Pre-Budget Report forecasts						
GDP growth (%)	–3½	2	3¼	3¼	3¼	3¼
Output gap (% of potential GDP)	–6.4	–5.3	–4.3	–3.4	–2.5	–1.6
Public finance forecasts (% of GDP)						
Current budget surplus	–9.1	–9.3	–7.2	–5.6	–4.3	–3.2
Cyclically adjusted current budget surplus	–5.5	–5.4	–3.9	–3	–2.3	–1.9
Net borrowing	12.6	12.0	9.1	7.1	5.5	4.4
Net debt	55.6	65.4	71.7	75.4	77.1	77.7
Green Budget baseline						
GDP growth (%)	–3½	2	3¼	3¼	3¼	3¼
Output gap (% of potential GDP)	–6.4	–5.3	–4.3	–3.4	–2.5	–1.6
Public finance forecasts (% of GDP)						
Current budget surplus	–8.4	–8.8	–6.9	–5.4	–4.1	–2.9
Cyclically adjusted current budget surplus	–4.8	–4.9	–3.7	–2.9	–2.2	–1.6
Net borrowing	11.9	11.5	8.8	7.0	5.4	4.1
Net debt	54.9	64.2	70.3	74.0	75.6	76.0
Barclays central case						
GDP growth (%)	–3¼	2¼	2¼	1¼	1½	1¾
Output gap (% of potential GDP)	–3.1	–1.0	0.2	0.0	0.0	0.0
Public finance forecasts (% of GDP)						
Current budget surplus	–8.2	–8.7	–7.5	–6.7	–5.9	–5.4
Cyclically adjusted current budget surplus	–6.6	–7.6	–7.4	–6.7	–5.9	–5.4
Net borrowing	11.7	11.3	9.4	8.3	7.2	6.7
Net debt	54.5	63.5	70.3	76.7	81.5	85.5
Barclays 'optimistic' case						
GDP growth (%)	–3¼	2¾	2¾	2¼	2¼	2¼
Output gap (% of potential GDP)	–3.4	–1.5	–0.2	0.0	0.1	0.1
Public finance forecasts (% of GDP)						
Current budget surplus	–8.2	–8.6	–7.0	–5.7	–4.5	–3.6
Cyclically adjusted current budget surplus	–6.5	–7.1	–6.6	–5.7	–4.6	–3.7
Net borrowing	11.7	11.2	8.9	7.3	5.8	4.9
Net debt	54.4	63.3	69.5	74.5	77.6	79.5
Barclays 'pessimistic' case						
GDP growth (%)	–3¼	1½	1½	1	1½	1¾
Output gap (% of potential GDP)	–2.8	–0.7	0.1	0.0	–0.1	0.0
Public finance forecasts (% of GDP)						
Current budget surplus	–8.2	–8.8	–8.0	–7.5	–7.0	–6.6
Cyclically adjusted current budget surplus	–6.8	–7.9	–7.9	–7.5	–6.9	–6.6
Net borrowing	11.7	11.5	9.9	9.1	8.2	7.8
Net debt	54.5	63.9	71.4	78.8	84.7	89.8

Sources: Authors' calculations; Barclays; Treasury forecasts from HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/prebud_pbr09_index.htm.

The second alternative Green Budget scenario (the Barclays 'optimistic' case) assumes that the economy shrinks by 3¼% in 2009–10 and then is able to grow by 2¾% before growth falls to 2¼% from 2012–13 onwards.

