4. Green Budget public finance forecasts

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Summary

- 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.

4.1 Introduction

This chapter presents the IFS Green Budget fiscal forecasts, and discusses them in the context of the Chancellor's fiscal mandate and his supplementary target. Our baseline forecast, which assumes that the Office for Budget Responsibility's (OBR's) forecasts for the economy are correct, is for borrowing to be slightly lower than the latest OBR forecasts suggest, largely as a result of slightly faster growth in tax revenues over the next few years.

Considerable uncertainty surrounds the outlook for the UK economy and public finances over the medium term. The extent of this uncertainty is demonstrated by the fact that our calculations suggest that the hole in the public finances that has appeared since the financial crisis began was increased from £91 billion a year in the OBR's March 2011 forecast to £114 billion a year in its November 2011 forecast (an increase of £23 billion). This was largely the result of changes to the macroeconomic outlook between March and November. We therefore also present alternative forecasts for the UK's public finances under different scenarios for the economy. These suggest that the risks to the public finances are skewed to the downside.

Section 4.2 presents our forecasts for 2011–12 and for the medium term. We present medium-term forecasts under two assumptions: first, a baseline assumption that the economy evolves as forecast by the OBR in its November 2011 Economic and Fiscal Outlook (EFO); and second, using the Oxford Economics central forecasts for the economy. Section 4.3 then highlights the uncertainty around these forecasts for the public finances, in particular by considering two alternative macroeconomic scenarios provided by Oxford Economics: one in which growth in the next few years is stronger than the OBR forecasts as company investment picks up more quickly; and one in which a Eurozone collapse leads to a contraction in the UK economy in 2012–13. (More details on the Oxford Economics forecasts can be found in Chapter 2.) Section 4.4 concludes with what all these projections imply for our 2012 Budget judgement.

A comparison of last year's Green Budget forecasts for receipts, spending and borrowing in 2010–11 with the latest estimated out-turns, and how our forecasting errors compare with those made by the OBR in its November 2010 EFO, is provided in Appendix A.

4.2 IFS fiscal forecasts

This section provides an overview of our fiscal forecasts for the next five years. 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 2011 EFO. Additional detail on our methodology and individual components of our forecasts can be found in Appendix A.

Borrowing in 2011–12

The November 2011 OBR forecast for borrowing in 2011–12 was higher than its March 2011 Budget forecast – public sector net borrowing was revised upwards from £121.8 billion to £127.1 billion. This was almost entirely due to downwards revisions to the underlying economic forecast, rather than policy measures, since the discretionary policy measures announced in the 2011 Autumn Statement had no significant net direct effect on the public finances in 2011–12. The OBR reduced its forecast for growth in 2011–12 from 1.8% to 0.6% between March and November 2011. While this is partially reflected in higher forecast borrowing for 2011–12, much of the effect on borrowing will not be felt until next year.

The Green Budget forecast for 2011–12, as shown in Table 4.1, is that receipts will be £0.4 billion lower than was forecast by the OBR in November 2011, current spending will be £3.3 billion lower than forecast, and investment spending will come in as forecast by the OBR in November 2011. 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 (but borrowing will still be £2.4 billion higher than it forecast in March). The Green Budget baseline forecast is for a current budget deficit of £95.6 billion and public sector net borrowing totalling £124.2 billion, compared with the OBR's November forecasts of £98.5 billion and £127.1 billion respectively.

Table 4.1. Comparisons of forecasts for government borrowing, 2011–12

£ billion	OBR March 2011	OBR November 2011	Green Budget February 2012	Difference between Green Budget forecast and: March	November
Current receipts	588.6	575.5	575.1	–13.5	–0.4
Current expenditure[a]	678.6	673.9	670.6	–8.0	–3.3
Surplus on current budget	–90.0	–98.5	–95.6	–5.6	+2.9
Net investment	31.8	28.6	28.6	–3.2	0.0
Total Managed Expenditure	710.4	702.6	699.3	–11.1	–3.3
Public sector net borrowing	121.8	127.1	124.2	+2.4	–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: Authors' calculations. Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2011 (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-march-2011/). Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2011 (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011/).

The downgrade in growth between the March 2011 Budget and the November 2011 EFO led the OBR to revise down its forecast for receipts by £13.1 billion with, in particular, a £5.0 billion downwards revision to forecast corporation tax receipts. We forecast that receipts will be a further £0.4 billion lower than forecast by the OBR in November. Table A.3 in Appendix A shows both our and the OBR's forecasts for receipts in 2011–12, broken down into the constituent taxes. The most significant – though still individually small – differences between our forecasts and the OBR's are for VAT, fuel duties and capital gains tax.

We forecast that current spending in 2011–12 will be £3.3 billion lower than forecast by the OBR in November, at £670.6 billion (£8.0 billion lower than forecast in March). Central government spending excluding that on net social benefits and debt interest payments (broadly, spending by government departments on the administration and provision of public services) has been lower over the first nine months of 2011–12 than it was over the first nine months of 2010–11. This is in contrast to the OBR's November 2011 forecast that it would grow by 1.4% over the year as a whole. One possibility is that government departments are on course to undershoot their budgets in order to ensure that they do not end up with an overspend. Some departments might also be underspending in 2011–12 as they take more action now to help ensure that they are better placed to deliver their tight budgets for 2012–13, 2013–14 and 2014–15. Consequently, we forecast that government departments as a whole will underspend their current budget allocations by 1% (or £3.3 billion) in 2011–12.[1] We choose not to disagree with the OBR in our forecast for other components of spending, including debt interest spending, spending on net social benefits and public sector net investment (this is discussed in more detail in Section A.3 of Appendix A). Therefore, overall, we expect Total Managed Expenditure (TME) in 2011–12 to be £3.3 billion below what was forecast by the OBR in November, at £699.3 billion.

Medium-term prospects: overview

For 2012–13, we again forecast that tax revenues and spending will be slightly lower than what the OBR forecast last November. Therefore, our baseline forecast is that borrowing will be £1.0 billion higher next year than expected by the OBR.

From 2013–14 onwards, our baseline forecast is for borrowing to be lower each year than forecast by the OBR, with the gap between our baseline borrowing forecast and the OBR's increasing between 2012–13 and 2016–17. In 2016–17, we forecast that borrowing will be £11.2 billion (or 0.6% of national income) lower than the OBR's latest forecast. Forecasts for the key fiscal aggregates under both our baseline Green Budget forecast and the OBR's November 2011 forecast are shown in Table 4.2 (in £ billion) and Table 4.3 (as a percentage of national income).

Our baseline forecast is that the current budget will move from a deficit of 6.3% of national income this year to a surplus of 0.4% of national income in 2016–17. Of this 6.7% of national income (or £102 billion in today's terms) improvement, 0.6% of national income (or £9 billion in today's terms) comes from an increase in the tax burden and 6.2% of national income (or £94 billion in today's terms) from a fall in current spending as a share of national income. Over the same period, the OBR forecasts a similar (though slightly larger) fall in spending but no increase in the tax burden, and hence a smaller improvement in borrowing.

The lack of any increase in the tax burden under the OBR's forecasts is surprising, not least because of tax increases that have already been announced which it judges will bring in 0.4% of national income higher revenues in 2015–16 than in 2011–12 (see Figure 3.5). The IFS Green Budget baseline forecasts, by contrast, do project an increase in the tax burden over time, as fiscal drag in, for example, income tax and stamp duty land tax is sufficiently large to offset those taxes, such as council tax and fuel duties, where revenues are projected to fall over time as a share of national income. Our forecasts for the growth in revenues from individual taxes and our forecasts for spending are discussed in more detail below.

