3. IFS public finance forecasts

In December's Pre-Budget Report, the Chancellor substantially revised up his short-term forecasts for government borrowing. Over the medium term, he predicted that growth in tax receipts as a share of national income would be sufficient to finance his current spending plans and to continue to meet his fiscal rules without the need to announce further tax-raising measures. This chapter details IFS's latest public finance forecasts and compares them with the Treasury's December 2003 Pre-Budget Report (PBR) projections.

Our main conclusions are as follows:

1. For this year, our forecasts are very similar to those in the PBR. We forecast public sector net borrowing in 2003–04 of £36.7 billion, slightly lower than the PBR forecast of £37.4 billion. For 2004–05, our forecasts are slightly more pessimistic than those of the Treasury. We forecast public sector net borrowing of £34.7 billion, compared with the £31.0 billion forecast in the PBR.
2. We also forecast higher levels of borrowing over the medium term than the Treasury, despite our assumption that the economy behaves as the Treasury expects. In 2007–08, we forecast public sector net borrowing of £38 billion, compared with the PBR forecast of £27 billion.
3. If our forecasts are correct, then between April 1999 and March 2006, the average current budget surplus as a share of national income will be zero. As a result, our central estimate implies that the golden rule will just be met over the current economic cycle on the retrospective method of calculation currently favoured by the Chancellor.
4. To avoid unnecessarily disruptive short-term policy changes, it would be more sensible for policy to focus on establishing that the golden rule is on course to be met on a forward-looking basis. The Treasury is forecasting that, given current spending plans, tax revenues will increase sufficiently as a share of national income to allow it to continue to expect to meet the golden rule. Our forecasts suggest that further tax increases or cuts in spending plans will be required to achieve this with the comfort Mr Brown has sought in the past.
5. The spending plans set out in the PBR already imply that non-NHS public spending will fall as a share of national income between April 2006 and March 2008. Given the government's stated objectives for public services, and its previous actions, if the Chancellor does decide to narrow the gap between spending and revenues he is more likely to opt for tax increases than for spending cuts.
6. If our forecasts are correct, the Chancellor will need to announce measures to raise an extra £10 billion to begin the next economic cycle in 2006–07 with the current budget in balance. To expect to meet the golden rule looking forward to 2007–08 with the same degree of comfort that he sought in the last Budget would raise this to around £13 billion.

3.1 Borrowing in 2003–04

In 2002–03, government revenues were below the Treasury's forecast from the November 2002 Pre-Budget Report and marginally lower than was forecast by IFS in the January 2003 Green Budget. Public spending also came in lower than the Treasury expected, but higher than was forecast by IFS. The net effect was that public sector net borrowing was £22.5 billion, compared with the £20.1 billion predicted by the Treasury and the £22.1 billion predicted by IFS.[1]

Receipts have continued to come in lower than expected during the current financial year. In the PBR last December, the Treasury cut its April Budget forecast for current receipts in 2003–04 by £5.5 billion to £422.8 billion, as shown in Table 3.1. On the spending side, it revised its Budget forecast for total managed expenditure up by £4.5 billion to £460.2 billion.[2] The most significant factor was a £2.5 billion special allocation to help finance the conflict in Iraq.

Table 3.1. Comparison of Green Budget and HM Treasury forecasts for government borrowing, 2003–04 (£ billion)

	Budget, Apr. 03	Pre-Budget Report, Dec. 03	Green Budget, Jan. 04	Differences in Green Budget forecast relative to:	
				Budget	PBR
Current receipts	428.3	422.8	423.2	–5.1	0.4
Current expenditure	436.7	442.1	441.9	5.1	–0.3
Net investment	18.9	18.0	18.0	–0.9	0.0
Total managed expenditure	455.7	460.2	459.9	4.2	–0.3
Of which:					
Departmental expenditure limits	263.8	266.3	266.3	2.5	0.0
Annually managed expenditure	191.9	193.9	193.6	1.7	–0.3
Public sector net borrowing	27.3	37.4	36.7	9.4	–0.7
Surplus on current budget	–8.4	–19.3	–18.7	–10.3	0.6

Sources: Treasury forecasts from HM Treasury, *Pre-Budget Report*, Cm. 6042, London, December 2003 (www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr03/prebud_pbr03_index.cfm), and HM Treasury, *Financial Statement and Budget Report*, Hc500, London, April 2003 (www.hm-treasury.gov.uk/budget/bud_bud03/bud_bud03_index.cfm).

Weaker receipts and higher spending imply higher borrowing. The Budget had forecast public sector net borrowing of £27.3 billion and a current budget deficit of £8.4 billion. The Pre-Budget Report showed public sector net borrowing of £37.4 billion and a current budget deficit of £19.3 billion.

