The Public Finances

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Summary

- The public finances were strengthening when Labour took office in 1997 and continued to do so during its first term in office, thanks to spending restraint and buoyant revenues. Then they weakened in the second term, as a deliberate decision to increase spending coincided with lower-than-expected revenues.
- Fiscal policy has been broadly successful to date under Labour, judged against the government's self-imposed rules. Debt has been kept below 40% of national income and government borrowing is likely to be broadly in line with investment spending in the economic cycle running from 1999–2000 to 2005–06.
- By historic standards, government debt and borrowing are modest compared with levels under recent previous governments. But the UK now has one of the largest structural budget deficits in the industrial world. So while the UK has remained in the middle of the industrial countries' league table for government debt since 1996, its position is likely to deteriorate unless fiscal policy is tightened significantly.
- Labour is planning a fiscal tightening. It wants to increase spending modestly as a share of national income while it expects a larger increase in the tax burden to pay for it and meet its fiscal rules looking forward. The Chancellor believes this will happen without him needing to announce new tax increases; we think he may need to raise another £11 billion.
- The Liberal Democrats propose slightly higher spending and a slightly higher tax burden than Labour. Their tax increases may not raise as much money as they hope, but they have a small reserve built into their plans. Like Labour, they will need to announce new tax increases to pay for their spending plans if revenues undershoot Treasury forecasts.
- The Conservatives plan to announce tax cuts worth £4 billion in their first Budget and after six years to cut spending relative to Labour's plans by £25 billion in today's terms. By cutting borrowing, they should avoid the need to announce new tax increases (or reverse their own tax cuts) even if revenues are weaker than the Treasury expects. But this assumes that the Conservatives are able to cut spending as quickly and painlessly as they claim. Past experience suggests caution.
- Whoever wins the election, the tax burden is likely to be higher at the end of the next parliament than at the end of this one. And even the Conservatives' proposed spending cuts would reverse only half the increase in spending seen since 1999. The similarities between the parties are as striking as the differences.

1. Introduction

This Briefing Note assesses the government's management of the public finances since 1997, judged against the rules it set itself to constrain public sector borrowing and debt, and against the performance of other industrial countries over the same period (Section 2). It then discusses how the public finances might evolve given the tax and spending policies of the three main parties (Section 3), as well as their proposals to reform the framework in which the public finances are managed (Section 4).

2. The public finances since 1997

2.1 The government's aims in managing the public finances

In its 1997 general election manifesto, Labour committed itself to two fiscal rules, designed:

- to ensure that the public finances are sustainable without the need for big policy changes;
- to ensure that the burden of paying for public spending is shared fairly between present and future taxpayers, and that there is no bias against investment spending.

Labour formally adopted the rules on taking office, and the Conservatives and Liberal Democrats have now signed up to them as well. Specifically:

- The **'golden rule'** states that the government should only borrow to finance investment spending (which is presumed to benefit future taxpayers), while the remaining 'current' spending (which is presumed to benefit only today's taxpayers) has to be covered by tax and other revenues. This does not have to be true every year, but only on average over the ups and downs of the economic cycle. The Treasury calculates whether the rule is met by summing or averaging the current budget balances (total revenue minus current spending) in each year of the economic cycle as shares of national income. The rule is met if the average or cumulative balance – sometimes converted into cash – is zero or positive.
- The **'sustainable investment rule'** states that public sector debt (net of financial assets, mostly foreign exchange reserves) should be kept at a 'stable and prudent' level. The Treasury defines this as no more than 40% of national income. The government has said that this rule needs to be satisfied in every year of the current economic cycle, which the Treasury estimates will encompass the seven financial years from 1999–2000 to 2005–06.

So how have changes in public sector revenues and spending contributed to movements in government borrowing and debt since 1997? And how does this reflect on the government's management of the public finances?

2.2 Government borrowing

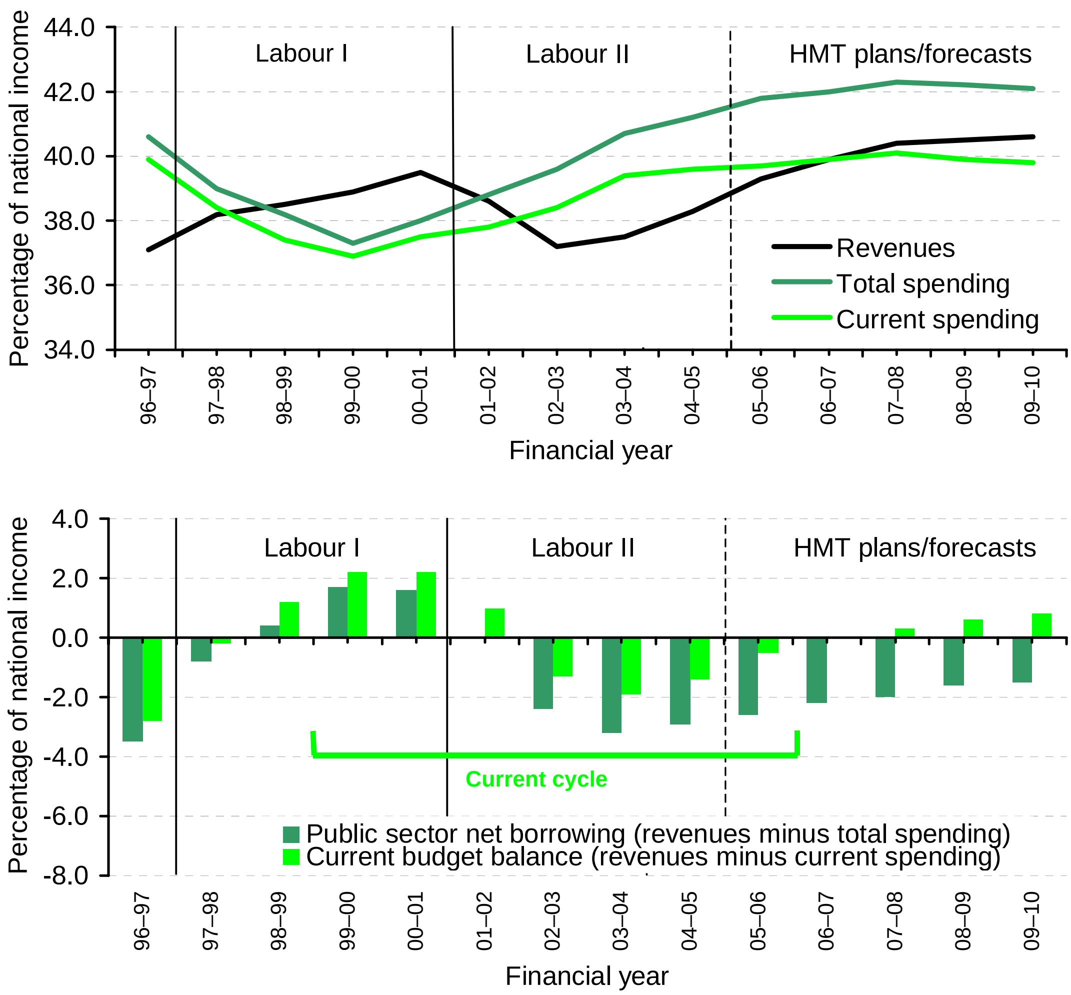
Revenues, spending and borrowing since 1997

In 1996–97, the year before Labour took office, the public sector spent 40.6% of national income, while government revenues totalled 37.1% of national income. This left a gap of 3.5% of national income to be covered by public sector net borrowing.

Only a fifth of this borrowing was in effect used to pay for investment, leaving a current budget deficit of 2.8% of national income. The current budget was in the red in part because economic activity was below its long-term sustainable level, depressing tax revenues and increasing spending on social security benefits. But if the economy had been at full capacity, the underlying or cyclically adjusted 'structural' current budget deficit would still have been 2.3% of national income on Treasury estimates. This meant that fiscal policy would need to be tightened over the coming years to meet Gordon Brown's golden rule.

In the 1997 manifesto, Labour promised to keep to the tight spending plans that it was set to inherit from the Conservatives for two years. Mr Brown more than kept that promise and, despite spending more in the run-up to the 2001 election, public spending ended Labour's first term 2.6% of national income lower than it started (Figure 1). Over this period, public sector net investment fell by 0.1% of national income (rather than rising, as the government had planned), so the remaining 2.4% of national income decline (after rounding) was in current spending.

Figure 1. Public sector revenues, spending and budget balances



Source: HM Treasury, *Public Finances Databank*, London, March 2005 (http://www.hm-treasury.gov.uk/media/C62/B0/March05WEB.xls).

Over the same four years of Labour’s first term, government revenues rose by 2.4% of national income, thanks to ongoing increases in fuel and tobacco taxes (put in place by the Conservatives and maintained until 2000 by Mr Brown), above-average economic growth, and the Chancellor’s decision not to raise income tax thresholds as quickly as earnings (which meant that a progressively larger proportion of people’s incomes was taxed at higher rates).

With revenues rising by 2.4% of national income and current spending falling by 2.5% of national income, by the time of the 2001 election the current budget had moved into a healthy surplus – and the Treasury expected it to remain that way. It looked as though the golden rule would be met by a huge margin over the economic cycle running from 1999–2000 to 2005–06. Even after £3.6 billion of pre-election tax cuts and spending increases in Budget 2001, the Treasury predicted an average current budget surplus over the cycle of almost 1.4% of national income, implying that the rule would be met with a cumulative £118 billion to spare.

Mr Brown had described his determination to reduce borrowing in his early years in office as ‘prudence with a purpose’. The purpose became clear after 1999 – and especially as Labour’s second term unfolded. Public spending reversed its earlier decline, with health, education and tax credits the main beneficiaries of the Chancellor’s largesse. But as spending rose by 3.2% of national income in Labour’s second term, tax revenues weakened unexpectedly when the stock market fell, reducing tax payments by financial sector firms and their employees. The tax-raising Budget of 2002 helped begin to reverse the decline, but government revenues have ended Labour’s second term 1.2% of national income lower than they began it.

So where does this leave us now?