Given that our baseline forecast assumes that the economy evolves broadly as the OBR has forecast, the difference between our baseline forecast and its (while not small by the standards of more normal periods) may still miss an important element of uncertainty about the outlook for the public finances – namely, that the economy might evolve along a

[1] The Office for Budget Responsibility also now expects that central government departments will underspend their allocations. Specifically, it has stated that it 'looks likely that departments will underspend on their current expenditure by more than the £0.25 billion allowed for in the EFO' (Office for Budget Responsibility, *Commentary on the Public Finances Release*, January 2012, http://budgetresponsibility.independent.gov.uk/category/topics/monthly-public-finance-data/).

different path. Therefore, we have also produced fiscal forecasts using the Oxford Economics central forecast for the economy – the details of this economic forecast are set out in detail in Chapter 2. Tables 4.2 and 4.3 show our forecasts for the main fiscal aggregates from 2011–12 to 2016–17 assuming that the UK economy evolves, instead, as Oxford Economics expects.

Table 4.2. Medium-term public finance forecasts – £ billion

£ billion	**2011–12**	**2012–13**	**2013–14**	**2014–15**	**2015–16**	**2016–17**
IFS: baseline						
Current budget						
Current receipts	575.1	593.3	625.3	661.7	702.3	746.3
Current expenditure[a]	670.6	689.2	701.1	714.5	726.0	737.8
Surplus on current budget	**–95.6**	**–95.9**	**–75.9**	**–52.8**	**–23.6**	**8.5**
Capital budget						
Net investment	28.6	25.2	21.9	21.8	20.4	20.7
Public sector net borrowing	**124.2**	**121.1**	**97.8**	**74.6**	**44.0**	**12.3**
IFS: Oxford Economics central						
Current budget						
Current receipts	576.3	592.8	624.4	663.3	706.2	750.9
Current expenditure[a]	670.9	690.8	703.4	717.3	728.9	740.9
Surplus on current budget	**–94.6**	**–97.9**	**–79.1**	**–54.0**	**–22.8**	**10.0**
Capital budget						
Net investment	28.6	25.2	21.9	21.8	20.4	20.7
Public sector net borrowing	**123.2**	**123.1**	**101.0**	**75.8**	**43.2**	**10.7**
OBR forecasts						
Current budget						
Current receipts	575.5	594.4	623.6	657.4	693.5	735.2
Current expenditure[a]	673.9	689.3	701.2	714.6	726.2	738.0
Surplus on current budget	**–98.5**	**–94.9**	**–77.6**	**–57.2**	**–32.7**	**–2.8**
Capital budget						
Net investment	28.6	25.2	21.9	21.8	20.4	20.7
Public sector net borrowing	**127.1**	**120.1**	**99.5**	**79.0**	**53.1**	**23.5**
Difference in borrowing forecasts (IFS:B – OBR)	**–2.9**	**1.0**	**–1.7**	**–4.4**	**–9.1**	**–11.2**
Difference in borrowing forecasts (IFS:OE – OBR)	**–3.9**	**3.0**	**1.5**	**–3.2**	**–9.9**	**–12.8**

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

Source: Authors' calculations. OBR forecasts from the Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2011 (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011/).

Table 4.3. Medium-term public finance forecasts – % of national income

% of national income	2011–12	2012–13	2013–14	2014–15	2015–16	2016–17
IFS: baseline						
Current receipts	37.8	37.6	37.8	38.0	38.1	38.4
Current expenditure[a]	44.1	43.7	42.4	41.0	39.4	37.9
Surplus on current budget	–6.3	–6.1	–4.6	–3.0	–1.3	0.4
Cyclically-adjusted surplus on current budget	**–4.3**	**–4.0**	**–2.6**	**–1.3**	**–0.1**	**1.1**
Net investment	1.9	1.6	1.3	1.3	1.1	1.1
Public sector net borrowing	8.2	7.7	5.9	4.3	2.4	0.6
Cyclically-adjusted public sector net borrowing	6.2	5.6	3.9	2.6	1.2	0.0
Public sector net debt	**67.4**	**73.3**	**76.6**	**77.8**	**77.1**	**74.7**
IFS: Oxford Economics central						
Current receipts	38.0	38.1	38.5	38.9	39.4	39.9
Current expenditure[a]	44.2	44.4	43.4	42.1	40.7	39.3
Surplus on current budget	–6.2	–6.3	–4.9	–3.2	–1.3	0.5
Cyclically-adjusted surplus on current budget	**–4.1**	**–4.0**	**–2.9**	**–1.8**	**–0.5**	**0.9**
Net investment	1.9	1.6	1.4	1.3	1.1	1.1
Public sector net borrowing	8.1	7.9	6.2	4.5	2.4	0.6
Cyclically-adjusted public sector net borrowing	6.0	5.6	4.3	3.1	1.6	0.2
Public sector net debt	**67.5**	**74.4**	**78.4**	**79.9**	**79.5**	**77.3**
OBR forecasts						
Current receipts	37.8	37.7	37.7	37.7	37.6	37.8
Current expenditure[a]	44.3	43.7	42.4	41.0	39.4	37.9
Surplus on current budget	–6.5	–6.0	–4.7	–3.3	–1.8	–0.1
Cyclically-adjusted surplus on current budget	**–4.6**	**–3.9**	**–2.7**	**–1.6**	**–0.6**	**0.5**
Net investment	1.9	1.6	1.3	1.3	1.1	1.1
Public sector net borrowing	8.4	7.6	6.0	4.5	2.9	1.2
Cyclically-adjusted public sector net borrowing	6.4	5.5	4.0	2.8	1.7	0.6
Public sector net debt	**67.5**	**73.3**	**76.6**	**78.0**	**77.7**	**75.8**
Difference in borrowing forecasts (IFS:B – OBR)	**–0.2**	**0.1**	**–0.1**	**–0.3**	**–0.5**	**–0.6**
Difference in borrowing forecasts (IFS:OE – OBR)	**–0.2**	**0.3**	**0.2**	**–0.1**	**–0.5**	**–0.6**

[a] In line with the National Accounts, depreciation has been included as current expenditure.
Source: Authors' calculations. OBR forecasts from the Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2011 (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011/).

Under the Oxford Economics central scenario, headline borrowing and the current budget deficit are both forecast to be slightly better than under our baseline forecast this year and in 2015–16 and 2016–17, but worse in the intervening years, in £ billion terms. However, because the Oxford Economics forecast is for national income to be lower every year in future than forecast by the OBR, the forecast for borrowing as a share of national income in 2015–16 and 2016–17 is the same under both the Green Budget baseline forecast and our fiscal forecast using the Oxford Economics central macro forecast.

Using the Oxford Economics central scenario for the economy, our forecast is for a 6.8% of national income improvement in the current budget between 2011–12 and 2016–17, which is slightly greater than under our baseline forecast. However, while the overall change in borrowing is small, the composition is different: 1.9% of national income (or £29 billion in today's terms) improvement comes from an increase in the tax burden, and 4.9% of national income (or £74 billion in today's terms) improvement comes from a fall in current spending (compared with 0.6% and 6.2%, respectively, under our baseline forecast). The improvement under the Oxford Economics forecasts is, therefore, weighted more towards coming from an increase in the tax burden than under the IFS baseline scenario or the OBR's forecasts. The difference between our forecasts for spending and tax receipts under the OBR assumptions for the economy and under the forecasts of Oxford Economics are each discussed separately in more detail below.

Meeting the fiscal rules?

The Chancellor's fiscal mandate (discussed in Chapter 3) requires that the cyclically-adjusted current budget be forecast to be in balance or surplus by the end of the forecast horizon. Our baseline forecast – of a cyclically-adjusted current budget surplus of 1.1% of national income in 2016−17 – is slightly stronger (0.6% of national income, or £9 billion in today's terms) than the OBR's forecast of a 0.5% surplus. Since our baseline forecast is for a stronger cyclically-adjusted current budget in 2016−17 than that forecast by the OBR, if our baseline forecast were to prove correct then the Chancellor could loosen fiscal policy by £9 billion in 2016−17 and still achieve the 0.5% of national income surplus on the cyclically-adjusted current budget he is currently planning for 2016−17. Our fiscal forecasts using the Oxford Economics central forecasts for the economy are also more optimistic than the OBR's forecasts – under that scenario, we forecast that the cyclically-adjusted current surplus in 2016−17 would be 0.9% of national income (i.e. 0.4% of national income, or £6 billion in today's terms, larger than forecast by the OBR).

