5. Green Budget public finance forecasts

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Summary

- We expect both public sector net borrowing and the current budget deficit in 2010–11 to be £2.9 billion, or 0.2% of national income, smaller than the Office for Budget Responsibility (OBR) forecast in November 2010.
- Assuming that the economy evolves largely as the OBR expects, in the medium term we are around 0.2% of national income more optimistic than the OBR about the current budget balance, the cyclically-adjusted current budget balance and public sector net borrowing. We forecast that the current budget balance will improve from a deficit of 7.0% of national income in 2010–11 to a surplus of 0.5% of national income in 2015–16. Of this 7.5% of national income forecast reduction in the current budget deficit, 6.2% of national income is forecast to come from a fall in current spending as a share of national income and 1.3% of national income from an increase in the tax burden.
- We forecast that the cyclically-adjusted current budget balance will improve from a deficit of 4.5% of national income in 2010–11 to a surplus of 1.1% of national income in 2015–16. Our forecast therefore implies that current policy is consistent with the Chancellor's fiscal mandate. We also forecast that, under this scenario, net debt would peak at 69.3% of national income in 2013–14, before falling in 2014–15 and 2015–16, suggesting that the Chancellor's supplementary target would be on course to be met.
- Despite our slightly more optimistic outlook for the public finances than that of the OBR, there are large downside risks. If the economy were to evolve along the Barclays central scenario, we forecast that the cyclically-adjusted current budget would still be in deficit in 2015–16, albeit by only 0.4% of national income. Under this scenario, current policy would not be consistent with the Chancellor's fiscal mandate. Even under the Barclays 'optimistic' scenario for the economy, our fiscal forecasts are only just in line with the OBR's fiscal forecasts. This is because the composition of growth in this scenario is more skewed towards components that are taxed less heavily than in the OBR macroeconomic forecast. Under the Barclays 'pessimistic' scenario, the cyclically-adjusted current budget in 2015–16 is forecast to be in deficit by 2.2% of national income and public sector debt is forecast to be at 90.5% of national income and still rising.
- The case seems strong for the March 2011 Budget to contain no significant permanent net giveaways or takeaways. Any improvements in the public finances relative to the OBR's forecasts, such as those implied by our Green Budget baseline forecast, might best be banked to give the government additional headroom against a future worse outlook for the economy or the public finances or a need to top up its challenging plans for cuts to spending on public services. Although there may be no need to implement an alternative plan at this stage, with such large downside risks to the public finances, having alternative plans to hand could prove useful.

5.1 Introduction

A large fiscal tightening is required over the medium term to narrow the gap between public spending and government revenues in order bring the UK's public finances back to a sustainable position. The government has announced tax increases and spending cuts over the next five years to bring this about, as shown in Figure 2.1 of Chapter 2. This chapter presents the IFS Green Budget fiscal forecasts and discusses them in the context of George Osborne's new fiscal mandate and supplementary target (also described in Chapter 2).

We start in Section 5.2 by comparing last year's Green Budget forecasts for receipts, spending and borrowing in 2009–10 with the latest estimated out-turns and examine how our forecasting errors compare with those made by the Treasury in its December 2009 Pre-Budget Report (PBR). Section 5.3 then presents the 2011 Green Budget forecasts, using as a baseline the assumption that the economy evolves over the next five years largely as the Office for Budget Responsibility (OBR) forecast in its November 2010 *Economic and Fiscal Outlook*. Under this scenario, we forecast that tax revenues will be slightly stronger in the medium term than the OBR forecasts, although the differences are small relative to the size of the planned fiscal tightening. Section 5.4 compares our baseline forecasts with forecasts based on the alternative macroeconomic assumptions outlined by Barclays in Chapter 4. Section 5.5 concludes with what these projections imply for the 2011 Budget judgement.

5.2 Errors in forecasting borrowing for 2009–10

In 2009–10, receipts came in £15.7 billion higher than the Treasury had forecast in its 2009 Pre-Budget Report and £8.6 billion higher than we forecast in the February 2010 Green Budget, as shown in Table 5.1. The forecasting errors made by both the Treasury and last year's Green Budget on the receipts for individual taxes are shown in Table A.2 of Appendix A. The forecasting errors made in last year's Green Budget (which had the

Table 5.1. Comparisons of forecasts for government borrowing, 2009–10

£ billion	HM Treasury, PBR forecast, December 2009	IFS Green Budget forecast, February 2010	Estimate, OBR, November 2010
Current receipts	498.1	505.2	513.8
Current expenditure[a]	626.2	623.0	620.4
Surplus on current budget	–128.1	–117.7	–106.6
Net investment	49.5	49.5	49.4
Total Managed Expenditure	675.7	672.5	669.8
Public sector net borrowing	177.6	167.2	156.0

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

Note: Figures shown in this table exclude the temporary effects of financial interventions.

Sources: Out-turn figures from Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2010 (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html). Forecasts from HM Treasury, *Pre-Budget Report*, December 2009 (http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/prebud_pbr09_repindex.htm) and table 6.2 of R. Chote, R. Crawford, C. Emmerson and G. Tetlow, 'Green Budget public finance forecasts', in R. Chote, C. Emmerson and J. Shaw (eds), *The IFS Green Budget: February 2010*, IFS Commentary C112 (http://www.ifs.org.uk/budgets/gb2010/10chap6.pdf).

benefit of access to two months' additional out-turn data) were smaller than those made by the Treasury for all the major taxes.

The out-turn for current spending was £5.8 billion lower than the Treasury forecast and £2.6 billion lower than we had forecast. As a result of the higher-than-forecast receipts and lower-than-forecast spending, the current budget deficit was ultimately £21.5 billion smaller than the Treasury had forecast and £11.1 billion smaller than we had forecast. With investment spending coming in just £0.1 billion below both the Treasury's and our forecast, total borrowing was £21.6 billion lower than the Treasury forecast and £11.2 billion lower than we forecast.

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

5.3 Baseline forecasts

The IFS Green Budget baseline fiscal forecasts assume that the economy evolves over the next five years largely as the OBR forecast in its November 2010 *Economic and Fiscal Outlook*. While growth in 2010–11 is likely to undershoot this forecast given the estimated decline in national income in the fourth quarter of 2010, our estimates for the strength of the public finances in the current year are heavily based on the pattern of actual receipts and spending so far this year. Lower growth than expected at the end of 2010 does not necessarily imply lower growth going forwards, and it could imply higher growth than the OBR forecast – in particular to the extent to which it was caused by one-off factors such as adverse weather conditions. Additional detail on our methodology can be found in Appendix A.

Borrowing in 2010–11

Table 5.2 provides an overview of the OBR forecasts and Green Budget baseline forecasts for key fiscal aggregates in the current financial year. The 2011 Green Budget forecast for 2010–11 is that receipts will be £2.9 billion higher than was forecast by the OBR in November 2010, while we expect both current and investment spending to come in as forecast by the OBR. Consequently, we forecast that the current budget deficit and public sector net borrowing will both be £2.9 billion lower than was forecast by the OBR last November. The Green Budget baseline forecast is for a current budget deficit of £103.3 billion and public sector net borrowing totalling £145.6 billion, compared with the OBR's forecasts of £106.2 billion and £148.5 billion respectively.

Table 5.2. Comparisons of forecasts for government borrowing, 2010–11

£ billion	OBR November 2010	Green Budget February 2011	Difference
Current receipts	549.7	552.6	+2.9
Current expenditure[a]	655.9	655.9	0.0
Surplus on current budget	–106.2	–103.3	+2.9
Net investment	42.3	42.3	0.0
Total managed expenditure	698.2	698.2	0.0
Public sector net borrowing	148.5	145.6	–2.9

a. In line with the National Accounts, depreciation has been included as current expenditure.
Note: Figures shown in this table exclude the temporary effects of financial interventions.
Source: OBR forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2010 (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

Receipts in 2010–11

Between the June 2010 Budget and the November 2010 *Economic and Fiscal Outlook*, the OBR revised upwards its forecast for receipts by £2.0 billion. This was the combined effect of relatively small revisions (both upwards and downwards) for a number of taxes and other government receipts. We forecast that receipts will be a further £2.9 billion higher than was forecast by the OBR in November.