IFS forecasts that receipts this year will be £423.2 billion. This is £0.4 billion above the Treasury PBR forecast. We expect total managed expenditure to come in £0.3 billion below the PBR forecast, at £459.9 billion. This implies a

[1] See Appendix A for a breakdown of the November 2002 Pre-Budget Report and the January 2003 IFS Green Budget forecast for 2002–03.

[2] For more details of total managed expenditure and departmental expenditure limits, see C. Emmerson, C. Frayne and S. Love, *A Survey of Public Spending in the UK*, Briefing Note no. 43, Institute for Fiscal Studies, London, 2003 (www.ifs.org.uk/public/bn43.pdf).

deficit on the current budget of £18.7 billion and public sector net borrowing of £36.7 billion. These compare to the PBR forecasts of £19.3 billion and £37.4 billion respectively.

Table 3.2. Comparison of Green Budget and HM Treasury forecasts for government borrowing, 2003–04 and 2004–05 (£ billion)

	2003–04		2004–05	
	PBR Dec. 2003	*Gr. Budget Jan. 2004*	*PBR Dec. 2003*	*Gr. Budget Jan. 2004*
Inland Revenue				
Income tax (gross of tax credits)	118.8	118.7	128.3	127.1
Corporation tax (gross of tax credits)	29.4	29.5	34.6	32.4
Tax credits[a]	–4.6	–4.6	–3.9	–3.9
Petroleum revenue tax	1.4	1.4	1.0	1.0
Capital gains tax	1.0	1.0	1.4	1.4
Inheritance tax	2.5	2.5	2.8	2.8
Stamp duties	7.5	7.5	9.3	9.3
Social security contributions	72.6	73.0	78.4	79.1
Total Inland Revenue (net of tax credits)	**228.6**	**229.0**	**252.0**	**249.3**
Customs and Excise				
Value added tax (VAT)	69.0	69.0	72.2	73.2
Fuel duties	22.9	22.9	24.8	24.4
Tobacco duties	8.0	8.0	8.2	8.2
Spirit duties	2.4	2.4	2.4	2.4
Wine duties	1.9	1.9	2.0	2.0
Beer and cider duties	3.2	3.2	3.4	3.4
Betting and gaming duties	1.3	1.3	1.3	1.3
Air passenger duty	0.8	0.8	0.9	0.9
Insurance premium tax	2.3	2.3	2.5	2.5
Landfill tax	0.6	0.6	0.6	0.6
Climate change levy	0.8	0.8	0.8	0.8
Aggregates levy	0.3	0.3	0.3	0.3
Customs duties and levies	1.9	1.9	1.9	1.9
Total Customs and Excise	**115.5**	**115.5**	**121.3**	**121.9**
Vehicle excise duties	4.9	4.9	5.2	5.2
Business rates[b]	18.7	18.7	18.9	18.9
Council tax[c]	18.4	18.4	19.9	19.4
Other taxes and royalties[d]	12.5	12.5	13.2	13.2
Total net taxes and social sec. contribns[e]	**398.6**	**399.0**	**430.5**	**428.0**
Accruals adjustments on taxes	2.8	2.8	1.0	1.0
Less Own resources contribution to EU	–4.5	–4.5	–4.0	–4.0
Less PC corporation tax payments	–0.1	–0.1	–0.1	–0.1
Tax credits adjustment[f]	0.5	0.5	0.5	0.5
Interest and dividends	4.1	4.1	4.9	4.9
Other receipts	21.4	21.4	23.3	23.3
Current receipts	**422.8**	**423.2**	**456.2**	**453.6**
Current spending	**442.1**	**441.9**	**464.5**	**465.6**
Current balance	**–19.3**	**–18.7**	**–8.3**	**–12.0**
Net investment	18.0	18.0	22.7	22.7
Public sector net borrowing	**37.4**	**36.7**	**31.0**	**34.7**

[a] Includes enhanced company tax credits that offset tax liability. [b] Includes district council rates in Northern Ireland paid by business. [c] Net of council tax benefit. [d] Includes VAT refunds and money paid into the National Lottery Distribution Fund. [e] Includes VAT and 'traditional own resources' contributions to EC budget. Cash basis. [f] Tax credits which are scored as negative tax in the calculation of NTSSC but expenditure in the national accounts.

Note: For more details of the IFS forecast in 2003–04, see Table A.3 in Appendix A.

Sources: Treasury forecasts from HM Treasury, *Pre-Budget Report*, Cm. 6042, London, December 2003 (this table is similar to table B9, page 217); IFS calculations.

Table 3.2 compares our revenue forecasts for 2003–04 and 2004–05 with those of the PBR. Our slightly more optimistic view on government receipts in 2003–04 is entirely due to a £0.4 billion higher forecast for Inland Revenue taxes. We forecast that social security contributions will be £0.4 billion higher, and corporation taxes £0.1 billion higher, than the PBR. These are slightly offset by our forecast for income tax receipts, which is £0.1 billion lower than the PBR forecast.

