Summary

Chapter 1
The global economy

- Global growth prospects are heavily influenced by the financial crisis in the Eurozone, with the UK especially sensitive to Eurozone developments due to close trade and financial links.
- Eurozone GDP is expected to contract in 2012 as financial strains spill over to the real economy. However, our baseline forecast assumes that the Eurozone stays in its current shape, in particular thanks to further intervention by the European Central Bank.
- Emerging market growth is expected to slow in 2012, limiting prospects for export-led growth in the rest of the world.
- Meanwhile, a moderate recovery is expected to continue in the US, assuming only a limited drag from tighter fiscal policy.
- World growth is forecast at 2.5% in 2012 and 3.5% in 2013 (at market exchange rates). Risks to this forecast are skewed to the downside, with an escalation of the Eurozone crisis and a China hard landing perceived to be key sources of risk. In particular, refinancing very large amounts of government debt in the Eurozone this year perhaps represents the largest single threat to global growth.

Chapter 2
The UK economic outlook

- The UK likely re-entered recession at the end of 2011. Near-term prospects are bleak with a number of headwinds hampering the recovery. In particular, falling demand from continental Europe, continuing fiscal retrenchment and weak consumer and business confidence will keep GDP growth down to only 0.3% in 2012. Unemployment is projected to rise to close to 9% by the end of this year.
- But growth should gather pace in the later part of 2012 and average 1.9% in 2013. Key to this pick-up in activity is an expected fall in inflation that ends the squeeze on consumers' purchasing power. In addition, assuming that business confidence improves, sound balance sheets mean that companies can accelerate investment spending.
- We judge that there is currently a significant amount of spare capacity in the UK economy. However, growth in the capacity of the UK economy is likely to be relatively slow in the short term, constrained by tight credit conditions. We expect potential output growth to average only 1.6% over the period to 2016. GDP, however, is expected to grow on average by 2.1% a year over the next five years as the output gap gradually closes.
- Our short-term forecast is somewhat weaker than both the Office for Budget Responsibility (OBR) forecast and the market consensus, although in our view this discrepancy is largely a question of timing, with other forecasters – including the OBR – likely to downgrade their forecasts in the next few months.

- While our baseline forecast may appear to be rather gloomy, particularly in the short term, the risks remain heavily skewed to the downside. The most serious threat comes from the prospect of an escalation of the Eurozone sovereign debt crisis, with a series of defaults and exits from the Eurozone having the potential to cause another deep recession in the UK.

Chapter 3
Fiscal repair: painful but necessary

- Our latest estimates – based on official forecasts – suggest that the financial crisis and associated recession have punched a permanent hole in the public finances of 7.5% of national income, or £114 billion in today's terms.
- Measures announced by the previous Labour government and the coalition government are estimated to have the direct effect of strengthening the public finances by 8.1% of national income, or £123 billion in today's terms, by 2016–17.
- Official figures now suggest that the structural deficit was 0.8% of national income, or £12 billion in today's terms, larger in 2007–08 than the March 2008 Budget suggested. Even had the Labour government known and dealt with this problem, the need for a large fiscal repair job would still have become apparent post-crisis.
- The latest forecasts suggest that borrowing in 2016–17 will be £24 billion, which is not much lower than the £26 billion forecast by Alistair Darling in his March 2010 Budget, despite the large additional fiscal consolidation announced by the new coalition government. However, in the absence of these new measures, borrowing would now be forecast to be much higher.
- The additional spending cuts announced by George Osborne in the Autumn Statement for 2015–16 and 2016–17 mean that he continues to comply with his fiscal mandate. But the latest official forecasts suggest that he only has a fifty–fifty chance of meeting his supplementary target to have debt falling as a share of national income in 2015–16.
- One risk to the public finances is that the government fails to deliver its planned fiscal consolidation. By the end of 2011–12, 73% of the planned tax increases will have been implemented. The spending cuts, however, are largely still to come – only 12% of the planned total cuts to public service spending, and just 6% of the cuts in *current* public service spending, will have been implemented by the end of this financial year.
- The impact of the remaining cuts to the services provided is difficult to predict; they are of a scale that has not been delivered in the UK since at least the Second World War. On the other hand, these cuts come after the largest sustained period of increases in public service spending since the Second World War. If implemented, the planned cuts would, by 2016–17, take public service spending back to its 2004–05 real-terms level and to its 2000–01 level as a proportion of national income.
- Perhaps the only relevant example of such deep cuts being delivered elsewhere in recent decades is Ireland in the late 1980s. The rarity with which such cuts have been delivered no doubt reflects the fact that they have seldom been deemed necessary and therefore not attempted. Should they not be possible, further tax rises or welfare cuts would be needed to reduce borrowing as currently planned.