Table 5.3 shows the forecasts for receipts in 2010–11 broken down into the constituent taxes. For most taxes, we forecast receipts in 2010–11 to be in line with the OBR's forecasts. The most significant – though all still individually small – differences between our forecast and the OBR's are for income tax, National Insurance contributions (NICs), VAT, corporation tax and fuel duties.

The IFS Green Budget baseline forecast is that income tax revenues and NICs receipts will both be £1.5 billion higher this year than the OBR forecast. Our relative optimism is based on three factors. First, growth in employment and earnings this year would suggest, at least according to our model, that receipts from both of these taxes should grow more strongly than the OBR is predicting. Second, growth in receipts of these taxes so far this financial year has also been slightly stronger than implied by the OBR's forecast. Third, we also forecast some further acceleration in the growth of receipts in the final three months, particularly as higher bonuses return in the financial sector – driven both by increasing profitability and the removal of the temporary bank payroll tax, which was in place last year. Income tax owed on bonus payments made in January that is collected through the Pay-As-You-Earn (PAYE) system will show up in January's income tax receipts. The first estimated out-turn for these receipts is scheduled to be published by the Office for National Statistics (ONS) on 22 February 2011.

We forecast that VAT revenues will be £0.5 billion below those forecast by the OBR. Our model suggests that – based on the OBR's forecasts for consumer spending growth this year – VAT revenues (excluding VAT refunds) should come in above the OBR forecast, at £88.3 billion rather than £84.9 billion. However, growth in receipts of VAT so far this year has been somewhat weaker than the latest OBR forecast for VAT receipts suggests for the year as a whole. Assuming the OBR is correct about the scale of VAT refunds this year, the current receipts data so far this year suggest VAT receipts (excluding VAT refunds) will be just £82.3 billion in 2010–11. In addition, the year-on-year growth rate in VAT receipts has slowed in the two months since the OBR forecast was published, possibly reflecting the relatively bad weather towards the end of 2010. Therefore we project that VAT receipts will come in at £98.0 billion (including VAT refunds), £0.5 billion below the £98.5 billion projected by the OBR.

Since the OBR published its latest forecast, oil prices have risen substantially faster than it assumed – oil is now about £12 a barrel more expensive than it was in late November 2010. We expect this to have an impact on corporation tax receipts. Specifically, we forecast that the price rise will increase offshore corporation tax revenues (i.e. revenues derived from companies extracting oil and gas in UK coastal waters) by £1.4 billion both this year and next, while depressing onshore corporation tax receipts (by £1.0 billion this year and £1.7 billion next year).[1] As a result, we forecast corporation tax receipts will total £43.0 billion in 2010–11, £0.4 billion higher than forecast by the OBR.

[1] These calculations are based on the analysis in tables 1 and 2 (page 3) of Office for Budget Responsibility, *Assessment of the Effect of Oil Price Fluctuations on the Public Finances*, 14 September 2010 (http://budgetresponsibility.independent.gov.uk/d/assessment_oilprice_publicfinances.pdf).

We forecast fuel duties will yield £0.4 billion less revenue this year than forecast by the OBR. This judgement is based on the output of our forecasting model, coupled with the fact that the recent rise in the oil price has led to higher pump prices which in turn will tend to depress revenues from fuel duties as consumers respond by purchasing less fuel.

Table 5.3. Comparison of forecasts for tax receipts, 2010–11 and 2011–12

£ billion	**2010–11**		**2011–12**	
	OBR Nov 2010	***Green Budget Feb 2011***	***OBR Nov 2010***	***Green Budget Feb 2011***
Income tax (net of tax credits)	145.5	147.0	151.8	152.3
National Insurance contributions (NICs)	98.5	100.0	102.8	105.0
Value added tax (VAT)[a]	98.5	98.0	115.2	112.7
Corporation tax (net of tax credits)	42.6	43.0	44.6	46.0
Petroleum revenue tax	1.5	1.5	1.6	1.6
Fuel duties	27.7	27.3	29.3	28.5
Business rates	23.8	23.8	25.6	25.2
Council tax	25.7	25.7	26.1	26.1
Capital gains tax	2.8	2.9	3.2	3.8
Inheritance tax	2.7	2.7	2.7	2.9
Stamp duties	9.1	9.1	9.7	9.6
Tobacco duties	9.4	9.4	9.4	9.8
Spirits duties	2.6	2.6	2.5	2.7
Wine duties	3.2	3.2	3.3	3.4
Beer and cider duties	3.7	3.7	3.8	3.8
Air passenger duty	2.2	2.2	2.6	2.5
Insurance premium tax	2.5	2.5	2.8	2.8
Customs duties	3.0	3.0	3.1	3.1
Betting and gaming taxes	1.5	1.5	1.5	1.6
Landfill tax	1.2	1.2	1.3	1.4
Climate change levy	0.7	0.7	0.7	0.8
Aggregates levy	0.3	0.3	0.3	0.3
Vehicle excise duties	5.9	5.7	5.9	5.7
Temporary bank payroll tax / Bank levy[b]	3.5	3.5	1.2	1.2
Other taxes[c]	9.0	9.0	10.3	10.3
National Accounts taxes	**526.7**	**529.7**	**561.5**	**563.2**
Less Own resources contribution to EU budget	–4.9	–4.9	–4.9	–4.9
Interest and dividends	3.8	3.8	4.7	4.7
Other receipts[d]	24.0	24.0	25.0	25.0
Current receipts	**549.7**	**552.6**	**586.2**	**588.0**

a. Includes VAT refunds.
b. Includes both revenues from the temporary bank payroll tax introduced by the Labour government and the new, permanent bank levy announced in the June 2010 Budget.
c. Includes licence fee receipts and environmental levies.
d. Includes gross operating surplus of public corporations.
Notes: Figures for tax receipts in this table are on an accruals basis. Figures shown in this table exclude the temporary effects of financial interventions.
Sources: OBR forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2010 (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html); this table is similar to table 4.6 on page 91 and also uses public finances supplementary table 1.2. Authors' calculations.

Spending in 2010–11

As mentioned above, we expect that current spending for the year as a whole will be as forecast by the OBR in November 2010. So far this financial year, most of the components of central government current spending have evolved largely as the OBR forecast for the financial year as a whole. The one exception to this has been the growth in debt interest payments. Debt interest spending has grown by 55% so far this year, compared with the OBR forecast of 38% growth over the year as a whole.[2] However, debt interest payments depend almost entirely on the stock of gilts already in issuance and (in the case of index-linked gilts) on inflation out-turns from previous months. All of this information would have been available to the OBR at the time it produced its latest forecasts and we therefore have no reason to question its forecast for this item of spending.

Net investment spending by the public sector has also fallen more quickly so far this year than the OBR forecast for the year as a whole. Over the period from April 2010 to December 2010, public sector net investment spending was 19.7% lower than it was over the same period in 2009. The OBR forecast that, over the whole of 2010–11, net investment spending would be 9.2% below its 2009–10 level. Nonetheless, our judgement is that public sector net investment for the year as a whole will be in line with the OBR's forecast of £42.3 billion. In part, this is because investment spending is inherently lumpy and therefore is less likely to evolve smoothly over the financial year than other components of spending. It is also the case that, at the same time last year, investment spending was not in line with the forecast growth for the year as a whole but, as shown in Table 5.1, the December 2009 PBR forecast proved very accurate.

We therefore expect Total Managed Expenditure (TME) in 2010–11 to be as forecast by the OBR, £698.2 billion.

Medium-term prospects

As just discussed, in 2010–11 we forecast borrowing to be £2.9 billion (or 0.2% of national income) lower than forecast by the OBR in November 2010. In 2011–12, the gap between our forecast and the OBR's narrows slightly to £1.9 billion (or 0.1% of national income). Our forecast for spending in 2011–12 is just £0.1 billion lower than the OBR's, as we forecast fractionally lower debt interest spending resulting from our slightly lower forecast level of borrowing in 2010–11. On the receipts side, our forecast is that – on average – receipts will grow a little less quickly in 2011–12 than the OBR is forecasting (though from a higher base). This overall effect includes receipts from some taxes growing faster under our forecasts than the OBR's, but receipts from others growing less quickly. The gap between the OBR's forecast of receipts and ours therefore narrows somewhat in 2011–12. Table 5.3 provides a detailed breakdown of our receipts forecasts for 2011–12.

