

1. Summary

Chapter 2: The fiscal policy framework

- The Chancellor's tax and spending decisions are constrained by the golden rule (which states that the government should only borrow to invest on average over the economic cycle) and the sustainable investment rule (which states that public sector net debt should not rise above 40% of national income).
- The Treasury expects the current budget balance to swing from a deficit of 0.9% of national income in 2005–06 to a surplus of 0.8% over the next five years. Higher tax revenues are to deliver about three-quarters of this turnaround and a cut in public spending as a share of national income the remaining quarter.
- The Treasury believes that the economy is running 1.4% below potential this year and that half the swing from deficit to surplus will occur automatically as growth rebounds. Most independent economists believe that the economy is closer to full capacity, in which case the structural deficit would be deeper than the Treasury thinks.
- Most of the hoped-for increase in revenues is structural, rather than cyclical. Much is expected next year, thanks to higher tax payments from the financial sector, higher North Sea oil revenues and a year of 'fiscal drag' in income tax. Thereafter continued gains from fiscal drag are offset by falling VAT and excise duty revenues.
- The Chancellor has pencilled in growth in current spending of just 1.9% a year after economy-wide inflation over the three years of the 2007 Comprehensive Spending Review. If confirmed, this would reverse the increase over the 2004 Spending Review period and would be the least generous spending review under Labour to date.
- The Treasury has promised to meet the golden rule on average over the economic cycle. In the Pre-Budget Report (PBR), it 're-dated' the economic cycle from the seven years starting in 1999–2000 to the 12 years starting in 1997–98. If the Treasury's forecasts are correct, then this makes the rule easier to meet in this cycle and the next.
- For the fifth year running, the Treasury has had to downgrade its public finance forecasts between the Budget and the PBR. Based on its past forecasting record, the Chancellor has a more than 40% chance of breaking the golden rule and a 37% chance of breaking the sustainable investment rule in this economic cycle.
- Re-dating the cycle at such a convenient time risks undermining the credibility of the fiscal framework. The golden rule should be made more forward-looking and less reliant on a precisely dated economic cycle. If still required, the task of estimating the output gap could be handed to an independent body.

Chapter 3: The economic outlook

- Economic growth has been relatively robust over the past few years, although it slowed substantially in 2005. The Treasury expects the economy to pick up, with growth of between 2¾% and 3¼% in 2007 and the output gap closing in 2008–09.
- There are downside risks to the Treasury's forecasts in the medium term, from a slowdown in productivity growth, inadequate saving and a large and persistent current account deficit.
- Investment and developments in the labour and housing markets pose risks to the Treasury's forecasts in the short term. On balance, these are skewed more to the downside than to the upside.
- We do not expect growth to accelerate significantly over the next two to three years, as the Treasury does. We expect growth close to trend in 2006 and beyond. Growth could be slower still if inflationary pressures force the Bank of England to raise interest rates.
- Our analysis suggests that there is little spare capacity in the economy. We estimate that the last full cycle was relatively short, having begun in 1999 and ended in the second half of 2003. The Treasury identifies longer cycles than we do: it believes that only three have been completed since 1972, whereas we identify five to six.

Chapter 4: Public spending pressures

- The Pre-Budget Report contained projections for total public spending for the whole period to be covered by next year's Comprehensive Spending Review. If implemented, these would imply public spending falling by 0.7% of national income over the three years to 2010–11. This would be equivalent to £8½ billion in today's terms.
- Keeping to these spending plans would require tough choices. Under plausible scenarios for health, education and overseas aid, they would leave other spending growing at just 0.8% a year after economy-wide inflation. This compares with an expected 1.9% a year over the remainder of the current spending review and with 3.8% over the years to date covered by Labour's spending reviews.
- Recent years have seen increases in social security and tax credit expenditure, helping the government towards its targets for reducing child and pensioner poverty. If growth in spending on social security and tax credits were held to 2.2% a year in real terms (the average forecast for the period since Labour came to power), then this would require real cuts across the rest of government spending (i.e. excluding health, education and overseas aid). While this was achieved during Labour's first two years in office, a repeat would be hard to square with pledges to improve other services such as transport and law and order. Spending restraint in 1997–98 and 1998–99 was assisted by large falls in unemployment and debt interest payments, both of which are unlikely to be repeated.
- Mr Brown could set a spending envelope different from that in the Pre-Budget Report. One option would be to keep spending constant as a share of national income. Given reasonable assumptions about health, education, overseas aid, and social security and tax

credit expenditure, this would allow other spending to grow by 1.3% a year in real terms. This would require an extra £8½ billion in today's terms after three years, but would still be less generous than Labour's current or previous spending reviews.

Chapter 5: Public finance forecasts

- The current budget deficit this year is likely to be in line with the Treasury's December Pre-Budget Report forecast, but in 2006–07 it is likely to be almost 0.3% of national income (£3 billion) bigger than the Treasury expects, according to the Green Budget baseline forecast. We expect weaker revenues.
- We expect the gap between our forecast for the current budget balance and the Treasury's to widen to 0.5% of national income by 2008–09 and then to narrow to 0.2% of national income by 2010–11. We expect more revenue to be raised over time from 'fiscal drag' than the Treasury, mostly through rising income tax bills.
- The Treasury expects government revenues to rise by 1.3% of national income by 2010–11, with two-thirds of the increase occurring next year. We expect an increase of 1.1% of national income, with around half coming next year.
- The Pre-Budget Report forecast suggests that the golden rule will be met over a 12-year economic cycle ending in 2008–09, with the current budget in surplus by a cumulative £12.8 billion. On current policies, we forecast that the rule would be broken very narrowly over this period, with a cumulative deficit of £0.7 billion.
- If the past forecasting performances of the Treasury and the Green Budget are a reliable guide to the future, the Treasury's forecast implies a 58% probability of meeting the rule and the Green Budget forecast a 50% probability of meeting it.
- Our central forecast is for net debt to reach 39.2% of national income in 2008–09 and 39.6% in 2010–11. On past forecasting performance, this implies at least a 44% chance that net debt will breach the 40% of national income debt ceiling laid down in the sustainable investment rule by the last year of the current cycle.
- In the Pre-Budget Report, the Chancellor announced a £3 billion tax increase and pencilled in a cut in public spending as a share of national income worth £8½ billion a year in today's terms by the end of the 2007 Comprehensive Spending Review period. We see a reasonable case for a further £2½ billion tax increase. More would be needed if the Chancellor decides to cut spending less aggressively.

