

# 1. Summary

## Chapter 2: The public finances under Labour

- The evolution of the public finances since 1997 mirrors the first 12 years of Conservative governments after 1979: three years of impressive fiscal consolidation, eight years of drift (masked by economic overconfidence), and then a big jump in borrowing thanks to recession and newly-discovered structural weaknesses.
- Labour entered the current crisis with one of the largest structural budget deficits in the industrial world and a bigger debt than most OECD countries, having done less to reduce debt and – in particular – borrowing than most since 1997. Debt interest payments had fallen significantly since 1997, but less than in most OECD countries.
- Public sector borrowing is set to reach a post-war high next year, with public sector net debt in 2013–14 reaching its highest level since the early 1970s. Rising debt and cuts in investment will reduce the estimated net worth of the public sector – its assets minus liabilities – to less than half the level that Labour inherited from the Conservatives.
- The looming squeeze on public spending means that, even once the economy is back at trend in 2014–15, the Treasury plans imply that over the following two years only 21% of the ‘proceeds of growth’ will be consumed by the public sector. This is down from 44% under Labour to date and 29% under the previous Conservative governments.
- The Pre-Budget Report announced a net tax cut for 2008–09 and 2009–10 and a net tax rise for 2010–11 onwards. These help reduce tax revenues over the next two years, and increase them thereafter. This will smooth the path of after-tax incomes – national income less tax revenues will grow at a steady rate over these six years despite the forecast slowdown and subsequent recovery in the economy.
- From 1996–97 to 2007–08, the Treasury estimates that real national income rose by £12,700 per family – of which families are paying £5,600 more in tax, leaving them with £7,100 more income after tax. Between 2007–08 and 2013–14, the Treasury expects real national income to rise by £4,900 per family – of which £1,900 will be taken in tax, leaving an increase in after-tax income of £3,000.
- The revisions to the Treasury’s public finances forecasts in the PBR were far larger than average, but not dissimilar from those seen at the outbreak of the last recession in the early 1990s. There is always considerable uncertainty around all public finance forecasts, but there is good reason to be particularly wary in the current situation.

## Chapter 3: The fiscal impact of the credit crunch

- The credit crunch has probably imposed a permanent cost on the exchequer of around 3.5% of national income – just over £50 billion a year in 2008–09 terms. The government has responded with a fiscal squeeze starting next year that will reach 2.6% of national income a year (or around £38 billion in 2008–09 terms) by 2015–16. This will largely take the form of a cut in spending as a share of national income.

- The Pre-Budget Report forecasts imply that public sector net debt will be 21.1% of national income higher in 2013–14 than in 2007–08. This is equivalent to almost £10,000 for every family in the UK. But only about one-fifteenth of this increase is due to the temporary fiscal stimulus announced in the PBR. The weaker outlooks for the economy and asset markets are the main drivers.
- If the average interest rate faced by the government remains at current low levels, then the fiscal squeeze may still have to remain in place until the early 2030s before public sector debt falls back below 40% of national income. But the cost to the taxpayer of financing this debt would remain low by historical standards, with net interest payments remaining well below the 3.0% of national income paid in the last year that the Conservatives were in office, 1996–97.
- But if the interest rate faced by the government rose to that of the mid-1990s, then the burden of financing debt would rise gradually but unsustainably, requiring a bigger fiscal tightening – further tax increases or spending cuts – to keep it in check. An even sharper rise in borrowing costs would make the intensification of the squeeze more urgent just to avoid debt and interest payments exploding.
- Much of the focus on the PBR has been on those who will lose from the increases in tax. But to return tax and spending to around their pre-credit-crunch levels, the PBR cut spending by much more than it increased taxes. As a result, real spending by government departments in 2013–14 could be around 3% or £22 billion lower than projected at Budget time. Thus the largest group of losers from the PBR will be those who would have benefited from this forgone public spending.