The 2005 Budget estimated that the current budget was still in deficit by 1.4% of national income (£16 billion) in 2004–05, compared with the surplus of 0.8% of national income predicted for the same year in the 2001 Budget that preceded the last election. Adjusting for the fact that the Treasury believes that there is still slack in the economy, there remains a structural current budget deficit of 0.8% of national income. This is only a third the size of the structural deficit that Labour inherited, but stubbornly bigger than the Treasury predicted.

The golden rule over the current economic cycle

To meet the golden rule over the current economic cycle, the current budget must be in balance or surplus over the seven financial years running from 1999–2000 to 2005–06. Having predicted that the rule was on course to be overachieved by £118 billion at the time of Budget 2001, the Chancellor predicted in Budget 2005 that the margin would be only £5 billion (or £6 billion assuming that the contingency reserve for unexpected current spending in 2005–06 is not required). About a quarter of this decline reflects deliberate policy decisions (mostly to increase spending) while most of the remainder reflects unexpected weakness in tax revenues.

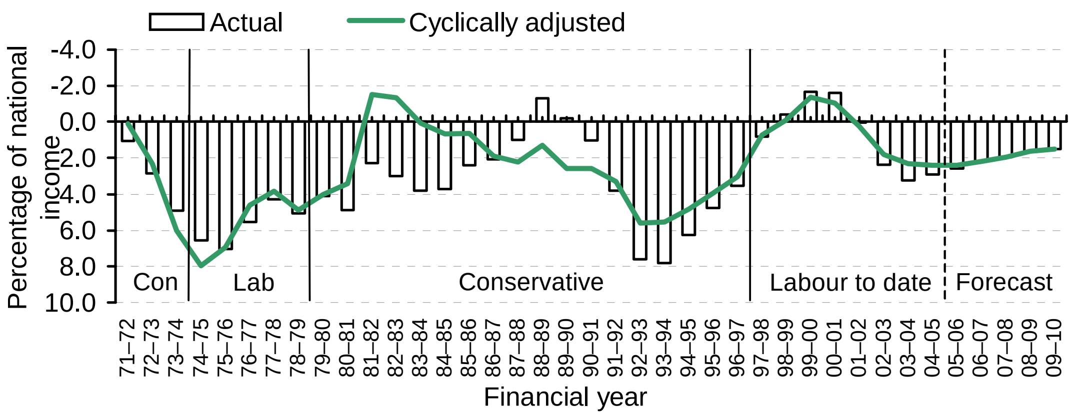
With one financial year of the cycle to go, the government must run a current budget deficit no larger than 0.9% of national income or £10.8 billion in the financial year just beginning (assuming that the Budget 2005 forecast for 2004–05 turns out to have been correct). The Treasury predicted in the Budget that it would run a current budget deficit of £5.7 billion this year, while IFS researchers predicted a deficit of £13.4 billion in January’s Green Budget.

Bearing in mind that the average absolute error in Treasury and IFS forecasts for government borrowing just one year ahead is around £12 billion, it is impossible to predict with confidence whether the rule will be met or not. But, in either event, it looks likely that the rule will be met or missed by a small margin. Despite the considerable uncertainty that surrounds all forecasts for the public finances, the Chancellor has rejected any suggestion that the rule might be broken. It would therefore be embarrassing for him if it were to be broken, even though the direct economic significance of a modest breach would be negligible.

Government borrowing in historical and international perspective

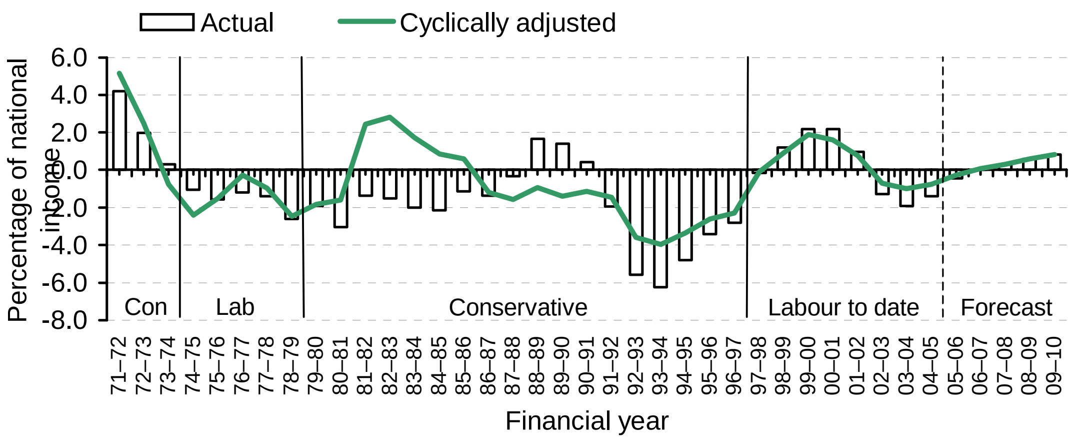
The Treasury estimates that in 2004–05 public sector net borrowing reached 2.9% of national income or 2.4% adjusting for estimated slack in the economy. This is the largest structural budget deficit since Labour took office in 1997, but is smaller than the 3.0% that it inherited, smaller than the average under the Major government (4.4% of national income), above the average under Mrs Thatcher (1.4% of national income) and smaller than that under the previous Labour government of 1974–79 (5.1% of national income). (See Figure 2.)

Figure 2. Public sector net borrowing



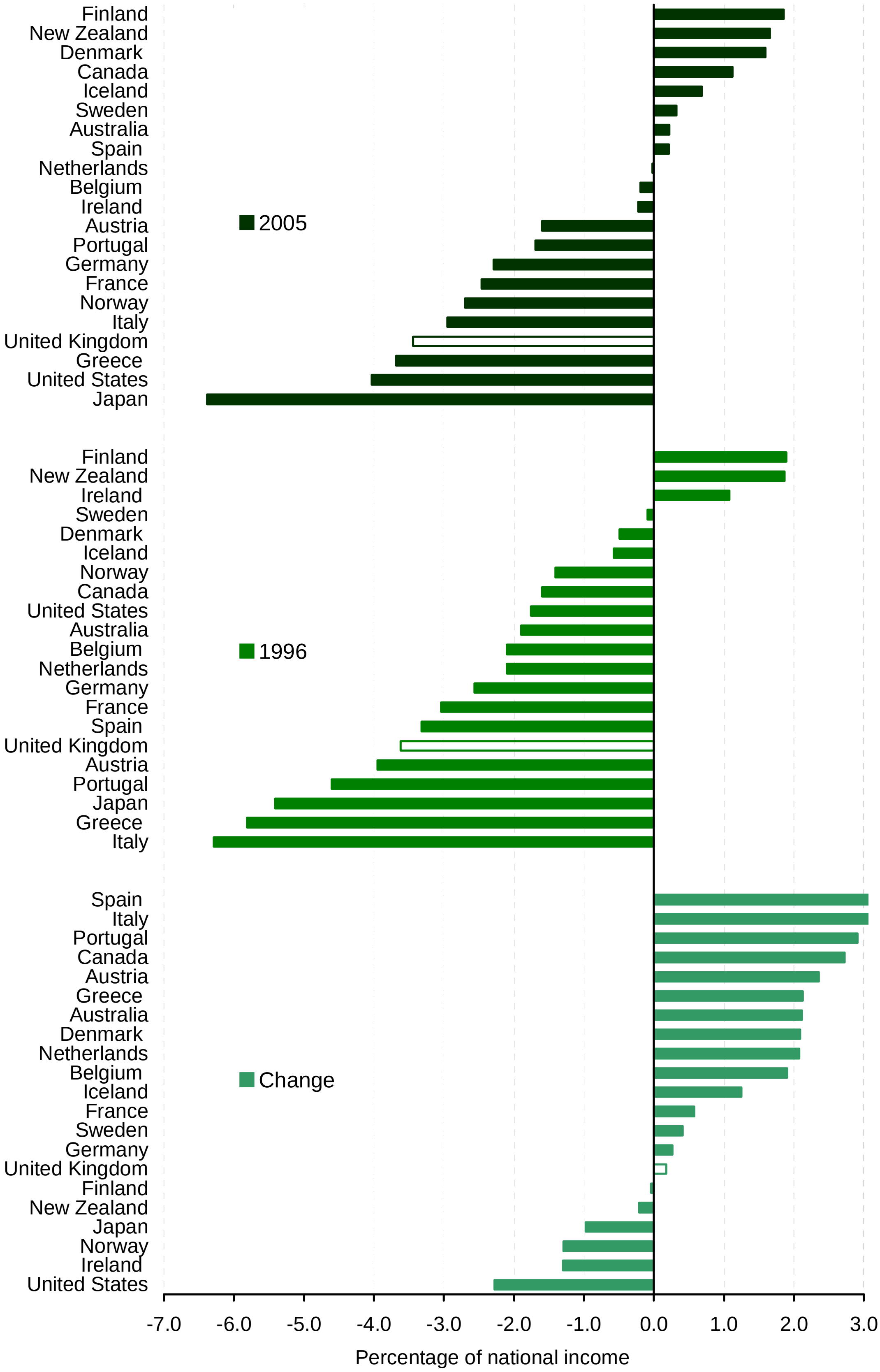
Source: HM Treasury, *Public Finances Databank*, London, March 2005 (http://www.hm-treasury.gov.uk/media/C62/B0/March05WEB.xls).

Figure 3. Current budget balance



Source: HM Treasury, *Public Finances Databank*, London, March 2005 (http://www.hm-treasury.gov.uk/media/C62/B0/March05WEB.xls).

Figure 4. Cyclically adjusted 'structural' general government balances



Source: Annex table 28, OECD Economic Outlook 76 database, December 2004 (http://www.oecd.org/document/61/0,2340,en_2825_32066506_2483901_1_1_1_1,00.html).

