4. Public finance forecasts

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Summary

- The current budget deficit is likely to be more than £3 billion bigger this year and £6 billion bigger next year than the Treasury predicted in December's Pre-Budget Report, according to the Green Budget baseline forecast. This reflects stronger-than-forecast spending and weaker-than-expected revenues.
- On these figures, the government would narrowly break its golden rule over the current economic cycle, if the cycle ends in 2005–06 as the Treasury expects. But if there is less spare capacity in the economy than the Treasury thinks, and the cycle is already in its final year, the rule should be met narrowly.
- The current budget balance will remain in deficit on the Green Budget baseline forecast, rather than moving into surplus in 2006–07 as the Pre-Budget Report predicted. By 2009–10, the Green Budget forecast for the current budget balance is over £15 billion more pessimistic than the Treasury's.
- The Treasury expects government revenues to rise by 2.2% of national income over the next five years, 1% of national income more than can be explained by the typical impact of the economic cycle and fiscal drag. The Green Budget baseline forecast shows revenues rising by 1.6% of national income.
- Higher borrowing than the Treasury expects translates into a faster build-up of public sector net debt. The Green Budget baseline forecast suggests that, on the basis of past forecasting performance, there is a 50-50 chance of public sector net debt breaching the 40% of national income limit laid down by the sustainable investment rule, in 2008–09.
- Morgan Stanley predicts somewhat weaker economic growth than the Treasury in the near term. This would result in slightly higher borrowing and see the net debt ratio breach 40% in 2008–09. If consumer spending is significantly depressed – for example, by a sharp downturn in the housing market – borrowing could be much higher and the debt ratio is likely to exceed 50% by 2009–10.
- It is impossible be sure whether tax-raising measures will be needed to meet the fiscal rules over the next economic cycle, as we do not know how long that cycle will be. But to put the public finances back on a path as strong as the Treasury aimed for in the 2004 Budget would require a tax increase of at least £11 billion.

4.1 Introduction

Chapter 2 discussed the Treasury's fiscal rules and the probability of meeting them, based purely on its Pre-Budget Report forecasts and the uncertainty implied by its past forecasting errors. Chapter 3 examined the plausibility of the Treasury's forecasts for the economy in the short and medium term, which will help determine the path of the public finances. In this chapter, we present our own forecasts for the public finances, with the baseline January 2005 Green Budget forecast assuming that the Treasury's 'cautious' Pre-Budget Report view of the outlook for the economy is correct. We also present two alternative projections for the public finances, based on Morgan Stanley's central and 'worse' case scenarios for the evolution of the economy, as described in Chapter 3. We then ask what the Green Budget forecasts imply for tax and spending decisions in this and future Budgets.

Section 4.2 describes in detail the Green Budget baseline projections for the public finances this year and next. Section 4.3 goes on to describe the medium-term outlook through to 2009–10 and the uncertainties around it. Section 4.4 sets out alternative projections based on Morgan Stanley's macroeconomic scenarios. Section 4.5 concludes with the implications for tax and spending policy in forthcoming Budgets. We also discuss briefly the implications of the tax and spending plans announced by the Conservatives in January 2005.

4.2 Short-term projections

In 2003–04, government receipts were lower than forecast either by the Treasury (in the December 2003 Pre-Budget Report) or by IFS (in the January 2004 Green Budget). Public sector current spending and net investment also came in lower than expected by both the Treasury and IFS. As the undershoot in spending was smaller than the undershoot in revenues, the net effect was a current budget deficit larger than expected. In 2003–04, there was a £21.1 billion deficit on the public sector current budget, compared with predictions of £19.3 billion by the Treasury and £18.7 billion by IFS. A £4.3 billion undershoot in net investment spending meant that the out-turn for public sector net borrowing was £34.8 billion, compared with a £37.4 billion Treasury forecast and a £36.7 billion IFS forecast.[1]

Borrowing in 2004–05

The weaker-than-forecast performance of current receipts has continued into 2004–05. As a result, the Treasury cut its revenue forecast for this year from the £454.7 billion it predicted in the March 2004 Budget to £451.0 billion in the December 2004 Pre-Budget Report, as shown in Table 4.1. The Treasury also cut its forecast for current spending this year by £1.7 billion to £463.5 billion and for public sector net investment by £0.7 billion to £21.7 billion.

By cutting its revenue forecast more than its spending forecast, the Treasury increased its prediction for the current budget deficit from £10.5 billion in Budget 2004 to £12.5 billion in the Pre-Budget Report. The forecast for public sector net borrowing increased by slightly less, from £32.9 billion to £34.2 billion. This reflected the fact that public sector net investment was expected to come in lower than at Budget time.

Compared with the Pre-Budget Report, the Green Budget baseline forecast for 2004–05 is for lower current receipts (£1.4 billion lower), higher current spending (£2.0 billion) and significantly lower public sector net investment (£3.2 billion). As a result, the Green Budget

[1] See Appendix A for more details.

predicts a current budget deficit of £15.9 billion, some £3.4 billion deeper into the red than forecast in the Pre-Budget Report. As a result of the lower forecast for public sector net investment than the Treasury's, the Green Budget forecasts public sector net borrowing in 2004–05 is just £0.2 billion greater than forecast in the Pre-Budget Report, at £34.4 billion.

Table 4.1. Comparison of forecasts for government borrowing, 2004–05

£ billion	Budget, Mar. 04	Pre-Budget Report, Dec. 04	Green Budget, Jan. 05	Differences in Green Budget forecast relative to:	
				Budget	PBR
Current receipts	454.7	451.0	449.6	–5.1	–1.4
Current expenditure[a]	465.2	463.5	465.5	0.3	2.0
Net investment	22.4	21.7	18.5	–3.9	–3.2
Total managed expenditure	487.6	485.3	484.0	–3.6	–1.2
Public sector net borrowing	32.9	34.2	34.4	1.5	0.2
Surplus on current budget	–10.5	–12.5	–15.9	–5.4	–3.4

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

Sources: Treasury forecasts – HM Treasury, *Pre-Budget Report*, Cm. 6408, London, December 2004; HM Treasury, *Financial Statement and Budget Report*, Hc301, London, March 2004.

Spending in 2004–05

It is clear from Table 4.1 that the difference between the Green Budget forecast and the Pre-Budget Report forecast for 2004–05 is in large part due to differences in the projections for spending. For both current spending and public sector net investment, the Green Budget forecast takes into account information on the growth in central government current spending and public sector net investment over the period from April 2004 to December 2004. Over these nine months, central government current spending has grown by 6.2% over the same nine months last year. The Pre-Budget Report forecast implies that this spending will only grow at 5.2% over the year as a whole. If central government current spending continues to grow at 6.2% over the next three months, then it would overshoot the Pre-Budget Report projection by £4.0 billion. The Green Budget assumes that the growth in central government current spending will slow over the next three months, but that spending overshoots the Pre-Budget Report by half of this difference – a total overspend of £2.0 billion.

The Treasury could simply instruct departments to spend much less over the remaining months of the year, but its ability to do so is complicated by its introduction of 'end-year flexibility': in order to prevent departments from engaging in wasteful spending at the end of the year, the Treasury told them in 1998 that any underspending in one year could be carried forward to the next rather than resulting in the reduction of their future spending allocation.[2] To date, departments have accumulated around £11.4 billion in underspends that in principle they should be allowed to spend if they wish.[3] If the Treasury were to tell departments that

[2] Source: HM Treasury, *Economic and Fiscal Strategy Report*, June 1998 (http://www.hm-treasury.gov.uk/budget/efsr_1998/bud_efsr98_index.cfm).