On the spending side, we forecast that current spending will be £0.3 billion lower than the PBR forecast for 2003–04. This is because we assume that the £0.3 billion left in the annually managed expenditure (AME) margin for 2003–04 will not be required. For public sector net investment, we simply take the PBR forecast of £18.0 billion.

3.2 Borrowing in 2004–05

Wherever possible, our forecasts for 2004–05 are based on the same macroeconomic assumptions that underlie the 'cautious' forecasts in the December 2003 PBR, including the assumption that the trend rate of economic growth is 2½% a year. We assume that no new measures are announced in the Spring 2004 Budget.

Looking first at government receipts, in Table 3.2, we forecast that these will be £453.6 billion in 2004–05. This is £2.6 billion lower than the £456.2 billion forecast by the Treasury in the PBR.

We are more pessimistic than is the PBR about receipts from income tax, corporation tax, fuel duties and council tax by £1.2 billion, £2.2 billion, £0.4 billion and £0.5 billion respectively. In the case of income tax revenues, we forecast that receipts will grow by 7.1% compared to the Treasury forecast of growth of 8.0%. With corporation tax, the difference is even more marked: we are forecasting that receipts will grow by just under 10% but the Treasury believes they will grow by 17.7%. We forecast that council tax, net of expenditure on council tax benefit, will grow in line with the national economy, at 5.7%. This is a lower growth assumption than the Treasury's 8.2% growth rate. However, reports that the Minister for Local and Regional Government, Nick Raynsford, has recently written to 31 local authorities that may be planning council tax increases of more than 5% to warn them against large increases suggest that IFS's more moderate growth rate may be a realistic assumption.[3]

Partially offsetting our relative pessimism on these taxes is the fact that we are more optimistic than the Treasury about receipts of VAT and social security contributions, by £1.0 billion and £0.7 billion respectively.

On the expenditure side, we forecast current spending in 2004–05 of £465.6 billion, which is £1.1 billion higher than that forecast in the PBR. This is largely because the AME margin, which comprises funds set aside for unforeseen contingencies, currently has no funds pencilled in for 2004–05. Traditionally, the Chancellor has set the AME margin to £1.0 billion for the

[3] See, for example, news.bbc.co.uk/1/low/uk_politics/3402359.stm.

coming year in each year's Budget.[4] We assume that this practice will continue in the Spring 2004 Budget. As with 2003–04, we assume that public sector net investment will be the same as forecast in the PBR (£22.7 billion).

We forecast that in 2004–05, the deficit on the current budget will be £12.0 billion and that public sector net borrowing will be £34.7 billion. These are slightly more pessimistic than the PBR projections of £8.3 billion and £31.0 billion respectively.

3.3 Medium-term prospects

Our forecasts for the current budget balance and public sector net borrowing this year and next are not very far out of line with those in the PBR. Looking further ahead, we are more pessimistic. As with our short-term forecasts, our medium-term projections are based on similar macroeconomic assumptions to those the Treasury used in the PBR. Further details can be found in Appendix A.

Over the medium term, we expect receipts overall to be lower than the Treasury forecast in the PBR. For 2005–06, we forecast that receipts will be £483.4 billion, which is £5.8 billion lower than the Treasury forecast. This is shown in Table 3.3. Looking further forward, this gap continues to grow. By 2007–08, we forecast that receipts will be £542 billion, which is £8 billion below the PBR forecast.

Table 3.3. Medium-term public finances forecasts, based on cautious macroeconomic assumptions (£ billion)

	2003–04	**2004–05**	**2005–06**	**2006–07**	**2007–08**
IFS forecasts					
Current budget					
Current receipts	423.2	453.6	483.4	511	542
Current expenditure[a]	441.9	465.6	496.1	522	548
Surplus on current budget	**–18.7**	**–12.0**	**–12.7**	**–11**	**–7**
Capital budget					
Net investment	18.0	22.7	25.2	27	31
Public sector net borrowing	**36.7**	**34.7**	**37.9**	**38**	**38**
HM Treasury forecasts					
Current budget					
Current receipts	422.8	456.2	489.2	520	550
Current expenditure[a]	442.1	464.5	493.8	520	546
Surplus on current budget	**–19.3**	**–8.3**	**–4.7**	**0**	**4**
Capital budget					
Net investment	18.0	22.7	25.2	27	31
Public sector net borrowing	**37.4**	**31.0**	**29.9**	**27**	**27**

[a] In line with the National Accounts, depreciation has been included as current expenditure.
Sources: Authors' calculations; Treasury forecasts from HM Treasury, *Pre-Budget Report*, Cm. 6042, London, December 2003 (this table is similar to table B5, page 213).

[4] See table 2.4, page 29 of R. Chote, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2003*, Commentary no. 92, London, January 2003 (www.ifs.org.uk/gbfiles/gb2003.shtml).