The Chancellor's supplementary target requires that debt as a share of national income falls between 2014−15 and 2015−16. Under our baseline forecast – where borrowing is slightly lower each year from 2013−14 – debt will peak at a slightly lower level than the OBR forecasts – at 77.8% of national income, rather than at 78.0% – in 2014−15. We forecast a 0.7 percentage point decline in debt as a share of national income between 2014−15 and 2015−16; this is larger than the 0.3 percentage point decline forecast by the OBR in its latest forecast. Under the Oxford Economics forecasts, the lower level of national income forecast for 2014−15 means that, despite slightly lower cumulative borrowing over the period from 2011−12 to 2014−15 than forecast by the OBR (see Table 4.2), debt will peak at a higher level, of 79.9% of national income, but still fall in 2015−16 (by 0.4% of national income). Under all of these forecasts, therefore, the supplementary target is on course to be met, but by a very small margin – even small errors in the forecast could lead to it being missed.

Medium-term prospects: detailed forecasts

Spending in the medium term

Following an overall underspend in 2011−12, we expect departments to keep to their budgets, as set out in the 2010 Spending Review, through to 2014−15.

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 spending, is the same as forecast by the OBR. Our lower borrowing forecast over the next three years feeds through into very slightly lower debt interest spending by 2014−15. Our baseline forecast for total current spending in 2014−15 is, therefore, essentially the same as the OBR's.

The Oxford Economics forecast for economic growth is weaker than that of the OBR, and this feeds through into higher social security spending. By 2014−15, we forecast that spending on net social benefits would be £219.1 billion under this scenario, rather than the £216.4 billion forecast by the OBR. As in our baseline scenario, we assume that departmental spending and other non-debt interest, non-social security spending evolves as the OBR has forecast from 2012−13 onwards. As shown in Table 4.2, based on the Oxford Economics forecasts for the economy, we forecast that borrowing will be (cumulatively) slightly lower over the period from 2011−12 to 2014−15 than the OBR forecasts, but the difference is marginal and so we forecast that debt interest spending would be almost exactly the same as the OBR forecast by 2014−15 under this scenario. Overall, we forecast that, if the world were to evolve as the Oxford Economics central forecasts suggest, total current spending in 2014−15 would be slightly higher than under the IFS baseline scenario, at £717.3 billion.

Under both scenarios for the economy, we assume that public sector gross investment (PSGI) spending in cash terms is as forecast by the OBR up to 2014−15 (which is based on the plans set out in the 2010 Spending Review). We therefore forecast that total public spending in 2014−15 would be £736.3 billion if the world were to evolve as the OBR expects and £739.1 billion if the world were to evolve as in the Oxford Economics central forecast.

For 2015−16 and 2016−17, under both scenarios, we assume that total public spending is cut by 0.9% in real terms each year and that, within this, PSGI is held constant in real terms, as was stated government policy in the 2011 Autumn Statement.[2] The higher nominal spending we forecast for 2014−15 under the Oxford Economics macro forecasts therefore feeds forward into 2015−16 and 2016−17. We forecast that, if the world were to evolve as forecast by Oxford Economics, total spending in 2016−17 would be £761.5 billion, £2.9 billion greater than under the IFS baseline scenario and £2.8 billion higher than the OBR's forecast. National income is forecast to be lower in 2016−17 under the Oxford Economics central scenario than under the OBR's forecast; therefore, this slightly higher cash spending translates into a larger difference in spending as a share of national income – total spending is forecast to be 40.4% of national income in 2016−17 under the Oxford Economics central scenario, compared with the OBR's forecast of 39.0%.

[2] Paragraph 4.89 of Office for Budget Responsibility, *Economic and Fiscal Outlook* (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011/).

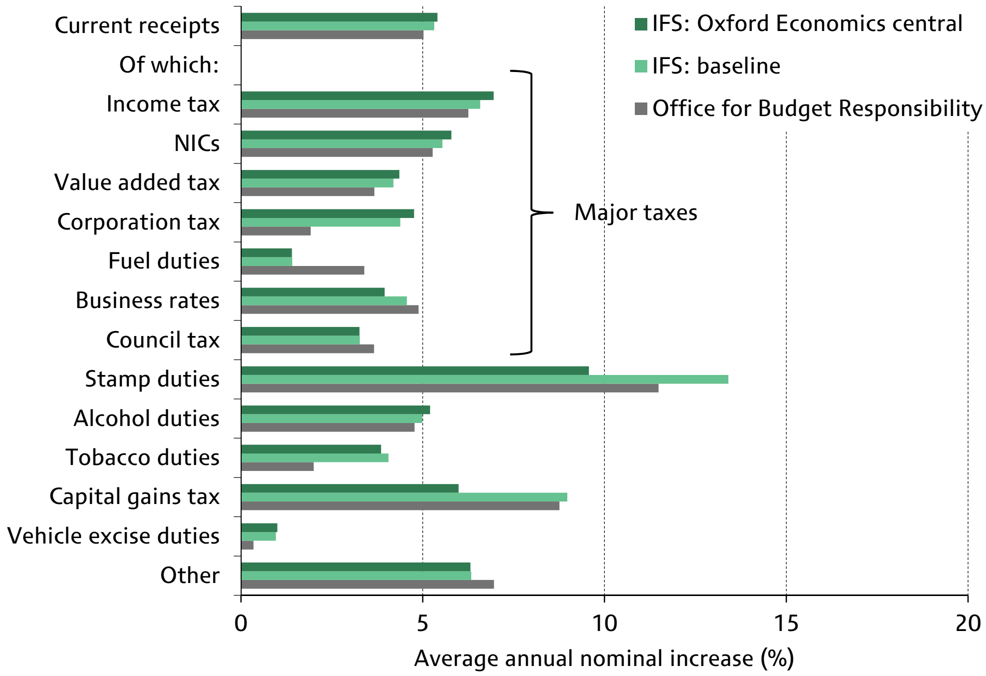
As mentioned above, if our forecasts were to prove correct, the Chancellor could loosen fiscal policy by £9 billion in 2016–17 and still achieve the 0.5% of national income surplus on the cyclically-adjusted current budget he is currently planning for 2016–17. If this fiscal loosening were all on the spending side, this could offset two-thirds of the additional £15 billion spending squeeze in 2016–17 that was announced in the Autumn Statement.

Revenues in the medium term

Overall, our baseline forecast is for slightly higher growth in tax (and non-tax) revenues between 2011–12 and 2016–17 than forecast by the OBR, although – as mentioned above – from a slightly lower base. Between 2011–12 and 2016–17, we forecast that, in nominal terms, receipts will grow by 5.3% a year on average, compared with the OBR's forecast of 5.0% and compared with forecast average annual growth in nominal national income of 5.0%. (This overall forecast is the result of aggregating the individual forecasts for different tax receipts, which are discussed below.)

The Oxford Economics central forecast for average annual growth in nominal national income between 2011–12 and 2016–17 is lower than that forecast by the OBR, at 4.4%. Despite this, our view is that, if the world were to evolve as Oxford Economics forecasts, tax (and non-tax) revenues would grow by an average 5.4% a year in nominal terms between 2011–12 and 2016–17 – faster than we expect receipts would grow if the world were to evolve as the OBR expects. This highlights the importance of the composition, as well as the level, of economic growth for tax receipts.

Figure 4.1. OBR and IFS forecasts for revenue growth, 2011–12 to 2016–17



Notes: Income tax net of tax credits; corporation tax net of company tax credits. VAT includes VAT refunds. Taxes ranked in descending order of the November 2011 Economic and Fiscal Outlook forecasts of what they will raise in 2016–17, with all taxes that are forecast to raise less than vehicle excise duties (£5.9 billion in 2016–17) grouped together in 'other'.