[3] Source: HM Treasury, Public Expenditure Outturn White Paper 2003–04, July 2004 (http://www.hm-treasury.gov.uk/media/732/2D/peowpJuly04opt.pdf). A more detailed discussion, and a breakdown by department, is

they could not spend this money in an attempt to restrain total spending in the short term, it would risk recreating the incentive for them to spend wastefully to protect their future budgets that end-year flexibility was designed to remove.

In contrast to the picture for current spending, the Pre-Budget Report forecast that spending on public sector net investment would grow by 55.8% in 2004–05, whereas over the nine months from April 2004 to December 2004 it has grown by 15.6%. If this continues over the next three months, then the shortfall in public sector net investment would be £6.3 billion. The Green Budget assumes that the growth in spending on public sector net investment does increase over the next three months, but that spending falls short of the Pre-Budget Report by half of this difference – a total underspend of £3.2 billion.

Taking the forecasts for current spending and public sector net investment together, the Green Budget forecasts total managed expenditure of £484.0 billion in 2004–05, £1.2 billion lower than the £485.3 billion forecast in the Pre-Budget Report.

Receipts in 2004–05

As set out in Table 4.1, the Green Budget forecasts current receipts in 2004–05 of £449.6 billion, slightly below the £451.0 billion forecast in the Pre-Budget Report. A detailed breakdown of the two forecasts is provided in Table 4.2. The Green Budget forecasts lower receipts of income tax (£1.2 billion lower), corporation tax (£0.7 billion) and VAT (£0.5 billion) than the Pre-Budget Report. Partially offsetting these is a higher forecast for National Insurance contributions (£0.8 billion). The IFS forecasting model and out-turns for the year to date both suggest that income tax and corporation tax will undershoot the Pre-Budget Report forecast, while National Insurance contributions and VAT will overshoot. More information can be found in Appendix A, Table A.2.

Table 4.2 also breaks down the two forecasts for receipts in 2005–06. Before discussing these, we first turn to the projections for the main fiscal aggregates.

Borrowing in 2005–06

Wherever possible, the Green Budget baseline forecasts are based on the same macroeconomic assumptions that underlie the ‘cautious’ forecasts in the December 2004 Pre-Budget Report. The forecasts presented here also assume that there are no new tax or spending measures announced in the Spring 2005 Budget.

The Pre-Budget Report forecast a larger current budget deficit and higher public sector net borrowing for 2005–06 than the March 2004 Budget. This was due to a lower forecast for current receipts (£2.8 billion), a lower forecast for current spending (£1.3 billion) and a higher forecast for public sector net investment (£1.3 billion), as in Table 4.3.

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provided on pages 35–37 of C. Emmerson, C. Frayne and S. Love, *A Survey of Public Spending in the UK*, IFS Briefing Note no. 43, 2004 (http://www.ifs.org.uk/bns/bn43.pdf).

Table 4.2. Comparison of Green Budget and HM Treasury forecasts for government borrowing, 2004–05 and 2005–06 (£ billion)

£ billion	2004–05		2005–06	
	PBR Dec. 2004	*Green Budget Jan. 2005*	*PBR Dec. 2004*	*Green Budget Jan. 2005*
Inland Revenue				
Income tax (net of tax credits)	123.7	122.5	134.1	131.1
Corporation tax (net of tax credits)	32.4	31.7	40.8	36.4
National Insurance contributions	77.7	78.5	82.3	82.9
Petroleum revenue tax	1.5	1.5	1.6	1.6
Capital gains tax	2.0	2.0	2.8	2.8
Inheritance tax	2.9	2.9	3.3	3.3
Stamp duties	8.8	8.8	9.5	9.5
Total Inland Revenue (net of tax credits)	**249.0**	**247.9**	**274.3**	**267.5**
Customs and Excise				
Value added tax (VAT)	73.5	73.0	77.3	76.4
Fuel duties	23.6	23.6	24.9	24.2
Tobacco duties	8.1	8.1	8.4	8.4
Spirits duties	2.4	2.4	2.4	2.4
Wine duties	2.1	2.1	2.3	2.3
Beer and cider duties	3.3	3.3	3.4	3.4
Betting and gaming duties	1.4	1.4	1.4	1.4
Air passenger duty	0.9	0.9	1.0	1.0
Insurance premium tax	2.5	2.5	2.6	2.6
Landfill tax	0.7	0.7	0.7	0.7
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	2.1	2.1	2.1	2.1
Total Customs and Excise	**121.6**	**121.2**	**127.6**	**126.0**
Vehicle excise duties	5.0	5.0	5.3	5.3
Business rates [a]	19.0	19.0	20.1	20.1
Council tax [b]	19.7	19.7	21.3	21.3
Other taxes and royalties [c]	11.3	11.3	12.5	12.5
Net taxes and NI contributions [d]	**425.5**	**424.1**	**461.1**	**452.7**
Accruals adjustments on taxes	1.9	1.9	0.8	0.8
Less Own resources contribution to EC budget	–3.9	–3.9	–3.8	–3.8
Less PC corporation tax payments	–0.1	–0.1	–0.1	–0.1
Tax credits adjustment [e]	0.6	0.6	0.6	0.6
Interest and dividends	5.1	5.1	5.1	5.1
Other receipts [f]	21.9	21.9	23.3	23.3
Current receipts	**451.0**	**449.6**	**487.0**	**478.6**

[a] Includes district council rates in Northern Ireland paid by business. [b] Net of council tax benefit. [c] Includes VAT refunds and money paid into the National Lottery Distribution Fund. [d] Includes VAT and ‘traditional own resources’ contributions to EC budget. [e] Tax credits that are scored as negative tax in the calculation of net taxes and NICs but expenditure in the National Accounts. [f] Includes gross operating surplus and rent; net of oil royalties and business rate payments by local authorities.

Note: For more details of the Green Budget forecast in 2004–05, see Table X.X in Appendix A.

Sources: Treasury forecasts from HM Treasury, *Pre-Budget Report*, Cm.6408, London, December 2004; this table is similar to table B13 (page 209); IFS calculations.

The Green Budget forecasts significantly lower current receipts (£8.4 billion), somewhat lower current spending (£1.9 billion) and significantly lower public sector net investment (£3.2 billion) in 2005–06 than the Pre-Budget Report. As a result, the Green Budget forecasts a deficit on the current budget of £13.4 billion, some £6.5 billion deeper into the red than predicted in the Pre-Budget Report. As a result of the lower forecast for public sector net investment, the Green Budget forecasts public sector net borrowing in 2005–06 of £36.7 billion, some £3.3 billion higher than forecast by the Treasury in the Pre-Budget Report.

Table 4.3. Comparison of forecasts for government borrowing, 2005–06

£ billion	**Budget, Mar. 04**	**Pre-Budget Report, Dec. 04**	**Green Budget, Jan. 05**	**Differences in Green Budget forecast relative to:**	
				Budget	**PBR**
Current receipts	489.8	487.0	478.6	–11.2	–8.4
Current expenditure [a]	495.2	493.9	492.0	–3.2	–1.9
Net investment	25.2	26.5	23.3	–1.9	–3.2
Total managed expenditure	520.4	520.5	515.3	–5.1	–5.1
Public sector net borrowing	30.6	33.4	36.7	6.1	3.3
Surplus on current budget	–5.5	–6.9	–13.4	–7.9	–6.5

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

Sources: Treasury forecasts – HM Treasury, *Pre-Budget Report*, Cm. 6408, London, December 2004; HM Treasury, *Financial Statement and Budget Report*, H301, London, March 2004.