Chapter 6: Funding issues and debt management

- Public sector net debt is likely to continue rising as a share of national income over the next few years, but empirical evidence suggests that this is unlikely in itself to trigger higher real interest rates – although we do believe that long-term interest rates are much more likely to rise significantly than to fall or remain at current levels.

- Demand for long-dated assets by defined-benefit pension schemes is set to continue, but does not guarantee long-term real interest rates will stay low. A cost-effective strategy would be for the corporate sector to buy back equity, issue more debt and so increase the supply of bonds available to its pension funds.
- The likelihood that long-term real interest rates will rise suggests that the Debt Management Office would benefit from locking in low real rates of interest now. Higher issuance of long-dated index-linked debt could also support cost-effective wider pension provision.
- The proportion of debt outstanding in index-linked gilts has been broadly constant in recent years. But the DMO seems prepared to take a more flexible approach going forward. Aside from this, the government may need to explore new ways to raise funds as debt reaches the 40% of GDP limit.

Chapter 7: Tax credits: fixed or beyond repair?

- Since April 2003, the child and working tax credits have been extensively criticised, chiefly for the difficulties some families experience when HM Revenue and Customs (HMRC) recovers overpayments.
- In the 2005 Pre-Budget Report, the government announced substantial changes to the administration and operation of tax credits. These should reduce the scale of, and problems caused by, overpayments, but at the cost of making some families wait longer to receive money to which they are entitled and increasing families' compliance costs.
- It is still too early to tell whether the changes go far enough to avoid the need for further significant reform. But it is hard to see what more the government could do to reduce the problems caused by tax credit overpayments without abandoning some of the key principles behind the system.
- One key government aim was to provide greater income security for families leaving welfare for work. But IT problems have continually delayed the extension of tax credits to families on out-of-work benefits.
- The government has succeeded in creating a more responsive system of support for low-income families with children. But this has created the problem of overpayments, underlining the key trade-off between responsiveness of awards and certainty over their level.

Chapter 8: Productivity policy

- The government is considering a number of potential changes to the R&D tax credit for small and medium-sized enterprises (SMEs). None of the options that we discuss is without potential drawbacks.
- Any change is also likely to increase the uncertainty and/or complexity associated with claiming relief. Given the long-term nature of R&D investment decisions, this seems to

be an area where policy stability is particularly desirable. Thus implementing no changes may well be the best option.

- The 2005 Pre-Budget Report confirmed the launch of the National Employer Training Programme (NETP) from April 2006, now branded ‘Train to Gain’. The evidence for the NETP’s likely effectiveness in improving productivity is not very strong so far.
- Whether the public funding directed towards the NETP provides value for money in terms of fulfilling its key productivity aims will ultimately depend on its effectiveness in terms of generating both additional take-up of training and positive returns to the qualifications acquired through the policy.
- In the 2005 Pre-Budget Report, the Chancellor and the Deputy Prime Minister asked Kate Barker to lead a review of how the planning system can better deliver economic goals. We discuss some aspects of the relationship between planning and productivity, and present some evidence from the retail sector.

Chapter 9: Company taxation

- Corporate tax rates have fallen in many developed countries since the current UK corporation tax rate of 30% was introduced in 1999. This trend may make it difficult for the UK to sustain a 30% tax rate and remain an attractive location for investment. Decisions of the European Court of Justice may also threaten the government’s medium-term projections for corporation tax revenues.
- 2005 saw two separate increases in the taxation of North Sea oil and gas producers. We explain why it is fear of further tax rises, rather than the level of the tax rate itself, that is likely to have a detrimental impact on investment.
- The 2005 Pre-Budget Report announced the final demise of the zero starting rate of corporation tax, introduced in 2002. We review the brief history of this curious initiative, and suggest there are important lessons to be drawn.

Chapter 10: Tax avoidance

- The government’s efforts to tackle tax avoidance have become more high-profile in recent years. Measures to ‘protect revenues’ announced since the 2002 Budget alone are estimated to be raising about £4½ billion this year.
- The traditional distinction between illegal tax evasion and legal tax avoidance (or planning) has been complicated by the efforts of the authorities to have some forms of avoidance seen as unacceptable even if they satisfy the letter of the law. In some areas, the government is now threatening to use retrospective legislation to ensure that taxpayers contribute what ministers regard as their ‘fair share’.
- The Tax Avoidance Disclosure regime is the most important recent legislative development in tackling avoidance. It appears to have been successful from the

government's point of view, judging by the volume of disclosures made and the blocking measures deployed to halt arrangements it sees as unacceptable.

- The authorities are also highlighting to senior executives the risk to their reputation of being found to engage in unacceptable tax avoidance, while leaving it unclear exactly what is unacceptable. This may help to raise revenue in the short run, but is also likely to make the UK a less attractive location for internationally mobile companies and individuals.