Forecasting spending is difficult since departmental expenditure limits (DELs) for non-NHS departments have only been set to 2005–06. This summer's spending review is expected to reconsider the spending plans set for 2005–06 and to set new DELs for 2006–07 and 2007–08. In last year's Green Budget, we assumed that non-NHS spending was kept constant as a share of national income in these years. This year, instead, we take the Treasury's PBR assumptions – namely, that non-NHS DELs fall as a share of national income and that other current AME increases by 1¾% a year in real terms after 2005–06 – for all spending components. As the IFS forecast is for slightly higher public spending in 2005–06, our new assumption also implies slightly higher public spending than the Treasury in both 2006–07 and 2007–08. However, our latest forecasts contain less medium-term spending than did the January 2003 IFS Green Budget.

Table 7.3 in Chapter 7 contains details of the implications for borrowing or taxation of alternative paths for public spending. The recent change in the inflation target also means that these spending plans are slightly less generous in real terms than those set out in the April 2003 Budget, as departmental budgets have been held fixed in cash terms despite the fact that the Treasury now expects slightly higher medium-term growth in economy-wide inflation. This is discussed in more detail in Box 3.1.

In forecasting AME spending, we assume that the margin will be set to £1.0 billion in 2004–05 and £2.0 billion in 2005–06. As the margin currently has no funds pencilled in for those years, this implies £1.0 billion of additional spending in 2004–05 and £2.0 billion of additional spending in 2005–06. We also take account of any differences in debt interest spending arising from previous differences in borrowing levels. The result is that in 2005–06 we forecast current spending of £496.1 billion, £2.3 billion higher than the PBR forecast. Under our forecast, current spending remains approximately this amount above the PBR projection in both 2006–07 and 2007–08. We assume that public sector net investment will be the same as forecast in the PBR in all years.

With lower forecasts for receipts and higher forecasts for spending, we believe that the public finances will be weaker in the medium term than the Treasury currently projects. In 2005–06, we forecast a deficit on the current budget of £12.7 billion, rather than the £4.7 billion forecast by the Treasury. In 2007–08, we project a current deficit of £7 billion while the Treasury forecasts a current surplus of £4 billion. We expect public sector net borrowing to rise to £37.9 billion in 2005–06 and still be at £38 billion in 2007–08, whereas the Treasury predicts that it will fall slightly, from £29.9 billion to £27 billion, over the same period.

Table 3.4 shows the IFS and Treasury forecasts as percentages of national income. The IFS forecast implies that current receipts as a share of national income will grow from 38.1% in 2003–04 to 39.6% in 2007–08, whereas the Treasury expects them to grow to 40.2%. By 2007–08, IFS expects debt to stand at 37.8% of national income, which is 2.4 percentage points higher than the 35.4% forecast by the Treasury. Nevertheless, under both the Treasury's and IFS's forecasts, net debt is set to stay below the 40% ceiling implied by the Chancellor's interpretation of the sustainable investment rule.

Box 3.1. The effect of the new inflation target on the public finances

In the 2003 PBR, the Chancellor announced that the inflation measure targeted by the Bank of England would switch from the retail price index excluding mortgage interest payments (RPIX) to the Harmonised Index of Consumer Prices (HICP) used by the European Central Bank. The index is now called the 'consumer prices index' (CPI) and the target for CPI inflation is 2.0%.[a]

CPI differs from RPIX in several ways, two of which suggest that there will be a difference between CPI and RPIX inflation. First, the formula used to calculate the CPI generally produces a lower measure of inflation than does that used to calculate RPIX. This 'formula effect' has accounted for around 0.5 percentage points of the difference between annual CPI inflation and annual RPIX inflation in the recent past.[b] Second, the CPI currently excludes housing depreciation, council tax and dwellings insurance, whereas RPIX includes all of these. Because house prices and council tax rates have risen faster than other prices, their exclusion in the past would have made inflation about 0.3 percentage points lower. Going forwards, this second effect would no longer exist if the CPI incorporated housing costs, but the Office for National Statistics considers this unlikely to happen before January 2006 at the earliest.[c]

The net result of these two differences is that CPI inflation has in the past been about 0.8 percentage points lower than RPIX inflation. If this difference persists going forwards, then a shift from an RPIX inflation target of 2.5% to a CPI target of 2.0% does not take account of the full gap between the two measures. The effect would be the same as that produced by a shift in the RPIX target from 2.5% to 2.8%. This is perhaps reflected in the fact that the Treasury has revised its forecast for the GDP deflator up from 2½% growth in the years after 2005–06 to 2¾%.[d] So monetary policy may be slightly easier for a while than it otherwise would have been, while inflation adjusts. Of course, this assumes that the whole 0.8% gap (the 0.5% 'formula effect' and the 0.3% from the exclusion of housing costs) persists.