Over the medium term, we forecast the gap between our borrowing forecast and the OBR's will close between 2011–12 and 2014–15 but then widen to 0.2% of national income in 2015–16. Forecasts for the key fiscal aggregates under both our baseline Green Budget forecast and the OBR's November 2010 forecast are shown in Table 5.4 (in billions of pounds) and Table 5.5 (as a percentage of national income). These differences

[2] Latest out-turns from Office for National Statistics, 'Public sector finances: December 2010' (http://www.statistics.gov.uk/pdfdir/psf0111.pdf). Forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2010 (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

in forecast borrowing are very small relative to the uncertainties around both forecasts, judging from past forecasting performance.

We forecast the current budget will move from a deficit of 7.0% of national income this year to a surplus of 0.5% of national income in 2015–16. Of this 7.5% of national income improvement, 1.3% of national income (or £19 billion in today's terms) comes from an increase in the tax burden and 6.2% of national income (or £92 billion in today's terms) from a fall in current spending. Over the same period, the OBR forecasts the same increase in the tax burden and the same fall in spending.

The Chancellor's fiscal mandate (discussed in detail in Chapter 2) requires that the cyclically-adjusted current budget should be forecast to be in balance or surplus at the end of the forecast horizon. Our baseline forecast is for a cyclically-adjusted current budget surplus of 1.1% of national income in 2015–16. This is slightly larger than the 0.9% of national income surplus forecast by the OBR at the time of its Autumn Forecast in November 2010 and than the 0.8% of national income surplus forecast by the OBR at the time of the June 2010 Budget.

The Chancellor's supplementary fiscal target (also discussed in more detail in Chapter 2) requires that debt be falling as a share of national income between 2014–15 and 2015–16. With our baseline forecast being for slightly lower borrowing in each of the next five years than was forecast by the OBR, our baseline forecast for debt is that it will peak slightly lower than the OBR forecasts – at 69.3% of national income rather than 69.7% – in 2013–14. We forecast that there will be a 1.7 percentage point decline in debt as a share of national income between 2014–15 and 2015–16; this is slightly larger than the 1.6 percentage point decline forecast by the OBR in its November 2010 Autumn Forecast.

Table 5.4. Medium-term public finance forecasts under OBR November 2010 assumptions: £ billion

£ billion	2010–11	2011–12	2012–13	2013–14	2014–15	2015–16
Green Budget forecasts						
Current budget						
Current receipts	552.6	588.0	620.6	659.8	698.6	737.9
Current expenditure[a]	655.9	672.7	684.0	695.8	708.9	728.4
Surplus on current budget	**–103.3**	**–84.7**	**–63.4**	**–35.9**	**–10.3**	**9.5**
Capital budget						
Net investment	42.3	30.9	27.1	23.3	23.8	24.1
Public sector net borrowing	**145.6**	**115.6**	**90.5**	**59.2**	**34.1**	**14.6**
OBR forecasts						
Current budget						
Current receipts	549.7	586.2	620.3	659.1	698.0	734.6
Current expenditure[a]	655.9	672.8	684.1	696.0	709.2	728.7
Surplus on current budget	**–106.2**	**–86.6**	**–63.8**	**–36.9**	**–11.2**	**5.9**
Capital budget						
Net investment	42.3	30.9	27.1	23.4	23.8	24.1
Public sector net borrowing	**148.5**	**117.5**	**91.0**	**60.2**	**35.0**	**18.3**
Difference in borrowing forecasts (GB–OBR)	**–2.9**	**–1.9**	**–0.4**	**–1.1**	**–0.9**	**–3.6**

a. In line with the National Accounts, depreciation has been included as current expenditure.
Sources: Authors' calculations. OBR forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2010 (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

Table 5.5. Medium-term public finance forecasts under OBR November 2010 assumptions: % of national income

% of national income	2010–11	2011–12	2012–13	2013–14	2014–15	2015–16
Green Budget forecasts						
Current budget						
Current receipts	37.3	37.9	38.1	38.3	38.4	38.5
Current expenditure[a]	44.2	43.4	42.0	40.4	39.0	38.0
Surplus on current budget	**–7.0**	**–5.5**	**–3.9**	**–2.1**	**–0.6**	**0.5**
Cyclically-adjusted surplus on current budget	**–4.5**	**–3.2**	**–1.8**	**–0.4**	**0.6**	**1.1**
Capital budget						
Net investment	2.9	2.0	1.7	1.4	1.3	1.3
Public sector net borrowing	**9.8**	**7.5**	**5.6**	**3.4**	**1.9**	**0.8**
Cyclically-adjusted public sector net borrowing	**7.4**	**5.2**	**3.5**	**1.8**	**0.7**	**0.1**
Public sector net debt	**60.6**	**66.0**	**68.8**	**69.3**	**68.4**	**66.7**
OBR forecasts						
Current budget						
Current receipts	37.1	37.8	38.1	38.3	38.4	38.3
Current expenditure[a]	44.2	43.4	42.0	40.4	39.0	38.0
Surplus on current budget	**–7.2**	**–5.6**	**–3.9**	**–2.1**	**–0.6**	**0.3**
Cyclically-adjusted surplus on current budget	**–4.7**	**–3.3**	**–1.8**	**–0.5**	**0.5**	**0.9**
Capital budget						
Net investment	2.9	2.0	1.7	1.4	1.3	1.3
Public sector net borrowing	**10.0**	**7.6**	**5.6**	**3.5**	**1.9**	**1.0**
Cyclically-adjusted public sector net borrowing	**7.6**	**5.3**	**3.5**	**1.9**	**0.8**	**0.3**
Public sector net debt	**60.8**	**66.3**	**69.1**	**69.7**	**68.8**	**67.2**
Difference in borrowing forecasts (GB–OBR)	**–0.2**	**–0.1**	**0.0**	**–0.1**	**0.0**	**–0.2**

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

Sources: Authors' calculations. OBR forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2010 (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

Spending in the medium term

Our baseline forecast is for a similar level of growth in spending over the next five years to that forecast by the OBR. We forecast slightly lower growth in current spending as our lower forecast borrowing feeds through into slightly lower debt interest spending.

The 2010 Spending Review set out detailed spending plans for the next four years, 2011–12 to 2014–15. In theory, the Spending Review set firm limits for departmental programme expenditure for each of the next four years. We assume that, in aggregate, these spending totals for Whitehall departments are met in cash terms.

As discussed in detail in Chapter 6, the plans for public service spending over the next four years are very tight, and one risk to the public finances is that these are not delivered. However, as also described in Chapter 6, when spending was cut during the early 1990s the government at the time was able to keep to its cash spending totals. There are, though, two important caveats to this. First, the current government intends to implement cash cuts to planned spending, whereas this was not the case in the early 1990s. Second, while the previous spending plans were adhered to in cash terms, lower-than-expected inflation meant that the government's intended real cut to spending took longer to materialise than initially envisaged. Higher-than-expected inflation would, if the cash plans were kept to, lead to deeper real cuts in public spending; while this could make implementing the cash spending plans less palatable, it might nonetheless help strengthen the public finances further.

One specific risk, related to inflation, to the current government's ability to adhere to its existing spending plans is the possible cost of David Cameron's public commitment to increase NHS spending in real terms in each of the next four years. As discussed in more detail in Chapter 6, the original Spending Review plans did imply a real-terms (i.e. after taking account of economy-wide inflation) increase for the NHS. However, the OBR has subsequently revised upwards its estimates for inflation over the next few years. This means that the cash spending plans set for the NHS last October now imply a small real-terms cut in budget, rather than an increase.

Our baseline forecast (and the alternative scenarios presented in Section 5.4) assumes that the government delivers the same real-terms increase in the NHS budget in each of the next four years as was planned in the Spending Review. In other words, in our baseline forecast, we increase the cash spending plans for the NHS (by £0.6 billion in 2011–12, rising to £0.7 billion in 2014–15) because inflation is now forecast by the OBR to be higher than was assumed at the time of the Spending Review. Under our baseline forecast, this does not actually increase total public spending because we assume that the government pays for this extra NHS spending out of the reserve that has already been set aside. This reserve amounts to £3.3 billion in 2011–12, rising slightly to £3.6 billion by 2014–15. However, using the reserve for this purpose would, of course, reduce the government's scope to absorb any other unexpected spending demands over the next few years. In all other areas, we assume that the government delivers its cash plans for departmental programme expenditure.