Spending in 2005–06

For current spending in 2005–06, the Green Budget forecast assumes that the overspend expected in 2004–05 does not persist. Furthermore, it assumes that the AME margin (the contingency reserve within annually managed expenditure) needs to contain only £1 billion and that the extra £1.9 billion currently allocated for that year does not need to be spent. Reducing the AME margin back to £1 billion is consistent with decisions that the Chancellor has made in previous Budgets.[4] The slightly higher level of public sector net borrowing forecast in 2004–05 leads to £0.1 billion of additional spending on debt interest payments in 2005–06. As a result, the Green Budget forecasts current spending £1.9 billion lower than projected in the Pre-Budget Report for 2005–06.

For public sector net investment, the Green Budget assumes that the forecast £3.2 billion underspend in 2004–05 persists fully (in cash terms) into 2005–06. This is because recent years have consistently seen public sector net investment fall short of the Treasury's forecasts (see Figure 2.20 in Chapter 2).

Taking the differences in forecasts for current spending and public sector net investment together, the Green Budget forecasts total managed expenditure in 2005–06 of £515.3 billion, some £5.1 billion lower than the £520.5 billion forecast in the Pre-Budget Report.

[4] For more details, see table 2.4 of R. Chote, C. Emmerson and H. Simpson (eds), *IFS Green Budget: January 2003*, (http://www.ifs.org.uk/budgets/gb2003/ch2.pdf).

Receipts in 2005–06

As set out in Table 4.3, the Green Budget forecasts current receipts of £478.6 billion in 2005–06, significantly below the £487.0 billion forecast in the December 2004 Pre-Budget Report. A detailed breakdown of the two forecasts is provided in Table 4.2. The Green Budget forecast implies that income tax receipts will grow by 7.0% and that corporation tax receipts will grow by 14.8%. These very high growth rates are still below those of 8.4% and 25.9% respectively implied by the forecasts in the December 2004 Pre-Budget Report. As a result, the Green Budget forecasts significantly lower receipts of income tax (£3.0 billion lower) and corporation tax (£4.4 billion) than the Treasury. There are smaller differences in the forecasts for receipts of VAT (£0.9 billion lower), fuel duty (£0.7 billion lower) and National Insurance contributions (£0.6 billion higher).

For council tax receipts, the Green Budget takes the same forecast as the Treasury for 2005–06 and, like the Treasury, assumes that revenues grow by 6.8% a year thereafter. While it might seem more appropriate to assume a lower growth in receipts (for example, that receipts remain constant as a share of national income), this would not have any impact on either the current budget or public sector net investment since lower forecast council tax receipts would also imply lower forecast local authority self-financed expenditure.

4.3 Medium-term prospects

The Green Budget forecasts current budget deficits £3.4 billion larger than the Pre-Budget Report for 2004–05 and £6.5 billion larger for 2005–06. Looking further ahead, the Green Budget forecasts become more pessimistic relative to the Pre-Budget Report, thanks to a combination of lower receipts and higher current spending than the Treasury expects. As with the short-term forecasts, the Green Budget medium-term forecasts are based on similar ‘cautious’ macroeconomic assumptions to those used by the Treasury in the Pre-Budget Report. Further details can be found in Appendix A.

Table 4.4 compares the medium-term projections. In 2007–08 (the last year covered by the 2004 Spending Review), the Green Budget forecasts current receipts just over £12 billion below the Pre-Budget Report forecast (at £539.7 billion) and current expenditure about £1.4 billion higher than the Pre-Budget Report forecast (at £549.7 billion). The extra spending includes £0.5 billion to restore the AME margin to its conventional level and £1.4 billion of extra debt interest as a result of higher borrowing in previous years. Weaker revenues and higher spending give a Green Budget forecast for the current budget in 2007–08 of a deficit of £10.0 billion, compared with the Pre-Budget Report forecast of a £4 billion surplus.

Looking further ahead, the gap between the current budget forecasts of the Green Budget and the Pre-Budget Report forecast widens steadily until the last year of the forecasting horizon in 2009–10. This is because the Green Budget assumes that current spending remains constant as a share of national income in 2008–09 and 2009–10, whereas the spending figures contained in the Pre-Budget Report imply that it falls very slightly as a share of national income. The government has not published detailed spending plans for these years and would not be expected to until the Spending Review of 2006. The Green Budget assumption of spending not falling as a share of national income seems reasonable, given that all four of Labour’s spending reviews have chosen to increase current spending as a share of national income. In addition, the government has aspirations for reducing child poverty and improving the NHS that are likely to require additional resources. For example, the Wanless Review into the long-term resource requirements of the NHS set out three scenarios, all of which required public spending on the NHS to increase as a share of national income to at least March 2018.[5]

Table 4.4. Medium-term public finances forecasts under 'cautious' assumptions

£ billion	2004–05	2005–06	2006–07	2007–08	2008–09	2009–10
Green Budget forecasts						
Current budget						
Current receipts	449.7	478.6	508.3	539.7	569.8	601.5
Current expenditure [a]	465.5	492.0	519.9	549.7	576.5	605.0
Surplus on current budget	**–15.9**	**–13.4**	**–11.6**	**–10.0**	**–6.8**	**–3.4**
Capital budget						
Net investment	18.5	23.3	29.3	30.9	32.4	34.0
Public sector net borrowing	**34.4**	**36.7**	**40.9**	**40.9**	**39.2**	**37.4**
HM Treasury forecasts						
Current budget						
Current receipts	451.0	487.0	520	552	582	612
Current expenditure [a]	463.5	493.9	519.5	548.3	574	601
Surplus on current budget	**–12.5**	**–6.9**	**1**	**4**	**9**	**12**
Capital budget						
Net investment	21.7	26.5	29.3	31.2	32	34
Public sector net borrowing	**34.2**	**33.4**	**29**	**28**	**24**	**22**

[a] In line with the National Accounts, depreciation has been included as current expenditure.
Sources: Authors' calculations and Treasury forecasts from HM Treasury, *Pre-Budget Report*, Cm. 6408, London, December 2004; this table is similar to table B8 (page 204).

In the last year of the forecast horizon, 2009–10, the Green Budget forecasts a current budget deficit of over £3 billion, while the December 2004 Pre-Budget Report forecasts a surplus of £12 billion. Since the forecasts for public sector net investment in this year are the same, the difference in forecasts for the current budget translate directly into differences in forecasts for public sector net borrowing. In 2009–10, the Green Budget forecasts net borrowing of £37.4 billion compared with the December 2004 Pre-Budget Report forecast of £22 billion.

Table 4.5 presents the same figures as Table 4.4, but as shares of national income. It also shows forecasts for public sector net debt. The December 2004 Pre-Budget Report forecast that public sector net debt would increase from 34.3% of national income in 2004–05 to 37.1% in 2009–10, but still below the Chancellor's 40% ceiling. In contrast, the Green Budget forecasts that public sector net debt will increase to 41.0% in 2009–10. While Budget 2004 states that 'To meet the sustainable investment rule with confidence, net debt will be maintained below 40 per cent of GDP in each and every year of the current economic cycle',[6]

[5] Chapter 5 of D. Wanless, *Securing Our Future Health: Taking a Long-Term View*, HM Treasury, London, April 2002 (http://www.hm-treasury.gov.uk./media/A5C/F6/chap5.pdf).

[6] HM Treasury, *Budget 2004*, paragraph 2.58.

it is unclear whether over future economic cycles net debt will need to be below 40% of national income in every year or just on average over the whole economic cycle. A requirement of keeping debt under 40% every year over the next cycle would result in a breach of the rule under the Green Budget scenario, but this is not necessarily implied if the sustainable investment rule is judged on average over the cycle. Moreover, the Green Budget forecast assumes that the Treasury's plans for net investment in 2006–07 and beyond materialise. As was shown in Figure 2.20 in Chapter 2, so far there has been consistent underspending on net investment compared with Treasury plans. If this were to persist, other things being equal, net debt would be lower and the sustainable investment rule would be less likely to be breached.