The exchequer should benefit because the Treasury is assuming that some components of the tentative spending plans it has pencilled in for the next few years will be unchanged in cash terms, while tax receipts over the same period should be higher in cash terms due to the increase in expected nominal national income. If the 2003 PBR had uprated receipts in every financial year from 2004–05 to 2007–08 to reflect the impact of the new inflation target, but had stuck to the 2003 Budget's cash projections for total managed expenditure, then projected public borrowing in 2007–08 would have been about £3 billion lower than it would have been without the change in target.

But this assumes that public spending does not rise in line with the expected higher inflation. The 2003 PBR indeed assumed that the *cash* growth rates for current spending within the departmental expenditure limits (DELs) in the years after 2005–06 would be the same as those set out in the 2003 Budget. This implies a cut in the projected real growth rates of current spending within DELs. But most social security and tax credit payments – which fall within AME rather than DEL – are indexed to the RPI or a related index, so their expected real growth rates are unchanged. Public sector net investment is also expected to remain the same in real terms. Had the Treasury also chosen to uprate the 2003 Budget's figures for current spending within DEL in line with the higher expected RPI inflation, then forecasts of both public spending and public borrowing in four years' time would have been about £1 billion higher than if current spending within DEL had remained constant in cash terms. So the net impact of the move to the new inflation target and the associated assumptions that the Treasury has made regarding revenues and spending is to increase the expected current budget deficit and public sector net borrowing in four years by less than 0.1% of national income.

Notes appear on next page

Notes to Box 3.1:
[a] Chancellor of the Exchequer's Pre-Budget Report Statement, 10 December 2003 (www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr03/prebud_pbr03_speech.cfm).
[b] Also, differences in the methodologies for calculating the two indices mean that CPI is further depressed relative to RPIX because the former responds more to consumers switching from more expensive to cheaper goods and services. See paragraph 45 of Office for National Statistics, *The New Inflation Target: The Statistical Perspective*, London, December 2003 (www.statistics.gov.uk/downloads/theme_economy/New_inflation_target_031210.pdf).
[c] Source: Office for National Statistics, *The New Inflation Target: The Statistical Perspective*, London, December 2003 (www.statistics.gov.uk/downloads/theme_economy/New_inflation_target_031210.pdf).
[d] See table C3 of the April 2003 Budget and table B3 of the December 2003 Pre-Budget Report.

Table 3.4. Medium-term public finances forecasts, based on cautious macroeconomic assumptions (% of national income)

	2003–04	2004–05	2005–06	2006–07	2007–08
IFS forecasts					
Current budget					
Current receipts	38.1	38.6	39.0	39.2	39.6
Current expenditure[a]	39.8	39.7	40.1	40.1	40.1
Surplus on current budget	**–1.7**	**–1.0**	**–1.0**	**–0.8**	**–0.5**
Average surplus on current budget since 1999–2000	**0.5**	**0.2**	**0.0**	**–0.1**	**–0.1**
Capital budget					
Net investment	1.6	1.9	2.0	2.1	2.3
Public sector net borrowing	**3.3**	**3.0**	**3.1**	**2.9**	**2.7**
Public sector net debt	**32.7**	**34.1**	**35.5**	**36.8**	**37.8**
HM Treasury forecasts					
Current budget					
Current receipts	38.1	38.9	39.5	39.9	40.2
Current expenditure[a]	39.8	39.6	39.9	39.9	39.9
Surplus on current budget	**–1.7**	**–0.7**	**–0.4**	**0.0**	**0.3**
Average surplus on current budget since 1999–2000	**0.4**	**0.3**	**0.2**	**0.1**	**0.2**
Capital budget					
Net investment	1.6	1.9	2.0	2.1	2.3
Public sector net borrowing	**3.4**	**2.6**	**2.4**	**2.1**	**2.0**
Public sector net debt	**32.8**	**33.8**	**34.6**	**35.1**	**35.4**
Memo: Output gap[b]	–1.4	–0.7	–0.2	0.0	0.0

[a] In line with the National Accounts, depreciation has been included as current expenditure.
[b] Output gap is measured as a percentage of trend output rather than actual output.
Sources: Treasury forecasts from HM Treasury, *Pre-Budget Report*, Cm. 6042, London, December 2003 (this table is similar to table B6, page 213); authors' calculations.

Our forecasts suggest that there will have been an average surplus on the current budget of 0.0% of national income between 1999–2000 and 2005–06, the Treasury's estimate of the current economic cycle. This is less than the 0.2% of national income average surplus predicted in the PBR, but would still mean that the golden rule had been met using the method of calculation currently favoured by the Chancellor. Summing the cash values of the current budget balances over the years of the cycle, the method the Chancellor used in his 2003 Budget and 2002 Pre-Budget Report speeches, our forecast is a cumulative deficit of £6½ billion rather than the cumulative surplus of

£4½ billion stated in December's PBR. On this method of calculation, therefore, the golden rule would be narrowly missed. Given the past pattern of forecasting errors, it is clearly possible for the golden rule to be missed over the current cycle whichever method of calculation is used.