Figure 4.1 provides a breakdown of the forecast average annual growth rates for each of the largest taxes over the period from 2011–12 to 2016–17. Among the major taxes, compared with the OBR forecast, our forecast is for higher growth in income tax, VAT, NICs and – in particular – corporation tax, offset by lower growth in council tax, business rates, and – in particular – fuel duties.

Our forecasts for income tax and NICs receipts are based on the OBR's forecast for growth in nominal earnings and employment over the next few years, coupled with estimates of the extent to which an increase in earnings feeds through into increases in income tax and NICs revenues calculated using the IFS tax and benefit microsimulation model.

For corporation tax receipts, we forecast the growth in three components of these taxes separately: receipts from North Sea oil companies (offshore receipts), onshore receipts from the financial sector and onshore receipts from the non-financial sector. The IFS baseline forecast is for corporation tax receipts over this period to grow slightly less quickly than national income and, as a result, fall from 2.8% of national income in 2011–12 to 2.7% of national income in 2016–17. This reflects a slight increase in receipts from onshore corporation tax as a share of national income, offset by a slightly larger decline in offshore receipts. The OBR's forecast is also for corporation tax receipts to fall as a share of national income over this period, although it is forecasting a sharper decline – from 2.9% of national income in 2011–12 to 2.5% of national income in 2016–17.

Our forecast for revenues from 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, which is taken from a previous IFS study.[3]

If the world were to evolve as in the central forecast from Oxford Economics, then amongst the major taxes our forecast is for higher growth in income tax, NICs, VAT and corporation tax. Despite the lower growth in national income over this period under the Oxford Economics central forecast, its forecasts for employment growth and nominal consumer spending growth are slightly more optimistic than those of the OBR, feeding through into higher revenues from taxes on employment and consumption.

Growth in onshore corporate profits is forecast to be lower by Oxford Economics than by the OBR, for both the financial and non-financial sectors. However, offsetting that is a higher forecast oil price, and higher levels of production of both oil and gas from the North Sea, than those forecast by the OBR. This leads us to forecast that overall corporation tax revenues would be greater under the Oxford Economics central macroeconomic forecasts than they would be using the OBR's macroeconomic forecasts (with a greater proportion contributed by offshore companies than by onshore companies).

Future policy changes

The forecasts we present here assume no further policy changes in addition to those already set out in the 2011 Autumn Statement or the previous Budgets, Spending Reviews and Pre-Budget Reports. However, there are some policy aspirations that would have implications for the public finances if implemented. One such 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

[3] L. Blow and I. Crawford, *The Distributional Effects of Taxes on Private Motoring*, IFS Commentary 65, 1997 (http://www.ifs.org.uk/publications/1887).

longer-term policy objective. We will prioritise this over other tax cuts, including cuts to Inheritance Tax'.[4]

Deputy Prime Minister Nick Clegg wrote, in an article in *The Sun* on 11 January 2011, that this policy would be in place before the next election.[5] This would mean that it would need to be in place in the 2015–16 financial year at the latest. Mr Clegg reiterated his commitment to this policy in a speech at the Resolution Foundation on 26 January 2012: 'I want to make clear that I want the Coalition to go further and faster in delivering the full £10,000 allowance'.[6]

The personal allowance was increased by more than the usual inflationary increase in 2011–12, and a further above-inflation increase is due to happen in April 2012. In 2012–13, the personal allowance will stand at £8,105. Increasing this to £10,000 in 2015–16, in the same way as planned for April 2012, would result in a net cost to the government of £4.1 billion. If the policy were coupled with a reduction in the higher-rate tax threshold so that higher-rate income taxpayers did not benefit, then it would involve a net cost of £3.1 billion. However, this latter policy would also increase the number of higher-rate taxpayers by around 500,000.[7] 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.

In principle, the government also has a legally binding target to 'eradicate' child poverty by 2020.[8] On current policies, the number of children living in relative poverty is forecast to increase by around 400,000 between 2010–11 and 2015–16,[9] rather than fall. To stop it from rising by using tax and benefit reforms would require a significant giveaway and to meet the official target in this way over this timescale would be substantially more expensive than merely aiming to keep it constant.

4.3 Uncertainties around the central forecasts

Public finance forecasts rely heavily on forecasts for the macroeconomy. This makes them uncertain at the best of times, and these are far from the best of times. This section examines the uncertainties around our baseline forecast, particularly focusing on alternative scenarios for the performance of the UK economy.

Previous IFS Green Budgets have used the errors made in previous official fiscal forecasts to present a 'fan chart' around our central forecasts for borrowing. From its inception, the OBR has chosen to present its forecasts in the same way. This method of quantifying

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[4] http://www.cabinetoffice.gov.uk/sites/default/files/resources/coalition_programme_for_government.pdf.

[5] 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).

[6] Source: Nick Clegg's speech at Resolution Foundation, 26 January 2012 (http://www.libdems.org.uk/speeches_detail.aspx?title=Nick_Clegg%27s_tax_cut_speech_at_the_Resolution_Foundation&pPK=dd9bb7ba-4acb-4801-825e-ace76c4bbe76).

[7] These figures are net costs and are lower than the reduction in income tax revenues because there would be a knock-on reduction in spending on Housing Benefit and Council Tax Benefit. In the case where there were more higher-rate income taxpayers, there would also be £200 million less spending on Child Benefit and some families would lose from the change. See J. Browne, 'Personal tax and benefit changes', 2011 Budget analysis and presentation slides, http://www.ifs.org.uk/projects/347.

[8] See Child Poverty Act 2010 (http://www.legislation.gov.uk/ukpga/2010/9/contents).

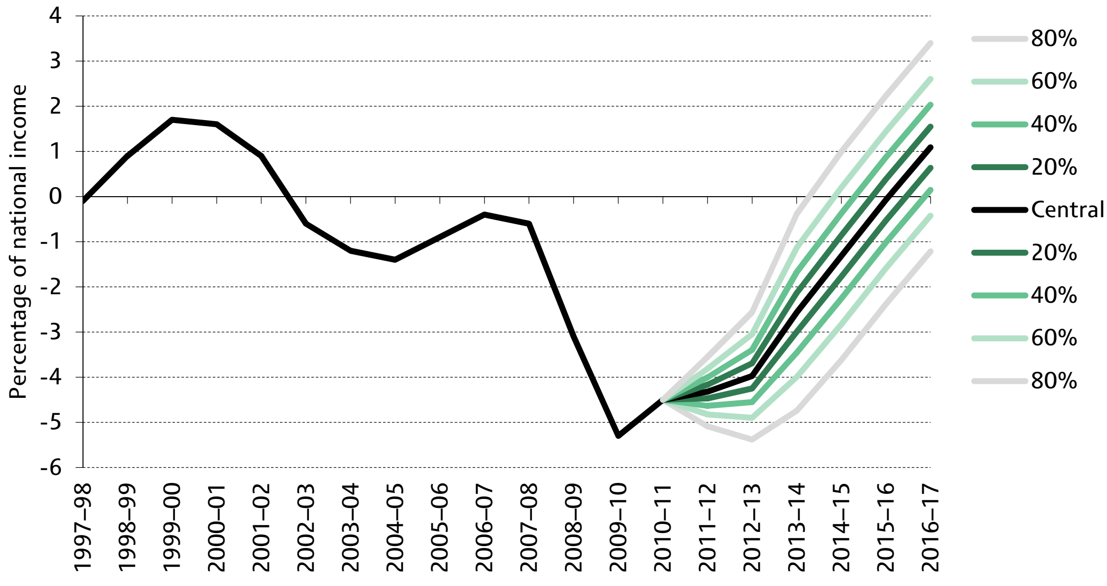
[9] Source: J. Browne, *The Impact of Austerity Measures on Households with Children*, Family and Parenting Institute, 2012 (http://www.ifs.org.uk/publications/5973).

uncertainty relies on 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 Pre-Budget Report forecasts made by HM Treasury; and third, that there are no further new policy announcements.[10]

This year's IFS Green Budget baseline forecast for the cyclically-adjusted current budget surplus is shown in fan-chart style in Figure 4.2. The uncertainty around the forecasts is taken from that used for the OBR's 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 2016–17 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 2016–17 is consistent with a 73% chance of there being a balance or surplus on the cyclically-adjusted current budget in 2016–17. In other words, there is around 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 2016–17.