As our baseline forecast assumes that the economy evolves largely as the OBR expects, we forecast that spending on social security benefits and other non-debt-interest, non-departmental-programme spending is the same as forecast by the OBR. With lower borrowing in 2010–11 and in each of the next five years, our forecast for debt interest spending is slightly lower than the OBR forecasts. By 2014–15, we forecast that public sector gross debt interest payments will amount to £59.8 billion, rather than the £60.1 billion forecast by the OBR.

In 2015–16, we assume that total current spending is frozen in real terms, as is public sector net investment. This is in line with the government's stated intention to freeze real-terms public spending in that year.[3] Decisions over the split between different spending priorities will be made in the next Spending Review; as we argue in Chapter 6, it would be sensible for this Review to consider spending on welfare benefits alongside spending on public services, as was the case with the October 2010 Spending Review. Our forecast for lower debt interest and thus lower total current spending than forecast by the OBR in 2014–15 therefore feeds through into lower total spending in 2015–16. We forecast that current spending will be £728.4 billion in 2015–16, while net investment

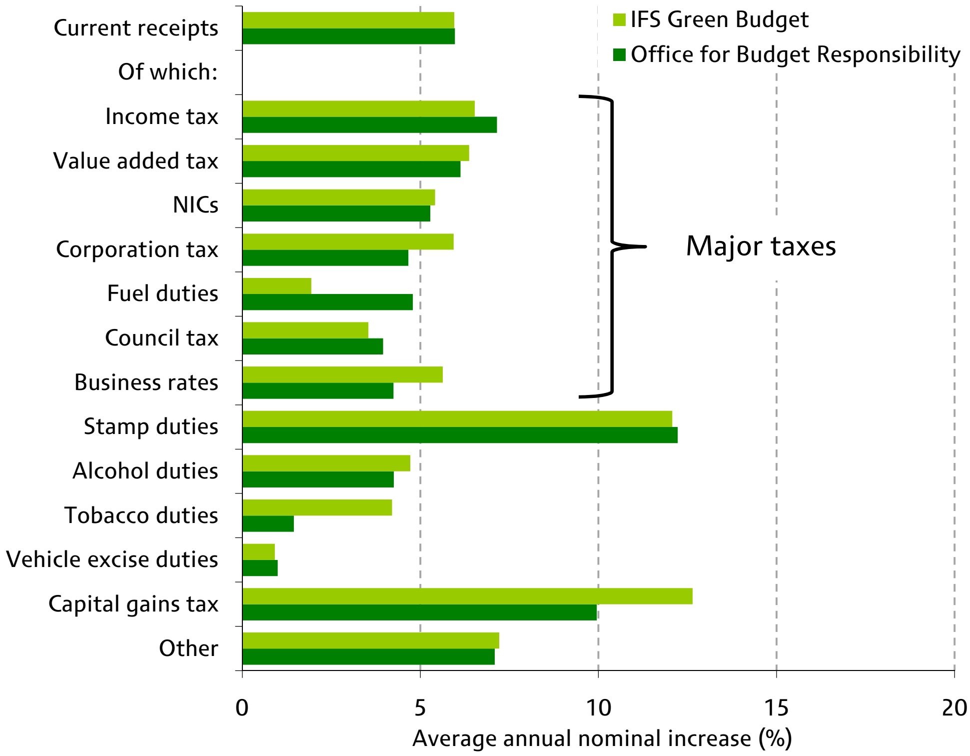
[3] Source: paragraph 1.37 (page 16) of HM Treasury, *Budget 2010*, June 2010 (http://www.hm-treasury.gov.uk/junebudget_documents.htm).

will be £24.1 billion (this is almost identical to the £728.7 billion and by assumption identical to the £24.1 billion, respectively, forecast by the OBR).

Revenues in the medium term

On the receipts side, overall our baseline forecast is for the same growth in tax (and non-tax) revenues between 2010–11 and 2015–16 as that forecast by the OBR in November 2010 but, as mentioned above, from a slightly higher base. Between 2010–11 and 2015–16, we forecast that, in nominal terms, receipts will grow by 6.0% a year on average. This compares with assumed average annual growth in nominal national income of 5.3% a year.

Figure 5.1. OBR and IFS forecasts for revenue growth, 2010–11 to 2015–16



Notes: Income tax net of income tax credits; corporation tax net of company tax credits. VAT includes VAT refunds. Taxes ranked in descending order by amount that the *Economic and Fiscal Outlook: November 2010* forecasts suggest they will raise in 2015–16, with all taxes that are forecast to raise less than capital gains tax (£4.5 billion in 2015–16) included in 'other'.
Sources: Authors' calculations. OBR forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2010 (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

Figure 5.1 provides a breakdown of the forecast average annual growth rates for each of the largest taxes over the period from 2010–11 to 2015–16. For some of these taxes, we forecast higher growth than the OBR does, while for others we forecast lower growth. Amongst the major taxes, our forecast is for lower growth in income tax, council tax and – in particular – fuel duties, offset by higher growth in NICs, VAT, corporation tax and business rates.

Our forecast for income tax receipts is based on the OBR's forecasts for growth in earnings and employment over the next few years, coupled with an assumption that the incomes of the highest-income 5% of income taxpayers (who contribute about a quarter of total income tax revenues) will grow more strongly than the incomes of lower-income individuals in 2011–12.

In our baseline forecast, we assume that the unexpectedly high current oil price unwinds next year – that is, oil prices return to the level forecast by the OBR. Therefore, beyond 2011–12, we forecast that the boost to offshore corporation tax receipts and the (slightly larger) depression of onshore corporation tax receipts resulting from the high oil price, mentioned above, will also unwind. The forecast decline in oil and gas production over the next few years leads us to forecast a decline in receipts of offshore corporation tax, which offsets somewhat the growth in onshore corporation tax receipts.

Our forecast for fuel duties is based on the OBR's forecast for nominal earnings growth coupled with an estimate of the extent to which any increase in income feeds through into additional fuel purchases taken from a previous IFS study.[4]

Our forecasts for growth in tobacco duties and capital gains tax are different from the OBR's, but these taxes make up only a small part of total revenues (amounting to just 2% of total revenues in 2009–10). Our forecast for capital gains tax revenues is based on expected growth in property and equity prices, coupled with forecast increases in the volume of housing transactions. Our forecast for tobacco duty is based on the OBR's forecast for consumer spending growth over the medium term, coupled with an estimate of the extent to which any increase in spending will feed through into higher spending on tobacco taken from a previous government study.[5]

The forecasts we present here assume no further policy changes in addition to those already set out in the June 2010 Budget, the October 2010 Spending Review or previous Budgets and PBRs. However, there are some policy aspirations – for example, those outlined in the government's coalition agreement[6] drawn up in May – that would have implications for the public finances if implemented.

One high-profile example is stated in the section on taxation in the coalition agreement:

> We will further increase the personal allowance to £10,000, making real terms steps each year towards meeting this as a longer-term policy objective. We will prioritise this over other tax cuts, including cuts to Inheritance Tax.

Deputy Prime Minister Nick Clegg recently wrote, in an article in *The Sun* on 11 January 2011, that this policy would be in place before the next election.[7] This would mean that it would need to be in place in the 2015–16 financial year at the latest.

The June 2010 Budget announced that the income tax personal allowance will be increased in cash terms by significantly more than the rate of inflation (from £6,475 to £7,475) in April 2011, with the income tax higher-rate threshold and the National

[4] The elasticity of fuel purchases with respect to income is taken from L. Blow and I. Crawford, *The Distributional Effects of Taxes on Private Motoring*, IFS Commentary 65, 1997 (http://www.ifs.org.uk/publications/1887).

[5] The elasticity of tobacco consumption with respect to consumer spending is taken from M. Chambers, 'Consumers' demand and excise duty receipts equations for alcohol, tobacco, petrol and DERV', Government Economic Service, Working Paper 138, August 1999.

[6] See HM Government, *The Coalition: Our Programme for Government*, 2011 (http://www.cabinetoffice.gov.uk/sites/default/files/resources/coalition_programme_for_government.pdf).

[7] See N. Clegg, *We'll help the alarm clock heroes keep Britain ticking*, The Sun, 11 January 2011 (http://www.thesun.co.uk/sol/homepage/features/3341539/Well-help-the-Alarm-Clock-heroes-keep-Britain-ticking.html).