Chapter 4
Green Budget public finance forecasts

- The IFS Green Budget baseline forecast is for a current budget deficit in 2011–12 of £95.6 billion and for public sector net borrowing of £124.2 billion. These are £2.9 billion lower than the latest Office for Budget Responsibility (OBR) forecasts, due to a forecast £3.3 billion underspend by Whitehall departments.
- Assuming that the economy evolves broadly as the OBR expects, we forecast the cyclically-adjusted current budget will reach a surplus of 1.1% of national income in 2016–17, complying with the Chancellor's fiscal mandate. This is 0.6% of national income, or £9 billion in today's terms, larger than the latest OBR forecast, and arises largely from stronger forecast growth in tax revenues.
- Using the Oxford Economics central scenario for the economy makes relatively little difference to these estimates, as weaker economic growth than forecast by the OBR is partly offset by a higher oil price and greater North Sea oil and gas production.
- Under both the baseline forecast and the Oxford Economics central forecast, the Chancellor's supplementary target to have debt falling as a share of national income between 2014–15 and 2015–16 would be on course to be only just met. Small changes would lead to it being missed.
- The differences between these forecasts are dwarfed by the uncertainties around them. The risks to the economy are skewed to the downside.
- Oxford Economics puts a significant probability on a 'Eurozone break-up' scenario. In this scenario, national income falls in the short run, public sector net debt rises and, despite a forecast strong bounce-back in growth towards the end of the forecast horizon, the cyclically-adjusted current budget is still forecast to be in deficit by 1.0% of national income in 2016–17.
- Given the uncertainties surrounding the public finances, and the longer-term need for a net fiscal tightening to offset the impact of an ageing population, there is a strong case for the Budget not to contain a significant permanent net giveaway.
- The case for a short-term fiscal stimulus package to boost the economy is stronger now than it was a year ago. Decisions made in the Autumn Statement are likely to have had a small but positive impact on growth. The case for taking this further is not clear-cut: ongoing uncertainty over the future fiscal situation and the importance of credibility argue against it, but the continued weakness of the economy and the low chance of monetary tightening offsetting it make a loosening look more attractive than a year ago. The case would be strengthened significantly were the outlook for the UK economy to deteriorate sharply.
- A cut to the main rate of VAT, a reduction in employer National Insurance contributions and a boost to investment spending plans all seem sensible choices for a temporary fiscal stimulus package, were one deemed necessary.

Chapter 5
Public sector pensions and pay

- Public spending on public service pensions, having risen dramatically over the last forty years, is set to fall as a share of national income. This is due to reforms already implemented by the last Labour government and the current government that will sharply reduce the generosity of these schemes for many members. Public sector workers will still have much more generous pensions than those typically available to their private sector counterparts.
- The two major structural reforms to public pensions – the move to career average from final salary pensions and the alignment of normal pension ages to the state pension age – are coherent changes, with the latter making sense in the context of increasing longevity at older ages.
- Decisions over the rates of accrual and indexation mean that the latest reforms might not save money in the long term. Lower earners are likely on average to benefit from the reforms, while higher earners will lose somewhat. These distributional consequences enhance rather than diminish the differences between public and private sector labour markets.
- Average hourly wages of public sector workers are 24.3% higher than those in the private sector. Most – but not all – of this difference can be explained by public sector workers typically having greater experience and more education. After taking into account these differences, average hourly wages are estimated to be 8.3% higher in the public sector than in the private sector.
- This estimated public sector pay premium has grown over the period since 2008, largely due to the fall in private sector earnings during the recession. The government's proposed squeeze on public sector pay, which is to run until 2014–15, will roughly eliminate this unintended increase.
- After taking into account differences in age and education, lower-paid workers have a greater estimated public sector pay premium than higher-paid workers. The government is relatively protecting the lowest-paid in the public sector. Lower earners will also typically gain, and high earners lose, from the public service pension reforms. Both enhance rather than diminish the differences between public and private sector labour markets.
- The estimated public sector pay premium varies remarkably across regions. There is no evidence of a public sector pay premium in the South East of England, while in Wales the estimated premium is 18.0% for men and 18.5% for women. This provides a strong case for having regional variation in the pay awards that are set centrally. But there is also tentative evidence that the premium varies across different occupations within the same region; therefore any regional variation in public sector pay awards would need to be carefully designed.