As we argued in Chapter 2, placing too much emphasis on meeting the golden rule between 1999–2000 and 2005–06 from a position in which there is little remaining margin for forecasting error could require a disruptive short-term policy response towards the end of the cycle that would not be justified in terms of ensuring the medium-term sustainability of the public finances. It is more important to demonstrate that current policy is consistent with meeting the golden rule and the sustainable investment rule in the future.

The Treasury predicted in the PBR that the next cycle would begin in 2006–07 with the current budget in balance and that a cyclically adjusted surplus would thereafter build up as a result of fiscal drag and rising tax revenues from financial companies. This is a weaker position than that at the beginning of the last cycle, which began in 1999–2000 with a current budget surplus of 2.1% of national income (or 1.8% of national income after adjusting for the size of the output gap), but would nonetheless be consistent with expecting to meet the golden rule over the next cycle and subsequent ones.

Our medium-term forecast is more pessimistic than that of the PBR, primarily because we expect lower levels of receipts for a given level of economic activity. Further details are provided in Table 3.5. This shows that, while in 2003–04 there is little difference between the PBR and the IFS forecasts for current receipts, by 2007–08 we expect receipts to be 0.6% of national income lower than is forecast in the PBR. The main reasons are that our forecasts for corporation tax and 'other taxes' are respectively 0.3% and 0.4% of national income lower than the Treasury's in that year.

Looking first at corporation tax receipts, we assume that revenues will increase from their current depressed level to the average level (of about 3.1% of national income) that has been seen over recent years.[5] This implies that corporation tax receipts, including petroleum revenue tax, will grow from 2.8% of national income in 2003–04 to 3.2% of national income in 2007–08. This is equivalent to nominal growth in receipts of 9.7% a year between April 2004 and March 2008. The Treasury expects growth in corporation tax receipts to outstrip this comfortably, although it is no longer as optimistic as it was at the time of last year's Budget.

Explaining the differences in revenue forecasts for 'other taxes' is difficult, as the Treasury does not provide a breakdown of its medium-term forecasts tax by tax. The main taxes included in this category are stamp duties (receipts from which came to £7.5 billion in 2002–03), capital gains tax (£1.6 billion),

[5] This comprises just under 2.9% of national income in non-North-Sea corporation tax receipts and 0.2% of national income in North Sea corporation tax receipts. For more details, see figure 2.8, page 25 of R. Chote, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2003*, Commentary no. 92, London, January 2003 (www.ifs.org.uk/gbfiles/gb2003.shtml).

inheritance tax (£2.4 billion), climate change levy (£0.8 billion), business rates (£18.5 billion) and council tax (£16.7 billion).[6]

For stamp duties, capital gains tax and inheritance tax revenues, we assume that revenues will grow in line with income tax revenues, and will therefore exhibit considerable fiscal drag. Offsetting this is the fact that we assume that revenues from business rates and the climate change levy only grow in line with the RPI and therefore fall as a share of national income. This assumption reflects the facts that, by design, business rate receipts should only increase in line with the RPI and that receipts from the climate change levy should grow in line with expenditure on energy.

Table 3.5. Comparison of IFS and PBR revenue forecasts in 2003–04 and 2007–08 (% of national income)

	2003–04		2007–08	
	PBR, December 2003	**IFS Green Budget, January 2004**	**PBR, December 2003**	**IFS Green Budget, January 2004**
Income tax (gross of tax credits)	10.7	10.7	11.5	11.5
Social security contributions	6.5	6.6	6.8	6.8
Corporation tax[a]	2.8	2.8	3.5	3.2
Tax credits	–0.4	–0.4	–0.3	–0.3
VAT	6.2	6.2	6.1	6.2
Excise duties	3.5	3.5	3.3	3.3
Other	8.8	8.8	9.3	8.9
Current receipts	**38.1**	**38.1**	**40.2**	**39.6**

[a] Including petroleum revenue tax.
Sources: Treasury forecasts from table B11, page 220 of HM Treasury, *Pre-Budget Report*, Cm. 6042, London, December 2003; authors' calculations.

It is not possible to compare our assumptions on this set of taxes with those underlying the Treasury's PBR projections. For receipts from stamp duty on equity purchases, the Treasury publishes its assumption that the FTSE All Share Index grows in line with national income. For receipts from other components of stamp duty and other taxes, the Treasury does not publish its forecast for growth in the relevant tax base. For example, we do not know what the Treasury is assuming for growth in either house prices or earnings.