Insurance upper earnings limit (UEL) both being cut to ensure that higher-income individuals do not gain from this change (for more details of the April 2011 planned changes, see Chapter 12). By 2015–16, we forecast that under current policy the personal allowance would be at £8,505. To increase this to £10,000, while clawing the gains back from higher-income individuals through reductions in the higher-rate threshold and the UEL, would reduce tax revenues by £4.8 billion. Offsetting this cost to the government slightly would be a knock-on reduction in spending on Child Benefit, Housing Benefit and Council Tax Benefit, which means that overall the policy would have a net cost to the government of £4.3 billion (in 2010–11 prices). The measure would have the advantage of taking about 1 million people out of income tax altogether, although it would also increase the number of higher-rate income taxpayers by about 850,000.[8] Incorporating this policy into our forecasts would clearly weaken the outlook for the public finances unless offsetting tax rises or spending cuts were introduced elsewhere.

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. As discussed in Chapter 2, it is a welcome development that the OBR has, since its inception, presented an estimate of the uncertainty surrounding its central forecast for borrowing, following a methodology similar to that which we have previously argued for, and used in past Green Budgets.[9]

The OBR's November 2010 fiscal forecasts are presented as 'fan charts', with lines showing how likely a fiscal aggregate is to be within a particular range. These ranges are calculated under three key assumptions: first, that the central forecast is as likely to be an underestimate as it is to be an overestimate; second, that the latest forecasts are likely to be as (in)accurate as previous PBR forecasts; and third, that there are no further policy changes implemented.[10]

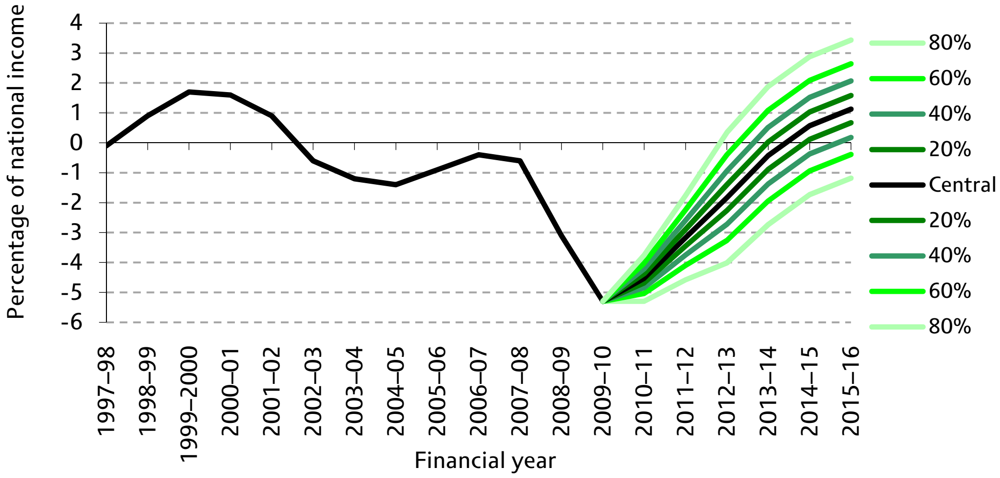
The IFS Green Budget baseline forecast for the cyclically-adjusted current budget surplus is shown in fan-chart style in Figure 5.2. The uncertainty around the forecasts is taken from that used for the OBR's forecasts – that is, we are also assuming that our forecasts are as (in)accurate as previous Treasury PBR forecasts. The figure shows that, under the assumptions just described, there is an 80% chance on our baseline IFS Green Budget forecast that the cyclically-adjusted current budget in 2015–16 will be between –1.2% of national income and +3.4% of national income, with the narrower bands corresponding to ranges with lower likelihoods of occurring. The forecast surplus of 1.1% of national income for 2015–16 is, again under the assumptions set out above, consistent with a 75% chance of there being a balance or surplus on the cyclically-adjusted current budget in 2015–16. In other words, there is a one-in-four chance that additional fiscal tightening – in the form of further tax increases and/or deeper spending cuts – would be required to prevent the cyclically-adjusted current budget from being in deficit in 2015–16.

[8] The authors would like to thank James Browne for producing these calculations, which were done using the IFS tax and benefit model, TAXBEN, run on the 2008–09 Family Resources Survey.

[9] See 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).

[10] The fan charts assume a normal distribution for forecast errors with a mean of zero and a standard deviation calculated from comparing previous PBR forecasts with eventual out-turns.

Figure 5.2. Probabilities of cyclically-adjusted current budget balance outcomes (Green Budget baseline)



Note: Central projections are taken from Table 5.5.
Source: Standard errors on forecasts taken from appendix B of Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2010 (http://budgetresponsibility.independent.gov.uk/d/econ_fiscal_outlook_291110.pdf).

5.4 Alternative macroeconomic assumptions

Another way to highlight the uncertainty in the public finances is to produce forecasts for key fiscal aggregates under not just a central scenario for the macroeconomy but also some alternative scenarios. This has been longstanding practice in the IFS Green Budget, and we welcome the fact that the OBR also chose to present fiscal forecasts under different alternatives for the economy in its November 2010 Autumn Forecast.

Table 5.6 presents forecasts for the public finances under three alternative scenarios for the economy, along with the OBR and IFS baseline forecasts discussed above. These alternative scenarios are the Barclays central case, the Barclays ‘optimistic’ case and the Barclays ‘pessimistic’ case, as set out in detail in Chapter 4.[11]

Under the Barclays central scenario, headline borrowing and the current budget deficit are both forecast to be worse than under the IFS Green Budget baseline forecast through to 2015–16. As the Barclays central forecast is for a smaller output gap than estimated by the OBR, a greater proportion of the borrowing is expected to be permanent rather than explained by temporary weakness in the economy. This therefore means that, while the headline current budget surplus is forecast to be 1.3% of national income lower in 2015–16 under the Barclays central case than under our baseline forecast, the cyclically-adjusted current budget surplus is projected to be 1.5% of national income lower. In 2015–16, we forecast that, under the Barclays central scenario, the cyclically-adjusted current budget would be in deficit by 0.4% of national income (£6 billion in today’s terms), meaning that, under this forecast, current policy would not comply with the Chancellor’s fiscal mandate.

[11] Further details of these scenarios can be found in Appendix A.

Table 5.6. Public finance forecasts under various macroeconomic scenarios

% of national income	2010–11	2011–12	2012–13	2013–14	2014–15	2015–16
OBR, November 2010						
Real GDP growth (%)	2.5	2.0	2.7	2.9	2.8	2.7
Output gap (%)	–3.2	–3.3	–2.8	–2.2	–1.4	–0.7
Public finance forecasts (% GDP)						
Current budget surplus	–7.2	–5.6	–3.9	–2.1	–0.6	0.3
Cyclically-adjusted current budget surplus	–4.7	–3.3	–1.8	–0.5	0.5	0.9
Net borrowing	10.0	7.6	5.6	3.5	1.9	1.0
Net debt	60.8	66.3	69.1	69.7	68.8	67.2
Green Budget baseline						
Real GDP growth (%)	2.5	2.0	2.7	2.9	2.8	2.7
Output gap (%)	–3.2	–3.3	–2.8	–2.2	–1.4	–0.7
Public finance forecasts (% GDP)						
Current budget surplus	–7.0	–5.5	–3.9	–2.1	–0.6	0.5
Cyclically-adjusted current budget surplus	–4.5	–3.2	–1.8	–0.4	0.6	1.1
Net borrowing	9.8	7.5	5.6	3.4	1.9	0.8
Net debt	60.6	66.0	68.8	69.3	68.4	66.7
Barclays central case						
Real GDP growth (%)	2.0	1.8	2.1	2.3	2.3	2.5
Output gap (%)	–2.5	–2.5	–2.1	–1.7	–1.1	–0.4
Public finance forecasts (% GDP)						
Current budget surplus	–7.1	–5.7	–4.4	–3.1	–1.9	–0.8
Cyclically-adjusted current budget surplus	–5.3	–4.0	–2.9	–1.9	–1.0	–0.4
Net borrowing	10.0	7.7	6.1	4.5	3.3	2.1
Net debt	61.2	67.1	71.0	73.4	74.2	73.6
Barclays 'optimistic' case						
Real GDP growth (%)	2.0	2.1	2.4	3.2	3.3	3.1
Output gap (%)	–3.4	–3.4	–3.2	–2.3	–1.3	–0.5
Public finance forecasts (% GDP)						
Current budget surplus	–7.1	–5.5	–4.0	–2.4	–0.9	0.2
Cyclically-adjusted current budget surplus	–4.6	–3.2	–1.8	–0.6	0.2	0.7
Net borrowing	10.0	7.5	5.7	3.8	2.2	1.1
Net debt	61.2	66.5	69.8	70.8	69.7	67.7
Barclays 'pessimistic' case						
Real GDP growth (%)	1.9	0.6	0.9	1.7	1.7	1.8
Output gap (%)	–1.5	–2.6	–3.4	–3.4	–3.4	–3.4
Public finance forecasts (% GDP)						
Current budget surplus	–7.1	–6.3	–5.9	–5.8	–5.5	–4.5
Cyclically-adjusted current budget surplus	–6.0	–4.7	–3.7	–3.4	–3.1	–2.2
Net borrowing	10.0	8.3	7.6	7.3	6.9	5.9
Net debt	61.2	68.2	74.5	80.6	86.1	90.5