Table 4.5. Medium-term public finances forecasts under 'cautious' assumptions

% of national income	**2004–05**	**2005–06**	**2006–07**	**2007–08**	**2008–09**	**2009–10**
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**
HM Treasury forecasts						
Current budget						
Current receipts	38.3	39.2	39.8	40.2	40.4	40.5
Current expenditure [a]	39.4	39.8	39.7	39.9	39.8	39.7
Surplus on current budget	**–1.1**	**–0.6**	**0.0**	**0.3**	**0.6**	**0.8**
Capital budget						
Net investment	1.8	2.1	2.2	2.3	2.2	2.3
Public sector net borrowing	**2.9**	**2.7**	**2.2**	**2.0**	**1.6**	**1.5**
Public sector net debt	**34.3**	**35.4**	**36.2**	**36.8**	**37.0**	**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, *Pre-Budget Report*, Cm. 6408, London, December 2004; this table is similar to table B9 (page 204).

Breakdown of medium-term revenue projections

Over the five-year period from 2004–05 to 2009–10, the Green Budget expects current receipts to grow from 38.2% of national income to 39.8% of national income. Of this 1.6% of national income increase, 0.2% of national income is the cyclical effect of economic activity returning to trend (since these projections are based on the macroeconomic assumptions set out in the Pre-Budget Report) and a further 1.0% of national income can be expected from normal fiscal drag over this period.[7] This leaves an increase of 0.4% of national income over and above what would normally be expected on 'unchanged' policies. In contrast, the 2004 Pre-Budget Report expects current receipts to grow by 2.2% of national income over the next five years, which is 1.0% of national income more than could normally be expected from the economy returning to trend and from fiscal drag over a five-year horizon.

Table 4.6 provides a more detailed breakdown of the receipts forecasts in these two years. The Green Budget forecasts receipts of 39.8% of national income in 2009–10, which is 0.7% of national income below the December 2004 Pre-Budget Report. The main difference is a weaker forecast for corporation tax receipts. The Green Budget forecasts corporation tax receipts to grow strongly as a share of national income from 2.7% in 2004–05 to 3.4% in 2009–10. The December 2004 Pre-Budget Report forecasts that corporation tax receipts will grow even more strongly as a share of national income, from 2.9% in 2004–05 to 3.8% in 2009–10. After taking account of economy-wide inflation, the Green Budget forecast expects corporation tax receipts to grow by 7.1% a year in real terms over the next five years. As in last year's Green Budget, we assume that corporation tax receipts climb strongly to reach the recent average level of receipts (adjusted for policy changes) in 2007–08. We assume that they remain constant as a share of national income thereafter. The December 2004 Pre-Budget Report predicts real growth of 8.6% a year. Box 4.1 assesses the plausibility of the Treasury's medium-term corporation tax forecasts by looking at the relationship between revenues from that source and the earnings of companies quoted on the UK stock market.

Table 4.6. Medium-term revenue forecasts under 'cautious' assumptions

% of national income	**2004–05**		**2009–10**	
	PBR, December 2004	Green Budget, January 2005	PBR, December 2004	Green Budget, January 2005
Income tax (gross of tax credits)	10.8	10.7	11.8	11.6
National Insurance contributions	6.6	6.7	6.8	6.9
Corporation tax [a]	2.9	2.7	3.8	3.4
Tax credits	–0.4	–0.4	–0.2	–0.2
Value added tax	6.3	6.2	6.1	6.1
Excise duties	3.4	3.4	3.1	3.1
Other	8.9	8.9	9.0	9.0
Current receipts	**38.3**	**38.2**	**40.5**	**39.8**

[a] Includes petroleum revenue tax.

Sources: Authors' calculations and Treasury forecasts from HM Treasury, *Pre-Budget Report*, Cm. 6408, London, December 2004; this table is similar to table B13 (page 214).

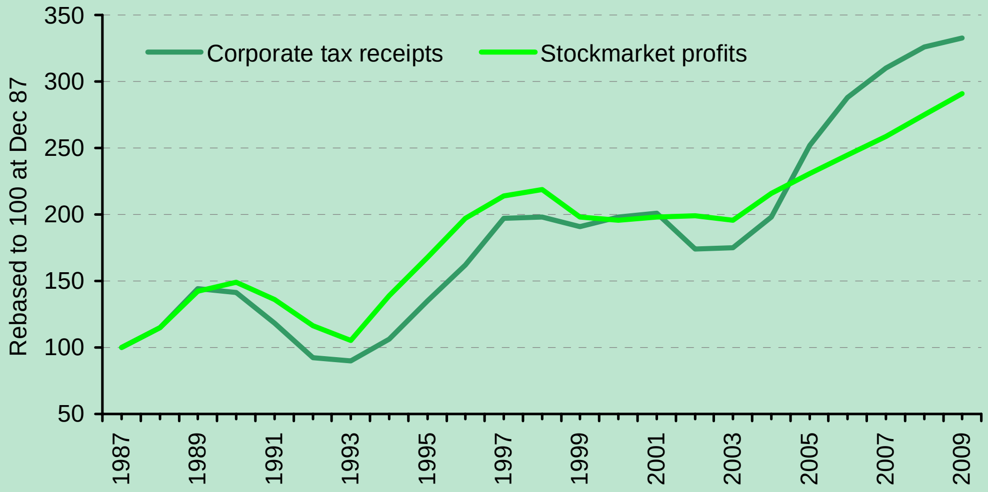
[7] The output gap is assumed to be 1.4% in 2003–04 and 0.8% in 2004–05. This suggests that cyclically adjusted current receipts in 2004–05 are 0.2% of national income higher than unadjusted receipts (0.1×1.4+0.1×0.8). This cyclical adjustment and the estimate of fiscal drag use the estimate published in appendix A of HM Treasury, *End of Year Fiscal Report*, December 2003 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr03/assoc_docs/prebud_pbr03_adend.cfm).

Box 4.1. Company earnings and corporation tax revenues

By Graham Secker (Morgan Stanley)

There has been a close historical relationship between the level of corporate tax receipts and the earnings of companies quoted on the UK stock market (Figure 4.1). But if stock market analysts are right about the likely growth of corporate profits over the next couple of years, the Treasury appears too optimistic about the growth of corporation tax revenues.

Figure 4.1. The Treasury's forecast for Corporation Tax Receipts looks optimistic.



Note: Stockmarket profits from 2005 onwards are based on Morgan Stanley forecasts.
Sources: ONS; MSCI; Morgan Stanley Research.

According to IBES consensus data, the average of forecasts by equity analysts for the profits growth of companies quoted on the UK market is around 12% for 2004, about 8% for 2005 and 5.5% for 2006. Morgan Stanley is slightly more pessimistic, expecting earnings to rise by around 10% in 2004, 7% this year and 6% in 2006. In December's Pre-Budget Report, the Treasury forecast corporate tax receipts (gross of council tax benefit) of £32.9 billion in 2004–05 and £41.3 billion for 2005–06 – implying growth in receipts of 15% in 2004–05 and of 25% in 2005–06.

Further ahead, the Treasury's forecasts for growth in tax receipts are much lower and, as such, more in line with profit expectations from Morgan Stanley and other stock market analysts. From 2006–07 through to 2009–10, the Treasury forecasts that corporate tax receipts (including North Sea revenue) will grow by about 7.2% a year compound (specifically by 14%, 8%, 5% and 2% in each year from 2006–07 to 2009–10). Morgan Stanley expects stock market earnings to grow at a compound rate of no more than 6% per annum over this period – in line with the long-run average earnings growth generated by the UK stock market since 1960. Although the 1.2% differential between the two forecasts is not that significant, it further underlines the Treasury's relative optimism. Based on the Treasury's forecasts, corporate tax receipts are likely to rise from the £28.6 billion for 2003–04 stated in the Pre-Budget Report to about £54 billion by 2009–10. But if Morgan Stanley's earnings forecasts are correct, corporate tax receipts are likely to be only around £43 billion in 2009 – equivalent to a shortfall of about 20% or £11 billion.