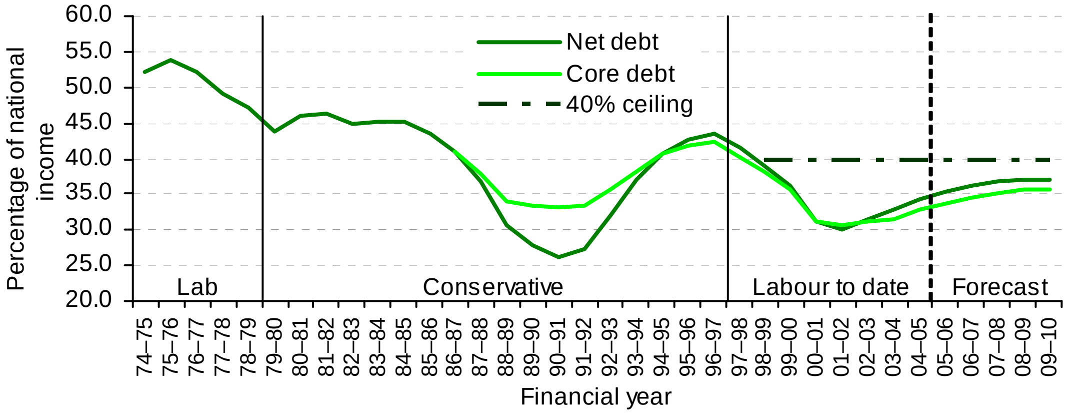
Labour's record in recent years looks less impressive compared with those of past governments when focusing on current budget balances rather than public sector net borrowing. (See Figure 3.) This reflects the fact that capital spending was higher (but falling) under previous governments, which meant that the current budget was stronger relative to the overall budget position. Public sector net investment has risen by 1.1% of national income under Labour to date, having fallen by 1.3% of national income under Mr Major, by 0.4% of national income under Mrs Thatcher and by 2.8% of national income under the Wilson/Callaghan Labour government of 1974–79.

Figure 4 compares borrowing under Labour to date with that of other industrial countries. Based on internationally comparable figures for 'general government' rather than the entire public sector, the UK had a relatively large estimated structural budget deficit in 1996 of 3.6% of national income, which had only shrunk to 3.4% by 2005. Most other industrial countries have tightened fiscal policy more, so among the 21 for which we have the data, the UK has moved from having the 6th largest structural deficit to having the 4th largest.

2.3 Government debt

The budget surpluses run by the Labour government in its early years in office and the proceeds of auctioning 3G mobile telephone licences helped reduce public sector net debt from 43.6% of national income in 1996–97 to barely 30% of national income by 2001–02. By 2004–05, the debt ratio had returned to 34.4% and the Treasury expects it to level off at around 37% of national income in four or five years' time.

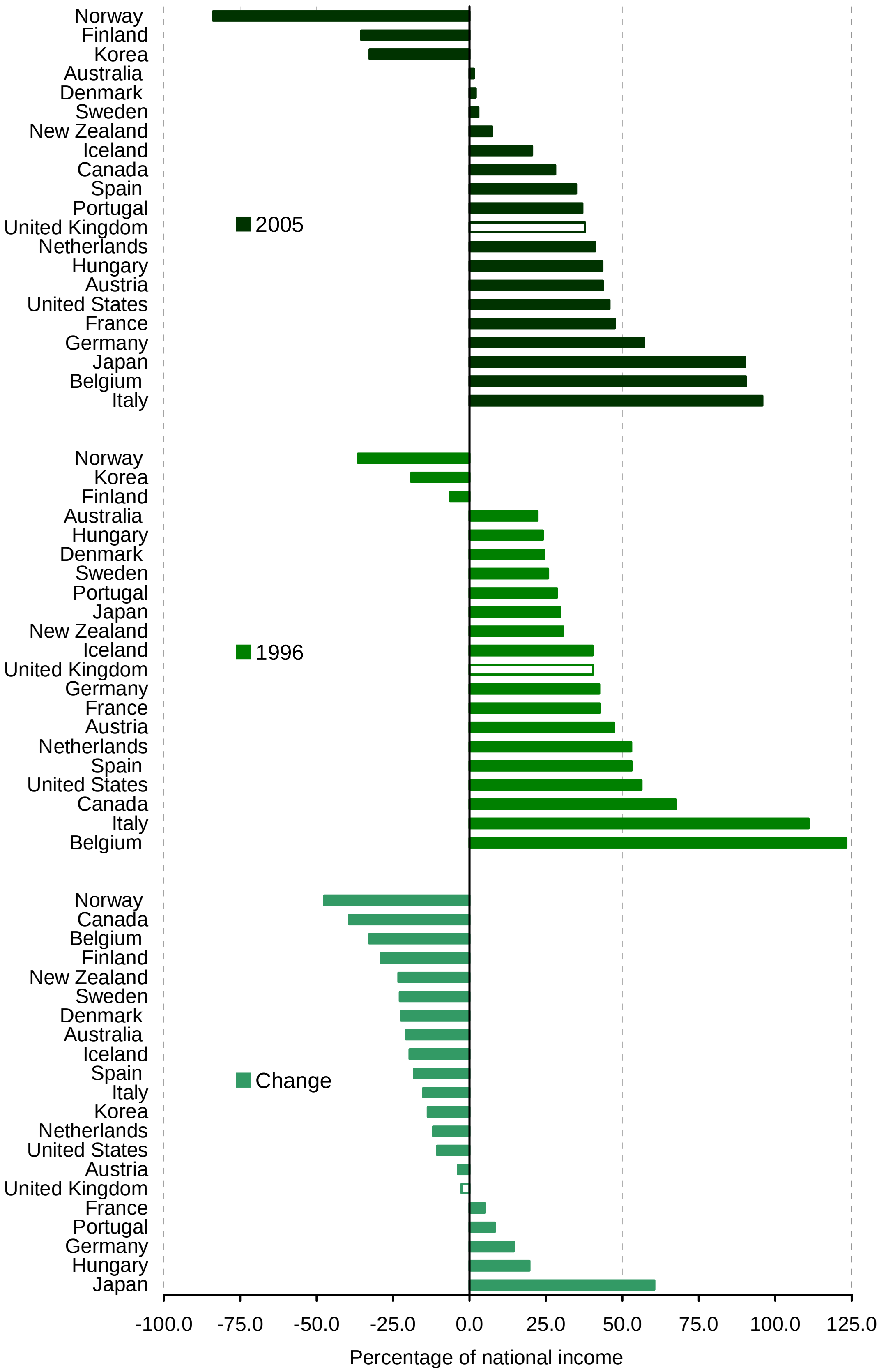
Figure 5. Public sector net debt, out-turns and latest Treasury forecasts



Sources: HM Treasury, *Public Finances Databank*, London, March 2005 (http://www.hm-treasury.gov.uk/media/C62/B0/March05WEB.xls); HM Treasury, *Budget 2005*, London, March 2005 (http://www.hm-treasury.gov.uk/budget/budget_05/bud_bud05_index.cfm); HM Treasury, *End of Year Fiscal Report*, London, December 2004 (http://www.hm-treasury.gov.uk./media/8F5/65/pbr04end_year_456.pdf); HM Treasury, *Core Debt: An Approach to Monitoring the Sustainable Investment Rule*, London, April 2002 (http://www.hm-treasury.gov.uk./media/52F/5B/bud02_coredebt.pdf).

Figure 5 shows that since 1997, public sector debt has been relatively low by comparison with the previous Conservative and Labour eras. The debt ratio did dip below 30% of national income in the late 1980s, but the Treasury estimates that this was only because of the budget surpluses generated by the unsustainable economic boom. Adjusting for the cycle, the low-

Figure 6. General government net financial liabilities



Note: Data for Hungary prior to 1997 not available, so 1997 figure taken instead of 1996.
Source: Annex table 33, OECD Economic Outlook 76 database, December 2004 (http://www.oecd.org/document/61/0,2340,en_2825_32066506_2483901_1_1_1_1,00.html).

point in 'core' debt under the Conservatives was no lower than current levels. Since 1998–99, the debt ratio has stayed comfortably below the sustainable investment rule's 40% ceiling and there is no chance of a breach in the remaining year of the current economic cycle.

Based on internationally comparable measures, the UK government has reduced its debt by less than most other industrial countries since 1996, as Figure 6 illustrates. The UK remains roughly in the middle of the industrial countries' league table for government debt. The UK shows no signs of emulating the Australasian and Scandinavian countries in seeking to eliminate net government indebtedness or – in some cases – to build up net financial assets.

2.4 Summary

In 1997, the incoming Labour government inherited a position in which the public finances were already strengthening, with the budget deficit shrinking and the debt burden stabilising. This reflected the fact that the Conservatives had been tightening fiscal policy since 1992, having allowed the structural budget deficit to become unsustainably large in the boom of the late 1980s and the subsequent recession. The big loosening in monetary policy following sterling's exit from the exchange rate mechanism had also made fiscal tightening necessary.

During Labour's first term, the public finances continued to strengthen as Mr Brown kept a tight grip on spending and increased the tax burden. But during the second term, the public finances have deteriorated as the government has chosen to increase spending, while tax revenues have come in unexpectedly weakly. Nonetheless, the structural budget deficit and the government's debt burden remain smaller in 2004–05 than they were in 1996–97, so on these measures Labour has to date presided over a strengthening in the public finances.

Judged by the benchmark of the rules that the Chancellor set himself on taking office, fiscal policy has been managed pretty successfully to date under Labour. Government debt has been kept comfortably below the 40% ceiling set out in the sustainable investment rule, while the golden rule is likely to be met or missed by a small margin over the economic cycle that ends this year. The Chancellor's dismissal of any suggestion that the golden rule may be missed does not take adequate account of the uncertainty that surrounds all forecasts of the public finances. It will be embarrassing for him if the rule should be missed, but any direct damage to the economy or the principles of fairness that underlie the rule would be negligible.

By historical standards, borrowing and debt are modest compared with the levels under previous administrations over the past 30 years. By international standards, the government's debt is still in the middle of the industrial countries' league table, as it was in 1996. But the UK now has one of the largest estimated structural budget deficits in the industrialised world and has presided over a big increase in government borrowing in recent years. So a significant fiscal tightening will probably be needed over the next few years if the UK's public finances are not to look increasingly weak by the standards of other industrial nations.

3. The public finances beyond the election

The three main political parties have all committed themselves to meeting the government's existing golden rule and sustainable investment rule over the next economic cycle. Judging whether their tax and spending plans are consistent with this aspiration is difficult because we do not know how long the next economic cycle will be. For forecasting purposes, the Treasury assumes that this economic cycle is the last and that economic activity remains at the sustainable level consistent with stable inflation from 2006–07 onwards. Neither do we know what margin for error the parties will seek in aiming to meet the rules. The fairest way to compare the parties is to assume that they would aim to meet the rules over the next cycle with the same confidence that the government is aiming for in its Budget 2005 forecasts.