Chapter 6
Local government spending: where is the axe falling?

- Local government spending varies significantly across England. Excluding education, local government expenditure per person in London in 2009–10 (£1,868) was much higher than that in the rest of the country, and almost double that in the South East of

England (£976), the region with the lowest spending. Higher spending on transport and police in London explains a large part of this difference. More generally, spending is higher in poorer, more urban districts and lower in more affluent, rural and suburban districts.

- Local authority budgets for 2011–12 imply real-terms cuts in net current service expenditure (excluding education) of 9.4% since 2009–10, or 10.4% when expenditure on fire and police services is also excluded. This reflects both cuts in the amount provided by central government grants (13.3% in real terms) and reductions in the forecast revenue raised by the council tax (2.1% in real terms).
- The size of the cuts varies significantly across local authority areas. Planned cuts (excluding education, fire and police services) between 2009–10 and 2011–12 exceed 15% in around one-quarter of local authority areas, whilst in another quarter they are smaller than 6% (or spending is even set to increase). Increases in real-terms expenditure are planned in around one-tenth of local authority areas.
- The planned cuts are largest in both absolute and percentage terms in areas with higher expenditure in 2009–10. Amongst councils in the top quarter of spenders in 2009–10, the cuts average 16.8%, versus 5.5% amongst those in the bottom quarter of spenders. This means spending cuts are larger, absolutely and proportionally, in urban and poorer parts of England than in more affluent rural and suburban districts. It also means cuts are larger in London and the northern regions of England than in southern regions.
- The size of cuts varies significantly across service areas. Expenditure on planning and development services is hardest hit, with an average cut across England of 43% over the two years since 2009–10. Expenditure on this area, and on libraries and other culture and leisure, is set to be lower in real terms in 2011–12 than in 2001–02. Expenditure on police services, fire services and social services is relatively protected, and expenditure on environmental and refuse services is set to increase (by 1.7%). There is no clear pattern of whether services that previously saw the biggest increases in expenditure are now seeing the biggest cuts or vice versa.

Chapter 7
UK development aid

- The government has ring-fenced the UK aid budget and committed to increasing expenditure to meet the international target of providing 0.7% of gross national income (GNI) as official development assistance (ODA) from 2013. In 2010, the UK government spent £8.45 billion on international development, equating to £321 for each household, and this is planned to rise to £12 billion in 2013.
- Sixteen European countries have committed to reaching a target of spending 0.7% of GNI on ODA by 2015. While this level has already been surpassed by five of these countries, the UK is among only a handful of others that have currently achieved a level near to the target.
- The majority of UK ODA is channelled through the Department for International Development (DfID). Of the aid that DfID delivers bilaterally, the largest share is allocated to Africa. The majority of multilateral expenditures are made through the European Commission and the World Bank.

- DfID expenditures were reviewed in 2011. As a result, DfID spending will now be focused on fewer countries, will be channelled through fewer multilateral organisations, and will be reported on more regularly and in a more detailed manner. This is intended to improve the value gained from ODA.
- Despite the recent reviews, there remains a need to evaluate the value for money achieved by UK ODA. To do this, a greater amount of information is needed, along with increased transparency, particularly relating to multilateral expenditures. The creation of the Independent Commission for Aid Impact, an independent aid watchdog, should go some way to achieving this.