Although the Treasury's central scenario is by no means impossible, we note that it has consistently overestimated corporate tax receipts. In the short history of the Pre-Budget Report, we calculate that the average forecast for corporate tax receipts has been 1% higher than the final result for that year (in other words, that the £32.9 billion forecast for 2004–05 in December's Pre-Budget Report is likely to be 1% too high). The Treasury's estimates one year ahead (i.e. 2005–06 for the latest Pre-Budget Report) have been 13% too high. This figure is adversely affected by the unexpected slowdown in corporate profits in 2001 and 2002, but even if we assume that the Treasury's latest forecast for corporate tax receipts in 2005–06 is only 5% too high, this corresponds to a shortfall of £2 billion on its current estimate.

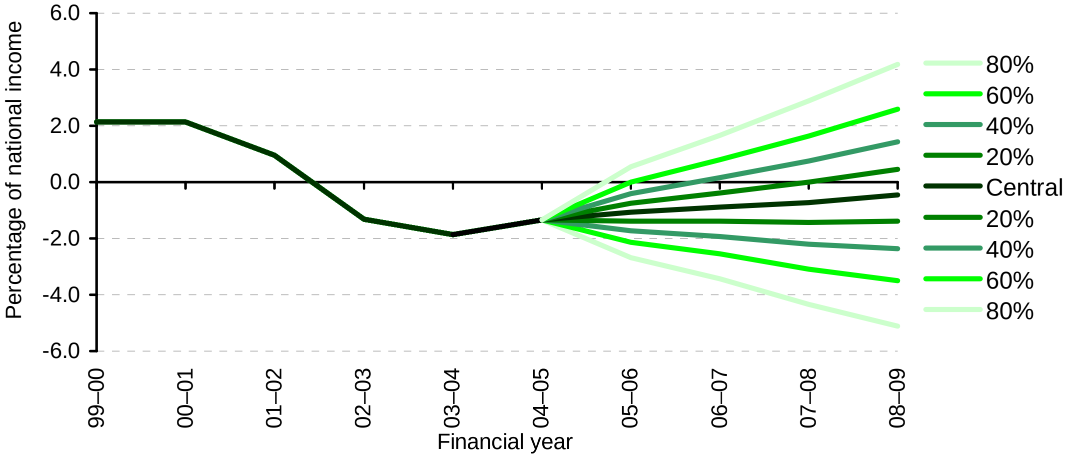
Uncertainties around the baseline Green Budget forecast

As we noted in Chapter 2, when drawing policy conclusions from forecasts for the public finances it is important to take into account the uncertainty around those forecasts. Probabilistic 'fan charts' around the Green Budget baseline forecasts are shown for the current budget balance in Figure 4.2 and for public sector net debt in Figure 4.3. These assume that the forecasting performance of Green Budget projections is broadly the same as that of the Treasury, which is in line with the available evidence.[8] If the Green Budget forecasting performance were worse than that of the Treasury's, then the fans in both of these graphs would be wider.

The 'central' estimates are the same forecasts shown as in Table 4.5. The figures show that there is a 20% probability that the outcome will lie within the darkest bands either side of the central forecast, a 40% probability that it will lie between the next darkest bands, and so on. Figure 4.2 shows, for example, that in 2008–09, there is a 16% chance that the current budget deficit will be greater than 4% of national income and a 45% chance that the deficit will have been eliminated. The probabilities implied by the December 2004 Pre-Budget Report are 10% and 57% respectively. Figure 4.3 shows that the probability of the sustainable investment rule being breached on the Green Budget forecast is 42% in 2007–08 and 50% in 2008–09. The Pre-Budget Report forecast implies probabilities of 28% and 36% respectively.

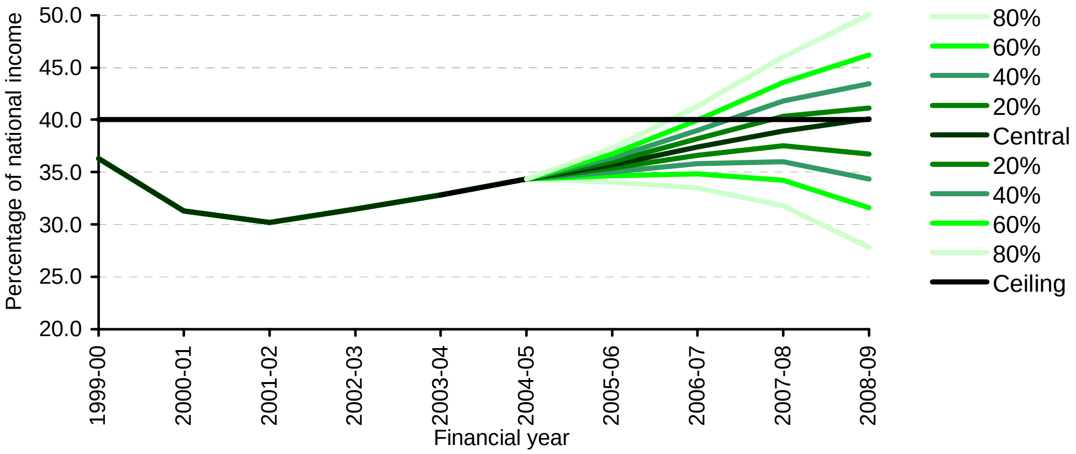
[8] For more details see C. Giles and J. Hall, 'Forecasting the PSBR outside government: the IFS perspective, *Fiscal Studies*, 1998, vol. 19, no. 1.

Figure 4.2. Current budget balance probabilities (Green Budget baseline)



Source: Central projections are taken from Table 4.5 and assume that the Green Budget projection for 2004–05 is correct; methodology for computing fan charts taken from C. Emmerson, C. Frayne and S. Love, 'Updating the UK's code for fiscal stability', IFS Working Paper no. W04/29, November 2004 (http://www.ifs.org.uk/publications.php?publication_id=3163).

Figure 4.3. Probabilities of public sector net debt outcomes (Green Budget baseline)



Notes: Central projections are taken from Table 4.5 and assume that the Green Budget projection for 2004–05 is correct and that any cumulative variation in PSNB from that forecast in the Green Budget projection directly adds to public sector net debt. The second-order impact of changes in debt interest is ignored.
Source: Methodology for computing fan charts adapted from that set out in C. Emmerson, C. Frayne and S. Love, 'Updating the UK's code for fiscal stability', IFS Working Paper no. W04/29, November 2004 (http://www.ifs.org.uk/publications.php?publication_id=3163).

4.4 Alternative macroeconomic assumptions

The Green Budget baseline forecasts for the public finances are based as far as possible on the same assumptions about the behaviour of the macroeconomy as the December 2004 Pre-Budget Report forecasts. In particular, this implies that the economy enjoys two years of above-trend growth until spare capacity is exhausted and that growth thereafter is a 'cautious' quarter of a percentage point below the Treasury's central expectation of trend growth. This does not imply a judgement that the Treasury's forecasts for the macroeconomy are the mostly likely outcome, but rather makes it possible to assess whether the Treasury's projections for the public finances are consistent with its view of the economy.

In this section, we also adjust the baseline Green Budget forecast to reflect two alternative scenarios for the macroeconomy (discussed in greater detail in Section 3.4):

- The **Morgan Stanley central case** assumes that growth is weaker in the near term (in part reflecting the assessment that there is no longer any spare capacity in the economy). Growth is then a quarter of a percentage point higher each year than the Treasury's assumption in the medium term (because it is not deliberately 'cautious'). But this is still fractionally lower than the constant trend growth rate of 2.55% a year assumed by Morgan Stanley, so a modest negative output gap opens up.
- The **Morgan Stanley 'worse' case** assumes that consumer spending is severely depressed, perhaps as result of a sharp correction in the housing market. Under this scenario, growth is much weaker than the baseline over the next two years and remains below even the Treasury's 'cautious' growth assumption until the end of the forecasting period. This pushes economic activity well below potential.