3.1 Labour's proposals

Gordon Brown is confident that Labour will meet his fiscal rules with room to spare over the next economic cycle. He plans to increase public spending only modestly as a share of national income over the next few years, while the tax burden is set to rise much more sharply (supposedly without him having to announce any new tax-raising measures).

The plans outlined in Mr Brown's three-year Spending Review in July 2004 imply an increase in current spending (including depreciation) of just 0.5% of national income between 2004–05 and 2007–08, compared with the increase of 1.8% of national income over the previous three years. This would take current spending (including depreciation) from 39.6% to 40.1% of national income, only slightly higher than the level Labour inherited. The Treasury then assumes, in making its longer-term projections, that current spending (including depreciation) drops to 39.9% of national income in 2008–09 and 39.8% in 2009–10. Labour also plans to make £21.5 billion of efficiency savings by 2007–08, which have been identified by the government's Gershon Review. The proceeds would then be reinvested in public services, with no net impact on the spending total. However, past experience suggests that these savings may be hard to deliver as quickly and painlessly as the government hopes. If that proves to be the case, the government will either have to spend more than it currently plans to or accept public services of lower quality than it is aiming for.

In our Green Budget earlier this year, IFS researchers produced their own forecast for the public finances under Labour over the next few years, based wherever possible on the same 'cautious' assumptions for the behaviour of the economy as those used by the Treasury. We took the plans laid out in the government's Spending Review at face value, but questioned whether it was plausible to assume that current spending will fall as a share of national income after 2007–08 given the government's goals for NHS spending, overseas aid, reducing child poverty etc. It seemed more sensible to assume that spending would be flat as a share of national income beyond 2007–08.

On the revenue side, the Treasury predicted in the Budget that net taxes and National Insurance contributions would rise from 36.3% of national income in 2004–05 to 38.5% in 2009–10. Taking other government revenues (mostly the gross operating surpluses of public enterprises and rent) into account, total government receipts are expected to rise from 38.3% in 2004–05 to 40.6% in 2009–10. This increase of 2.3% of national income is much larger than the increase in current spending over the same period.

We were not convinced in January that the money would flow into the Treasury's coffers as quickly as Mr Brown hopes. The Treasury expects the tax burden to rise in very small part because of strong economic growth in the near term, with most of the increase split evenly between 'fiscal drag' (an assumption that the Chancellor will allow the burden of income tax to creep up by failing to adjust tax allowances and thresholds for real earnings growth) and a rebound in corporation tax and income tax payments from the financial sector.

Table 1 shows the forecasts for government revenue published by IFS in January 2005 and compares them with the Treasury's forecasts published two months later in the Budget. They were very similar overall for 2004–05 (although there were offsetting differences for individual taxes), but the Treasury expects revenues in 2009–10 to be 0.8% of national income higher than predicted in the IFS Green Budget. The IFS forecast has not been updated since the Budget, but there seems little reason to believe that there would not be a revenue gap of similar magnitude now. The main areas of difference between the IFS and Treasury forecasts are corporation tax and income tax.

Table 1. Medium-term revenue forecasts

% of national income	**2004–05**		**2009–10**	
	Budget, Mar 2005	**IFS Green Budget, Jan 2005**	**Budget, Mar 2005**	**IFS Green Budget, Jan 2005**
Income tax (gross of tax credits)	10.8	10.7	11.9	11.6
National Insurance contributions	6.6	6.7	6.8	6.9
Corporation tax [a]	3.0	2.7	3.9	3.4
Tax credits	–0.4	–0.4	–0.3	–0.2
Value added tax	6.2	6.2	6.1	6.1
Excise duties	3.4	3.4	3.1	3.1
Other	8.8	8.9	9.2	9.0
Current receipts	**38.3**	**38.2**	**40.6**	**39.8**

[a] Includes petroleum revenue tax.

Sources: Authors' calculations and Treasury forecasts from HM Treasury, *Budget Report*, London, March 2005 (http://www.hm-treasury.gov.uk/budget/budget_05/budget_report/bud_bud05_report.cfm); this table is similar to table C9 (page 254). More details of the IFS forecasts can be found in table 4.6 of R. Chote, C. Emmerson, D. Miles and Z. Oldfield (eds), *The IFS Green Budget: January 2005*, IFS, London, 2005 (http://www.ifs.org.uk/budgets/gb2005/05chap4.pdf).

As Figure 1 illustrated, the Treasury expects the combination of a flat and then falling profile for public spending on the one hand, and a rising tax burden on the other, to push the current budget back into balance by 2006–07, with surpluses building from zero in that year to 0.8% of national income by 2009–10. This clearly implies that the golden rule will be met over the next cycle, however long it is.

Table 2 shows that the IFS Green Budget forecasts in January had a slower improvement in the current budget balance than the Treasury's Budget forecast, largely because of weaker tax revenues. It should be emphasised that IFS produces only one forecast a year and that the Green Budget predictions have not been updated to reflect new information in the Budget. However, the Treasury made few significant policy or forecasting changes between last year's Pre-Budget Report and this year's Budget. If anything, we might now expect both spending and revenues to be a little higher as shares of national income over the medium term than we thought at the time of the Green Budget, which has little net impact on borrowing and debt.

Table 2. Medium-term public finance forecasts

% of national income	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
IFS Green Budget forecasts						
Current budget						
Current receipts	38.2	38.5	38.9	39.3	39.6	39.8
Current expenditure [a]	39.6	39.6	39.7	40.0	40.0	40.0
Surplus on current budget	**–1.4**	**–1.1**	**–0.9**	**–0.7**	**–0.5**	**–0.2**
Capital budget						
Net investment	1.6	1.9	2.2	2.3	2.3	2.3
Public sector net borrowing	**2.9**	**3.0**	**3.1**	**3.0**	**2.7**	**2.5**
Public sector net debt	**34.3**	**35.7**	**37.4**	**38.9**	**40.1**	**41.0**
HMT Budget 2005 forecasts						
Current budget						
Current receipts	38.3	39.3	39.9	40.4	40.5	40.6
Current expenditure [a]	39.6	39.7	39.9	40.1	39.9	39.8
Surplus on current budget	**–1.4**	**–0.5**	**0.0**	**0.3**	**0.6**	**0.8**
Capital budget						
Net investment	1.6	2.1	2.3	2.3	2.3	2.3
Public sector net borrowing	**2.9**	**2.6**	**2.2**	**2.0**	**1.6**	**1.5**
Public sector net debt	**34.4**	**35.5**	**36.2**	**36.8**	**37.1**	**37.1**

[a] In line with the National Accounts, depreciation has been included as current expenditure.

Sources: Authors' calculations and Treasury forecasts from HM Treasury, *Budget 2005*, London, March 2005 (http://www.hm-treasury.gov.uk/budget/budget_05/budget_report/bud_bud05_report.cfm); this table is similar to table C5 (page 247).

The Green Budget forecast shows the current budget remaining in deficit at least until 2009–10, suggesting that the golden rule would only be met if there were a longer-than-normal economic cycle with fiscal drag exploited throughout. (The Treasury assumes in its long-term forecasts that it is unrealistic for fiscal drag to be sustained indefinitely.) As we do not know how long the next cycle will be, and how much margin for error the government will aim for, it is impossible to say precisely how big a tax increase or cut in spending would be necessary to meet the rule with the comfort sought in the past.

But we can ask what new tax-raising measures would be needed to pay for the government's existing spending plans through to 2007–08, while achieving the current budget surplus that the Chancellor signalled in the Budget that he felt necessary for that year to be on course to meet the golden rule with an acceptable degree of comfort over the next cycle. Our forecast suggests that the current budget would be in deficit by 0.7% of national income in that year on existing policies, instead of the surplus of 0.3% of national income the Chancellor is aiming for. This suggests a need for at least £11 billion of fresh tax increases to bridge the gap. The amount would be similar if we asked what would be necessary to close the gap between our forecast and the Treasury's at the end of the forecasting period in 2009–10.

Assuming that the government carries out as much public sector net investment over the next few years as it hopes (something which it has in fact found impossible to do to date), the extra borrowing we predict over the next few years on unchanged policies would see the Treasury's 40% ceiling on debt as a share of national income breached in 2008–09.

But it is very important to remember that there is significant uncertainty around any forecast for the public finances. The Treasury and IFS have had similar forecasting records in recent years, and if our current forecasts are as accurate as our past ones then there is still around a one-in-three chance that the outcome could be even better than the Treasury expects rather than worse as our best guess implies. This suggests that Mr Brown will have to weigh up a balance of risks if he returns as Chancellor on 6 May. If he does not tighten fiscal policy after the election and our central forecast is correct, the eventual adjustment will need to be bigger, more abrupt and presumably more politically damaging. If he takes action and we are wrong, he would go into an election in 2009 or 2010 with the public finances in stronger-than-expected shape and with scope to cut taxes or increase spending.

3.2 Liberal Democrat proposals

The Liberal Democrats propose to increase modestly both taxes and spending relative to Labour's plans. The increase in tax revenue is slightly larger than the increase in spending, implying that borrowing would be around £1 billion lower each year on average over a four-year parliament under the Liberal Democrats than under Labour. This is much less than the average error in forecasting the public finances and is not therefore a meaningful tightening in fiscal policy, but it does provide some leeway in case the Liberal Democrats' costing of their proposals is overoptimistic. We assume in this Briefing Note that the parties have correctly costed their proposals, but note risks to particular costings when we can identify them.

The Liberal Democrats have new spending commitments that rise from £1.8 billion in 2005–06 to £10.0 billion in 2009–10 (or from 0.1% of national income to 0.7% of national income over the same period. The most expensive include higher pensions for those aged 75 and over, free personal care for those aged 65 and over, and payments to universities to compensate for the loss of student fee income. More than two-thirds of these increases are offset by cuts in other spending programmes rising from £1.9 billion in 2005–06 to £7.2 billion in 2009–10. These include cuts in business subsidies and scrapping the Child Trust Fund. Taken together, this implies little net impact on spending in 2005–06 and then net increases of £2½–3 billion a year thereafter.

