

## The IFS Green Budget 2004

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### Planning the public finances

The Chancellor's tax and spending plans are constrained by two self-imposed fiscal rules: the golden rule and the sustainable investment rule. In the December 2003 Pre-Budget Report, the Treasury estimated that the average surplus on the current budget between 1999–2000 and 2005–06 (which it regards as the current economic cycle) would be positive and that the golden rule would therefore be met.

But the amount by which the Treasury expects to overachieve the golden rule has fallen substantially over the past three years, reflecting policy decisions and forecast revisions. This is partly to be expected as the uncertainties surrounding the out-turn over the rest of the cycle diminish. But given the size and direction of recent forecasting errors, even on the Treasury's own figures it is touch-and-go whether the golden rule can be met over the current cycle without reducing existing spending plans or raising more revenue.

The Chancellor has invested considerable political capital in meeting the golden rule and the credibility of the rule could suffer if it is broken on this basis. But judging compliance with the rule by calculating the average surplus on the current budget in the current cycle places too much emphasis on the legacy of past policy decisions and external shocks. The Green Budget argues that a better approach would be to ask if current policy appears consistent with meeting the golden rule in the future.

We can assess this by looking at what the expected path of the current budget balance would be if the economy were running at full capacity. Even in the absence of new policy announcements, the Treasury expects this cyclically adjusted balance to move from a deficit of 0.8% of national income this year – the weakest since Labour came to power – to a surplus of 0.6% in 2008–09. This would be consistent with meeting the golden rule looking forward.

This forecast implies that the rise in current spending as a share of national income seen since April 1999 comes to a halt this year, underlining the pressure facing many government departments to deliver noticeable improvements in public services without further increases in their resources. The forecast also implies a steady rise in tax revenues as a share of national income over the next few years. The question for Mr Brown in the Budget is whether he will have to announce new measures to deliver that rise.

### IFS public finance forecasts

The Green Budget is marginally more optimistic than the Pre-Budget Report about the public finances during the current financial year, expecting a current budget deficit £600 million lower than the Treasury, at £18.7 billion, and public sector net borrowing £700 million lower than the Treasury, at £36.7 billion. For 2004–05, we are slightly more pessimistic than the Treasury, expecting a current deficit of £12.0 billion (compared with £8.3 billion in the Pre-Budget Report) and public sector net borrowing of £34.7 billion (compared with £31.0 billion in the Pre-Budget Report).

We are also more pessimistic than the Pre-Budget Report about the medium-term prospects for the public finances, because we expect revenues to be lower and spending higher than the Treasury projects. By 2007–08, we expect current receipts to be 0.6% of national income lower than the Treasury. The overall impact is that we expect public sector net borrowing to be £38 billion in 2006–07 and 2007–08 rather than the £27 billion predicted in the Pre-Budget Report. And while the Treasury expects the current budget to be in balance in 2006–07 and in surplus by £4 billion in 2007–08, we expect a deficit of £11 billion narrowing to a deficit of £7 billion. Our forecasts imply an average current budget surplus of 0.0% of national income a year over the current economic cycle, just meeting the golden rule, but with less margin for error than shown by the Pre-Budget Report.

Our forecasts do not imply that there is a crisis in the public finances. The government's debt remains modest by international and historical standards. But the Chancellor has said that he wishes to be judged by the fiscal rules he set himself in 1998. Against that benchmark, in the absence of fresh policy measures, we do not believe that he can expect to meet the golden rule on a forward-looking basis with the comfort he has sought in previous Budgets. We assume from past experience that if the Chancellor comes to share this view, he will opt to announce fresh tax increases rather than cut his spending plans.

Our forecasts suggest that the next economic cycle will begin in 2006–07 with a current budget deficit of 0.8% of national income. To safeguard the golden rule in the future would require this gap to be closed. This would require the announcement of fresh tax increases worth around £10 billion.

But in the last Budget, Mr Brown aimed for a cyclically adjusted current budget surplus of 0.6% of national income at the end of his forecasting period. This was justified in part on the grounds that the public finances might be less healthy than they seem if the Treasury has overestimated the amount of spare capacity in the economy. This seems a pertinent concern now, given that the IMF, OECD and Bank of England all appear to believe that the Treasury is overestimating the amount of spare capacity.

To achieve a cyclically adjusted surplus of 0.6% of national income in the first year of the next cycle would require new tax measures raising £17 billion. But Mr Brown indicated in the last Budget that he was happy with a surplus of 0.4% of national income in 2006–07, relying on fiscal drag to raise taxes by the extra 0.2% of national income in the following year.

This implies that Mr Brown needs to announce extra tax increases worth £13 billion to expect to meet the golden rule looking forward with the comfort he sought in last year's Budget. There is no indication that the Chancellor shares this belief. But if he comes to do so, he should act promptly to maintain the credibility of his fiscal framework.

### **Options for raising revenue**

Income tax, National Insurance (NI), VAT and excise duties are currently the government's largest sources of revenue. If the Chancellor decides that he needs to raise more money, they offer potential tax-raising opportunities.