## Chapter 4: The economic outlook

- The UK economy is already in recession and the near-term outlook is worse than it has been for many years. But our central forecast is that the UK will avoid a deep and prolonged recession, thanks to enormous monetary and substantial fiscal stimuli already announced. However, we expect a decidedly slow recovery.
- Our central forecast is similar to the Treasury's in the near term, but has weaker growth than the Treasury expects in 2012–13 and 2013–14. We agree with its assessment that the credit crunch will reduce the productive potential of the economy by about 4%, albeit more slowly than the Treasury expects.
- Weak consumer spending and investment will be the main drivers of the recession and continued below-trend growth. With credit conditions likely to remain tight, and given high indebtedness, consumers in aggregate will increase their saving rates and companies will cut investment.
- The risks to this outlook remain skewed to the downside. A sharp change in household behaviour could drive the saving rate much higher and consumer spending sharply lower. But there are upside risks too. In particular, there may be positive supply-side responses to the shocks, which would reduce the loss of productive potential and allow the economy to sustain a stronger recovery.

## Chapter 5: The fiscal rules and policy framework

- In 1997, the government promised to abide by two fiscal rules that constrain how much it borrows and to what purpose. It claims to have met them over an economic cycle running from 1997 to 2006, but they had already lost credibility as a meaningful constraint on policy prior to the current crisis.
- Having overachieved the golden rule by delivering an average current budget surplus of £2 billion a year over the last economic cycle, Labour now expects an average current budget deficit of £37 billion a year over the next. This would be a much larger average deficit than in either of the two cycles under the previous Conservative government.
- The headline measure of public sector net debt could rise to around 170% of national income now that RBS is to be treated as a public corporation – or to around 240% if Lloyds Banking Group is treated similarly. But whether these investments will increase or reduce debt in the long term remains uncertain.
- Given the scale of the shock to the public finances resulting from the credit crunch, the government has sensibly decided to suspend the rules rather than taking the draconian decisions necessary to adhere to them.
- The government's 'temporary operating rule' offers it considerable flexibility in setting fiscal policy, but it may not be seen as much of a constraint on tax and spending decisions. In practice, the verdict of the financial markets may be the main constraint and the government's loss of credibility in the past may make a rise in its borrowing costs more likely.
- The government should consider adopting a target for future debt servicing costs and other commitments imposed on future taxpayers, rather than the stock of public sector net debt. The government could also commit to overachieving the golden rule by an amount sufficient to 'pre-fund' any increase in public sector pension costs that its actions impose on future taxpayers.
- The government should consider creating a properly funded independent body, with access to all the information currently available to the Treasury, to prepare fiscal forecasts and recommend to the Chancellor what fiscal tightening or loosening would be consistent with meeting the fiscal rules.

## Chapter 6: Green Budget public finance forecasts

- Our central forecast is for public sector net borrowing and the current budget deficit to be £6.6 billion bigger this year, and £6.4 billion bigger next year, than forecast in the November 2008 Pre-Budget Report.
- Assuming that the economy evolves largely as the Treasury expects, over the medium term we are around 1.3% of national income – or around £20 billion in today's terms – less optimistic than the Treasury about the current budget balance and public sector net borrowing. This reflects a weaker outlook for receipts from income tax, National Insurance contributions and corporation tax.