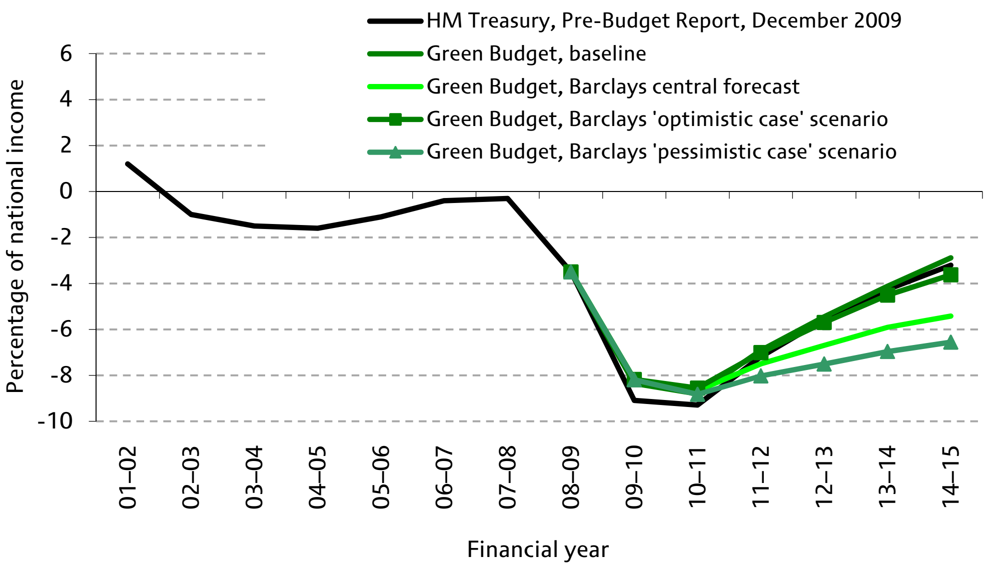
The final alternative Green Budget scenario (the Barclays 'pessimistic' case) assumes that the economy shrinks by 3¼% in 2009–10 and then grows by just 1½% in 2010–11 and 2011–12, with growth remaining below 2% thereafter.

The Green Budget public finance forecasts using the Barclays central scenario show a similar current budget deficit in 2009–10 to that under the Green Budget baseline scenario. However, because there is less estimated spare capacity in the Barclays central economic forecast than in the PBR 2009 economic forecast, this similar current budget deficit represents a greater cyclically-adjusted current budget deficit. From 2011–12 onwards, both the current budget and the cyclically-adjusted current budget remain further below the Green Budget baseline. Indeed, even once the economy is judged to be operating at its potential level, the current budget deficit is forecast to be 5.4% of national income in 2014–15, unless further policy measures were introduced.

Under the Barclays 'pessimistic' scenario, there is a larger current budget deficit from 2010–11 onwards than under the Barclays central scenario. By the end of the forecast period under this scenario, the current budget deficit is still running at 6.6% of national income, even though the economy is then judged to be operating at its potential level. Especially under this scenario, it is difficult to imagine there not being a policy response involving some combination of new tax-raising measures and deeper cuts to public spending being implemented before we get to the end of the current forecasting period.

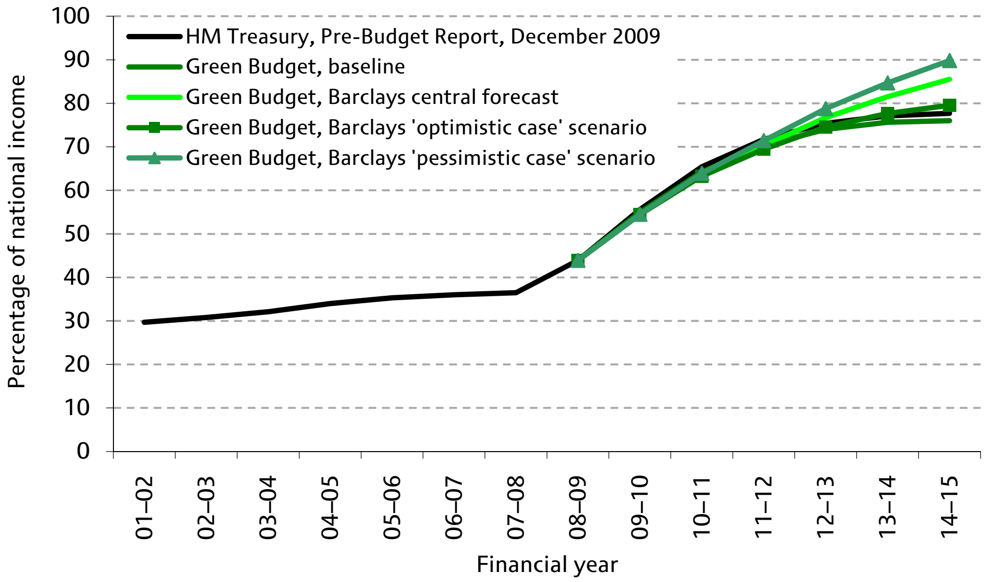
Though somewhat more pleasing than the other Barclays scenarios, even their 'optimistic' scenario for the macroeconomy suggests a weaker outlook for the public finances than the PBR 2009 forecast or our baseline forecast. Though the Barclays 'optimistic' case sees the current budget balance reaching a similar level in 2014–15 to that forecast by the Treasury (3.6% of national income, compared to 3.2%), more of this deficit is thought to be structural under the Barclays 'optimistic' case. This is because,

