

# 1. Summary

## **Economic prospects**

Developments in the UK economy over the past year have been broadly in line with the projections in last year's Green Budget. A year ago, we expected GDP growth in 2000 to be 2.9% and RPIX inflation (retail prices excluding mortgage interest payments) to run below target throughout the year, averaging 2.0% in the fourth quarter. The out-turn for RPIX inflation was 2.1%, while GDP is now estimated to have grown by 3.0%.

In early 2001, there are concerns that recessionary forces could spread from the United States. Given the UK's excellent inflation performance, the Monetary Policy Committee of the Bank of England is in a very good position to respond quickly to adverse shocks. Thus the pace at which the UK economy can grow in 2001 is determined less by international factors than by the question of what growth rate is consistent with keeping inflation on target. Our judgement is that GDP growth of 2½–3% can be maintained in 2001 and beyond while meeting the government's 2½% inflation target.

## **An audit of the public finances**

As last year, the public finances seem healthier than the government forecast. We expect public sector net borrowing (PSNB) to record a surplus of £15.9 billion in 2000–01, virtually unchanged from 1999–2000. This is £10 billion better than the March 2000 Budget forecast and £5.8 billion better than the November 2000 Pre-Budget Report forecast. The better-than-expected performance in the public finances reflects a combination of greater buoyancy in tax receipts and an undershoot in public spending. The government's fiscal rules continue to be met with ease.

The Pre-Budget Report announced measures that increase government borrowing by £2.6 billion in 2001–02, rising to £3.9 billion in 2002–03. The Chancellor also announced a range of motoring-related measures for consultation, that if implemented will raise borrowing by an additional £1.7 billion in 2001–02, rising to £2.2 billion in 2002–03. In our baseline forecast, we assume that these will be implemented. For our medium-term forecasts, we have adopted the Treasury's cautious assumption of trend GDP growth of 2¼% a year. Even so, we expect the surplus on current budget in the medium term to run about 0.5% of GDP above the path in the 2000 Budget and Pre-Budget Report. The Chancellor could announce additional discretionary measures costing £3–4 billion by 2002–03 to bring the public finances broadly onto the path envisaged in the 2000 Budget and Pre-Budget Report. If trend GDP growth turns out stronger, as we expect, the Chancellor of the day will have further room for manoeuvre in future years.

We consider how the public finances have evolved relative to the projections set out in the Conservatives' last Budget, in November 1996. Our main findings are the following:

- Tax receipts in 2000–01 are likely to be £24 billion higher than projected in the November 1996 Budget. Higher-than-expected inflation explains £7 billion of this increase; hence, in real terms, taxes are £17 billion higher than the November 1996 forecast.
- Up until 1999–2000, all of the additional real increase in taxes was used to reduce public borrowing. Public spending in the first three years of the parliament was actually lower in real terms than the Conservatives' plans.
- By reducing public borrowing, the government has made significant savings on debt interest payments. Falls in unemployment have reduced cyclical social security spending. Discretionary public spending has risen, on average, by 2.1% a year in real terms during the past four years. This is slightly less than the annual increase in discretionary public spending by the Major Government.
- The government plans further significant increases in public spending in 2001–02 and beyond. If this parliament were to run for a full five-year term and the spending plans were delivered, real discretionary public spending would increase by an average of 2.9% a year, compared with the 1.4% a year recorded during the Conservative period of office from 1979 to 1997 and the 2.2% achieved during John Major's period as Prime Minister.

### **Personal taxes and benefits**

Given the likelihood of some give-away in the Budget, the Chancellor will be considering a range of options on personal taxes and benefits. This government has already dramatically increased support for children, and in April of this year the new children's tax credit, replacing the married couple's allowance, will be introduced. An increase in the value of the children's tax credit from the £8.50 per week proposed to £10.00 has been widely discussed. But such a move would not help the poorest families, who pay no income tax. We therefore consider a package that adds increases to the child allowances in income support and the working families' tax credit, which could together deliver a highly progressive result and would help to achieve the government's aim of reducing child poverty. We also examine the alternative of a general tax cut benefiting both those with and without children. Options considered are cutting the basic rate of income tax, widening the 10% tax band, increasing the value of personal allowances and raising the higher-rate threshold. All of these tax reductions are substantially less progressive than a reform including benefit increases.

### **Taxation of fuel and the environment**

The recent debate surrounding the taxation of private motoring has succeeded in highlighting the complex nature of tax design in this area. One message that is clear is that trying to address the wide range of different social costs associated with motoring with a single tax cannot be optimal. In most cases, finding a suitable tax base is difficult, but where a more appropriate tax base is available, such as congestion, it would be sensible to move away from a fuel tax towards a more targeted tax. In the Pre-Budget Report, the government

attempted to improve incentives for motorists to behave in a more environmentally friendly way. The extent to which this was achieved can, at best, be described as mixed.

Environmental issues are not restricted to motoring and there is no reason to focus too heavily on a road fuel tax whilst ignoring the damaging effects on the environment caused by other sectors of the economy. In some respects, the government is beginning to address environmental issues in other ways through the introduction of the climate change levy, although there is still scope for improving incentives for environmentally friendly behaviour in the use of other fuels.

### **Tax policy and companies**

Raising productivity remains high on the Chancellor's agenda, with tax policy one of the possible instruments for achieving change. We discuss the arguments for extending the provision of research and development (R&D) tax credits from small and medium-sized enterprises (SMEs) to larger firms, in response to the relative decline in the UK's R&D spending in recent decades. We consider a range of options for the design of an incremental tax credit. These aim to target marginal R&D, rather than all R&D as is the case for the current SMEs credit.

We note that, in common with many other industrialised countries, the UK has recently reduced corporate tax rates while at the same time broadening the tax base. In the UK, these changes have led to a net increase in taxes on company profits. We also discuss recent debates about double taxation relief and North Sea oil taxation.

### **Longer-term welfare reform**

The government's welfare reforms since 1997 have blurred the distinction between taxes and benefits. These reforms include the introduction of the working families' tax credit in 1999 and the children's tax credit in 2001, and the promise of the integrated child credit and the pension credit. We analyse these reforms and find that, together, they amount to a substantial change in the structure of government support to families with children and to pensioners. These developments have taken place alongside increases in generosity of means-tested transfers and a greater use of the family as the unit of assessment. The increases in generosity have undoubtedly meant that extra resources have been targeted at the less well-off. Other reforms improve the incentives to work for some and may increase take-up of the transfers. But these effects come at a cost of subjecting more individuals and families to a means test, the inconvenience of having to claim support and the need to provide detailed information to the authorities about their private lives.