On the revenue side, the Liberal Democrats propose a new 49p rate of income tax on incomes above £100,000, giving a combined income tax and employee National Insurance contribution rate of 50p. Figures from the Inland Revenue suggest that this would raise £4.8 billion in 2005–06 (although the Liberal Democrats assume it would only be introduced in June and thus raise £4 billion over 10 months). Calculations with this information from the House of Commons Library assuming that the £100,000 threshold is not indexed (even in line with inflation) and used by the Liberal Democrats suggest that this yield could increase to £6.2 billion in 2009–10. The Liberal Democrats also plan to replace council tax with a local income tax, set at an average rate implying a net giveaway rising from £1.2 billion in 2005–06 to £2.5 billion in 2009–10. In addition, they propose to increase the stamp duty threshold to £150,000 at a cost of £200 million. This leaves an overall net tax increase rising from £2.6 billion in 2005–06 to £3.5 billion in 2009–10.

Taken together, the Liberal Democrat tax and spending plans imply a modest net reduction in government borrowing averaging £1 billion a year over a four-year parliament. This provides some scope for a spending overrun or a revenue undershoot before borrowing would end up higher than under Labour's plans.

One key risk is that either local income tax or the new 49p income tax rate would fail to raise as much revenue as the Liberal Democrats hope. The Inland Revenue estimate of the money that would be raised from the 49p income tax rate assumes that people's behaviour does not change. But the increase in the marginal tax rate facing these individuals could encourage them to reduce their taxable incomes, since the financial penalty from doing so is diminished.

There are many ways in which individuals might reduce their taxable incomes. They could decide to reduce their work effort, or to retire earlier than they otherwise would. At the extreme, they could even choose to leave the country, or high-income foreigners might be discouraged from immigrating. People could also try to reduce their taxable income by engaging in greater tax avoidance – for example, the fact that the Liberal Democrats are not proposing an equivalent increase in the rate of capital gains tax would create an incentive for the well-off to take their income in the form of capital gains. They might also raise their contributions to private pensions, since they would receive tax relief at 49p in the pound and might only expect to be paying higher-rate tax at 40p once in retirement. The likely extent of such behavioural responses is debatable, but to the extent that people do any of these things, the yield of the 49% rate would be reduced.

Conversely, it is possible that people might choose to increase their pre-tax incomes (work harder etc.) to make up for the extra tax they are paying. This would increase the revenue raised from this reform. However, to the extent that the revenue is redistributed to the population (for example, used to reduce local tax rates, reduce the cost of long-term care, provide increased pensions and reduce the cost of higher education), we might expect the reduced work effort of the beneficiaries broadly to offset the increased work effort of the losers.

The Liberal Democrats might also find that their spending proposals cost more or less than they expect. For example, free personal care has cost more than initially expected in Scotland.[1] If they cost more, they will have to decide whether to spend more and borrow more, or to make offsetting savings elsewhere. The Liberal Democrats also intend to implement and reinvest the £21.5 billion of efficiency savings identified in the government's Gershon Review (these are not presented in Tables 3 and 4, but could be thought of as a £21.5 billion spending increase in 2007–08 and an equivalent £21.5 billion spending cut in the same year). Experience suggests that these savings will not be easy to deliver painlessly. If that proves to be the case, there may be pressure to spend more than planned.

With their net tax increase and net spending increase broadly cancelling out, the Liberal Democrat proposals imply much the same outlook for government borrowing and debt as Labour's plans. Like Labour, if the Liberal Democrats found tax revenues less buoyant over the next few years than the Treasury currently expects, they would have to announce fresh tax-raising measures to pay for their spending plans and to be on course to meet the golden rule with the same confidence that the current Chancellor aspired to in this year's Budget. They, like Labour, would, if the IFS January 2005 Green Budget projection proves correct, also be on course to breach the 40% ceiling on public sector net debt.

[1] http://news.bbc.co.uk/1/hi/scotland/3696738.stm.

Table 3. Liberal Democrat proposals (£ billion)

	2005–06	2006–07	2007–08	2008–09	2009–10	2010–11	2011–12	Ave to 08–09
Spending increases	1.8	7.2	8.1	9.0	10.0	10.5	11.0	6.5
Spending cuts	1.9	4.6	5.7	6.4	7.2	7.5	7.9	4.7
Net spending increase	**–0.1**	**2.6**	**2.4**	**2.7**	**2.8**	**3.0**	**3.1**	**1.9**
Tax increases, of which:	4.0	5.1	26.6	28.3	30.2	31.7	33.3	16.0
Local income tax	*0.0*	*0.0*	*21.1*	*22.5*	*24.0*	*25.2*	*26.5*	*10.9*
49p income tax rate	*4.0*	*5.1*	*5.5*	*5.8*	*6.2*	*6.5*	*6.8*	*5.1*
Tax cuts, of which:	1.4	2.2	23.7	25.1	26.6	28.0	29.4	13.1
Council tax	*1.2*	*2.0*	*23.5*	*25.0*	*26.5*	*27.8*	*29.2*	*12.9*
Stamp duty land tax	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*	*0.2*
Net tax increase	**2.6**	**2.9**	**2.9**	**3.2**	**3.5**	**3.7**	**3.9**	**2.9**
Net effect on:								
Current budget	**2.7**	**0.4**	**0.7**	**0.7**	**0.9**	**0.9**	**0.9**	**1.1**
PSNB	**–2.7**	**–0.3**	**–0.5**	**–0.5**	**–0.7**	**–0.7**	**–0.8**	**–1.0**
Current receipts:								
HMT baseline	489.3	522.9	555.9	585.2	615.5	646.7	679.4	538.3
IFS baseline	481.2	511.2	542.6	573.0	605.0	635.7	667.8	527.0
Current expenditure: [a]								
HMT baseline	492.3	522.3	551.2	575.5	602.7	633.2	665.2	535.3
IFS baseline	491.9	522.4	552.0	579.0	607.7	638.4	670.8	536.3
Total managed expenditure:								
HMT baseline	518.5	551.8	582.4	607.7	636.8	669.1	702.9	565.1
IFS baseline	515.2	551.8	583.0	611.6	641.8	674.3	708.5	565.4
Current budget balance:								
HMT baseline	–3.0	1.4	4.7	9.7	12.9	13.5	14.2	3.2
IFS baseline	–10.7	–11.2	–9.3	–6.1	–2.6	–2.7	–2.9	–9.3
Public sector net debt: [b]								
HMT baseline	35.3	36.0	36.5	36.8	36.8	38.6	40.6	36.2
IFS baseline	35.5	37.2	38.6	39.8	40.7	42.7	44.9	37.8

[a] Including depreciation.

[b] % of national income.

Table 4. Liberal Democrat proposals (% of national income)

	2005–06	2006–07	2007–08	2008–09	2009–10	2010–11	2011–12	Ave to 08–09
Spending increases	0.1	0.5	0.6	0.6	0.7	0.7	0.7	0.5
Spending cuts	0.2	0.4	0.4	0.4	0.5	0.5	0.5	0.4
Net spending increase	**0.0**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.1**
Tax increases, of which:	0.3	0.4	1.9	2.0	2.0	2.0	2.0	1.2
Local income tax	*0.0*	*0.0*	*1.5*	*1.6*	*1.6*	*1.6*	*1.6*	*0.8*
49p income tax rate	*0.3*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*	*0.4*
Tax cuts, of which:	0.1	0.2	1.7	1.7	1.8	1.8	1.8	0.9
Council tax	*0.1*	*0.2*	*1.7*	*1.7*	*1.8*	*1.8*	*1.8*	*0.9*
Stamp duty land tax	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Net tax increase	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**	**0.2**
Net effect on:								
Current budget	**0.2**	**0.0**	**0.0**	**0.0**	**0.1**	**0.1**	**0.1**	**0.1**
PSNB	**–0.2**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**–0.1**
Current receipts:								
HMT baseline	39.5	40.1	40.6	40.7	40.8	40.8	40.8	40.2
IFS baseline	38.8	39.2	39.6	39.9	40.1	40.1	40.1	39.4
Current expenditure: [a]								
HMT baseline	39.7	40.0	40.3	40.1	40.0	40.0	40.0	40.0
IFS baseline	39.7	40.0	40.3	40.3	40.3	40.3	40.3	40.1
Total managed expenditure:								
HMT baseline	41.8	42.3	42.5	42.3	42.3	42.3	42.3	42.2
IFS baseline	41.5	42.3	42.6	42.6	42.6	42.6	42.6	42.2
Current budget balance:								
HMT baseline	–0.2	0.1	0.3	0.7	0.9	0.9	0.9	0.2
IFS baseline	–0.9	–0.9	–0.7	–0.4	–0.2	–0.2	–0.2	–0.7
Public sector net debt:								
HMT baseline	35.3	36.0	36.5	36.8	36.8	38.6	40.6	36.2
IFS baseline	35.5	37.2	38.6	39.8	40.7	42.7	44.9	37.8

[a] Including depreciation.

Tables 3 and 4 show the impact on the public finances of the Liberal Democrat proposals, using both the Treasury's Budget forecast and the IFS Green Budget forecast as baselines. In calculating the impact on the current budget balance and public sector net borrowing (PSNB), we assume that the split in any net change in spending between current and capital spending mirrors their relative importance in existing spending.

3.3 Conservative proposals

The Conservatives have promised to cut taxes in their first Budget and to cut public spending progressively as a share of national income. The spending cuts outweigh the tax cuts, thereby reducing government borrowing by increasing amounts over time. The Conservatives hope that this will allow them to avoid the need to announce fresh tax increases (or to reverse their initial cuts) even if revenues come in weaker over the next few years than the Treasury expects. If revenues come in as strongly as the Treasury expects, they would have scope to announce further tax cuts without borrowing more than Labour intends to do.

In 2007–08, the Conservatives intend to increase spending on defence, the police and pensions by £1.3 billion relative to Labour's plans. They plan to spend the same as Labour on schools, hospitals, transport and international development, and then to make cuts of £13.3 billion in other areas. This implies a net cut in spending of £12 billion or 0.9% of national income.