If we were to assume that the world evolves as Oxford Economics has forecast rather than as the OBR expects, then the picture remains essentially the same: there is an 80% chance that the cyclically-adjusted current budget in 2016–17 will be between –1.4% of national income and +3.2% of national income, and the forecast surplus of 0.9% of national income in 2016–17 is consistent with a 69% chance of there being a balance or surplus on the cyclically-adjusted current budget in 2016–17.

Figure 4.2. Probabilities of cyclically-adjusted current budget balance outcomes (IFS: baseline)



Note: Central projection is taken from Table 4.3.
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/docs/econ_fiscal_outlook_291110.pdf).

[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.

However, the methodology just presented may not adequately reflect the true uncertainty that currently surrounds the fiscal forecasts. This year's Green Budget baseline forecast is for significantly higher borrowing over each of the next five years than we forecast in last year's Green Budget. The majority of these differences reflect changes in the macroeconomic outlook. Table 4.4 shows a comparison of our baseline forecasts for public sector net borrowing from the 2011 Green Budget and this Green Budget, with additional figures showing what our forecasting model would have predicted last year: (i) if we had known then what the OBR now thinks about the macroeconomic outlook; and (ii) if, in addition, we had also had perfect foresight of the additional policy measures announced over the last 12 months (in particular, the additional cut to public spending planned for 2015–16 that was announced in the November 2011 Autumn Statement).

Table 4.4. Explaining the differences between the 2011 and 2012 Green Budget baseline forecasts for public sector net borrowing

% of national income	2010–11	2011–12	2012–13	2013–14	2014–15	2015–16
IFS: baseline, GB 2011	**9.8**	**7.5**	**5.6**	**3.4**	**1.9**	**0.8**
Incorporating latest macroeconomic forecasts	9.9	8.1	7.1	5.5	4.0	2.6
Plus policy changes	9.9	8.0	7.3	5.5	3.9	2.1
IFS: baseline, GB 2012	**9.3**	**8.2**	**7.7**	**5.9**	**4.3**	**2.4**

Source: Authors' calculations. R. Crawford, C. Emmerson and G. Tetlow, 'Green Budget public finance forecasts', in M. Brewer, C. Emmerson and H. Miller (eds), *The IFS Green Budget: February 2011* (http://www.ifs.org.uk/budgets/gb2011/11chap5.pdf). Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2011 (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011/).

In last year's Green Budget, we were forecasting that public sector net borrowing (PSNB) would fall from 7.5% of national income in 2011–12 to 0.8% by 2015–16. Had we known then what the OBR now predicts for economic performance over the next five years and also been perfectly informed about the policy changes that the government has made since last February, we would instead have forecast PSNB of 8.0% of national income in 2011–12, falling to 2.1% by 2015–16. The differences resulting from the altered macroeconomic outlook explain the vast majority of the difference between the forecast we published last year and the 2012 Green Budget baseline forecast. (The remaining difference not explained by the policy measures is from judgements made from data on receipts and spending over the financial year to date and other changes – hopefully improvements – that we have made to our forecasting model.) This highlights the fact that any consideration of the uncertainties around the fiscal forecasts should – particularly under current circumstances – take explicit account of the uncertainties surrounding the macroeconomic outlook.

As discussed in Chapter 2, not only is uncertainty about the macroeconomic outlook currently large but it is also asymmetric around the central forecast. To examine the implications of this for the public finances, we now consider fiscal forecasts under two alternative scenarios for the macroeconomic outlook provided by Oxford Economics.

Alternative macroeconomic assumptions

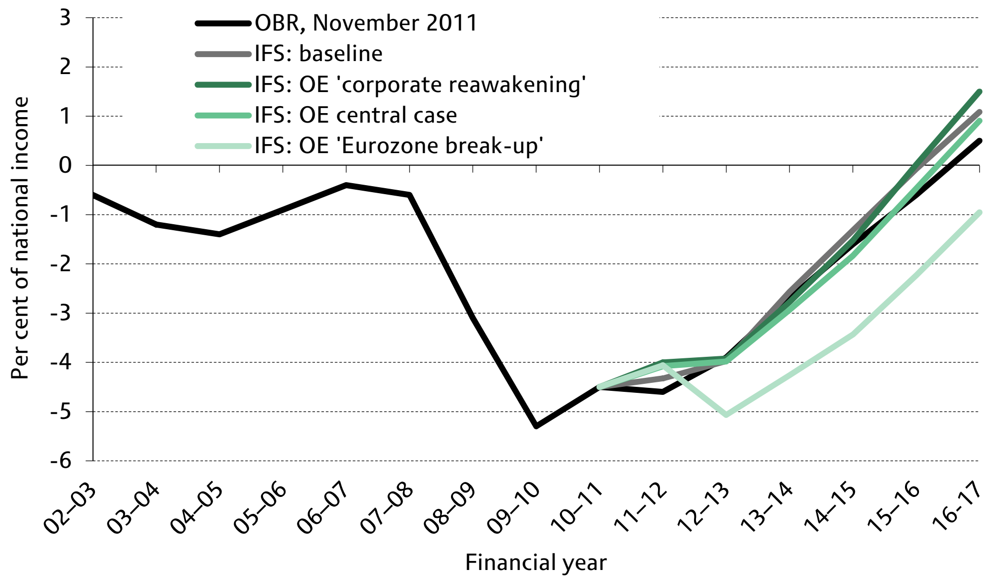
Presenting fiscal forecasts under alternative scenarios for the economy has been standard practice in IFS Green Budgets for many years, and again is something that the OBR has since adopted. Table 4.5 presents forecasts for the public finances under two additional alternative scenarios for the economy. These alternative scenarios are the Oxford Economics 'corporate reawakening' case and its 'Eurozone break-up' case, as discussed in Chapter 2 (with some further details of the components of the forecasts shown in Table 4.5 and additional details provided in Appendix A). The forecast path of

