

**STRICTLY UNDER EMBARGO UNTIL 10 AM, WED 26TH JANUARY 2005**

## **IFS Green Budget 2005**

The Chancellor of the Exchequer would need to announce fresh tax increases worth at least £11 billion to pay for his spending plans and to get the public finances back onto the track he was hoping for in last year's Budget, according to forecasts by economists at the independent Institute for Fiscal Studies in the 2005 Green Budget. But if, as Morgan Stanley estimates suggest, the current cycle ends this year, the Chancellor would probably not miss his Golden Rule in the near term.

The Green Budget is widely regarded as the most authoritative analysis of the issues facing the Chancellor in making tax and spending decisions. For the first time, the Green Budget is produced this year in collaboration with Morgan Stanley, which has contributed analyses of the economic outlook and debt management policy. Financial support for the Green Budget is also provided through the Economic and Social Research Council's Centre for the Microeconomic Analysis of Public Policy at IFS.

The Green Budget baseline forecast suggests that the government is on course to miss narrowly its "golden rule" (to borrow only to pay for investment) if the economic cycle ends in 2005-06, which is what the Treasury expects. But Morgan Stanley estimate that spare capacity in the economy has been exhausted and the cycle is already in its final year. If this position, which is consistent with analysis from the OECD and Bank of England, is right, the rule would probably be met.

Whether or not the rule is met over the current cycle, the Green Budget baseline forecast suggests that government borrowing will be higher over the next few years than the Treasury thinks, in large part because tax revenues are not expected to grow as quickly as it hopes. To be reasonably confident of meeting the golden rule over the next cycle the government would need to announce fresh tax increases or cut its proposed spending. As the Labour Government's spending plans have now been laid down through to 2007-08, new tax increases look more likely.

Proposals by the Conservatives to cut public spending by 2% of national income over the next six years would in principle allow them to announce £4 billion in tax cuts if they won the forthcoming election and still be able to expect to meet the Chancellor's "golden rule", to which they have also subscribed. But our analysis suggests that if they want to achieve a fiscal position as strong as that which the government was looking for in Budget 2004 they would probably not be able to cut taxes again until some way into their second term in office. This, of course, assumes that the spending cuts could be delivered on schedule, which would be more difficult if they have to rely more over time on efficiency savings rather than slimming the role of government.

Conclusions from the other chapters in the Green Budget include:

- The Treasury should take explicit account of the uncertainty around its forecasts for the public finances in judging whether it is on course to meet its fiscal rules. The rules could also be reformed to promote fairness between the generations more effectively and to create better incentives for policymakers. (*The fiscal policy framework, Robert Chote & Carl Emmerson, IFS*)

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- The Treasury's medium-term view of the economy is plausible, but it is probably too optimistic about growth in the short term. The Treasury claims that economic activity is still below the level consistent with stable inflation, but various techniques for analysing the economic cycle suggest that there is little or no spare capacity left in the economy. (*The economic outlook, David Miles, with Melanie Baker & Vladimir Pillonca, Morgan Stanley*)
- The government is likely to have to issue much more debt over the next five years than the last five, but this need not require a significant rise in bond yields. The government should consider changing its funding policy, for example by issuing more long-dated and index-linked gilts, and by providing liquidity to the options market. Policies to encourage the development of a market in longevity bonds are desirable, though it is not clear that the government should be the issuer of such bonds. (*Funding issues and debt management, David Miles, with Mark Capleton, Morgan Stanley*)
- On Treasury forecasts the tax burden will hit a 25-year high at the end of the decade. Over the next five years 'national income after tax' is set to grow at its slowest rate since the early 1980s. Labour cut taxes in its 2001 pre-election budget, but raised them significantly after both the 1997 and 2001 elections. (*The tax burden under Labour, Carl Emmerson, Christine Frayne & Gemma Tetlow, IFS*)
- Poorer households have had their incomes increased by tax and benefit changes since 1997 while richer ones have had theirs cut. This progressive pattern is even more pronounced in Labour's second term than its first. Households will be £0.84 a week better off on average as a result of central government tax and benefit reforms since 1997, but £3.62 a week worse off after including changes in council tax. (*The distributional impact of tax and benefit changes since 1997, Stuart Adam & Matthew Wakefield, IFS*)
- Corporation tax revenue is under threat from international tax competition and anti-discrimination decisions by the European Court of Justice. The Treasury's desire for the tax system not to influence the choice of legal status for small businesses will be hard to achieve as long as capital and labour income are taxed differently. (*Issues in business taxation, Alexander Klemm, IFS*)
- The childcare tax credit is complex, poorly targeted and does little to improve childcare quality; money could be rerouted to childcare providers to improve quality or allocated in a way that does not try to influence the choice between formal and informal childcare. Government plans to expand free nursery places could cost another £1.3 billion; targeting extra nursery provision on poorer households or neighbourhoods would be more cost-effective. (*Reforms to childcare policy, Mike Brewer, Claire Crawford & Lorraine Dearden, IFS*)

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Notes to editors:

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2. The IFS Green Budget 2005 will be launched on the morning of Wednesday 26<sup>th</sup> January 2005. Please contact Bonnie Brimstone (020 7291 4800, 07730 667013 or [bonnie\\_b@ifs.org.uk](mailto:bonnie_b@ifs.org.uk)) for details if you would like to register to attend.