As Table 5 illustrates, the Conservatives also plan to save and reinvest £23 billion within the areas in which they plan in total to spend at least as much as Labour (including schools, hospitals, the police and defence). This includes some of the savings identified by the government's Gershon Review, plus some identified in the Conservatives' own James Review. This figure is not included in Tables 6 and 7, which show the impact of the Conservative plans. If it were to be included, Table 6 would show gross spending cuts of approximately £35 billion, gross spending increases of £23 billion and the same net spending cut of £12 billion in 2007–08.

Table 5. Comparison of Gershon and James Reviews

£ billion (2007–08 prices)	**2007–08**
Gershon Review (Labour and Liberal Democrat)	
Efficiency savings	21½
Increased 'front line' spending	21½
Net change in spending	0.0
James Review (Conservative)	
Gershon efficiency savings	21½
Additional reductions in spending	13½
Total spending reductions	35
Increased spending	23
Net change in spending	–12

The Conservatives have explained in detail how they intend to achieve their spending cut in 2007–08, which is also the last year for which the current Labour government has published detailed spending proposals. But they have also said that they intend to continue cutting spending as a share of national income through to 2011–12, eventually reducing it by 2% of national income relative to Labour's plans. This implies a £35 billion cut in 2011–12 terms, although this is equivalent to only £25 billion in today's terms.

Table 6. Conservative proposals (£ billion)

	2005–06	2006–07	2007–08	2008–09	2009–10	2010–11	2011–12	Ave to 08–09
Spending increases	0.0	1.2	1.3	1.3	1.4	1.5	1.6	1.0
Spending cuts	0.0	7.2	13.3	13.6	17.4	25.8	34.8	8.5
Net spending increase	**0.0**	**–6.0**	**–12.0**	**–12.3**	**–16.0**	**–24.3**	**–33.2**	**–7.6**
Tax increases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Tax cuts, of which:	0.0	3.8	4.0	4.2	4.4	4.6	4.9	3.0
Council tax discount	*0.0*	*1.3*	*1.4*	*1.4*	*1.5*	*1.6*	*1.7*	*1.0*
Pension support	*0.0*	*1.6*	*1.7*	*1.8*	*1.9*	*2.0*	*2.1*	*1.3*
VED cuts	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.1*	*0.0*
Stamp duty land tax	*0.0*	*1.0*	*1.0*	*1.0*	*1.0*	*1.0*	*1.1*	*0.7*
Net tax increase	**0.0**	**–3.8**	**–4.0**	**–4.2**	**–4.4**	**–4.6**	**–4.9**	**–3.0**
Net effect on:								
Current budget	**0.0**	**1.9**	**7.4**	**7.5**	**10.7**	**18.4**	**26.6**	**4.2**
PSNB	**0.0**	**–2.2**	**–8.0**	**–8.1**	**–11.6**	**–19.7**	**–28.3**	**–4.6**
Current receipts:								
HMT baseline	486.7	516.2	549.0	577.8	607.6	638.4	670.7	532.4
IFS baseline	478.6	504.5	535.7	565.6	597.1	627.3	659.1	521.1
Current expenditure:[a]								
HMT baseline	492.4	514.1	537.5	561.4	584.9	607.4	630.9	526.4
IFS baseline	492.0	514.2	538.3	564.9	589.9	612.6	636.4	527.4
Total managed expenditure:								
HMT baseline	518.6	543.2	568.0	592.7	618.0	641.8	666.6	555.6
IFS baseline	515.3	543.2	568.6	596.6	623.0	647.1	672.1	555.9
Current budget balance:								
HMT baseline	–5.7	2.9	11.4	16.5	22.7	31.0	39.8	6.2
IFS baseline	–13.4	–9.7	–2.6	0.7	7.3	14.7	22.7	–6.3
Public sector net debt:[b]								
HMT baseline	35.5	36.0	36.1	35.8	35.1	34.0	32.4	35.9
IFS baseline	35.7	37.2	38.2	38.8	39.0	37.9	36.3	37.5

[a] Including depreciation.

[b] % of national income.

Table 7. Conservative proposals (% of national income)

	2005–06	2006–07	2007–08	2008–09	2009–10	2010–11	2011–12	Ave to 08–09
Spending increases	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Spending cuts	0.0	0.6	1.0	0.9	1.2	1.6	2.1	0.7
Net spending increase	**0.0**	**–0.5**	**–0.9**	**–0.9**	**–1.1**	**–1.5**	**–2.0**	**–0.5**
Tax increases:	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Tax cuts, of which:	0.0	0.3	0.3	0.3	0.3	0.3	0.3	0.2
Council tax discount	*0.0*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*
Pension support	*0.0*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*
VED cuts	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*	*0.0*
Stamp duty land tax	*0.0*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*	*0.1*
Net tax increase	**0.0**	**–0.3**	**–0.3**	**–0.3**	**–0.3**	**–0.3**	**–0.3**	**–0.2**
Net effect on:								
Current budget	**0.0**	**0.1**	**0.5**	**0.5**	**0.7**	**1.2**	**1.6**	**0.3**
PSNB	**0.0**	**–0.2**	**–0.6**	**–0.6**	**–0.8**	**–1.2**	**–1.7**	**–0.3**
Current receipts:								
HMT baseline	39.3	39.6	40.1	40.2	40.3	40.3	40.3	39.8
IFS baseline	38.6	38.7	39.1	39.4	39.6	39.6	39.6	38.9
Current expenditure: [a]								
HMT baseline	39.7	39.4	39.3	39.1	38.8	38.4	37.9	39.4
IFS baseline	39.7	39.4	39.3	39.3	39.1	38.7	38.3	39.4
Total managed expenditure:								
HMT baseline	41.8	41.6	41.5	41.2	41.0	40.5	40.1	41.5
IFS baseline	41.6	41.6	41.5	41.5	41.3	40.9	40.4	41.6
Current budget balance:								
HMT baseline	–0.5	0.2	0.8	1.1	1.5	2.0	2.4	0.4
IFS baseline	–1.1	–0.7	–0.2	0.0	0.5	0.9	1.4	–0.5
Public sector net debt:								
HMT baseline	35.5	36.0	36.1	35.8	35.1	34.0	32.4	35.9
IFS baseline	35.7	37.2	38.2	38.8	39.0	37.9	36.3	37.5

[a] Including depreciation.

On the revenue side, the Conservatives plan to announce tax cuts worth £4 billion or 0.3% of national income in their first Budget. This includes a £1.7 billion tax incentive for pension savings, a £1.0 billion cut in stamp duty on properties and a £1.4 billion council tax discount for some pensioner households (in 2007–08). We assume when assessing the outlook for the public finances that this package costs 0.3% of national income each year.

Costing the increase in support for contributions to private pensions is difficult due to the paucity of available data and the targeting of the policy on individual (but not employer) contributions to funded (but not unfunded) pension schemes that currently attract basic-rate income tax relief (but not higher-rate tax relief). However, the assumptions made by the Conservatives do not look unreasonable, and they have allowed for a large increase in pension saving (around 20%) induced by the policy. A smaller increase in pension saving would make the policy less effective, but also less expensive.

Taken together, the Conservative tax and spending plans cut government borrowing relative to Labour's plans by 0.2% of national income in 2006–07, rising to 1.7% of national income by 2011–12. The average tightening over a four-year parliament would be 0.3% of national income. The Conservatives propose to cut spending by more than taxes because they assume that we and other commentators, such as the International Monetary Fund, are right in predicting that tax revenues are likely to be weaker than the Treasury expects.

We cannot be certain whether the net tightening proposed by the Conservatives would be sufficient to meet the golden rule over the next economic cycle, based on our more pessimistic forecasts for revenues, as we do not know how long that cycle will be. The £8 billion net fiscal tightening planned by the Conservatives for 2007–08 is smaller than the £11 billion increase that we believe necessary to get the public finances back onto the path the government was looking for in the Budget, but if we bear in mind that the additional fiscal tightening increases with every passing year, it looks unlikely that the Conservatives would need to reverse any of the tax cuts in their first Budget if they deliver their spending cuts. They are unlikely, though, to be able to deliver further significant tax cuts until a second term in office. But the proposed tightening should keep net debt below 40% of national income.

If the public finances turn out to be as strong as the Treasury expects and the Conservatives succeed in making the spending cuts they propose, they would presumably feel emboldened to cut taxes further. In this event, they could cut taxes by as much as they cut spending – eventually 2% of national income – and end up borrowing no more than Labour would. (Alternatively, they could choose to increase spending above the plans set out in their Medium-Term Expenditure Strategy.)

Of course, the Conservatives may find, as experience suggests they might, that they are unable to cut spending as quickly or as painlessly as they hope by adopting the proposals in the government's Gershon Review and their own James Review. That would leave the choice of spending and borrowing more than they intend or making other, potentially more painful, spending cuts to fill the gap.

3.4 Comparing the parties

We can now compare directly the impact of the three parties' proposals on the public finances. Figures 7 and 8 show total public spending as a share of national income on the Treasury's Budget baseline and on the IFS Green Budget baseline respectively (the latter assumes that spending under Labour does not fall as a share of national income after the end of the current Spending Review period in 2007–08). Both graphs show spending slightly higher under the Liberal Democrats than under Labour, with the share of national income broadly constant a little above 42% of national income. Under the Conservatives, public spending drops by 2% of national income by 2011–12. This leaves it significantly lower than it would be under Labour in that year, but reverses less than half the increase in spending since 1999 and leaves spending higher than it was in 2002–03.