Sources: Authors' calculations. Barclays. OBR forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2010 (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

Under the Barclays central scenario, public sector net debt is forecast to peak one year later than in our Green Budget baseline forecast, at 74.2% of national income in 2014–15, and then fall to 73.6% of national income in 2015–16. This suggests that under this scenario, the Chancellor's supplementary target would, despite the breach of the fiscal mandate, be on course to be met.

The Barclays 'optimistic' scenario features higher real GDP growth than both its central forecast and the OBR's forecast. This is because this scenario assumes that there is more spare capacity in the UK economy at the moment, and thus more scope for above-trend growth over the next few years before inflationary pressures emerge. This scenario also involves the composition of growth in the economy being more skewed towards components that are taxed less heavily than in the OBR macroeconomic forecast: in particular, it contains a forecast of lower nominal growth in consumer spending than the OBR forecast. The evolution of the public finances under this scenario is closest to the OBR's own public finance projections. The current budget strengthens to a surplus of 0.2% of national income in 2015–16, implying an estimated cyclically-adjusted current budget surplus of 0.7% of national income. This is 0.2% of national income lower than the cyclically-adjusted current budget forecast by the OBR for 2015–16. Public sector net debt is forecast to peak at 70.8% of national income in 2013–14 and then fall over time. Therefore, under the Barclays 'optimistic' forecast for the economy, current policy would be consistent with the fiscal mandate and the supplementary target would be on course to be met.

The final alternative Green Budget scenario (the Barclays 'pessimistic' case) assumes that economic growth is much lower over the next few years, as a result of there being less spare capacity in the economy at the moment. This feeds through into higher headline and cyclically-adjusted borrowing and a higher current budget deficit. By 2015–16, the headline current budget deficit is forecast still to be running at 4.5% of national income, with the cyclically-adjusted deficit running at 2.2% of national income (£33 billion in today's terms). Public sector net debt would still be rising, reaching 90.5% of national income in 2015–16. So under current policy in this scenario, the fiscal mandate would be missed and the supplementary target would be on course to be missed. In practice, with borrowing remaining so high and debt still rising, it would be likely that this scenario would lead to current policy having to be revised significantly.

5.5 The Budget judgement

A large fiscal tightening is required over the medium term to narrow the gap between public spending and government revenues in order to bring the UK's public finances back to a sustainable position. The government has announced tax increases and spending cuts over the next five years to bring this about. The IFS Green Budget baseline forecast, which assumes that the economy evolves in line with the macroeconomic forecasts set out by the OBR in November 2010 and that all policies confirmed to date (and no others) are implemented, is for the public finances to follow a similar path to that projected by the OBR. We forecast that by 2015–16 the cyclically-adjusted current budget surplus would be 1.1% of national income compared with the 0.9% forecast by the OBR in November (and the 0.8% of national income forecast by the OBR at the time of the June 2010 Budget).

In last year's Green Budget, our baseline forecast for the public finances was also similar to the then latest official forecast (taken from the December 2009 PBR). Our main recommendations at that time were that:

- it would be desirable to put in place a fiscal tightening that was more ambitious over this parliament than that set out in the December 2009 PBR;
- significant additional net spending cuts or tax rises should be avoided in 2010–11;
- credibility could be enhanced if the official forecasts for the public finances were produced or overseen by a properly resourced independent body.[12]

The March 2010 Budget did little to alter the medium-term path of the public finances, but there were significant changes after the general election. First, the new government has set about implementing measures (largely spending cuts and an increase in the main rate of VAT that came into force on 4 January 2011) that the Treasury estimates will reduce borrowing by £8.1 billion in 2010–11.[13] Second, it has both significantly increased the size of the planned fiscal consolidation and brought forward the timescale so that the fiscal repair job is scheduled to be completed in 2015–16 rather than in 2016–17, as was the case under the previous Labour government's March 2010 Budget plans (or rather than in 2017–18 as was planned by the Labour government in the December 2009 PBR, the prevailing official forecast at the time of last year's Green Budget).[14] Third, the coalition government has set up the new, independent OBR with its three-person Budget Responsibility Committee now operating under the leadership of Robert Chote (as discussed in Chapter 2).

The IFS baseline forecast is slightly more optimistic about the outlook for the public finances than the OBR forecast in November 2010, although the differences are small relative to the size of the planned fiscal tightening. Therefore, under our baseline, the Chancellor could afford to reduce the size of the planned fiscal tightening by 0.3% of national income by 2015–16, equivalent to about £4 billion in today's terms, and retain a comparable degree of caution to that which he was planning in his June 2010 Budget. However, we believe that to do so would be hasty. Given the uncertainties facing the UK economy and public finances, our judgement is that Mr Osborne should refrain from announcing any net permanent giveaway in his March Budget.

This section sets out our recommendations – based on the analysis in this chapter and elsewhere in the Green Budget – for Mr Osborne's Budget, which is scheduled for 23 March 2011.

Short-term risks and judgement

Quite what impact the £8.1 billion of fiscal tightening implemented by the new government in 2010–11 has on economic growth will never be known for certain. The overall tightening amounts to half of one per cent of national income. While the

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[12] See R. Chote, R. Crawford, C. Emmerson and G. Tetlow, 'Green Budget public finance forecasts', in R. Chote, C. Emmerson and J. Shaw (eds), *The IFS Green Budget: February 2010*, IFS Commentary 112 (http://www.ifs.org.uk/budgets/gb2010/10chap6.pdf).

[13] Source: Table 2.1 (page 40) of HM Treasury, *Budget 2010*, June 2010 (http://www.hm-treasury.gov.uk/2010_june_budget.htm).

[14] More detailed discussion of the public finance impact of the financial crisis and recession and the Labour and coalition governments' fiscal responses can be found in R. Chote, R. Crawford, C. Emmerson and G. Tetlow, 'Disease and cure in the UK: the fiscal impact of the crisis and the policy response', presented at the European Commission workshop 'The UK Economy, Post-Recession – Same As It Ever Was?', 29 June 2010 (http://ec.europa.eu/economy_finance/events/2010/20100629-uk_seminar/main_en.htm).

£5.2 billion of net spending cuts may have been significant for some of those areas directly affected – the affected Departmental Expenditure Limits were cut by an estimated 3.7% overall[15] – the cuts are smaller when considered as a share of total government spending (amounting to less than 1% of total public spending). Whatever the effect, however, by the time of the forthcoming Budget it will be too late to reverse these changes.