Table 4.5. Public finance forecasts under various scenarios

% of national income, unless otherwise stated	2011–12	2012–13	2013–14	2014–15	2015–16	2016–17
IFS: baseline						
Real GDP growth (%)	0.6	0.9	2.4	2.8	3.1	3.0
Output gap (% of potential)	–2.8	–3.1	–2.8	–2.3	–1.5	–0.7
Current budget surplus	–6.3	–6.1	–4.6	–3.0	–1.3	0.4
Cyclically-adjusted current budget surplus	–4.3	–4.0	–2.6	–1.3	–0.1	1.1
Net borrowing	8.2	7.7	5.9	4.3	2.4	0.6
Net debt	67.4	73.3	76.6	77.8	77.1	74.7
IFS: Oxford Economics central						
Real GDP growth (%)	0.4	0.6	2.2	2.8	2.8	2.6
Output gap (% of potential)	–3.2	–3.4	–2.5	–1.7	–0.9	–0.4
Current budget surplus	–6.2	–6.3	–4.9	–3.2	–1.3	0.5
Cyclically-adjusted current budget surplus	–4.1	–4.0	–2.9	–1.8	–0.5	0.9
Net borrowing	8.1	7.9	6.2	4.5	2.4	0.6
Net debt	67.5	74.4	78.4	79.9	79.5	77.3
IFS: Oxford Economics 'corporate reawakening'						
Real GDP growth (%)	0.5	1.5	3.2	3.0	2.4	2.2
Output gap (% of potential)	–3.2	–2.6	–1.2	–0.5	–0.2	0.0
Current budget surplus	–6.2	–5.9	–3.9	–2.0	–0.2	1.5
Cyclically-adjusted current budget surplus	–4.0	–3.9	–2.8	–1.5	0.0	1.5
Net borrowing	8.1	7.5	5.2	3.3	1.3	–0.4
Net debt	67.4	73.2	75.4	75.5	74.3	71.8
IFS: Oxford Economics 'Eurozone break-up'						
Real GDP growth (%)	0.4	–2.3	0.3	3.5	4.3	3.4
Output gap (% of potential)	–3.2	–4.4	–5.5	–3.3	–1.5	–0.5
Current budget surplus	–6.3	–7.9	–7.9	–6.2	–3.6	–1.5
Cyclically-adjusted current budget surplus	–4.1	–5.1	–4.3	–3.4	–2.2	–1.0
Net borrowing	8.1	9.6	9.3	7.5	4.8	2.6
Net debt	67.5	78.3	86.9	90.5	90.5	89.1
OBR, November 2011						
Real GDP growth (%)	0.6	0.9	2.4	2.8	3.1	3.0
Output gap (% of potential)	–2.8	–3.1	–2.8	–2.3	–1.5	–0.7
Current budget surplus	–6.5	–6.0	–4.7	–3.3	–1.8	–0.1
Cyclically-adjusted current budget surplus	–4.6	–3.9	–2.7	–1.6	–0.6	0.5
Net borrowing	8.4	7.6	6.0	4.5	2.9	1.2
Net debt	67.5	73.3	76.6	78.0	77.7	75.8

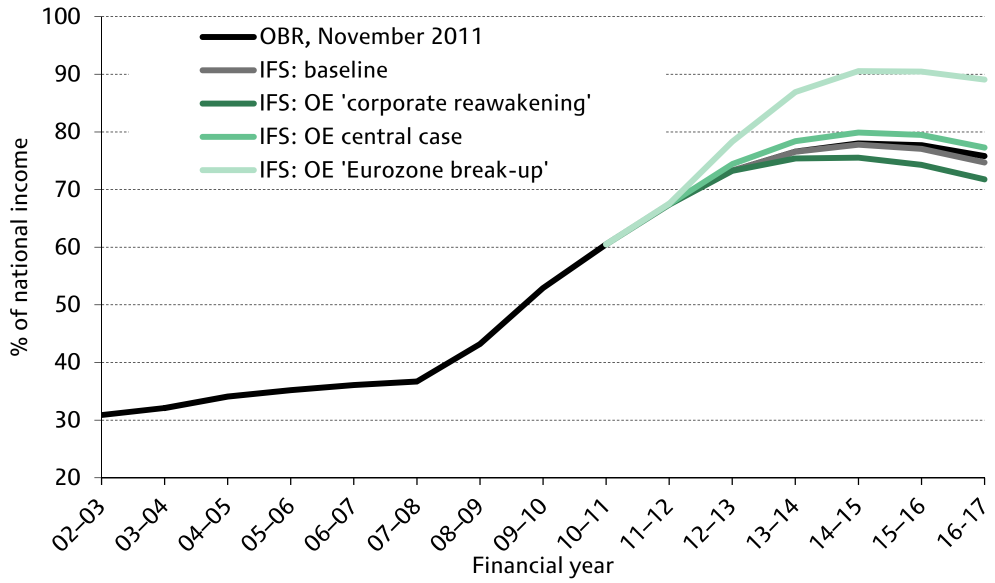
Sources: Authors' calculations. Oxford Economics. OBR forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2011 (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011/).

Figure 4.3. Cyclically-adjusted current budget balance forecasts



Source: Authors' calculations. Oxford Economics. OBR forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2011 (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011/).

Figure 4.4. Public sector net debt forecasts



Source: As for Figure 4.3.

the cyclically-adjusted current budget surplus under these two scenarios, along with the forecasts discussed above, are shown in Figure 4.3, while Figure 4.4 shows the forecast paths for public sector net debt.

There are some upside risks to the UK's economic performance and consequently to the public finances. The Oxford Economics 'corporate reawakening' scenario presents a slightly more optimistic (or perhaps better described as less pessimistic) outlook for the UK economy over the next few years. It features higher real GDP growth in the short term than under both its central forecast and the OBR's forecast, driven by increased business investment. This feeds through into faster employment growth and faster growth in real consumer spending. The evolution of the public finances under this scenario is better than both the forecasts of the OBR and the IFS baseline case. The cyclically-adjusted current budget strengthens and reaches balance in 2015–16, and a surplus of 1.5% of national income in 2016–17. This compares with our baseline forecast of a 1.1% of national income surplus in 2016–17. Public sector net debt is forecast to peak at 75.5% of national income in 2014–15, slightly below the level we expect on our baseline forecast.

However, unfortunately, the biggest risks to the UK economy and hence to the path of the public finances are judged to be on the downside, as discussed in more detail in Chapter 2. The Oxford Economics 'Eurozone break-up' scenario forecasts a decline in national income between 2011–12 and 2012–13 and slow growth in 2013–14, due to the financial shocks and adverse trade effects of a Eurozone break-up on the UK. These lead to declining employment, real wages and real consumer spending in the short run, and the output gap grows until 2013–14. From 2014–15, the UK economy starts to bounce back, with high growth in national income and real consumer spending. This all feeds through into a higher current budget deficit in each of the next five years. Under this scenario, the cyclically-adjusted current budget is forecast to remain in deficit by 1.0% of national income by 2016–17 – a substantially weaker position than our baseline forecast suggests. In addition, under this scenario, we forecast that net debt would peak at 90.5% of national income – this is 12.5% of national income higher than the level forecast by the OBR. Higher levels of debt would increase the UK's exposure to the whims of financial market players and there are studies that suggest that it could start to negatively affect potential growth.[11]

While it is hard to quantify the likelihood of any particular events occurring, these scenarios suggest that the risks around our (and the OBR's) baseline forecast are larger on the downside than the upside. Furthermore, the amount by which our baseline forecast differs from the OBR's forecast (peak debt being 0.2% of national income lower, and the medium-term cyclically-adjusted current budget surplus being 0.6% of national income larger) is small relative to the differences forecast under the 'Eurozone break-up' scenario. This underlines the fact that any current fiscal plans should allow capacity to accommodate future adverse shocks of this type.

4.4 The Budget judgement

The forecasts presented in this chapter show that the UK needs to plan for a substantial fiscal tightening over the medium term. The current government has set out such a deficit reduction plan – building on the fiscal tightening plans inherited from the last Labour government – intended to total 8.1% of national income (£123 billion in today's terms). By the end of 2011–12, one-quarter of this will have been implemented, with the remaining three-quarters to come over the next five years. This discretionary tightening explains the majority of the fall in public sector net borrowing over the medium term under all of the scenarios we consider (and therefore why the decline in borrowing is not too dissimilar in magnitude under each scenario).

[11] C. Reinhardt and K. Rogoff, *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2010. M. Kumar and J. Woo, 'Public debt and growth', IMF Working Paper WP/10/174, 2010 (http://www.imf.org/external/pubs/ft/wp/2010/wp10174.pdf).

There are two major choices about the fiscal stance that Mr Osborne should consider in his Budget, which is due on 21 March 2012. The first is whether the size of the medium-term fiscal consolidation remains appropriate. The second is whether it might be appropriate to implement a short-term fiscal giveaway in order to help the economy and, if so, what measures should be included in such a package. This section now turns to address each of these in turn in light of our baseline forecast and the risks around it.

The medium-term fiscal plans

Changing the size of the fiscal consolidation?