For council tax revenues, we assume growth in line with the national economy from April 2004 to March 2008; this implies average nominal growth of 5.3% a year. The Treasury does not make its assumptions on council tax revenues explicit in the PBR. In the April 2003 Budget it stated that the medium-term assumption was that council tax receipts continued to increase at the rate seen in recent years.[7] In the PBR, the Treasury forecasts that council tax revenues will grow by 8.2% between 2003–04 and 2004–05. If it is also assuming that revenues continue to grow at this rate beyond 2004–05, then by 2007–08 its

[6] Source: Table B9, page 217 of HM Treasury, *Pre-Budget Report*, Cm. 6042, London, December 2003.

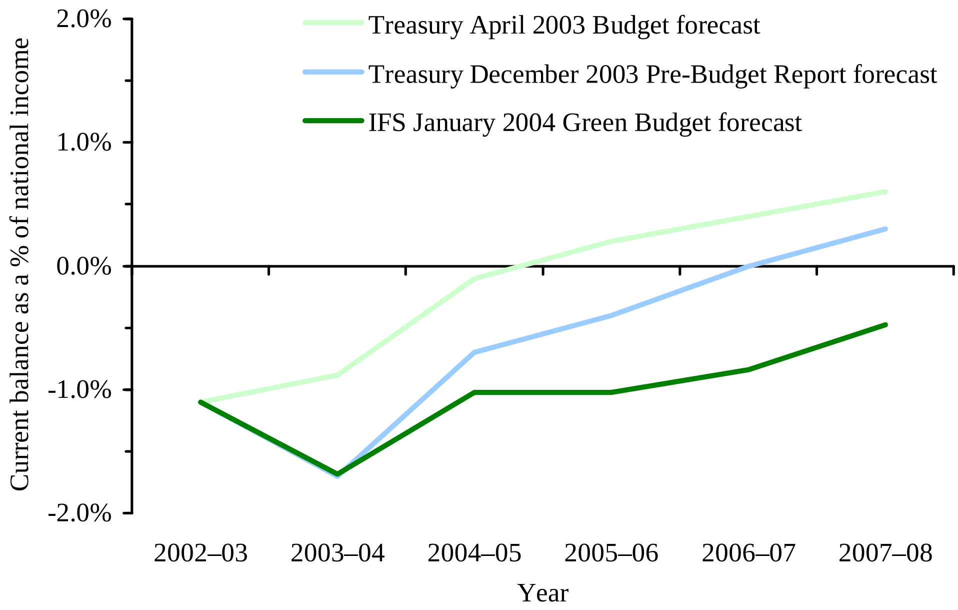
[7] Paragraph C42, page 255 of HM Treasury, *Financial Statement and Budget Report*, Hc500, London, April 2003.

forecast for council tax revenues will be around £2 billion higher than the revenues implied by the IFS forecast.

3.4 The Budget judgement

The current budget balances forecast in the April 2003 Budget, the December 2003 Pre-Budget Report and the January 2004 IFS Green Budget are shown in Figure 3.1. Neither our forecasts nor the Treasury's imply that there is any fundamental crisis in the public finances. They are consistent with maintaining public sector net debt at levels that are modest by both international and historical standards. But the Chancellor has also said that he wishes to be judged against the more stringent benchmark of the fiscal rules he set himself in 1998. This is what we do in our discussion of the Budget judgement.

Figure 3.1. Current budget surplus as a percentage of national income



Sources: Treasury forecast from HM Treasury, *Pre-Budget Report*, Cm. 6042, London, December 2003, and HM Treasury, *Financial Statement and Budget Report*, Hc500, London, April 2003.

The PBR predicts that the golden rule will be met over the current cycle, that the next cycle will begin with the current budget in balance and that cyclically adjusted surpluses will build up thereafter. In large part, this reflects fiscal drag, an ongoing increase in revenues as a share of national income arising from the fact that, by default, allowances and thresholds go up in line with prices rather than earnings.

Our forecast also implies that the golden rule will be met over the current cycle on the Chancellor's presently preferred method of calculation, but that that the next cycle will begin with the current budget in deficit. Over time, fiscal drag would mean that we too would forecast that the current budget would eventually return to a cyclically adjusted surplus. But it is not clear whether the lost ground would be made up sufficiently quickly to meet the golden rule over the next cycle without announcing further tax-raising measures or slower spending growth in future spending reviews. In any event, the Treasury believes that it is unrealistic to assume that fiscal drag can be allowed to continue unchecked over the long term.

In discussing the Budget judgement, we assume that the Chancellor is content with the public spending plans he has pencilled into the PBR. As we have noted, these are slightly tighter in real terms than those he assumed at the time of the 2003 Budget and they imply that non-NHS public spending falls as a share of national income over the period from 2005–06 and 2007–08. Given continued dissatisfaction among voters about the quality of public services, we assume that the eventual spending plans for the years of the 2004 spending review will be no lower than those in the PBR. This means that if the Chancellor believed that fiscal policy needed to be tightened, the adjustment would probably take the form of further tax increases. This would be in line with the choices the Chancellor has made in the past: the July 1997 Budget increased taxes to reduce borrowing, while the April 2002 Budget increased taxes to increase public spending.