Figure 6.4. Current budget balance forecasts



Sources: Authors' calculations; Barclays; Treasury forecasts from HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/prebud_pbr09_index.htm.

Figure 6.5. Public sector net debt forecasts



Sources: Authors' calculations; Barclays; Treasury forecasts from HM Treasury, *Pre-Budget Report 2009*, December 2009, http://www.hm-treasury.gov.uk/prebud_pbr09_index.htm.

under this scenario, the economy would be operating closer to its productive potential at the end of the forecasting horizon than under the December 2009 PBR scenario. Looking at the cyclically-adjusted current budget shows that this will stand at 3.7% of national income in 2014–15 under the Barclays 'optimistic' case, compared with 1.9% under the Treasury's PBR forecast and 1.6% under the Green Budget baseline.

These forecasts for the current budget surplus are also compared in Figure 6.4.

Under the Barclays central scenario, net debt rises more quickly than under the Green Budget baseline scenario, reaching 85.5% of national income by 2014–15. Under the Barclays 'pessimistic' scenario, net debt is forecast to reach almost 90% of national income by 2014–15. Under either of these scenarios, the government would undoubtedly be forced to implement a combination of further tax increases and deeper spending cuts in order to stop investors fearing that debt is being allowed to develop along an explosive path. Under the Barclays 'optimistic' scenario, net debt is still forecast to be 3.5% of national income higher than under our baseline scenario by the end of the forecast horizon.

These forecasts are compared in Figure 6.5.

6.5 The Budget judgement

Introduction

Two key uncertainties dominate the policy judgements in this year's Budget (or Budgets): the scale of the fiscal tightening necessary to restore the public finances to a sustainable path, and the potential strength and resilience of the nascent economic recovery. The central challenge for fiscal policy this year is to set about repairing the public finances in a convincing and sustainable way, without putting the recovery at undue risk and potentially storing up even bigger fiscal problems for the future.

To that end, it would seem desirable to put in place a fiscal tightening somewhat more ambitious over the next Parliament than that set out in the December 2009 PBR – but one that does not involve significant additional net public spending cuts or tax increases in the coming year, 2010–11. The unwinding of the discretionary fiscal stimulus measures means that the current projected tightening is already front-loaded. To make it much more front-loaded would risk leaving an already very loose monetary policy bearing too much of the burden of supporting the recovery through its most vulnerable early phase. Given the distance that needs to be covered, repairing the public finances will be a marathon rather than a sprint, so it is more important to convince investors that you will last the course than it is to lead on the first bend.

The credibility of the Fiscal Consolidation Plan would be enhanced if official forecasts for the public finances were produced or overseen by a properly resourced independent body with access to the same information that Treasury forecasters currently enjoy (a detailed discussion of this issue can be found in Chapter 11). But, in any event, ministers should avoid returning to the 'conviction forecasting' that Gordon Brown engaged in as Chancellor prior to the financial crisis, and to which the inflexible targets in its Fiscal Responsibility Bill could well encourage a return. Credibility is best served not by insisting that the public finances will evolve as forecast (either by ministers or by an independent body), but by explaining how policy would respond in the highly likely event that things turn out differently. Specifically, the government should explain as clearly as it can how fiscal policy would respond: first, if the economic recovery were to turn out significantly stronger or weaker than expected; and second, if the scale of the necessary tightening were to look much larger or smaller than currently estimated.

What should we be aiming for?