Figure 7. Total managed expenditure, Budget baseline

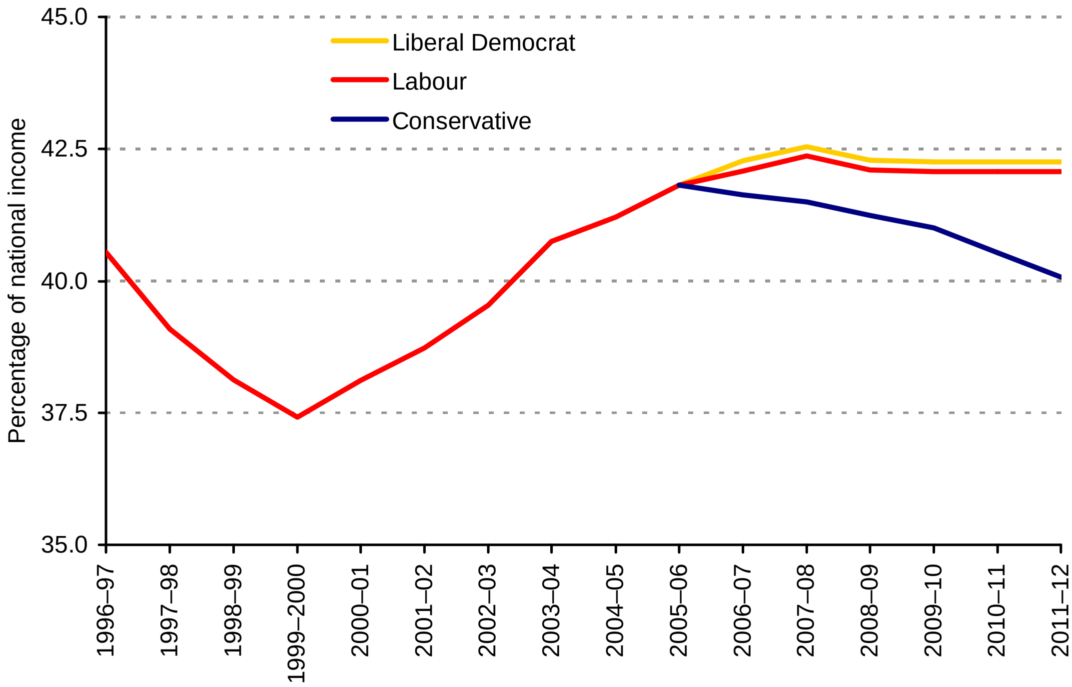


Figure 8. Total managed expenditure, IFS Green Budget baseline

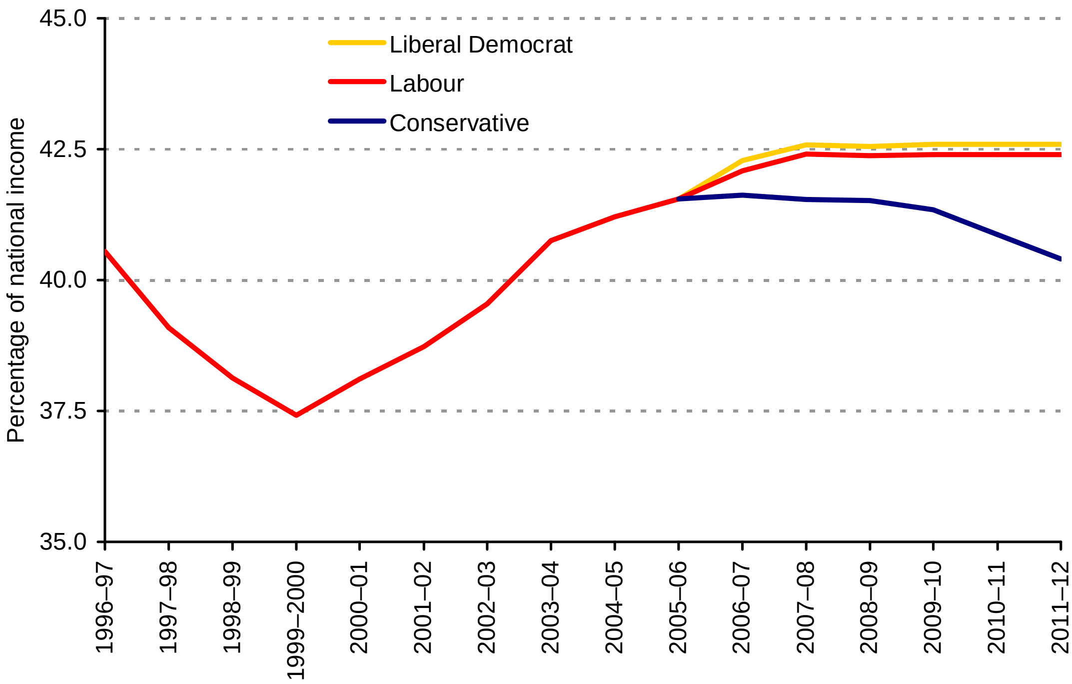


Figure 9. Current receipts, Budget baseline

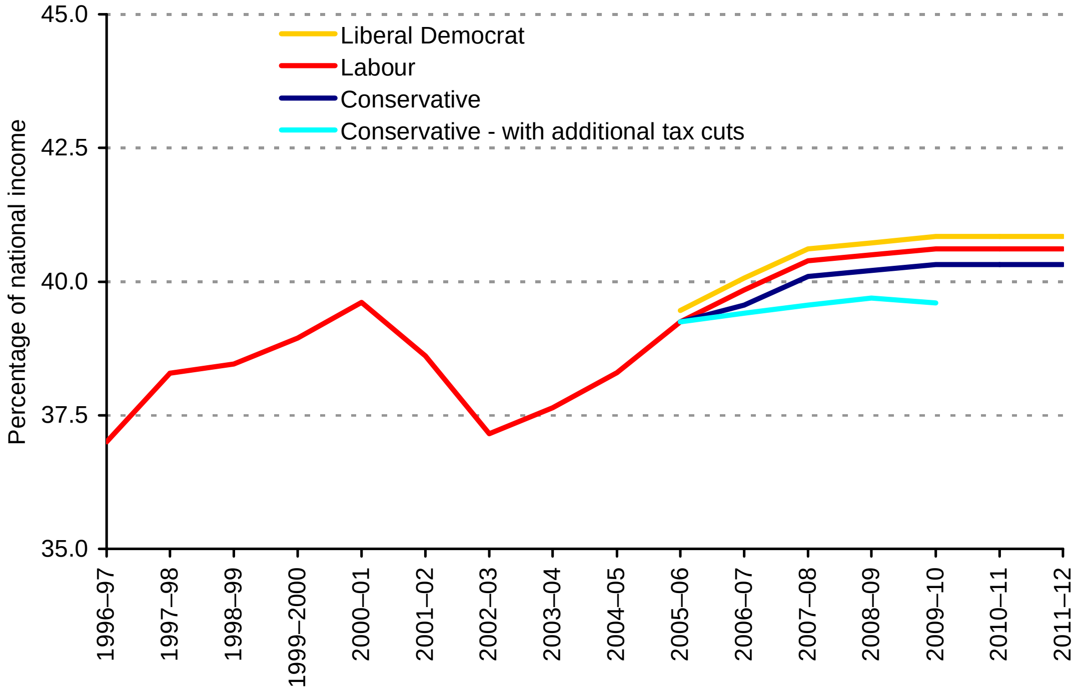
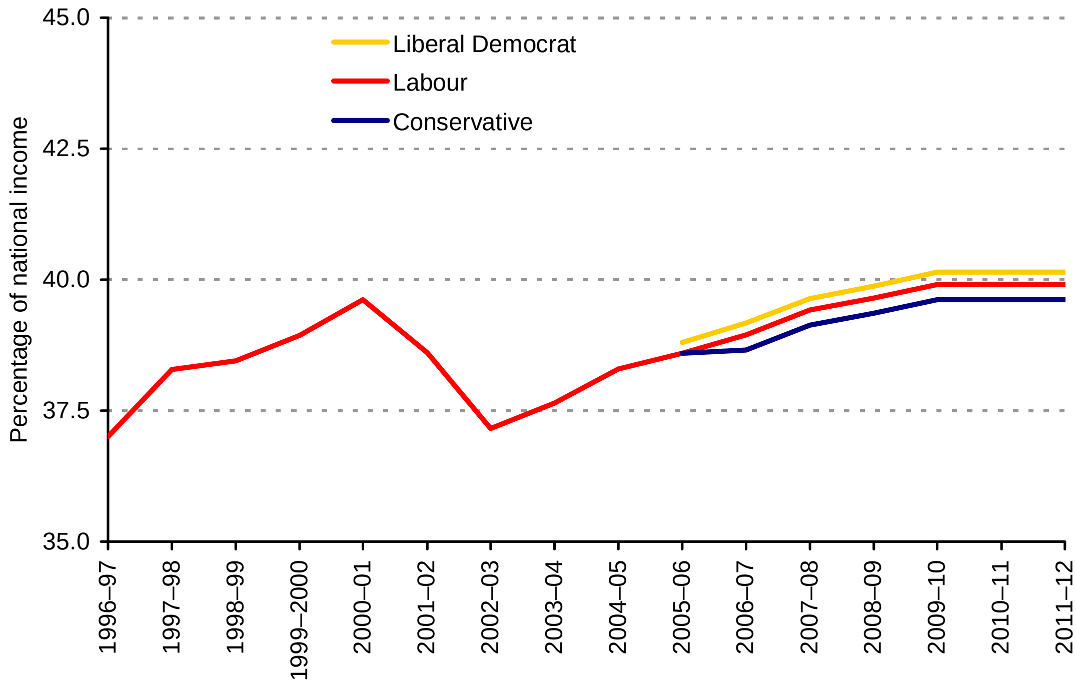