With both the IFS Green Budget baseline forecast and the IFS forecast based on the Oxford Economics central scenario suggesting that the public finances are in slightly better shape than the OBR expects, there might be scope for the Chancellor to implement a permanent net fiscal giveaway in the Budget. Under the IFS baseline forecast, Mr Osborne could announce a permanent net giveaway of £9 billion in today's terms and still expect the same level of borrowing in the medium term as he planned for in his November 2011 Autumn Statement. Under the Oxford Economics central scenario, this falls to £6 billion. In more normal times, margins of this size would allow tax cuts or spending increases that would be considered reasonably large: £9 billion would be sufficient to allow, for example, the basic rate of income tax to be cut from 20p to 18p.

However, given that the risks facing the UK economy appear skewed to the downside and that there are longer-term pressures on the public finances (as discussed in Chapter 3), there is a strong argument for Mr Osborne refraining from announcing any significant net permanent giveaway in his March Budget. Our view on this remains unchanged from last year's Green Budget when, under our baseline scenario, we also forecasted slightly lower borrowing over the medium term than the OBR but nonetheless advocated no significant permanent fiscal loosening. Should the downside risks not materialise, a permanent net giveaway could always be announced at a later date. For example, the spending cuts pencilled in for the next Spending Review, which total £15 billion in 2016–17 (relative to 2015–16), could be reduced, and/or the Chancellor could make further progress towards the coalition government's aspiration of an annual income tax personal allowance of £10,000.

A reason for the Chancellor not to implement a permanent net giveaway prior to 2016–17 is his supplementary target that debt should fall as a share of national income between 2014–15 and 2015–16. On the OBR's latest forecast, Mr Osborne has only a slightly better than fifty–fifty chance of meeting this target. This chance is not much improved under our baseline forecast. Implementing a permanent net giveaway prior to 2016–17 would, in the absence of a significant improvement in the OBR's forecasts for economic growth, reduce further the Chancellor's likelihood of meeting this target. Missing this target would have little economic consequence – as the target is not a sensible way to judge fiscal sustainability – but, having publicly set himself this goal, Mr Osborne presumably will want to meet it.

Of course, even in the absence of a net change in the medium-term fiscal stance, there are changes to the tax and benefit system that should still be made, as discussed in Chapter 8. These include changes to corporation tax, environmental taxes, and the incentives to work faced by different individuals. All of these reforms would promote stronger economic growth over the medium term without necessarily requiring any net fiscal giveaway.

Planning public spending

So far, the government has set out detailed spending plans through to 2014–15. Beyond this, it is assuming that total public spending will fall by 0.9% a year in real terms for another two years. However, no details have yet been published about how this will be achieved. At this stage, just one year through the current four-year Spending Review period, when much uncertainty remains both over the economic outlook and over what the impact of the currently-planned cuts on the quality and quantity of public services provided might be, it seems sensible not to draw up more detailed plans for public spending beyond 2014–15.

The government has not yet said when it intends to hold the next Spending Review, but there is a strong case for this being in Autumn 2013. An Autumn 2013 Spending Review could revise (if deemed necessary) the plans for spending in 2014–15 and set new spending plans for 2015–16 and 2016–17, in light of the information then available on the economic outlook and the impact of the cuts that will by then have been implemented. Delaying the next Spending Review instead to Autumn 2014 would mean that departments would have less time to plan how best to deliver the cuts that were required of them. The next Spending Review should consider all discretionary public spending – rather than just spending by Whitehall departments on the administration and delivery of public services – to ensure that the most appropriate mix of welfare spending and spending on public services is delivered over that period. The current government sensibly pursued such a strategy in the October 2010 Spending Review.

A short-term net giveaway?

The second key issue facing Mr Osborne regarding the current fiscal stance is whether it is appropriate to implement a short-term fiscal giveaway – measures that would increase government borrowing in, say, 2012–13 and 2013–14 but have no direct impact thereafter – in order to help boost demand in the economy and, if so, what measures such a package should include.

While the policy measures announced in the 2011 Autumn Statement for the period up to 2014–15 were estimated to be fiscally neutral overall, they are nonetheless expected to boost the UK economy. Planned cuts to public sector net investment were reduced, which should directly boost demand in the economy. This was financed through cuts to tax credits, a reduction in the planned increase in spending on overseas aid (see Chapter 7) and a continued squeeze on public sector pay (see Chapter 5), all of which are thought to have a smaller impact per pound on the UK economy than investment spending does.[12]

In addition, the government has also allowed the 'automatic stabilisers' to operate. The structure of the tax and spending regime in the UK is such that, when economic performance is weak, an automatic boost is provided to demand in the economy because government borrowing tends to rise, as (in particular) tax payments fall and demands on welfare spending increase. In November 2011, the OBR revised up its forecast for borrowing each year going forwards compared with its March 2011 forecast, as a result of its more pessimistic view of the economic outlook, but the government chose not to attempt to offset any of this automatic increase until 2015–16. As a result, borrowing is

[12] Official estimates of some fiscal multipliers can be found in table C8 of the Office for Budget Responsibility, Budget Forecast June 2010 (http://budgetresponsibility.independent.gov.uk/wordpress/docs/junebudget_annexc.pdf).

now forecast by the OBR to be £5 billion higher in 2011–12, £20 billion higher in 2012–13 and £30 billion higher in 2013–14 than thought at the time of the March Budget.

The Chancellor's decisions in November illustrate some willingness on his part to adjust plans in a way that is likely to boost growth, albeit modestly, and to allow public borrowing to rise temporarily in the face of a worsening economic situation, thus providing some additional support to the economy.

The planned fiscal tightening between 2011–12 and 2012–13 is expected to be broadly comparable in scale to that implemented between 2010–11 and 2011–12. This can be shown in two ways:

- The OBR's latest forecasts suggest that public borrowing will fall by 0.7% of national income between 2011–12 and 2012–13. In other words, overall, the public sector will be pumping 0.7% of national income (or £11 billion in today's terms) less into the economy next year than it is this year. This is slightly smaller than the 0.9% of national income fall in borrowing that occurred between 2010–11 and 2011–12.

- Discretionary policy measures are expected to have a slightly larger impact on borrowing between this year and next than they did between this year and last year: between 2011–12 and 2012–13 there is a 1.6% of national income planned fiscal tightening coming from new measures, whereas between 2010–11 and 2011–12 these were worth 1.5% of national income. In both cases, this is larger than the headline fall in borrowing due to other underlying changes in the economy, such as weak growth.

The direct impact of a temporary net giveaway in the March 2012 Budget would be to boost the economy. The argument for this is that the economy is, by most estimates, operating below its potential level and so additional fiscal stimulus could reduce the short-term pain of weak economic performance. This argument is strengthened if the stimulus could reduce any long-term harm resulting from low economic activity today, but would be weakened if the gap between current and potential output is not large.

The argument for a temporary net giveaway would be further weakened if: (i) it was believed that monetary policy would be tightened in response, thereby offsetting the impact on demand; or (ii) if the giveaway reduced international investors' confidence in the government's ability or willingness to reduce borrowing back to sustainable levels over the medium term and the cost of government borrowing rose as a result.