Table 4.7 shows the outlook for the public finances under the Green Budget baseline and the two alternative scenarios, plus the forecast from the Pre-Budget Report.

As we saw in the previous section, the Green Budget baseline predicts a weaker current budget balance (actual and cyclically adjusted), larger public sector net borrowing and higher public sector net debt over the next five years than the Pre-Budget Report. Public sector net debt reaches the 40% level in 2008–09 and exceeds it in 2009–10.

Using the Morgan Stanley central case macroeconomic assumptions, we find that borrowing is higher over the next two years than in the baseline because of weaker economic growth, but then moves in line with the Green Budget baseline. Morgan Stanley's assumptions regarding the initial level of spare capacity and future trend growth mean that the cyclically adjusted current budget is slightly stronger at the end of the forecasting period than in the Green Budget baseline, but much weaker than in the Pre-Budget Report. Under this scenario, the extra borrowing pushes up public sector net debt and the sustainable investment rule is breached a year earlier, in 2008–09.

Using the Morgan Stanley 'worse' case macroeconomic assumptions, we find not only that the current budget deficit is larger than in the Green Budget baseline – as we would expect given the relative weakness of growth assumed for the next three years – but also that the current budget deficit continues to widen as a share of national income as economic activity falls further and further below potential. Rather than improving steadily as a share of national income as in all the other scenarios, the cyclically adjusted current budget deficit remains at just over 1% of national income, partly because of mounting debt interest payments. Public sector net debt also increases much more rapidly, breaching the 40% level in 2006–07 and exceeding 50% of national income in 2009–10.

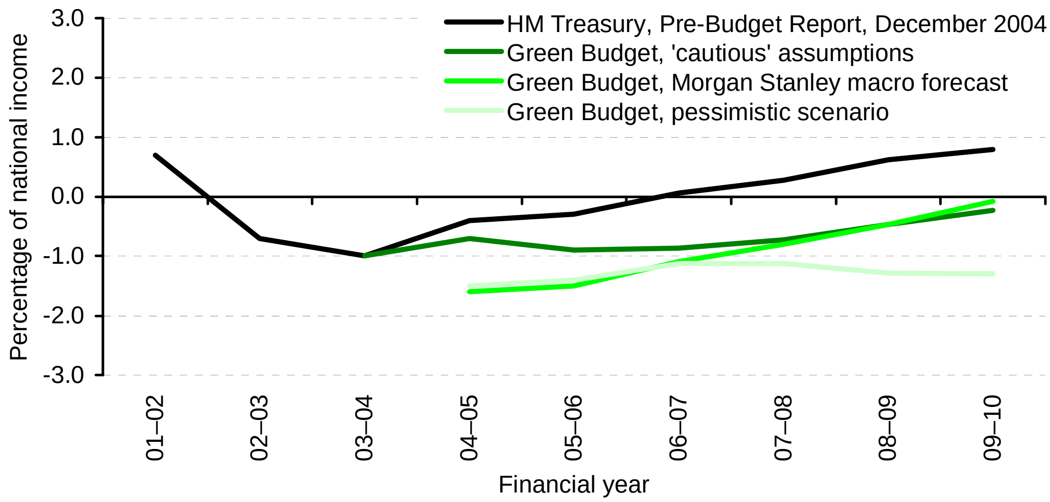
Table 4.7. HM Treasury and IFS public finance forecast under alternative macroeconomic scenarios

	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Treasury Pre-Budget Report forecasts (PBR 'cautious' macro assumptions)						
GDP growth	3¼	3	2½	2¼	2¼	2¼
Output gap (% potential GDP)	-0.80	-0.10	0.00	0.00	0.00	0.00
Public finance forecasts (% GDP)						
Current budget surplus	-1.1	-0.6	0.0	0.3	0.6	0.8
Cyclically adjusted current budget surplus	-0.4	-0.3	0.1	0.3	0.6	0.8
Net borrowing	2.9	2.7	2.2	2.0	1.6	1.5
Net debt	34.3	35.4	36.2	36.8	37.0	37.1
Green Budget baseline (PBR 'cautious' macro assumptions)						
GDP growth	3¼	3	2½	2¼	2¼	2¼
Output gap (% potential GDP)	-0.80	-0.10	0.00	0.00	0.00	0.00
Public finance forecasts (% GDP)						
Current budget surplus	-1.4	-1.1	-0.9	-0.7	-0.5	-0.2
Cyclically adjusted current budget surplus	-0.7	-0.9	-0.9	-0.7	-0.5	-0.2
Net borrowing	2.9	3.0	3.1	3.0	2.7	2.5
Net debt	34.3	35.7	37.4	38.9	40.1	41.0
Alternative Green Budget scenario I (Morgan Stanley central macro case)						
GDP growth	2.86	2.13	2.83	2.50	2.50	2.50
Output gap (% GDP)	0.40	0.20	0.00	0.10	-0.10	-0.30
Public finance forecasts (% GDP)						
Current budget surplus	-1.4	-1.3	-1.1	-0.8	-0.5	-0.3
Cyclically adjusted current budget surplus	-1.6	-1.5	-1.1	-0.8	-0.5	-0.1
Net borrowing	2.9	3.2	3.3	3.0	2.8	2.5
Net debt	34.3	35.9	37.8	39.3	40.6	41.7
Alternative Green Budget scenario II (Morgan Stanley 'worse' macro case)						
GDP growth	2.76	0.66	1.44	2.00	2.25	2.25
Output gap (% GDP)	0.30	-1.70	-2.80	-3.20	-3.20	-3.70
Public finance forecasts (% GDP)						
Current budget surplus	-1.4	-2.2	-2.9	-3.3	-3.5	-3.8
Cyclically adjusted current budget surplus	-1.5	-1.4	-1.1	-1.1	-1.3	-1.3
Net borrowing	2.9	4.1	5.2	5.7	5.9	6.2
Net debt	34.3	36.7	40.4	44.3	48.4	54.5

Figures 4.4 and 4.5 show the projections for the cyclically adjusted current budget balance and public sector net debt under each of the scenarios. They underline the fact that the Green