Chapter 8
Tax reform and growth

- The tax system takes on average £4 of every £10 of income in the economy. Its design matters a great deal for economic welfare and for growth.
- This chapter focuses on reforms that could increase national income in the medium term, not on possible short-term stimulus to promote economic recovery. We emphasise that economic growth (i.e. increases in national income) and increases in welfare are not synonymous. There are many welfare-enhancing reforms to the tax system which should be pursued even if they don't promote growth. And there are growth-promoting but welfare-reducing reforms which should not be pursued.
- In general, a tax system that is significantly more neutral than the current one would do less to distort economic activity, would involve lower administration and compliance costs, and would increase both national income and welfare. The scope for reform in this direction is substantial.
- One set of reforms that would raise levels of economic activity over the medium term would involve strengthening financial work incentives for groups that are particularly responsive to them. We suggest changes that could lead to increased employment among mothers of school-age children and among people aged between 55 and 70, two groups known to be particularly responsive to incentives.
- The design of business taxes is important. By discouraging investment in the UK and favouring some forms of investment and finance over others, corporation tax has direct effects on economic activity. Moving to a system that exempts a 'normal' return to capital from taxation would reduce these problems. Replacing business rates with a land value tax, meanwhile, would remove a damaging bias against property-intensive production.
- We can also improve the design of environmental taxes in the UK in ways that would both boost output and improve their effectiveness in dealing with the externalities they are designed to tackle. Replacing much of fuel duty with a system of congestion charging would have major economic benefits. Reforming and simplifying carbon taxation would help to minimise the cost of reducing emissions.
- International studies suggest that moves away from income taxation and, in particular, corporate income taxes, towards consumption and property taxes would enhance growth. In part, this reflects the structure of corporate taxes which, as currently designed, are relatively damaging to growth. But one of the reasons that consumption taxes may be more growth-friendly than income taxes is that they are

generally less progressive. And there is a clear balance to be struck between a focus on progressivity and a focus on growth. In general, reducing the amount of redistribution done in the tax system would increase aggregate income, but at the cost of greater inequality. That is a trade-off that all governments face.

Chapter 9
The 50p income tax rate: what is known and what will be known?

- There has been much discussion about the impact on tax revenues of the 50p income tax rate above £150,000 that was introduced in 2010–11, but, as we lack robust evidence, this is currently a debate characterised by much heat and little light.
- The impact of the 50p tax rate on revenues will depend not just on how many taxpayers there are with incomes above £150,000, but also on how taxpayers react to the increased rate of tax (the so-called behavioural response).
- The HM Treasury (HMT) estimate of how much revenue the 50p rate will raise assumes a lower level of behavioural response than previous UK and US studies have found, and does not allow for any impact on indirect tax revenues. This might imply that the 50p rate is raising less than HMT was expecting. On the other hand, the HMT estimate does not take account of the possibility that more tax will be raised later on, or through other taxes such as capital gains tax.
- It is important not to fixate just on whether any revenue is raised. Even if HMT's estimate is right, there will be a great deal of avoidance activity and changed economic behaviour. There are costs to this and there might well be better ways of raising a similar amount of revenue from a similar group of people.
- Experience from reforms to higher rates of tax in other countries suggests that most of the behavioural response to the 50p rate will take the form of increased (legal) tax avoidance. With or without the 50p tax rate, an effective way of increasing the tax take from high-income individuals would be to remove opportunities for tax avoidance.
- The Chancellor has asked HM Revenue and Customs to estimate the impact of the 50p tax rate on tax revenues and to report to him in time to inform his Budget 2012 decisions. The first shreds of evidence will appear shortly, once tax returns for the 2010–11 tax year have been processed. However, this will tell us, at most, only the very short-run impact of the 50p tax rate on revenues; the true impact in the long run could be higher or lower. If the future of the 50p rate is to be determined on the basis of evidence about its impact, then Budget 2012 will be too soon to form a robust judgement.