- If the economy evolves as the PBR predicted, we would expect the current budget balance to move from a peak deficit of 5.7% of national income in 2009–10 to a deficit of 2.4% of national income in 2013–14. Of this 3.3% of national income forecast improvement, 1.8% of national income comes from a forecast fall in current spending and 1.5% of national income from a forecast increase in the tax burden.
- We would also predict higher levels of public sector net debt – excluding the impact of the temporary interventions in financial institutions – than the Treasury, expecting it to rise to 62.1% of national income in 2013–14. In contrast, the Treasury forecasts that it will be at 57.4% in that year.
- There is considerable uncertainty around any fiscal forecast, and even more so in the present climate. If the economy were to follow Morgan Stanley’s central case, we would expect the current budget in 2013–14 to be 2.8% of national income worse than the Treasury predicts. Under its ‘pessimistic case’, this gap rises to 6.4% of national income. Even under its ‘optimistic case’, where public sector net borrowing would be back in balance in 2013–14, net debt would still hit a peak of 47.3% of national income. This would be the highest level since 1977–78.
- Our forecasts suggest that to expect to achieve the improvement in the public finances set out in the PBR would require some combination of spending cuts and tax increases sufficient to raise an extra £20 billion or so by the end of the next Parliament. In current circumstances, the cost of doing nothing, should action be required, is larger than the cost of acting, only to find that it was unnecessary and can subsequently be reversed.

## **Chapter 7: Funding government borrowing**

- The government’s ballooning budget deficit will soon require it to issue debt on a scale last seen at the end of the Second World War. On its 2008 Pre-Budget Report projections, the government will have to issue about £630 billion in gilts over the next five years, £300 billion more than it expected at Budget time.
- But demand for government debt is likely to remain firm. UK households, insurance companies and pension funds may all wish to hold more gilts, but the main source of additional demand is likely to be banks looking for liquid assets with little risk attached.
- The state of the economy means that demand for short-dated gilts is strong relative to demand for long-dated gilts. The Debt Management Office can therefore help keep the cost of government borrowing down by issuing relatively more short-dated gilts while current market conditions persist.
- Taken at face value, recent movements in the credit default swap (CDS) market suggest that investors see a more-than-7% chance that the UK government will default on its debt. But this probably reflects unusual developments in this market rather than a genuine belief that there is a 1-in-15 chance of default.
- Firm demand for gilts – combined with a sensible approach to issuance from the Debt Management Office – should keep gilt yields low by historical standards, allowing a further decline in the average coupon paid on the outstanding stock of gilts. But there is clearly a risk that the surge in issuance could push gilt yields higher. Even if it does

not, the total amount the government will have to pay in interest will rise because the stock of debt goes up so much.

## Chapter 8: Government and the financial sector

- The financial crisis has forced governments in the UK and elsewhere to intervene in the financial sector in a way that had long been unthinkable.
- The scale of the intervention in the UK is enormous, but the long-term costs to taxpayers could well be small – they may even make a profit. That said, the downside risks are huge because the payoffs on the support measures are asymmetric: taxpayers are much more likely to make big losses than big profits.
- If the government forces the banks to lend on a scale and at interest rates more generous than they would have chosen for themselves, this could increase the direct cost to taxpayers. But if it does not force the banks to do so, the cost in lost tax revenue of deepening or extending the credit crunch could be greater.
- Three reforms could help stop the current difficulties reoccurring. First, reintroducing housing costs into the measure of inflation targeted by the Bank of England might provide limited protection against housing bubbles. Second, capital adequacy requirements need to be higher in the long term and counter-cyclical. Third, better incentives are needed to promote responsible lending and borrowing.

## Chapter 9: Public spending: set for a squeeze

- The government is projecting much slower growth in public spending over its next Spending Review than over any of its previous reviews – and slower than under the 18 years of Conservative governments from 1979 to 1997. The increase of 1.1% a year in real terms would cut public spending by 2.5% of national income over three years – £37 billion in today's terms.
- The squeeze on Whitehall departments may be even more severe, given plausible scenarios for social security and tax credit costs, net debt interest payments, and other non-departmental spending. Total departmental spending may well have to be frozen in real terms over the three years.
- In that event, most departments are likely to see real cuts, with only high priorities such as health and education being allocated any real growth – and even these may see their budgets cut as a share of national income. Capital-intensive departments, such as transport and housing, are likely to suffer more than most due to the planned cash freeze on investment spending.
- The spending squeeze also has implications for some specific government objectives. Earnings indexation of the basic state pension is likely to be delayed, pushing up pensioner poverty. The government is also projected to miss its child poverty target for 2010 – and unless additional resources can be found, it could stay above the target for some time after 2010–11. Lower growth in education spending is likely to squeeze public funding for higher education, which could force funding reforms that may conflict with the government's objectives to widen and increase participation.