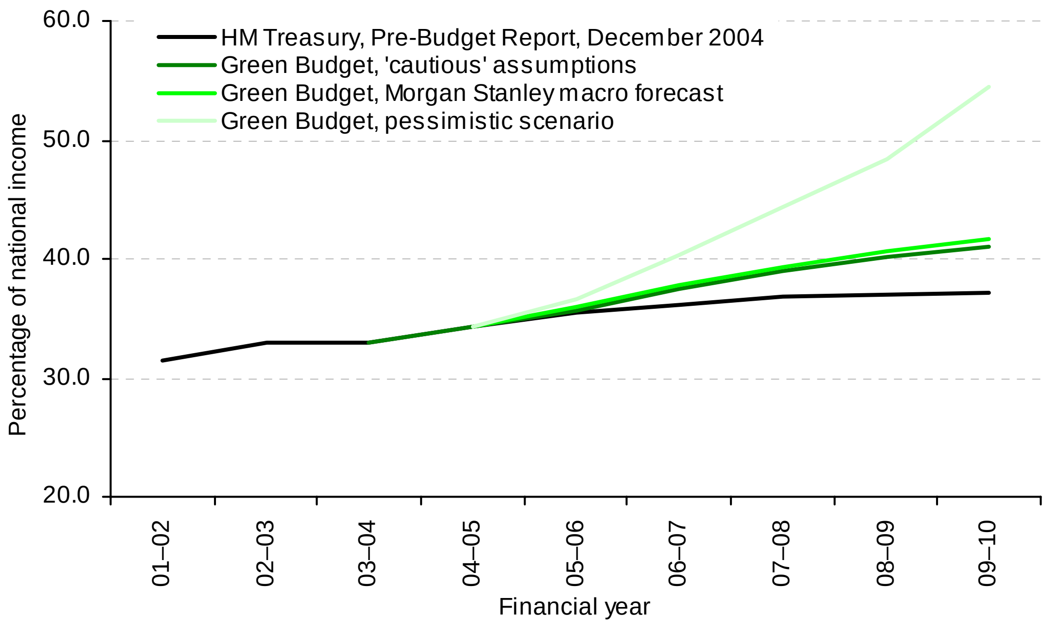
Budget baseline forecast shows the sustainable investment rule set to be broken even if the economy evolves as the Treasury assumes – and more quickly if growth is weaker than it assume over the next two or three years. The scenarios also show the current budget remaining in deficit throughout the forecasting period, suggesting that the golden rule would be broken over the next economic cycle unless it is much longer than past cycles. On the Morgan Stanley 'worse' case scenario the rule would probably be broken however long the next cycle lasts, as mounting debt interest costs outweigh the proceeds of fiscal drag.

Figure 4.4. Cyclically adjusted current budget balance forecasts



Sources: Authors' calculations and Treasury forecasts from HM Treasury, Pre-Budget Report, Cm. 6408, London, December 2004.

Figure 4.5. Public sector net debt forecasts



Sources: Authors' calculations and Treasury forecasts from HM Treasury, Pre-Budget Report, Cm. 6408, London, December 2004.

4.5 The fiscal rules and the Budget judgement

The current cycle

The Treasury assumes that the current economic cycle covers the seven financial years from 1999–2000 to 2005–06. To meet the golden rule over this cycle, the current budget must be in balance or surplus on average over the seven years. Over the first five years of the cycle, there has been an average surplus of 0.4% of national income. In the Pre-Budget Report, the Treasury predicted a deficit of 1.1% of national income this year and 0.6% next year, which would reduce the average surplus to 0.1% of national income (equivalent to a cumulative £5 billion in today's terms or £8 billion if the contingency reserve within annually managed expenditure is not spent). The Green Budget baseline predicts a deficit of 1.4% of national income this year and 1% next year, which would mean an average deficit of 1.1% of national income. The golden rule would therefore be broken by a cumulative £6½ billion (or £5½ billion if the contingency reserve within annually managed expenditure is not spent). (See Table 4.8.) Given the size of past forecasting errors, if the Green Budget forecast for 2004–05 is correct, there would only be a one-in-three chance of meeting the rule with a year to go. In order to give himself even a 50-50 chance of meeting the rule, the Chancellor would have to announce tax increases worth £6.5 billion in this year's Budget. As discussed in Section 6.4, if the Spring 2005 Budget is to be the last Budget of this parliament, then on the basis of previous experience of pre-election Budgets, it is unlikely to contain a net tax increase.

Table 4.8. The golden rule under the Green Budget baseline forecast

% of national income	2003-04	2004-05	2005-06	2006-07	2007-08	2008-09	2009-10
Surplus on current budget	–1.9	–1.4	–1.1	–0.9	–0.7	–0.5	–0.2
Average surplus since 1999–2000	0.4	0.1	–0.1				
Average surplus since 2005–06			–1.1	–1.0	–0.9	–0.8	–0.7
Average surplus since 2006–07				–0.9	–0.8	–0.7	–0.6

Given the uncertainties around forecasts of the current budget balance even just a year ahead, it therefore seems more likely than not that the golden rule will be broken over a seven-year cycle ending in 2005–06, although it is by no means impossible that it will be met. It would be embarrassing for the Chancellor to break the golden rule at his first attempt, but it is highly unlikely that he will increase taxes this year by enough to make a breach of the rule a remote possibility. To all intents and purposes, whether the golden rule is met or not over the current cycle is now in the lap of the gods. But it looks likely to be met or missed by a relatively small margin and the potential political consequences of a small breach would seem likely to be greater than the economic ones.

If the Chancellor accepts the view outlined in Chapter 3 and by a number of independent forecasters – that spare capacity in the economy has probably been exhausted and that the cycle therefore came to end during the current financial year – the Green Budget baseline forecast suggests that there will have been an average current budget surplus over the present economic cycle of 0.1% of national income and the golden rule will be met. Whether the cycle ends this year or next, the sustainable investment rule will clearly be met.

All this suggests that the aggregate tax and spending decisions taken in this year's Budget should focus on ensuring that the fiscal rules are likely to be met with an appropriate margin for error over the next cycle rather than doing anything dramatic to ensure it is met over this one. As discussed in Chapter 6, recent history suggests that any fiscal tightening, if necessary, would be more likely to begin after the election. So what does the outlook over the next cycle imply for the decisions that should be taken?

The next economic cycle

It is impossible to say definitively if and by how much taxes need to rise (or spending plans need to be cut) to meet the golden rule and sustainable investment rule over the next economic cycle, because we do not know how long that cycle is going to be. And if the cycle is of typical six- or seven-year duration, it will extend beyond the forecasting horizon.

But given the outlook for the public finances as we move into the next cycle, the Green Budget baseline forecast (and the scenarios based on alternative macroeconomic prospects) strongly suggest that some tightening of policy will be necessary to convince people that the rules can be kept to under any reasonable assumption about the cycle's length.

If the Treasury is correct that the current cycle ends next year, the Green Budget baseline forecast suggests that the next cycle will begin with a current budget deficit of 0.9% of national income in 2006–07, falling to 0.2% of national income in 2009–10. If the current budget improved thereafter by 0.2% of national income a year through fiscal drag, we would need to expect the next cycle to last nine years for the Chancellor even to have a 50-50 chance of meeting the golden rule. Not only is a cycle of this duration longer than the historic average (although not impossible), the Treasury has said that it is unrealistic to assume that fiscal drag can be allowed to continue unimpeded beyond the normal medium-term forecasting horizon of five years. If the current cycle is already in its final year, the chances of meeting the rule over the next cycle are even lower – it would begin with a current budget deficit of 1% of national income in 2005–06 and need to last 11 years for the Chancellor to have a 50-50 chance of success. In any event, whether the next cycle begins in 2005–06 or 2006–07, the Green Budget baseline forecast suggests that it is more likely than not that the sustainable investment rule would be breached by 2009–10. So, on this baseline forecast, there would be no cycle simultaneously long enough for the golden rule to be met and short enough not to see debt exceeding 40% of national income without some tightening of policy.

Given the uncertainty over the duration of the cycle, we can estimate the appropriate degree of fiscal tightening based on the Green Budget baseline forecast in a number of different ways by asking a series of different questions.

There are two ways of assessing what magnitude of tax increase would be required under the Green Budget forecast for the public finances to be in as strong a position as the Chancellor sought in the last Budget. They both point to a tax increase of at least £11 billion:

- **By how much would taxes need to rise for the Chancellor to expect to begin the next cycle in as strong a position as he signalled he was looking for in last year's Budget?** The Chancellor signalled in Budget 2004 that he wanted to begin the next cycle in 2006–07 with the current budget in balance. This would require a tax increase in the forthcoming Budget worth 0.9% of national income or £11 billion in 2005–06 terms. Or, given the looming election, if he wanted to wait a year and match the Budget 2004 figure for 2007–08, he would need to raise taxes starting in April 2006 by 1.0% of national income or £13 billion.
- **By how much would taxes have to rise for the Chancellor to achieve a current budget surplus of 0.7% of national income at the end of the forecasting horizon, as he has done in recent Budgets?** The Green Budget baseline forecast predicts a current budget deficit of 0.2% in 2009–10, so this would again require a tax increase worth 0.9% of national income or around £12 billion in 2005–06 terms. But this could be phased in over time.