In last year's Green Budget, we concluded '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'.[13] The possibility that the impact of any temporary fiscal loosening would be offset by tighter monetary policy is less likely now than it was a year ago. At that time, many forecasters were expecting that the Bank of England base rate would be increased above 0.5% at some point during 2011, with two members of the Monetary Policy Committee (MPC) having already voted for such an increase (rising to three in February 2011). But this increase in interest rates never materialised and, in fact, the MPC instructed the Bank of England in October 2011 to undertake a second phase of quantitative easing, increasing the total amount of asset

[13] Page 125 of R. Crawford, C. Emmerson and G. Tetlow, 'Green Budget public finance forecasts', in M. Brewer, C. Emmerson and H. Miller (eds), *The IFS Green Budget: February 2011* (http://www.ifs.org.uk/budgets/gb2011/11chap5.pdf).

purchases from £200 billion to £275 billion. A rise in interest rates is not now seen as imminent and, in fact, with the Bank of England's medium-term forecast suggesting that, under current policies, inflation is more likely to undershoot rather than overshoot the 2% target, a further loosening of monetary policy (such as an extension of planned quantitative easing) may follow.[14]

It continues to be important that markets remain confident that the government's fiscal consolidation plan will be delivered so that the risk of the UK government facing a higher interest rate is kept low. Over the five years from 2012–13 to 2016–17 (inclusive), the UK government is expected to have to issue £740 billion of new debt in order to cover the borrowing projected by the OBR and to refinance expected gilt redemptions; even a small increase in the interest rates at which this debt could be financed would result in a not insignificant increase in future debt servicing costs.[15]

In our view, the case for a temporary fiscal loosening is now much more evenly balanced than it was a year ago. But the dilemma is that a relatively modest loosening – say of a fraction of 1% of national income – would be likely to deliver only a modest boost to the economy, while a substantial loosening – say of the order of 1% of national income (£15 billion in today's terms) – would run a higher risk of international investors taking fright and demanding a higher interest rate from the UK government.

In the absence of significant changes to the OBR's forecast for the economy in March 2012 relative to the forecast made in November 2011, it seems unlikely that Mr Osborne will implement a significant net giveaway in the Budget. But measures that bring about a relatively modest short-term loosening, or perhaps a further growth-enhancing reshuffling of public spending plans as was seen in the November 2011 Autumn Statement, might not be unlikely. One possibility is that, if Whitehall departments do not exhaust their 2011–12 budget allocations (the IFS Green Budget baseline forecast is for a £3.3 billion underspend across their non-investment budgets), the Chancellor could use these funds to reduce further the scale of the planned cuts to public sector net investment in 2012–13. This would represent a modest fiscal loosening that could be easily explained to the markets and therefore would be relatively risk-free.

The case for a fiscal stimulus package would be strengthened considerably were the short-term outlook for the UK economy to deteriorate significantly – for example, if the Eurozone were to collapse. This is because it would lead to a much larger near-term gap between potential and actual output (the output gap) and further increase concerns that this could do permanent damage to the future potential output of the UK economy. The Oxford Economics scenario in which this occurs forecasts that the UK economy would decline by 2.3% in 2012–13 rather than grow by 0.9% or 0.6% as envisaged by the OBR and the Oxford Economics central scenario, respectively.

If the Chancellor were to set out now how fiscal policy would react if things turn out worse than the OBR currently expects, it could help boost investor confidence that the fiscal policy response would be appropriate. Setting this out in advance would also help to avoid accusations that he was changing direction if such an eventuality did occur.

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[14] See charts 5.6 and 5.8 of Bank of England, *Inflation Report: November 2011* (http://www.bankofengland.co.uk/publications/inflationreport/ir11nov.pdf).

[15] See table 4 of Debt Management Office, 'Autumn Statement 2011: revision to the DMO's financing remit 2011–12', November 2011 (http://www.dmo.gov.uk/documentview.aspx?docname=remit/sa291111.pdf&page=Remit/full_details).

If the Chancellor did want to implement a short-term fiscal stimulus, he should ensure that it is:

- **timely**: the impact would need to be felt when it was intended, likely to be as soon as possible;
- **temporary**: the net fiscal impact should be, and be seen to be, temporary and disappear in the medium term; and
- **targeted**: it should deliver the maximum beneficial impact on the economy.[16]

The options for a fiscal stimulus package are: cuts to direct or indirect taxes, increases in benefits, increases in investment spending or increases in non-investment spending on public services. We briefly consider each in turn.

Tax cuts

The OBR's fiscal multipliers suggest that a temporary cut to the main rate of VAT (as, for example, was implemented by the last Labour government between December 2008 and January 2010) would have a larger impact on aggregate demand than cuts to any of the other major taxes. Crucial for the design of this is that the window during which VAT is cut must be carefully chosen and be credible.[17] A cut to the main rate of VAT is also attractive because it could be implemented quickly. Reducing the main rate of VAT from 20% to 17.5% would have a direct cost of around £1 billion per month.

An alternative would be to cut direct taxes – perhaps through a cut to employer NICs. The OBR's model suggests this would have a lower fiscal multiplier than a VAT cut. But during periods when labour demand is depressed, and when some wages cannot adjust downwards quickly, cuts to employer NICs might be a more effective means to boost employment than under more normal circumstances. Reducing the rate of employer NICs by 1 percentage point would cost about £4.5 billion a year.

Spending increases

The spending increases that the OBR estimates have the largest short-term impact on the economy are increases in investment spending, followed by increases in benefit spending and in non-investment spending on public services. However, temporary increases in this last component of spending are less likely to be desirable.

The difficulty in using investment spending to deliver a fiscal stimulus lie in ensuring that the spending is done productively and in a timely manner. The risks are that either the resources would not be well spent or they would not materialise until it was too late to help the economy, or both. However, under the current circumstances – with sharp cuts to investment spending planned over the next three years – it may well be possible for the government to identify high-value projects that can be delivered quickly (as the Chancellor claimed in his November 2011 Autumn Statement). Another risk is that such an increase in spending might be considered likely to be permanent rather than temporary. But this is less likely to be a risk with investment spending than with non-investment public service spending.

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[16] See L. Summers, 'Risks of recession, prospects for policy', at *The State of the US Economy,* Brookings Institute, 19 December 2007 (http://www.brookings.edu/~/media/Files/events/2007/1219_economy/20071219_summers.pdf).

[17] See R. Blundell, 'Assessing the temporary VAT cut policy in the UK', *Fiscal Studies*, 30, 31–8, 2009 (http://www.ifs.org.uk/publications/4479).

Benefit spending increases also have a relatively high estimated fiscal multiplier, could be easily targeted at specific groups (such as those who are believed to have the highest propensity to spend this additional income) and could be implemented relatively quickly. The previous Labour government did, for example, include some temporary benefit increases of this type as part of the fiscal stimulus package implemented in 2008 and 2009; these benefit increases were delivered in a timely manner and did prove to be temporary. However, with the current government having announced significant cuts to benefit spending, of which only about 12% have so far been delivered, implementing any short-term giveaway might lead to suggestions that the government was not willing or able to deliver the ultimate savings it had promised in the medium term.

Budget judgement: conclusion

Under the IFS baseline forecast, Mr Osborne could announce a permanent net giveaway of £9 billion in today's terms and still expect the same level of borrowing in the medium term as he planned for in his November 2011 Autumn Statement. But much uncertainty remains about the outlook for the UK economy and, over the longer term, there are considerable pressures on the public finances from an ageing population. Therefore there is a strong argument for Mr Osborne to refrain from announcing any significant net permanent giveaway in his March Budget. Should the downside risks not materialise, a permanent net giveaway could always be announced at a later date.

A series of adverse shocks have weakened the economic outlook over the last year, and so the case for a further temporary fiscal stimulus package to boost the economy is stronger now than it was a year ago. However, in our view, neither the argument for nor the argument against doing so is clear-cut.

Unless the forecasts are significantly downgraded again, the Chancellor seems unlikely to implement a significant net giveaway in the Budget. But it is more likely that he might announce measures that bring about a relatively modest short-term loosening, or perhaps a further growth-enhancing reshuffling of public spending plans as was seen in the November 2011 Autumn Statement.

Regardless of whether or not Mr Osborne thinks that a substantial short-term fiscal stimulus is appropriate at the moment, he should set out now broadly what he would do under alternative scenarios where the economic outlook for the UK is sharply weaker – such as were the Eurozone to collapse. Under these circumstances, the arguments for a fiscal stimulus package would be greatly strengthened, as concerns that significant permanent damage was being done to the potential output of the UK economy would be increased. The most appropriate components of such a package would likely be a temporary cut to the main rate of VAT, a temporary cut in employer NICs and/or a short-term boost to public investment spending.