The surges in public sector borrowing and indebtedness triggered by the financial crisis and the recession have forced the government to abandon the 'golden rule' (to borrow only to invest over the economic cycle) and the 'sustainable investment rule' (to keep debt below 40% of national income in every year) that underpinned its fiscal strategy from 1997. Our projections in Chapter 2 suggest that on existing policies, it would probably be more than 20 years before a future government would be in a position to re-adopt those rules, should it then wish to do so.

The new fiscal targets set out by the government under the Fiscal Responsibility Bill – and the alternative targets set out by the Conservatives – clearly do not reflect their view of the desirable steady state for the public finances. For example, neither sets out a long-term objective for the level of public sector net debt. Rather, they reflect a desire to reassure investors and voters that the public finances will be restored to a sustainable path as quickly as it is safe to do so, albeit a path to an as-yet undefined final destination within an as-yet undefined timescale.

The December 2009 PBR sets out an eight-year tightening that by 2017–18 would slightly more than eliminate the Treasury's current estimate of the additional structural budget deficit created by the crisis. It would be understandable if investors were sceptical of a promise to tighten policy over this timescale, as it would extend well beyond the next Parliament – hence the setting of targets for 2013–14 and 2015–16 in the Fiscal Responsibility Bill, and the Conservatives' decision to adopt targets for the end of the forecasting horizon. (The Conservatives have not specified the forecasting horizon they would use, but the current five-year horizon is the same length as a Parliament if the latter were to run to its maximum length.)

Given the uncertainty over the eventual tightening that will be necessary, and the difficulty of making convincing policy promises beyond the duration of a single Parliament, setting a goal for 2015–16 (as Labour has done, and the Conservatives appear to have done) looks sensible as it would reflect the outcome of policy measures implemented over the five fiscal years of a full Parliament running from 2010–11 to 2014–15. However, it also clearly makes sense to set out forecast projections to the point at which the government believes that the consolidation would be completed, and also the trajectory of public sector net debt on unchanged policies beyond this point. Were an independent forecasting body introduced, it could then, prior to an election in 2015, judge whether enough had been done in policy terms to have a reasonable expectation of meeting whichever goals had been set for the 2015–16 fiscal year.

The Fiscal Responsibility Bill, once legislated, will commit the government to reduce public sector net borrowing year-by-year until 2015–16 and to ensure it is reduced to no more than half the 2009–10 level by 2013–14; if the PBR forecast for this year is correct, this implies borrowing of no more than 6.3% of national income in 2013–14. The subsidiary Fiscal Responsibility Order 2010 sets a target of borrowing no more than 5.5% of national income for 2013–14, which is the Treasury's current central forecast for that year. (Placing this target in secondary legislation looks an odd thing to do, as it signals upfront that the government is less committed to this goal than to the less onerous one in the primary legislation.)

As we saw in Chapter 2, the current government's policy announcements in the 2008 PBR, the 2009 Budget and the 2009 PBR imply a significant fiscal tightening over the next few years relative to a world in which no announcements had been made since Budget 2008. In total, these policy announcements amount to a fiscal tightening of 4.1% of national income (an eventual £57 billion a year in today's terms) between 2010–11 and 2015–16. Adding in the unwinding of the fiscal stimulus package that has been in place in this financial year increases this to 5.7% of national income (an eventual £80 billion a year) between 2009–10 and 2015–16.

Turning to our baseline forecasts outlined in Section 6.3, Labour's goal of borrowing no more than 5.5% of national income in 2013–14 would in principle permit a very modest giveaway (i.e. a partial reversal of the planned tightening) of 0.1% of national income (£1 billion) by 2013–14 if the economy were to evolve as the PBR predicted and if the public finances were to respond to that outcome as we would expect. However, if the economy evolves as outlined in the three Barclays scenarios, which all assume lower real growth in national income from 2011–12 onwards than the PBR, then the government's planned real-terms growth in public spending will translate into a smaller fiscal tightening than the government is expecting. This, and lower fiscal drag on tax receipts, would lead to more fiscal tightening being required in order to reduce borrowing to 5.5% of national income in 2013–14. The government would need to announce an additional tightening of 0.2% of national income (£3 billion) if the economy were to evolve as in Barclays' 'optimistic' scenario, 1.6% of national income (£23 billion) under their central scenario and 2.7% of national income (£38 billion) under their 'pessimistic' scenario.