What matters for the short-term decisions to be made in the Budget in March is the fiscal tightening to be implemented in 2011–12. The latest OBR forecasts (and our baseline forecast) suggest that public sector net borrowing will be 2.4% of national income lower in 2011–12 than in 2010–11. We estimate that, of this, 1.5% of national income is to come from discretionary fiscal measures that have been announced over the last few years but will come into force in April (the impact of these on the distribution of income and measures of work incentives is discussed in Chapter 12). The fall in overall borrowing between 2010–11 and 2011–12 is about twice as large as the overall reduction in borrowing that occurred between 2009–10 and 2010–11. However, the reduction in borrowing between 2010–11 and 2011–12 coming from discretionary measures (rather than a fall in borrowing that would be expected to have happened anyway, for example as the economy recovers from recession) is smaller than that which occurred between 2009–10 and 2010–11.[16]

Exactly what size of fiscal consolidation is appropriate in 2011–12 depends on the balance between opposing considerations. On the one hand, to reassure investors that the UK will continue to be able to service its stock of public debt, the government needs to have in place a credible plan for reducing annual borrowing from its currently unsustainably high level. But on the other hand, the risk with reducing government borrowing is that this may reduce demand in the economy and thus economic growth at a time when the economy is weak. The current weakness of the UK economy has been re-emphasised by the recent initial estimates for growth between the third and fourth quarters of 2010, which stands at –0.5%.[17]

Given this risk to growth and these recent developments, the government could consider loosening its currently planned fiscal tightening for 2011–12. However, this would not necessarily pass through into higher demand in the economy if it merely causes monetary policy to become tighter than would otherwise have been the case. Essentially, the argument in favour of announcing a temporary fiscal loosening in the forthcoming Budget is weaker the more confident one is that it would result in tighter monetary policy. A significant loosening of the planned fiscal tightening could push CPI inflation further above the 2% target and thus lead to increased concerns among members of the Monetary Policy Committee (MPC) of the Bank of England that expectations of above-target inflation could become engrained. Two of the nine MPC members voted for an increase in the bank rate from 0.5% to 0.75% in January 2011.[18]

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[15] See R. Chote and C. Emmerson, 'The first cut', IFS Observation, May 2010 (http://www.ifs.org.uk/publications/4924).

[16] The discretionary fiscal tightening between 2009–10 and 2010–11 includes the unwinding of the fiscal stimulus package that was in place in 2009–10 and the net fiscal tightening implemented by the new government, discussed above.

[17] ONS, 'Gross domestic product preliminary estimate: 4th Quarter 2010', *Statistical Bulletin*, 25 January 2011 (http://www.statistics.gov.uk/pdfdir/gdp0111.pdf).

[18] Andrew Sentance and Martin Weale – see http://www.bankofengland.co.uk/monetarypolicy/mpcvoting.xls. A concern about the possibility of expectations of persistent above-target inflation arising is mentioned in the

As discussed in Chapters 2 and 3, the UK has a large structural deficit compared with other similar countries. The government has announced measures to eliminate this deficit by the end of this parliament, but investors may start to question the credibility of this plan if the government appears to fail to implement the first part. We said in last year's Green Budget that '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'.[19] Having set out a game plan, however, shying at an early hurdle could lead investors to question the government's commitment to staying the course.

Given the importance of retaining credibility and the possibility that any fiscal loosening could prompt an offsetting monetary tightening, our judgement is that Mr Osborne might be best advised not to implement a significant short-term net loosening in the Budget.

Medium-term risks and judgement

The government has brought forward the planned fiscal tightening inherited from the previous Labour government so that the repair job is scheduled to be completed in 2015–16, a year earlier than implied by Labour's March 2010 Budget plans. Alongside this, the Chancellor has introduced a new fiscal mandate that currently requires the cyclically-adjusted current budget to be forecast to be in balance or surplus in 2015–16, which would be the year of the next general election if this parliament runs its full course. We continue to believe, as we argued in last year's Green Budget, that aiming to complete the fiscal repair job in one parliament is a sensible strategy as it should be more credible with international investors than a plan that involves tightening in a future parliament.

As well as being brought forward, the overall size of the intended fiscal tightening has been increased from that announced by the previous Labour government. This can be thought of as reflecting two factors.

First, the OBR's estimates for the structural budget deficit are now larger than the official estimates produced before the general election (see Chapter 1). This is because the OBR is less optimistic about the amount of spare capacity in the UK economy – that is, the scope for further above-trend growth before inflationary pressures emerge is now thought to be less. The OBR's assessment last June, therefore, implied that the current budget would (under Labour's bequeathed policies and indicative plans) be weaker than was forecast before the general election. Specifically, the OBR forecast in June implied that there would (under unchanged policy) be a cyclically-adjusted current budget deficit of 0.2% of national income by 2016–17 (the end of Labour's planned fiscal consolidation), rather than a surplus of 0.1% as previously implied by the Treasury's forecast before the general election.[20] An additional fiscal tightening of 0.2% of national income was, therefore, required to ensure that the forecast was for a cyclically-adjusted current budget balance, as required by the Chancellor's fiscal mandate. (In addition, all of the

minutes of the MPC meetings held on 12 and 13 January (http://www.bankofengland.co.uk/publications/minutes/mpc/pdf/2011/mpc1101.pdf).

[19] Page 128 of R. Chote, R. Crawford, C. Emmerson and G. Tetlow, 'Green Budget public finance forecasts', in R. Chote, C. Emmerson and J. Shaw (eds), *The IFS Green Budget: February 2010*, IFS Commentary 112 (http://www.ifs.org.uk/budgets/gb2010/10chap6.pdf).

[20] Sources: Authors' calculations. Treasury pre-election figure is based on table C2 and chart 2.4 of HM Treasury, *Budget 2010*, March 2010 (http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/budget2010_documents.htm). OBR figure is based on table 4.3 of Office for Budget Responsibility, *Pre-Budget Forecast: June 2010*.

fiscal tightening needed to be in place by 2015–16, rather than 2016–17, and so the timescale of Labour's planned tightening had to be accelerated.)

However, the OBR's revision to the estimated structural current budget deficit does not explain all the additional fiscal tightening that has been introduced by the new government. The second explanation is that Mr Osborne chose, in his June 2010 Budget, to build some additional caution into his plans. In June 2010, Mr Osborne chose to aim for a 0.8% of national income cyclically-adjusted current budget surplus, rather than simply a balance.[21] Ultimately, the appropriate degree of caution that should be built in will depend both on the type and magnitude of the uncertainties thought to face the UK's public finances and on an element of political judgement. In addition, the appropriate level of surplus on the current budget will also depend on the government's views on longer-term fiscal pressures, such as those arising from an ageing population. The OBR is due to publish a report in the summer on the long-term sustainability of the public finances (as discussed in Chapter 2). This, coupled with a judgement from the government on what its longer-term objectives for public indebtedness are, should shed light on the appropriate stance for medium-term fiscal policy.

As the OBR and we have highlighted, there are risks around any fiscal forecast. These risks are particularly considerable at the present time. Potential downside risks to the fiscal forecasts include the following:

- **Trend output lower than thought.** The outlook for the economy is uncertain. A key downside risk for the public finances is that the level of trend output in the UK, and possibly also trend growth, have both been more adversely affected by the financial crisis and associated recession than the OBR's central estimates imply. This is discussed in detail in Chapter 1, and the implications for the public finances are demonstrated through the forecasts under alternative Barclays scenarios presented in this chapter.
- **Public finances recover less as growth returns.** Even if the forecasts for the economy turn out to be correct, it does not necessarily follow that the public finances will strengthen as projected. As discussed in Chapter 2, the Treasury has previously estimated that the majority of past errors in projecting the public finances were not explained by errors in the macroeconomic forecasts.
- **Fiscal consolidation is not delivered.** While the impact of the tax rises and welfare cuts on household budgets can be estimated reasonably accurately, it is harder to assess what the impact will be of cuts to public service spending on the quantity and quality of services provided. As set out in Chapter 6, the planned cuts to some areas of public services are extremely deep. This, combined with low labour turnover, means that in some parts of the public sector – such as the police – a downsizing of the workforce on the scale implied by the Spending Review will be difficult to achieve, as discussed in Chapter 7. This suggests that some of the spending plans might need to be topped up to help ensure that the impact of the cuts is palatable to the government and the public.