Chapter 10
Corporate tax setting

- Following a trend that has been seen across many developed countries, the UK government has pursued a corporate tax strategy of rate cutting and base broadening. One rationalisation of this is that it will lower the tax burden on mobile firms, thus reducing the disincentive for firms to locate in the UK without losing too much tax revenue.

- Tax avoidance, especially by companies, has attracted increasing attention in light of the large budget deficit. A first step towards countering avoidance is to minimise the boundaries between what is and is not taxed, which create opportunities for avoidance. The government is considering introducing a General Anti-Avoidance Rule (GAAR) – a broad set of principle-based rules designed to prevent tax avoidance; there are mixed opinions as to the usefulness of a GAAR.
- The taxation of intellectual property has been a key issue for policymakers. The government will introduce a Patent Box in 2013, which will provide a substantially lower tax rate for the income derived from patents. The policy design weakens the link between the size of the tax deduction and the amount of underlying innovation and increases the deadweight cost of the policy.
- The government is considering whether to devolve the power to set the main rate of corporation tax in Northern Ireland to the Northern Ireland Assembly. There are suggestions that Scotland and Wales should be granted equivalent powers.
- The key aim of devolving corporation tax rate setting power is to reduce rates and therefore boost private sector investment. It is hard to judge whether the benefits from greater levels of activity would be sufficient to outweigh the costs of the public spending cuts that would be needed to finance reductions in the rate of corporation tax and the additional compliance costs and distortions to corporate decision-making that would result.
- Implementing such a policy move would be difficult, and likely require a number of years of transition. A key challenge would be to determine how to allocate profits to each nation and ensure that firms could not artificially allocate profits to the lower-tax nation. There would be an important debate over how to adjust the block grant from Westminster appropriately.
- A concern is that allowing separate rates across the four nations could lead to harmful tax competition within the UK, which would reduce tax revenues for all nations.

Chapter 11
Withdrawing Child Benefit from better-off families: are there better options?

- From January 2013, the government plans effectively to withdraw all Child Benefit from any family containing a higher-rate income taxpayer. The Treasury expects this to save it about £2.4 billion in 2013–14. Around 1.5 million families will effectively lose their Child Benefit as a result: about 600,000 one-child families will lose £1,056 per year; about 700,000 two-child families will lose £1,752 per year; and about 200,000 families with three or more children will lose at least £2,449 per year.
- The ‘cliff-edge’ feature of this policy, whereby all of a family’s Child Benefit is removed completely as soon as pre-tax income passes a certain threshold (rather than being tapered away gradually as income rises), will create a bizarre and economically damaging set of incentives for people within certain income bands. About 170,000 families could increase their net income if an individual in that family managed to lower their pre-tax income to just below the higher-rate tax threshold, and about 200,000 families slightly below the higher-rate tax threshold could find themselves with a lower net income if their pre-tax income were to rise slightly.

- The Treasury has estimated that the resulting distortions to people's behaviour will reduce the revenue raised by the reform by about £280 million per year due to 'tax planning' and another £60 million per year due to 'non-compliance'. A further £90 million per year will go uncollected due to difficulties in correctly identifying the families who should be affected by this reform. The total economic costs of the distortions to people's behaviour (such as reduced labour supply) are likely to be greater still; and one can clearly also question the fairness of effectively rewarding people for working less or arranging a pay cut with their employer.
- The fact that Child Benefit withdrawal would be based on individual income, rather than family income, will mean that Child Benefit will be removed from some couples whose joint pre-tax income is £43,000 per year but not removed from other couples whose joint pre-tax income is £84,000 per year.
- The Prime Minister has recently said that the government is reconsidering the way in which Child Benefit is removed from better-off families. This chapter presents alternative ways of removing Child Benefit from better-off families that address one or both of the issues outlined above. Withdrawing Child Benefit gradually through the income tax system would affect a similar set of families to the government's proposal and could easily be tweaked so that it would raise the same amount of money. Gradual withdrawal would avoid the 'cliff-edge' feature of the current policy and hence the most severe economic distortions. More rational solutions would use the existing system of means-testing for families with children, which is subject to neither of the criticisms outlined above: Child Benefit could be combined with the Child Tax Credit (and, later, Universal Credit).