



IFS Green Budget 2008

Alistair Darling would need to announce fresh tax increases worth about £8 billion in this year's Budget to keep public sector debt below the Government's self-imposed ceiling and to bring about the improvement in the public finances over the next five years that the Treasury wants to see, according to this year's IFS Green Budget.

The IFS Green Budget is once again produced this year in collaboration with Morgan Stanley and with financial support from the Economic and Social Research Centre, through the Centre for the Microeconomic Analysis of Public Policy that it funds at IFS. We are very grateful to both institutions for their continued support.

Not least because of the Government's current political difficulties, we do not expect to see a significant fiscal tightening in this year's Budget. The Government is likely to argue that further bad news on the public finances will only be temporary and that fiscal policy should support monetary policy as the economy slows this year.

However, recent experience suggests that 'temporary' problems in the financial sector can have a bigger and more persistent effect on the public finances than the Treasury initially expects. The Bank of England also has room to offset the impact of a modest fiscal tightening on growth and inflation through its interest rate decisions. This suggests that some action to underpin the fiscal position now would be prudent.

The Budget judgement should not be influenced by a possible decision by the Office for National Statistics to put Northern Rock on the public sector balance sheet. This would probably add £100 billion or 7% of national income to public sector net debt, easily breaching the Gordon Brown's ceiling of 40% of national income. But the eventual impact will be much smaller once Northern Rock's mortgage book is sold. The Government should publish public finance figures with and without the impact of Northern Rock while it remains in the public sector. The appropriate policy response depends on the long-term impact on net debt, which remains uncertain for now.

Over the next five years, to cut borrowing and comply with its self-imposed fiscal rules, the Government is planning to increase the tax burden to a 24-year high and cut public spending to an 8-year low as shares of national income. This would involve the Government taking 48% of the "proceeds of growth" (the extra real income generated by the economy) in tax and other revenues over the next five years, up from 45% under Labour to date and 30% under the previous Conservative government.

But we fear that tax revenues will not grow as strongly as the Treasury hopes, as the impact of the credit crunch and a weak outlook for profit growth depress Corporation Tax receipts and as weaker share and property prices reduce Stamp Duty revenues.

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Under existing policies, we expect the Government to have to borrow more than £40 billion this year, next year and in 2009-10. We expect public sector net debt to hit the Government's ceiling of 40% of national income in 2009-10 and to rise to 41.2% by 2012-13. The Government would also break its "golden rule" (to borrow only to pay for investment) over the new economic cycle, unless that cycle lasts at least a decade.

The Government begins this economic cycle with a much weaker outlook for the public finances than it began the last one. The last cycle began with big current budget surpluses that could be used to pay for later deficits. This cycle is beginning with years of deficits that the Government will only be able to pay for by generating later surpluses. Over recent years, the Treasury has repeatedly been overoptimistic in predicting how quickly such surpluses would begin to materialise.

Government debt and borrowing are still both lower than when the Conservatives left office in 1996-97. But of 21 comparable industrial countries, 16 have reduced their debts and 19 have reduced their structural budget deficits by more than the UK while Labour has been in office. The UK's debt remains below the OECD average, but one OECD government in three now has net financial assets rather than net debt.

The risks to the Green Budget baseline forecast may lie more on the downside than on the upside. David Miles and his colleagues at Morgan Stanley expect economic growth to be weaker over the next two years than the Treasury thinks, reflecting weaker consumer spending as households restore their savings to more comfortable levels. Under this scenario, borrowing would be even higher and net debt would exceed 44% of national income after five years. Morgan Stanley see a roughly one-in-three probability of an even more pessimistic scenario in which the economy suffers a 'technical recession' with output shrinking over two successive quarters.

The Government may also find itself under pressure to top up the spending plans that it announced in last year's Comprehensive Spending Review, if it wishes to achieve some of its stated policy goals. We estimate that in 2010-11 it would need to find an extra £3.4 billion to meet its child poverty target and an extra £6-10 billion if it wished to provide the resources for the health service that Sir Derek Wanless has argued would be necessary to achieve a world class service. The Government may also face pressure to top up the grant settlement for local government if it wishes to avoid big council tax rises or the blame for widespread capping of local authorities.

Other key conclusions in this year's Green Budget include:

Public sector pay and pensions: Unpopular decisions to "stage" public sector pay awards recommended by Pay Review Bodies generate only modest one-off financial savings, make little contribution to the fight against inflation, and threaten to undermine the credibility of the Pay Review Body process. The Government should expend any political capital it wishes to devote in this area to further reforms to public sector pensions. We estimate that relatively generous public sector pensions mean that a public sector worker is on average around 12% better off than a private sector worker on the same basic salary.