Figure 10. Current receipts, IFS Green Budget baseline

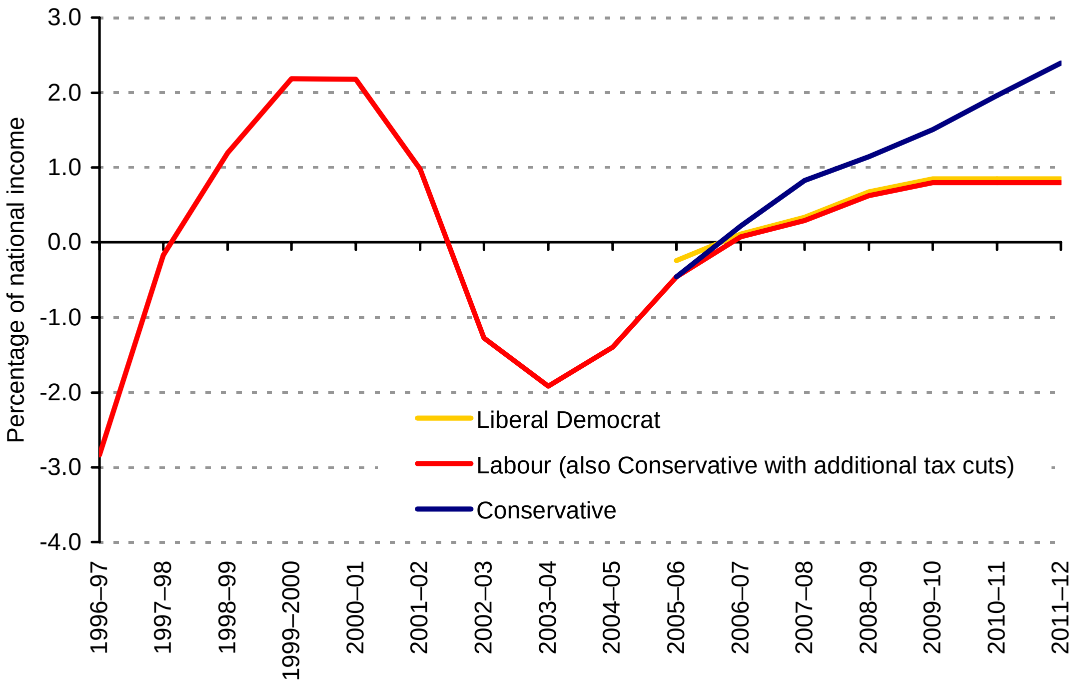


Figures 9 and 10 show current receipts as a share of national income, the broadest measure of the tax burden. The Treasury's Budget forecast shows current receipts rising by 2.3% of national income over the next five years under Labour. The Liberal Democrats raise the tax burden by a further 0.2% of national income while the Conservatives would raise it by 0.3% less, in both cases pushing it to levels significantly higher than today's.

However, if the underlying rise in the tax burden were to be as strong as the Treasury expects, the Conservatives would presumably no longer feel it necessary to impose a net fiscal tightening to be as confident as the current Chancellor of meeting the fiscal rules over the next cycle. So Figure 9 also shows the path of the tax burden through to the end of the Treasury's current forecasting horizon if the Conservatives found themselves able to give away their net fiscal tightening in tax cuts. This would still leave the tax burden higher in 2009–10 than it was last year.

Figures 11 and 12 show the current budget surplus under each party. Using the Treasury baseline, we see the current budget moving back into the black by similar amounts under Labour and the Liberal Democrats, reaching surpluses of around 0.8% of national income by 2011–12. The fiscal tightening under the Conservatives is greater, taking them to a surplus of around 2.4% of national income. (However, as we noted above, if the figures turned out to be this strong, the Conservatives would presumably cut taxes further.)

Figure 11. Current budget surplus, Budget baseline



On the IFS baseline, the current budget remains in deficit under Labour and the Liberal Democrats, which would force them to announce fresh tax increases to be confident of meeting the golden rule. Under the Conservatives, the current budget would move into the black. The golden rule would be met if there were a five-year economic cycle running from 2006–07 to 2010–11 or longer. If, as Morgan Stanley argued in the Green Budget, the new economic cycle begins in 2005–06, the rules would be met if the cycle lasted at least seven years until 2011–12. To be confident of meeting the rule with the caution the current Chancellor has aimed for, under this scenario it would not be possible for the Conservatives to cut taxes significantly again until a second term in office.

Figure 12. Current budget surplus, IFS Green Budget baseline

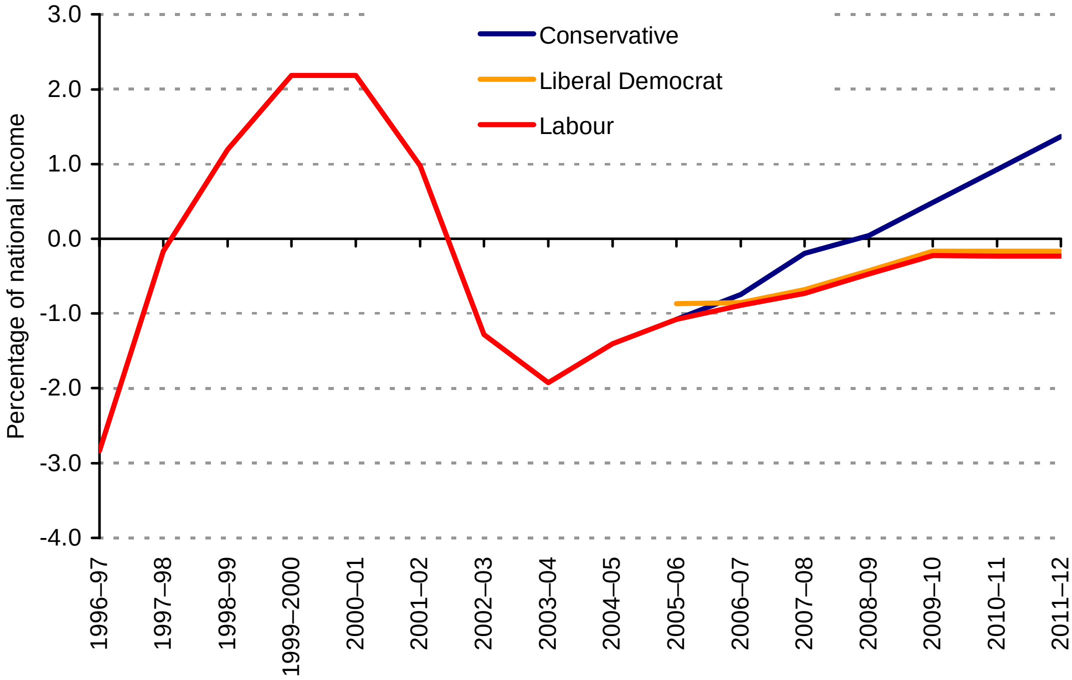


Table 8 compares the average level of spending (total and current), receipts and the current budget balance in Labour's first and second terms with the levels that would be expected in a parliamentary term encompassing the next four financial years (2005–06 to 2008–09), under each party and based on both the Treasury and IFS baselines. It shows that public spending and the broadest measure of the tax burden would be higher on average during the next parliamentary term than in either Labour's first or second – even under the Conservatives.

Table 8. Summary of public finances by parliament

% of GDP	Lab I	Lab II	Lab I + II	Lab III HMT	Lab III IFS	Con I HMT	Con I IFS	Lib Dem I HMT	Lib Dem I IFS
Total spending	38.2	40.1	39.1	42.1	42.1	41.5	41.6	42.2	42.2
Current spending [a]	37.5	38.8	38.2	39.9	39.9	39.4	39.4	40.0	40.1
Current receipts	38.8	37.9	38.4	40.0	39.2	39.8	38.9	40.2	39.4
Current budget	1.3	–0.9	0.2	0.1	–0.8	0.4	–0.5	0.2	–0.7

[a] Including depreciation.

4. Reforming the fiscal framework

The opposition parties have both signed up to the golden rule and sustainable investment rule, but each has suggested reforms to reflect concerns that the current fiscal framework is insufficiently transparent and accountable. At present, the Treasury publishes forecasts and out-turn data on the basis of which it judges whether it is on course to meet the rules. By way of outside scrutiny, it asks the National Audit Office to judge publicly whether a subset of economic assumptions underlying its public finance forecasts are ‘reasonable’ or not.

The Conservatives have proposed setting up an independent Fiscal Projection Committee within the National Audit Office, with sole responsibility for making official fiscal projections and assessing compliance with the rules. The committee would be given access to the necessary Treasury information and would have statutory access to HM Revenue and Customs and other government departments. The committee would be required to disclose all significant assumptions and inputs underlying its projections and present probability distributions of possible outcomes around a baseline case.

In similar vein, the Liberal Democrats have suggested that the National Audit Office should evaluate Treasury forecasts.

5. Conclusion

Labour plans to increase public spending relatively modestly as a share of national income if re-elected for a third term, following a sharp increase over the last five years. It hopes to offset the impact of the slowdown in spending growth on the quality of public services by making and reinvesting £21.5 billion of efficiency savings by 2007–08. Delivering these savings will not be easy. To pay for the extra spending and meet its fiscal rules, Labour needs the tax burden measured by current receipts to rise by more than 2% of national income over the next five years – £29 billion in today’s terms. The Chancellor believes this will occur without having to announce new tax increases, thanks to a rebound in payments from the financial sector and a gradual increase in average tax rates as the parameters of the tax system fail to keep pace with rising living standards. But we – like the IMF and others – are not this confident and think fresh tax increases worth £11 billion would be needed to return the public finances to the path the Chancellor was aiming for in the Budget.

The Liberal Democrats intend to reallocate about £5 billion of spending from within Labour’s plans and in addition to spend about 0.2% of national income more than Labour in total. The increase in spending will be offset by a slightly larger net tax increase in the form of a new 49p income tax rate on incomes above £100,000, which will also provide revenue to bridge the gap between what the Liberal Democrats will lose from abolishing council tax and gain from introducing local income tax. Borrowing would thus be fractionally lower under the Liberal Democrats than under Labour, providing some room for manoeuvre in case their tax increase raises less money than they hope. Like Labour, the Liberal Democrats would have to announce fresh tax increases to pay for their spending plans and meet the fiscal rules with confidence if revenues come in weaker than the Treasury predicted in the Budget.

The Conservatives plan to announce tax cuts worth £4 billion or 0.3% of national income in their first Budget, and to cut spending relative to Labour’s plans by an eventual 2% of national income by 2011–12. Over the first two years, the cut in spending (outside the areas where the Conservatives have promised to match Labour) is supposed to be split broadly evenly between efficiency savings and axing government activities. It is not clear that this can be achieved as quickly or as painlessly as the Conservatives hope, and cuts in further years may be increasingly reliant on harder-to-achieve efficiency savings. If the Conservatives do achieve their spending cuts, they are unlikely to have to reverse their initial tax cuts even if revenues turn out weaker than the Treasury expects. But they are also unlikely to be able to cut taxes again before a second term. If, however, the public finances are as strong as Gordon Brown says they are, the Conservatives could cut taxes as sharply as they cut spending.

Whoever takes office after the election, the tax burden is likely to be higher at the end of the next parliament than it is at the end of this one. And even the Conservative spending cuts would reverse less than half the increase in spending we have seen under Labour since 1999. In these respects, the similarities between the parties are as striking as the differences.