## Chapter 10: Value added tax

- VAT is an important source of government revenue, forecast to raise £82.6 billion or 16% of total tax receipts in 2008–09. Like taxes on earnings, VAT distorts the choice between leisure and consumption. Because VAT is applied at different rates to different goods and services, it also distorts people's spending decisions and firms' production decisions. In its current form, it is mildly progressive, not regressive as some commentators suggest.
- The temporary cut in the standard VAT rate from 17.5% to 15% is a better stimulus measure than its critics suggest. We estimate that the VAT cut will reduce prices on average by 1.2%. Past experience suggests this may lead people to buy 1.2% more goods and services. Those dismissing it as a failure ignore the likelihood that things would have been even worse without it.
- The government considered an increase in the rate of VAT to 18.5% in 2011–12. This would have acted as a stimulus to expenditure before that date, as well as raising about £5 billion per year thereafter. Whilst, on its own, such a change would be less progressive than further increases in National Insurance, it would be possible to compensate most poorer households.
- Broadening the VAT base by extending the standard rate to most goods and services would remove many of the distortions to consumption decisions caused by the current system and would raise significant revenue even after more than compensating poorer households on average. For instance, a net £10 billion could be raised, with the rest of the revenues used to help meet the child poverty targets and compensate poorer households, households with children, those with disabilities and pensioners.

## Chapter 11: Income tax and National Insurance

- Budget 2007 proposed a very simple set of combined income tax and National Insurance rates. Since then, however, changes have been announced, to come into effect by 2011–12, that would create a system where key elements of the two systems are misaligned and which involves a complicated structure for marginal tax rates on incomes above £100,000 a year.
- The government has proposed two 60% income tax bands, between £100,000 and £106,475 and between £140,000 and £146,475, to come into effect from 2010–11. These are likely to distort quite considerably the behaviour of people who expect to fall into these bands. If individuals at the top of the income distribution are more responsive to changes in their marginal tax rate than individuals lower down the distribution, there may be a case for having a lower marginal tax rate at the very top of the income distribution than slightly lower down. But it seems very unlikely that the optimal tax schedule has these two large spikes in it.
- It would appear that the Treasury has assumed that there will be a considerable behavioural response to the new 45% tax rate on incomes over £150,000. However, it is very difficult to estimate how much revenue reforms such as these would raise, as it requires accurate information about income growth at the top of the income distribution, the shape of the income distribution and the responsiveness of the very

rich to changes in their marginal tax rates. All of these are subject to a high degree of uncertainty, and the Treasury has so far declined to publish the assumptions it made when estimating how much these measures will raise.

- We present two alternative reforms that aim to realign the income tax and National Insurance thresholds in revenue-neutral and broadly distributionally-neutral ways.

## Chapter 12: Business taxation

- Finance Bill 2009 will move the UK to an exemption system under which most foreign dividends will be exempt from UK taxation. This is a welcome move that will put the UK more in line with other European countries and should help UK multinationals to make more productive use of their assets.
- The planned increase in the small companies' rate of corporation tax from 21% to 22% in April 2009 has been deferred by one year as part of a package aimed at supporting small businesses during the recession. This deferral is unlikely to be very effective, and maintains a greater artificial incentive for businesses to change legal form for tax purposes. The government would be better to settle on a small companies' rate and support small businesses by other means. In the long term, it is not clear that there should be separate tax rates for large- and small-profit firms.
- Empty properties with a rateable value of less than £15,000 will be exempt from business rates for the financial year 2009–10, but will be taxed again from April 2010. Neither regime is neutral towards the use of land.