

Press Release

Tel: +44 (0) 20 7291 4800
Fax: +44 (0) 20 7323 4780

mailbox@ifs.org.uk
www.ifs.org.uk

7 Ridgmount Street
London WC1E 7AE

More tax increases or spending cuts needed to pay for cost of credit crunch

The Government – or its successor – will need fresh tax increases or spending cuts worth an extra £20 billion a year by the end of the next Parliament, if it is to expect to repair the public finances as planned in November's Pre-Budget Report, according to the **2009 IFS Green Budget**. Even if it acts, public sector debt may well not return to pre-crisis levels for more than 20 years.

This Green Budget is the first event of the **IFS's 40th anniversary year** – and we would like to thank everyone who has taken an interest in our work over that time. We are delighted that, once again, this year's Green Budget has been produced in collaboration with David Miles and his colleagues at Morgan Stanley. We are also grateful to the Economic and Social Research Council for financial support for the publication and for so much of our research work.

Treasury figures suggest that the **credit crunch will cost the Exchequer** an ongoing 3.5% of national income (or a little over £50 billion a year in today's terms) in lost tax revenue and additional social security spending. This excludes any long-term impact from the Government's interventions in the financial sector, although even a large one-off loss adding to public sector debt should increase the ongoing cost in extra borrowing relatively modestly compared to the impact already reflected in current Treasury forecasts.

In the PBR the Treasury signalled **spending cuts and tax increases** starting in 2010–11 and raising 2.6% of national income (£38 billion a year) by 2015–16. If the public finances evolve as the Treasury hopes, this tightening would have to remain in place until the early 2030s before debt returns below the ceiling of 40% of national income Gordon Brown set as one of his two fiscal rules in 1997. So there is no prospect of a Government being able to readopt these rules any time soon. We hope they will be reformed in any event.

Unfortunately, the Green Budget **does not expect tax revenues to grow as strongly** as the Treasury hopes over the next few years. In the absence of any additional spending cuts or tax increases, we forecast that the Treasury would have to borrow 1.5% of national income more in 2015–16 than it predicted at PBR time – even if the economy performs no worse than expected in the PBR. This would take public sector net debt above 60% of national income, from where it would decline only very gradually over subsequent decades.

The average view among independent macroeconomic forecasters is that the **recession will be deeper and longer than the Treasury thought** at the time of the PBR. This would push government debt and borrowing further above the PBR forecasts. This might well unsettle nervous investors, but might not increase the level of borrowing and necessary tightening in the longer term.

Embargo

Until 10.00 am
Wed 28th Jan 2009

Contacts

**Bonnie Brimstone,
Emma Hyman.**
Institute for Fiscal Studies

020 7291 4800 or
07730 667013

Sebastian Howell
Morgan Stanley

020 7425 5324

Director:
Robert Chote

Research Director:
Richard Blundell

The Institute for Fiscal Studies
Limited by Guarantee,
Registered in England: 954616
7 Ridgmount Street
London
WC1E 7AE

Registered Charity: 258815
VAT no: GB 394 5830 17

Morgan Stanley's central scenario for the economy is more optimistic than the consensus in the short-term, but it still implies a bigger structural fiscal problem than the PBR, because it sees less spare capacity in the economy than the Treasury. Its pessimistic scenario shows a deeper recession and an even bigger structural problem. Conversely, in their optimistic scenario the credit crunch spurs positive supply-side responses and allows the economy to sustain a stronger recovery. If that turns out to be the case, in retrospect the Government may not have needed as big a fiscal tightening in the PBR.

Morgan Stanley argue that taxpayer losses from the Government's interventions in the financial system are most likely to be small, and there may even be a profit. But there is a much greater chance of big losses than big profits. To help prevent similar **problems arising in the financial sector**, they recommend incorporating housing costs in the inflation target, raising capital requirements in the long-term and making them countercyclical, and improving incentives for responsible borrowing and lending.

For the time being, the impact of rising public sector net debt is limited because **the Government can borrow relatively cheaply**. So, even though the Treasury expects net debt to rise to its highest levels since the 1970s, it expects the cost of debt interest to remain below the level Labour inherited from the Conservatives in 1997. In Morgan Stanley's view, there are good reasons to expect borrowing costs to remain low, for example strong demand for gilts from UK banks in search of liquid assets with low risk. The Debt Management Office can also help keep borrowing costs low by shifting issuance towards short-dated stock while current market conditions persist.

But there is clearly a **danger investors will take fright** at the state of the UK public finances, pushing up gilt yields. If borrowing costs were to return to the average levels of the 1990s, then further tax increases or spending cuts would probably be required to stop debt and debt interest costs rising unsustainably. This would be on top of those the Green Budget thinks necessary simply to achieve the improvement in the public finances sought in the PBR.

The potential consequences of a rise in borrowing costs underline the need for the **Government to reassure voters and investors** that it will take the necessary steps to repair the public finances, as soon as the economy has stabilised and it is safe to do so. This strengthens the case for pre-announcing a further fiscal tightening now, even though the uncertainties around all public finances forecasts are even greater than usual in current circumstances.

The fiscal tightening in the PBR was dominated by public spending cuts rather than tax increases. Given plausible projections for interest payments and social security spending, the Green budget estimates that the Government will have to impose a **real freeze on total spending by Whitehall departments** during the three years of the 2010 Spending Review to keep to its overall forecasts. Capital intensive departments like housing and transport are expected to be hit hardest. By 2013–14 spending on public services would be around £22 billion lower than was projected in the Budget.

Given the squeeze on spending already planned, the Government may be more likely to address any emerging revenue shortfall through **tax increases**. It is worth remembering that the tax increases announced in the PBR were

only one-tenth the size of those announced in the 1993 Budgets, the last time a government responded to a similar need for additional fiscal tightening.

One option to help close the gap would be to broaden the unusually narrow base of VAT in the UK, by removing zero and reduced rates. These distort people's spending and are an unnecessarily expensive way of helping less well-off families. **Abolishing zero and reduced rates of VAT** would improve economic efficiency and provide enough revenue to cut borrowing by more than £10 billion, even after increasing benefits and tax credits sufficiently to leave poorer families on average better off overall. This might not be popular politically, but neither would other methods of raising similar sums of money. The prospect of a future rise in VAT would also provide an additional boost to economic activity beforehand. This could be further enhanced – at a cost – by compensating poorer families in advance of the tax increase taking effect.

The Green Budget argues that the **temporary cut in VAT** that is now in place will be a more effective stimulus measure than its critics suggest. But deepening it would not be practical and extending it would not be sensible.

Any decision whether to announce a **further stimulus** package should be part of a broader discussion between the Government and the Bank of England over the appropriate mix of fiscal measures, further interest rate cuts, less orthodox methods of monetary loosening, and further measures to encourage bank lending. Public support from the Bank of England for any further fiscal stimulus measures would help bolster credibility.

The Green Budget discusses various other issues in **tax reform** raised by the PBR, including proposals for better aligning Income tax and National Insurance, the taxation of foreign profits, the delay in increasing the small companies' corporation tax rate, and the taxation of empty properties.

Summaries of the individual chapters in the Green Budget are attached below.

ENDS

Notes to Editors:

1. For embargoed copies of the report or other queries, contact:
Emma Hyman or Bonnie Brimstone at IFS: 020 7291 4800, emma_h@ifs.org.uk, bonnie_b@ifs.org.uk;
Sebastian Howell at Morgan Stanley: 020 7425 5324, Sebastian.Howell@morganstanley.com
2. The IFS Green Budget 2009 will be launched from 9:30am on the morning of Wednesday 28th January 2009. 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.