The Conservatives say that they want to balance the structural current budget (the difference between revenues and non-investment spending, adjusted for the temporary impact of the economy operating above or below its productive potential) at the end of the forecasting horizon. As we discuss in Chapter 2, if we were to assume that the Conservatives retain a five-year forecasting horizon and that the December 2009 PBR forecasts remain the best available, this implies the need to achieve an additional tightening (on top of that already planned by the government) of 1.2% of national income (or £17 billion a year in 2009–10 terms) by 2015–16. Similarly, under our baseline forecast, we estimate that to achieve our interpretation of the Conservative target would require an additional tightening on top of that already planned by the government of 0.9% of national income (£13 billion) if the economy were to evolve as the PBR predicted, 3.0% of national income (£42 billion) under the Barclays 'optimistic' scenario, 4.7% of national income (£66 billion) under the Barclays central scenario and 5.9% of national income (£82 billion) under the Barclays 'pessimistic' scenario.[6]

These scenarios illustrate that there is considerable uncertainty regarding the tightening that would be necessary to achieve the different targets that the government and the Conservatives have set out. The difference between our forecast for the public finances and that of the Treasury for the same economic outlook is relatively modest. The key uncertainties appear to arise more from the considerable doubt that surrounds the likely evolution of the economy's productive potential and its actual growth rate. Predicting what policy settings would deliver the level of public sector net borrowing that the government wants to see in 2013–14 – or the balanced cyclically-adjusted current budget deficit that the Conservatives want to see in 2015–16 – is even harder now than it would normally be. It is not at all clear that either party could credibly promise to deliver its target, come what may, given the large uncertainties that lie around all fiscal forecasts in the current environment.

This suggests to us that it might be more credible and sensible to set out a challenging but achievable plan for fiscal tightening over the next five years and, at the same time, explain if and how that plan might need to change if the economy, the underlying health of the public finances or investor sentiment were to depart significantly from current expectations.

The Barclays scenarios suggest that the eventual tightening required to offset the fiscal impact of the financial crisis is more likely to be larger rather than smaller than the Treasury currently estimates. We also know that there will be upward pressure on large components of public spending over the next few decades as a result of demographic and other factors. And we know that investors and credit rating agencies are nervous about the pace of the current plans for tightening, against a backdrop in which the UK's public finances are deteriorating not just in absolute terms but also relative to almost all other industrial countries.

All these factors suggest that it would be wise to aim for a fiscal tightening somewhat more ambitious than that currently planned by the government, but not so large that it would be seen as politically unsustainable or would threaten economic recovery. Reasonable people could easily differ as to how big such an adjustment might be, but a sensible goal might be to aim for a total tightening eventually reaching around 5% of national income by 2015–16 (an eventual £70 billion a year in today's terms). The government should spell out as soon as it can how it intends to bring this tightening about. At a minimum, this might include setting out the contributions expected to be made by specific reforms (perhaps pre-announced) to taxes, tax credits and benefits (see Chapter 7) and how much it expects to make available to spend on public services in total (see Chapter 8).

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[6] All these scenarios assume that the current government plan is to implement a 0.7% of national income improvement in the structural current budget between 2014–15 and 2015–16, as outlined in chart 2.4 and paragraph 2.79 of the December 2009 PBR.

Tightening by 5% of national income over five years is more ambitious than the current plan to tighten by 4.1% over five years. It implies the need to find additional spending cuts or tax increases worth £13 billion in today's terms on top of the £57 billion that the PBR plans already require by 2015–16. This comes on top of the front-loaded tightening of 1.6% of national income (£23 billion) between 2009–10 and 2010–11 that is required to unwind the fiscal stimulus package. Indeed, we suggest that no significant additional tightening is implemented in 2010–11 on top of that already planned, in light of the likely fragility of the nascent recovery and the fact that monetary policy remains very loose.