Capital gains tax: The Government's proposal in the Pre-Budget Report to abolish taper relief was a welcome step in the direction of making capital gains tax simpler and less distortionary. CGT could be

made even less distortionary by aligning CGT rates with the tax rates on earnings and dividend income, applying reduced rates to corporate equity to reflect corporation tax already paid, and perhaps reintroducing relief for inflation. Higher CGT rates might discourage saving, investment and entrepreneurship, but these could be encouraged in better-targeted ways. The announcement on 24 January 2008 of a £200 million 'entrepreneurs' relief' to be introduced in April 2008 will be a welcome reprieve for many owner-managers of small businesses, but reintroduces complexities and distortions similar to those inherent in taper relief, and the process by which the final proposals were arrived at was shambolic. It is hard to believe that they are the final word.

Debt management, the credit crunch and the mortgage market: Yields on shorter-dated gilts are exceptionally low, so the Government should issue more shorter-dated bonds and fewer medium-dated bonds than it otherwise would. Short-dated gilt yields are low in part because of the so-called 'credit crunch'. If this continues, it would pose significant difficulties for mortgage lenders. One strategy to alleviate this problem would be the creation of an agency to buy or lend against the collateral of mortgage-based securities issued by banks and building societies. Mortgage contracts that (i) link monthly repayments to consumer prices or house prices, and (ii) involve borrowers and lenders sharing the risk of house price changes, should be both attractive and commercially viable.

Tax and benefit changes taking effect in April 2008 and under Labour to date: Tax cuts and tax credit increases worth £14 billion are already due to take effect in April, offset by tax increases of roughly the same amount. In general, households at the top and bottom of the income distribution will gain most from the changes to personal taxes and tax credits, while those in the middle will see very little impact. However, some low income individuals ineligible or not claiming the working tax credit will be worse off. Cutting the marginal tax rate for basic-rate taxpayers will improve incentives to work and to save very slightly for many individuals, but the package will not reduce the very high marginal tax or deduction rates faced by those with the weakest work incentives. Taking this April's changes into account, the tax and benefit reforms since 1997 will have increased the incomes of the poorest tenth of the population by 12.4% (£1,300 a year) and reduced those at the top by 5.5% (£4,200 a year) on average. In spite of facing higher net taxes, a household in the middle of the top tenth of the income distribution has still enjoyed an increase in real post-tax income of around 20% between 1997 and 2006 due to growth in pre-tax incomes.

Aviation taxes: The government proposes putting a tax on flights from November 2009, replacing the current tax on passengers, air passenger duty (APD). This should allow it to target the level of emissions more effectively than APD does at the moment. To be targeted precisely on the environmental costs of aviation, the rates of a new aviation duty would have to vary by aircraft type, aircraft emissions and departure airport, as well as by distance travelled. But the more sophisticated the tax is, the more complicated it will be to administer and comply with. The winners from a relatively sophisticated aviation duty would be those flying short distances on full, clean, quiet planes from airports away from residential areas.

Corporation tax and entrepreneurship: Labour has changed corporation tax rates in seven of its 11 years in office and plans to change them again next year and in 2009–10. Throughout Labour's time in office, the tax and National Insurance system has provided incentives to be self-employed rather than employed, and incorporated rather than unincorporated. The removal of the starting rate of corporation tax (first introduced in 2000-01), together with the planned increase in the small companies' rate over the next two

years, suggests that the government has now acknowledged that creating tax incentives that favour one legal form over another may not be the most sensible way to encourage entrepreneurship. But stemming the continued tide of incorporations may require further increases in – and perhaps even the abolition of – the small companies' rate. This may be no bad thing, as the economic rationale for a distortion in the tax system in favour of companies with low profits is far from clear.

Taxation of companies' foreign profits: In June 2007, the Treasury and HM Revenue & Customs published a package of proposals for taxing foreign income, including a move away from taxing foreign subsidiary dividends (with credit for any foreign taxes paid in respect of those dividends) to a system in which foreign dividends are exempt from UK taxation altogether. Moving to an exemption system would ordinarily increase the after-tax profitability of UK multinationals and be less likely to distort investment decisions unhelpfully. In principle, an exemption system should also be simpler and cheaper for companies to comply with. Other elements of the proposed package, however, may detract from these outcomes and produce a new system that is as complex as the old..

Tax simplification: The government has reaffirmed its commitment to simplify the tax system, but attempts by this and previous governments to deliver real and long-lasting reductions in complexity have usually come to nothing and the volume of tax legislation has grown inexorably. The rewrite of direct tax legislation, initiated under the last Conservative government and still in progress, uses simpler language but at much greater length and without resolving any of the underlying complexity in the legislation. Real simplification is difficult to achieve without more fundamental consideration of what, who and how we tax. Tackling complexity requires that we recognise what is complex and why, and focus on what can sensibly be done about it.

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2. The IFS Green Budget 2008 will be launched on the morning of Wednesday 30th January 2008. Please contact Bonnie Brimstone (020 7291 4800, 07730 667013 or bonnie_b@ifs.org.uk) for details if you would like to register to attend.