Alternatively, the Chancellor could decide that, perhaps as a result of having gained economic credibility since coming to office in 1997, it was no longer necessary to plan ahead with a better than 50% chance of meeting the golden rule in the future. If this were the case, then there are two ways of assessing the magnitude of tax increase that would be required. These point to a tax increase of between £4½ billion and £7½ billion:

- **By how much would taxes have to rise in April 2006 to meet the golden rule over a seven-year cycle beginning in 2006–07?** Assuming (like the Treasury) that fiscal drag is not allowed to continue indefinitely and that in its absence the current budget deficit does not change beyond the end of the forecasting horizon, a tax increase worth £5½ billion in Budget 2006 (i.e. to give an extra 3.0% of one year's national income over seven years) would give the Chancellor a 50-50 chance of meeting the rule. This is a much smaller probability than the Chancellor was looking for even three or four years from the end of the current cycle, suggesting that a significantly bigger tax increase would be needed to give him the comfort he has looked for in the past.
- **By how much would taxes need to rise from April 2006 to meet the golden rule over a seven-year cycle beginning in 2005–06?** Assuming again that fiscal drag is not allowed to continue indefinitely, a tax increase worth £8 billion in Budget 2006 (i.e. to give an extra 3.8% of one year's national income over six years) would give the Chancellor a 50-50 chance of meeting the rule. Again, on past performance, the Chancellor would want a higher probability than this of meeting the rule and therefore would need a bigger increase.

Alternatively, the Chancellor or his successor could choose to cut current spending rather than raise taxes to achieve the same improvement in the current budget. However, the current spending plans, which run to March 2008, were only set out last July and the Chancellor has emphasised the advantages of allowing departments to be able to plan ahead.[9] This suggests that he is not likely to revise down the plans set out in the July 2004 Spending Review. In any case, on the basis of previous performance, the current Chancellor would be more likely to choose to increase taxes rather than to cut current spending. For example, the April 2002 Budget made the explicit choice to increase taxes to finance higher current spending. It is possible that this will not continue in the future; in this case, reductions in current spending of the same magnitude as the tax increases described in this chapter would be required.

The answers to these questions all suggest that there is a strong case for a rise in taxes worth at least £11 billion to signal that the government is committed to meeting its fiscal rules over the next economic cycle with a degree of comfort to reflect the uncertainties around any projection for the public finances. The longer the adjustment is delayed, the larger and more abrupt it is likely to have to be. That suggests that the Chancellor should certainly take action in Budget 2006, if he is not prepared to do so in the run-up to the election.

Last year's Green Budget concluded that tax increases worth up to £13 billion would be needed to go into the next cycle in as strong a position as the Chancellor was looking for in Budget 2003. The figure this year is lower not because the Green Budget baseline forecast is more optimistic than last year's, but rather because the Treasury signalled in Budget 2004 that it was content to go into the next cycle with a weaker fiscal position than it was looking for in Budget 2003. The implication is that the Treasury is happy to accept a lower probability of meeting the golden rule in the next cycle than it was a year ago. Given the uncertainties around both the outlook for the public finances and the length of the next cycle, it is important for the Chancellor to clarify as soon as possible how he intends to measure progress against the golden rule as we move out of this cycle into the next.

It is also possible to assess the plans set out by the two main opposition parties to see the extent to which, if implemented, they would comply with the Chancellor's fiscal rules. The Liberal Democrats' plans imply a similar profile for the current budget to the government's plans since their proposed net tax increase is to be spent on increases in spending. Hence the size of any shortfall under the Liberal Democrats would be the same as under Labour. The Conservatives, however, are planning to cut public spending by more than taxes. Box 4.2 assesses whether this would be consistent with the Chancellor's golden rule, to which they have also subscribed.

[9] For example, 'The Government has introduced a series of important reforms to the public expenditure framework to ensure that the right incentives are in place for departments to plan effectively and spend efficiently, including firm and fixed DEL budgets for three years, allowing departments, and in future local authorities, to plan with greater certainty over the medium term' from paragraph 1.20, page 8 of HM Treasury, *Spending Review 2004*, July 2004, HM Treasury, London (http://www.hm-treasury.gov.uk/media/53F/FE/sr2004_ch1.pdf).

Box 4.2. The Conservatives' tax and spending plans

On 17 January 2005, the Conservative Party promised to cut taxes by £4 billion in its first Budget, published detailed spending plans for 2007–08 and reaffirmed its goal of cutting public spending overall by around 2% of national income by 2011–12.[a]

IFS will publish a detailed comparison of the parties' tax and spending plans closer to the general election, but we take the opportunity here to make a preliminary assessment of the latest Conservative plans in the light of our baseline forecast.

The table below shows the net impact of the Conservatives' tax and spending plans. They intend to cut taxes by £4 billion on taking office, which we assume will reduce current revenues by 0.3% of national income each year from 2006–07. Assuming that their spending cuts reduce investment and non-investment spending proportionately, we estimate that the Conservative plans would reduce current spending by 0.3% of national income in 2006–07, rising to 2% of national income in 2011–12.

Table 4.9 Impact of Conservatives tax and spending plans

% of national income	**2006–07**	**2007–08**	**2008–09**	**2009–10**	**2010–11**	**2011–12**	***Average***
Net tax cut	–0.3	–0.3	–0.3	–0.3	–0.3	–0.3	*–0.30*
Net current spending change	–0.3	–0.5	–0.8	–1.1	–1.6	–2.0	*–1.05*
Net current budget tightening	0.0	0.2	0.5	0.8	1.3	1.7	*0.75*

The net effect would be to leave the current budget deficit unchanged in 2006–07 and then to progressively reduce it. By 2011–12, the current budget balance would be 1.7% of national income stronger under the Conservative plans than the government's. These figures suggest that the Conservative plans would be equivalent in their net impact on the current budget balance over six years to an upfront tax increase of 0.75% of national income or around £9 billion.

This is somewhat smaller than the tax increase that we estimate Gordon Brown would have to implement to get the public finances back onto the path he was looking for in Budget 2004. But as the relative tightening of policy under the Conservatives increases with every passing year, their initial tax-cutting package would be consistent with a fiscal position as strong as the government's as long as further tax cuts were delayed until some way into a second Conservative term.

However:

- This assumes that the spending plans are achievable. The Conservatives have explained in detail how they intend to achieve a net £12 billion cut in spending in 2007–08, partly by slimming the role of government and partly through efficiency savings such as those being sought through the current government's Gershon Review. But it cannot be guaranteed that these plans will achieve the savings claimed for them or, if they can, over what timescale. The detailed plans also achieve only a small part of the overall cut in public spending intended by 2011–12. It may be that the Conservatives will have to rely more on efficiency savings and less on further cuts in government activity beyond 2007–08, which would be harder to achieve.
- A £4 billion cut in taxes is relatively modest, and the Green Budget projections suggest that it is unlikely that the Conservatives would have scope to cut taxes further during a first parliament even if they continued to cut spending over the six-year profile they have proposed. The planned tax cut is much smaller than the tax increase announced by the government in Budget 2002, when national insurance contributions were increased. At around 0.3% of national income, it will also offset less than a quarter of the rise in the tax burden and current receipts in prospect between 2005–06 and 2009–10. So in all probability the tax burden will be higher at the end of a first Conservative term than it is now, albeit slightly lower than if Labour is re-elected.

[a] http://www.conservatives.com/tile.do?def=news.story.page&obj_id=118770