A tightening of 5% of national income would be broadly in line with what we think would be necessary to achieve our interpretation of the Conservatives' target of balancing the structural current budget by the end of the forecasting horizon, as described in Section 2.4. If the Treasury is correct in its assessment of the deterioration in the structural budget balance arising from the crisis, then a tightening reaching 5% of national income over five years would mean that most of the work to reverse it would have been done within a Parliament – just 0.3% of national income (or £4 billion) of additional tightening would be required after 2015–16 to return the structural current budget to balance. If the economy were to evolve as outlined in the PBR, but the public finances were to evolve as we outline in our baseline forecast, then implementing the additional fiscal tightening that we suggest would generate a small structural current budget surplus (less than 0.1% of national income) in 2015–16.

However, as we mentioned above, if the economy evolves as outlined in the Barclays scenarios, the government's current plans for real-terms spending growth over the next four years will deliver less of a fiscal tightening than the Treasury expects and thus more work would be left to do, even if the government did implement the additional fiscal tightening we suggest (0.9% of national income) by 2015–16. Under the Barclays scenarios, the additional fiscal tightening required in a second Parliament would be an additional 2.0% of national income (£29 billion) under the 'optimistic' scenario, 3.7% of national income (£53 billion) under the central scenario and 4.9% of national income (£69 billion) under the 'pessimistic' scenario. If a future government became convinced that the necessary tightening was indeed much larger than the Treasury currently estimates, it is far from clear that concentrating the pain into a single Parliament would be politically feasible without the spur of severe market pressure such as that experienced in Ireland.

Due to their relatively pessimistic assessment of the long-term growth rate of productive potential in the UK, the Barclays scenarios also imply that once the consolidation has been completed, we would not be able to sustain as big a real increase in public spending each year thereafter as the Treasury thinks.

Other things being equal, if this or a future government adopted a more ambitious fiscal consolidation plan than that currently in place, monetary policy would likely be kept looser for longer. Given the gradual tightening in monetary policy expected over the next few years, an acceleration of the tightening of the sort suggested here would seem unlikely to place an undue additional burden on monetary policy in keeping inflation on course to hit the government's target.

To underpin the credibility of the tightening plan, the government should try to spell out as clearly as it can how things might have to change if the economic, fiscal or market environment were to depart significantly from current expectations:

- **The strength of the recovery.** The Governor of the Bank of England has sensibly argued that fiscal consolidation should be contingent on the state of the economy (and presumably on the room for manoeuvre that the Bank has to target inflation with monetary policy alone). One way to make this more concrete might be to say upfront that the government would only slow the consolidation plans (or implement offsetting temporary stimulus measures) if the Bank predicted in its *Inflation Report* that growth would slow to some particular sub-trend rate and/or if it felt that monetary policy alone could not be relied upon to restore inflation to target over an appropriate horizon without fiscal assistance. The government might feel able to accelerate the tightening if the economy performed more strongly than expected, although this is less likely to be necessary for the purposes of macroeconomic management as monetary policy is less constrained in how far it can tighten than in how far it can loosen.
- **The size of the necessary fiscal tightening.** As we illustrated in Chapter 2, we have already seen the Treasury's estimate of the deterioration in the structural budget deficit (and the tightening that would be necessary to reverse it) change significantly over its past three forecasts. This may very well happen again as we see how government borrowing evolves in practice, as asset markets move and as official forecasters refine their analysis of the path of productive potential. It would not be sensible to rewrite the fiscal consolidation plan every time this happens. But the government could state that it might have to make the plan more ambitious if the estimate of the structural deficit increased by more than a certain amount, or that it could make it less ambitious if the estimate shrank by more than a certain amount. Needless to say, investors and voters would be suspicious that a government might deliberately reduce its estimate of the structural deficit to pave the way for a looser policy. So this would only be plausible given independent production or scrutiny of fiscal forecasts.
- **Investor sentiment.** There is no robust analytical way of assessing the optimal pace of fiscal tightening in circumstances such as those currently confronting the UK. One important driver in practice will be investor sentiment and its consequences for the rate of interest at which the government can borrow. As Michael Dicks and Simon Hayes of Barclays discuss in Chapters 4 and 5, the UK government is currently able to borrow at historically low interest rates, but those rates are likely to rise – and disruptively and expensively so if investors do not believe that the government is sufficiently serious about repairing the public finances. Of course, we cannot be certain what pace of tightening would satisfy investors now, and what would satisfy them in the future. This would depend not just on how the UK's public finances evolve in absolute terms, but also on how they evolve relative to those of comparable debt-issuing countries. In practice, the government might have to intensify its consolidation efforts if borrowing rates rise significantly, as Ireland was forced to do. It should ensure that it is prepared to act quickly should such a scenario arise.