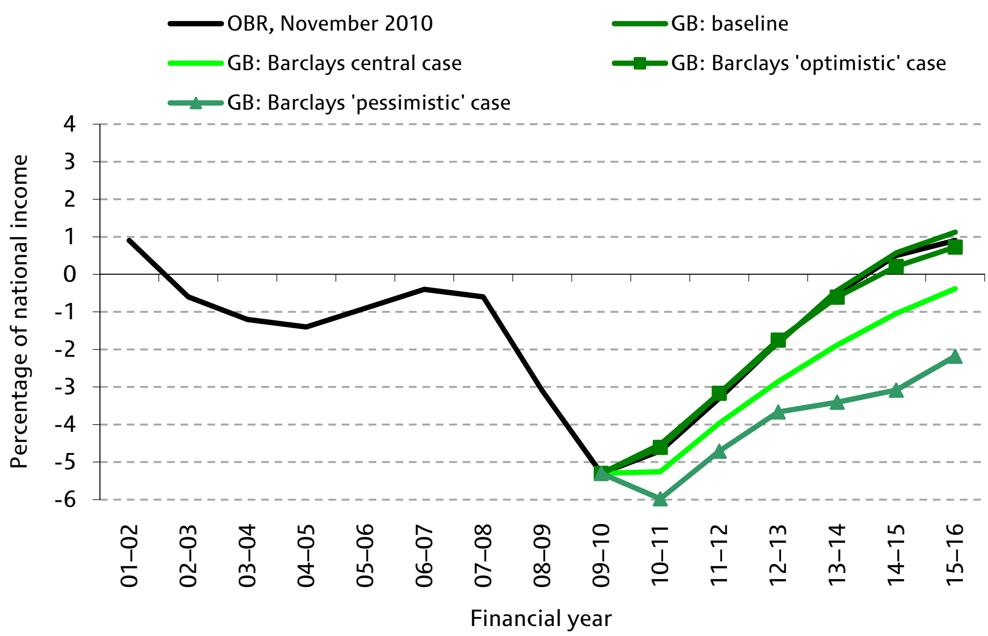
[21] A 0.8% of national income surplus on the cyclically-adjusted current budget by the end of the forecast horizon is similar to the forecasts typically produced by Gordon Brown when he was Chancellor, so it could be that there is a consensus over what the medium-term target should be. During Mr Brown's Chancellorship, the forecast cyclically-adjusted current budget surplus for the end of the forecast horizon was: 1.0% of national income in Budget 1999; 0.7% in Budget 2000; 0.7% in Budget 2001; 0.7% in Budget 2002; 0.6% in Budget 2003; 0.7% in Budget 2004; 0.8% in Budget 2005; 0.8% in Budget 2006; and 0.8% in Budget 2007.

- **Investor sentiment worsens.** A credible deficit reduction plan is important to help keep the rate of interest at which the government can borrow low. With debt interest payments expected to account for about 9% of public spending by 2015–16, the strength of the UK's public finances is clearly sensitive to movements in market interest rates, though not as sensitive as some other countries' finances are because – as discussed in Chapter 3 – a relatively large proportion of our debt is long-dated. Chapter 3 argues that over the last year, the UK government bond market has not shown any difficulties, but that reducing the structural budget deficit is likely to be one of the keys to ensuring that this situation continues, as this is one of the measures on which the UK scores badly compared with other countries.

One quantification of the downside risk to the public finances from the economy not recovering as the OBR expects is provided by the Barclays central scenario. This assumes that the financial crisis and associated recession have had a more detrimental impact on trend output than forecast by the OBR, and therefore assumes the output gap in 2010–11 is running at 2.5% of trend output rather than the 3.2% projected by the OBR. Under this scenario, our forecasts suggest that the current budget would strengthen, but that the cyclically-adjusted current budget would still be in deficit in 2015–16 by 0.4% of national income, as shown in Figure 5.3. Therefore, under this scenario, current policy would not be consistent with the Chancellor's fiscal mandate though the supplementary target (that debt should fall between 2014–15 and 2015–16) would still be on course to be met, as shown in Figure 5.4.

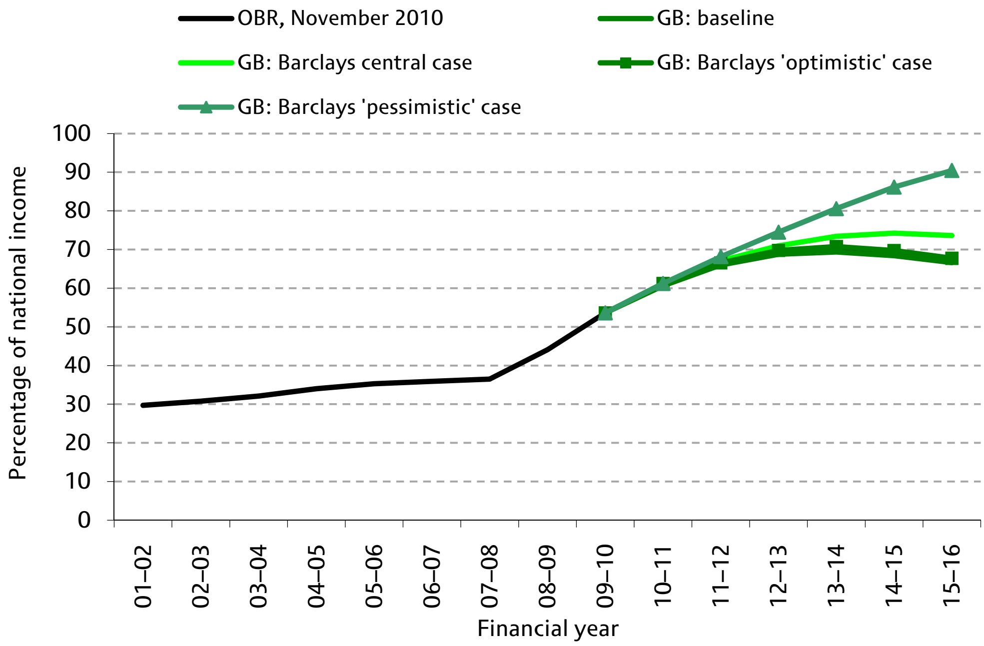
To bring the cyclically-adjusted current budget back to balance would require the Chancellor to announce further future tax rises and/or spending cuts amounting to 0.4% of national income (or £6 billion in today's terms). To restore the degree of caution in the public finances that he intended in his June 2010 Budget, Mr Osborne would in addition, under this scenario, need to announce further future tax increases or spending cuts of 0.8% of national income (or £12 billion in today's terms).

Figure 5.3. Cyclically-adjusted current budget balance forecasts



Sources: Authors' calculations. Barclays. OBR forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2010 (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

Figure 5.4. Public sector net debt forecasts



Sources: Authors' calculations. Barclays. OBR forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2010 (http://budgetresponsibility.independent.gov.uk/econ-fiscal-outlook.html).

Things would be even worse if the economy were to follow the Barclays 'pessimistic' scenario. Under this scenario, there is both less scope for above-trend growth in the economy before inflationary pressures return and demand in the economy is assumed to take a long time to catch up to supply. This means that the output gap starts off smaller but continues to widen over the next few years. Our forecasts under the Barclays 'pessimistic' case suggest that the cyclically-adjusted current budget deficit would still be running at 2.2% of national income in 2015–16. Under this scenario, current policy would not be consistent with the fiscal mandate and the supplementary target would be on course to be missed. To comply with the fiscal mandate and to restore caution in the public finances to the level Mr Osborne intended in June would require him to increase the fiscal tightening by a further 3.0% of national income by 2015–16, equivalent to £44 billion in today's terms.

Not all of the economic risks are on the downside: for example, the economy could evolve as set out in the Barclays 'optimistic' scenario. However, this scenario highlights another risk to the public finances. If this higher growth materialises in components that are taxed less heavily, such as exports and investment rather than consumer spending, the outlook for the public finances might still be no better than the OBR is forecasting. Under the Barclays 'optimistic' case, there would be more scope for above-trend growth than the OBR envisages but our forecasts suggest that the cyclically-adjusted current budget would only climb to a surplus of 0.7% of national income in 2015–16, slightly smaller than the 0.9% forecast by the OBR.

So, although our IFS Green Budget baseline forecast is slightly more optimistic than the OBR's November 2010 forecast, the downside risks are particularly large. As a result, even if the OBR or the Chancellor were to accept our central forecast, the case for the Budget containing no significant net permanent giveaway seems strong. A rosier outlook for the public finances could be used as a justification for a scaling-back of the planned medium-term fiscal consolidation plan, but investors might question whether the government would have been as keen to increase the size of the announced tightening had less rosy forecasts materialised. By banking any improvement in the public finance forecasts that occurs in the near term, the government would give itself a greater cushion against some of the risks mentioned above, including the risk that spending plans would have to be topped up for departments that were finding them particularly difficult and falling short of expectations.

Although there may be no need to implement an alternative short- or medium-term plan at this stage, the Chancellor would be best advised to consider how he would respond to a changing – and, in particular, a worsening – outlook for the economy, the public finances or the quality and quantity of public services being enjoyed. Having such alternative plans to hand could prove useful.