The simplest way to raise money would be to increase income tax or NI rates. The government has pledged not to increase the basic or higher rates of income tax during this Parliament, so higher NI rates look the more likely of the two. The last increase in NI rates took effect in April 2003 and meant employees and the self-employed paid contributions (at a rate of 1%) for the first time on earnings above the upper earnings limit. Increasing this contribution rate from 1% to 6% would raise a little over £4 billion, with the burden falling overwhelmingly on the richest tenth of the population. Raising the upper earnings limit for NI to the point at which higher-rate income tax begins to be paid would raise a little over £1 billion.

Another alternative would be to freeze both income tax and NI thresholds. Taking into account the impact on income-related benefits this would raise an extra £8.8 billion a year in today's money by 2009–10 and would result in an additional 2.4 million higher rate tax payers.

If the Chancellor does want to raise extra money, freezing the income tax personal allowance and National Insurance earnings threshold, raising the employees' National Insurance rate above the upper earnings limit, or

moving the upper earnings limit closer to the point at which higher-rate income tax begins to be paid may be the least unattractive options.

## **The taxation of housing**

The Treasury has been investigating whether tax instruments could be used to help stabilise the housing market and therefore the economy more generally, especially if Britain were to adopt the Euro. In that context, a study published by the Treasury last year argued that 'investment in housing is relatively lightly taxed compared to other investments'. This suggests that the Chancellor might consider raising housing taxes if he decides in the future that he needs more revenue or to create more stability in the housing market.

However, investment in principal residences does not appear to be particularly favourably taxed compared with other investments, such as private pensions or ISAs. Houses are consumption goods as well as investment goods, and the argument that they are lightly taxed by this yardstick has greater force. However, while housing is the only major durable good zero-rated for VAT, it is liable for both council tax and stamp duty.

The government has a number of options if it wants to tax housing more heavily although there has been no firm indication from the government that this is a route that it wishes to take. The Green Budget considers imposing VAT on new homes, increasing stamp duty on house purchases, introducing a property wealth tax or extending capital gains tax to principal residences.

## **Company taxation**

Issues raised for consultation

In August 2003, the government published a corporation tax reform consultation document for the third summer in a row. Continual consultation does not provide a stable environment for business planning, but the corporate tax system is facing international pressures beyond the government's control. First, the UK is competing with other countries to make itself an attractive location for businesses. Second, multinational companies are becoming more willing to take national governments to the European Court of Justice if they believe that tax regimes discriminate against them. The Green Budget discusses some of the issues raised for consultation.

Incorporation

The 2002 Budget announced a new 0% corporation tax rate for companies with taxable profits below £10,000. The Treasury predicted that this would cost £265 million in 2003–04, but IFS, among others, predicted that the costs would become much greater. The new rate increased the incentive for many self-employed people to form companies in which they are the sole employee and shareholder and thereby reduce their tax bill. The number of incorporations has jumped sharply in the wake of the 0% rate's introduction.

The Chancellor now appears to be considering steps to reduce the differential tax treatment between the self-employed and incorporated businesses, possibly by increasing dividend taxation. A simpler solution, if there is a concern over tax avoidance, would be to remove the 0% corporation tax rate. However, frequent changes to the tax system, particularly if made without prior consultation, do not lead to a stable environment for businesses making long-term investment decisions.

## **Issues in public service delivery**

The main public services have enjoyed large real increases in spending since April 1999. While there have been noticeable improvements in some outputs, in areas such as health, education and transport, there is more to do if the government's targets are to be met.

Progress on service delivery has been modest and mixed from area to area. Opinion polls show that most people believe public services have deteriorated since Labour came to power in 1997 and that many are also pessimistic about the future, especially with regard to public transport and the NHS. People are also pessimistic about law and order, but expectations for education are more finely balanced.

The Pre-Budget Report assumes that public spending rises by 3% a year in real terms in the forthcoming spending review period, from 2005–06 to 2007–08, rising slightly as a share of national income. Increasing spending at the planned average annual rate for 1999–2005 would cost an extra £4.6 billion a year, while holding spending static as a share of national income would save £2.5 billion a year and freezing it in real terms would save £14.2 billion a year, relative to current plans.

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Notes to Editors:

1. *The IFS Green Budget: January 2003*, edited by Robert Chote, Carl Emmerson and Zoë Oldfield, is published on 28<sup>th</sup> January 2004 and is available from the IFS, 7 Ridgmount Street, London, WC1E 7AE, price £40 (£15 to IFS members), telephone 020 7291 4800 or e-mail mailbox@ifs.org.uk
2. *The Green Budget* will be launched on 28<sup>th</sup> January, 11am at the IFS. For press places, please telephone IFS on 020 7291 4800.
3. *The Green Budget* will also be available from the IFS website, [www.ifs.org.uk/gbfiles/gb2004.shtml](http://www.ifs.org.uk/gbfiles/gb2004.shtml) after the conference.