If we take the spending plans as given, whether or not further tax increases need to be announced depends, first, on what we believe would be an appropriate path for the current budget balance over the next few years and, second, on whether further tax-raising measures need to be announced to deliver it.

Taking the first of these questions, we have argued that it is more important for policy to be consistent with meeting the golden rule looking forward into the medium term than to achieve it over the precise period 1999–2000 to 2005–06 of the ‘current’ cycle. One approach would therefore be to argue that we should start the next cycle with the current budget in cyclically adjusted balance. If we assume that over the long term, current spending on average grows in line with the economy, this implies that the golden rule could thereafter be met without requiring any rise in tax revenues as a share of national income (in other words, that we need not rely on fiscal drag in a fashion that the Treasury itself believes to be unrealistic in the long term).

A second, more cautious, approach would be to note that in the 2003 Budget, the Treasury aimed for a cyclically adjusted surplus on the current budget of 0.6% of national income at the end of its forecasting period and that it took a similar (indeed, slightly tougher) stance in previous Budgets. The Treasury has justified this desire for caution in part by noting the possibility that the underlying health of the public finances might be weaker than its central estimate if it has overestimated the degree of spare capacity in the economy. This seems a particularly pertinent concern at present, with the IMF, OECD and (implicitly) the Bank of England all indicating that they believe the output gap may be smaller than the Treasury thinks.

If the Chancellor sticks with his PBR spending plans and revenue forecasts, he can argue that there is no need to announce new tax-raising measures: the golden rule will be met over the current cycle and, based on the first approach discussed above, he will begin the next cycle with the current budget in balance. If he adopts the second approach, and seeks a similar degree of caution to that which he has sought in previous Budgets, he could argue that fiscal drag and rising corporate tax revenues would create an adequate safety margin in the early years of the next cycle. This implies again that he would not need to announce fresh tax-raising measures, and could merely acquiesce in the £7 billion rise in the tax burden between 2006–07 and 2008–09 this would imply.

If the latest IFS forecasts are correct, the current budget will begin the next cycle with a deficit of 0.8% of national income in 2006–07. To close this gap would require the announcement of further tax-raising measures worth £10 billion in today's money. To achieve the cyclically adjusted surplus of 0.6% of national income that the Chancellor indicated in the last Budget that he wanted to see as a medium-term safety margin in 2006–07 would require an additional £7 billion. But in the last Budget, Mr Brown indicated that he was happy to have a cyclically adjusted surplus of 0.4% of national income in 2006–07 and not to reach the 0.6% surplus until a year later. Aiming for this goal in 2007–08 would imply announcing further tax increases of around £3 billion rather than £7 billion and allowing fiscal drag to do the rest. But in the end, tax revenues would have risen by the same amount. This implies that in total the Chancellor would need to announce new measures to raise an extra £13 billion if he wanted to achieve the golden rule looking forwards with the comfort he sought in the last Budget.

Conversely, Mr Brown could choose spending cuts over further tax increases to achieve the same objective. If so, instead of allowing real spending to grow by about 3.0% a year in real terms from April 2005 to March 2008, he could cut the rate of growth to around 2% a year. Like a £13 billion tax increase plus a year of fiscal drag, this would also bring the current budget surplus in 2007–08 up to 0.6% of national income, the level Mr Brown was looking for in the last Budget. It would also imply that spending was falling as a share of national income.

The requirement that the golden rule has to be met on average over the cycle, rather than every year, is a sensible one. But flexibility has a price of ambiguity: we cannot say precisely what deficit or surplus is appropriate in a particular year and therefore when exactly a tax increase might need to take place. Still, action should not be delayed indefinitely simply because the future is uncertain. If the Chancellor accepts the case for downgrading his medium-term forecasts – which our analysis, like that of other independent forecasters such as the IMF and the OECD,[8] indicates – then he should take steps either to raise further revenue or to cut back on spending in the forthcoming Budget. This would protect the credibility of the rules in which Mr Brown has placed such faith. To date, the Chancellor has given no indication that he believes such steps are necessary.

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[8] In its concluding statement to its recent article IV consultation, the International Monetary Fund said, 'On unchanged policies, we see only a small improvement over the forecast horizon, with the deficit about 1 percentage point of GDP above the government's projections by FY 2006/07' (www.imf.org/external/np/ms/2003/121803.htm). In its recent economic survey of the UK, the OECD said, 'the more pessimistic OECD projections suggest that, although the golden rule would just be met in the current cycle, a sizeable structural deficit would persist' (paragraph 6, page 10, January 2004).