The composition of the tightening

In Green Budgets, we have traditionally avoided offering advice on the composition of any fiscal tightening or loosening that might be necessary or possible to achieve the fiscal goals of the government of the day. The choice between being a high-taxing and high-spending economy or a low-taxing and low-spending economy is at least as much a political or philosophical one as an economic one. Similarly, the form that a particular fiscal loosening or tightening should take will depend on the government's distributional goals and wider objectives. We stick to that self-denying ordinance here, but simply make a few observations arising from our analysis:

- PBR 2009 set out a plan for a fiscal tightening to 2014–15 comprising two-thirds from cuts to spending (amounting to a reduction of 2.2% of national income, or £32 billion in today's terms) and one-third from increases in tax (amounting to 1.1% of national income, £16 billion). The PBR also stated that a further 0.7% of national income (£10 billion) tightening would be implemented between 2014–15 and 2015–16. The overall planned tightening between 2010–11 and 2015–16 amounts to 4.1% of national income (£57 billion); if it were all delivered on the basis of a 2:1 ratio of spending cuts to tax increases, then overall there would be a 2.7% of national income (£38 billion) cut to spending and a 1.3% (£19 billion) increase in tax.
    - Delivering, instead, a 5% of national income tightening by 2015–16, as we suggest, and retaining a 2:1 ratio of spending cuts to tax increases would require a further 0.3% of national income (£4 billion) to be raised by tax measures and 0.6% of national income (£9 billion) cuts to public spending. Doing two-thirds of the total tightening through spending cuts would return total spending to the level seen in 2004–05.
    - Alternatively, Budget 2009 set out a plan to 2013–14 comprising four-fifths cuts to spending and one-fifth increases in tax. Following this composition while delivering an overall tightening of 5% of national income by 2015–16 would allow a net tax cut of 0.3% of national income (£5 billion) relative to the PBR plans, but would necessitate a further 1.3% cut in spending as a share of national income (£18 billion). Doing four-fifths of the total tightening through spending cuts would return total spending to the level seen in 2003–04.
    - Aiming for the medium-term level of spending set out in Budget 2008 would require tax increases to account for over half of the total adjustment. In other words, this would require further tax rises of 1.4% of national income (£20 billion), combined with a 0.5% of national income (£7 billion) increase in spending relative to our PBR 2009 counterfactual.
- The sooner the government is able to make specific and concrete policy commitments to bring about the planned tightening, the more credible it will be. Given that it would be sensible, for reasons of macroeconomic management and political sustainability, to phase in the planned tightening over the course of the Parliament, this suggests that, where possible, concrete tax and spending measures or decisions should be pre-announced to take effect in future years. This will be easier in some cases than others and may affect what measures would be implemented and when.
- If the Conservatives are determined to implement an additional net tightening in 2010–11, then, given the limited amount of time they would have available, it would probably be more straightforward to do so in the form of tax increases or cuts in welfare spending than by cutting the budgets that public service providers will already be working to for that year. If they were to try to identify cuts in public services in a financial year that was already under way, the danger is that most sensible cuts would not be significant and most significant cuts would not be sensible. An incoming Conservative government would be well advised to invest its time and political capital in developing a sustainable plan for public services reform

over the 2010 Spending Review years than chasing symbolic savings that could be delivered in what would remain of 2010–11.

- A squeeze on the public sector pay bill is likely to be an important part of the fiscal tightening, whichever party wins office. Cutting the level of public sector pay relative to pay in the private sector is likely to be only a temporary source of savings, as history suggests that the public sector will eventually ‘catch up’ in order to maintain the quality of its workforce (see Chapter 9). Lasting savings are more likely to be delivered by cuts in the size of the public sector workforce, which would require either offsetting productivity improvements or a fall in the quality and/or quantity of public services delivered.