6. Green Budget public finance forecasts

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Summary

- 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.

6.1 Introduction

This chapter presents the IFS public finance forecasts and discusses them in the context of the government's new temporary operating rules for the public finances. Section 6.2 presents the 2009 Green Budget forecasts for 2008–09 and 2009–10, using as a baseline the assumption that the economy evolves largely as the Treasury predicted in the November 2008 Pre-Budget Report (PBR), but where, as we shall see, tax revenues are slightly weaker. Section 6.3 looks at the medium-term prospects for the public finances (up to 2013–14), based on the same underlying economic assumptions. Section 6.4 compares our baseline forecasts with forecasts based on the alternative macroeconomic assumptions outlined by Morgan Stanley in Chapter 4. Finally, Section 6.5 concludes with what these projections imply for the 2009 Budget judgement.

6.2 Short-term projections

In 2007–08, receipts came in £3.7 billion lower than the Treasury had forecast in its PBR in October 2007 and about £1.2 billion lower than we forecast in the January 2008 Green Budget, as shown in Table 6.1. The out-turn for current spending was £5.3 billion lower than forecast by both the Treasury and us. The larger offsetting error for the Treasury meant that its PBR 2007 forecast for the current budget was more accurate than our January 2008 Green Budget forecast: the Treasury forecast was £1.6 billion too pessimistic while ours was £4.1 billion too pessimistic. This was the result of the relatively slow growth in current spending that had been seen at the end of 2006–07 being repeated in 2007–08. Slightly higher-than-forecast investment spending (£0.2 billion in both cases) meant that public sector net borrowing in 2007–08 was £1.4 billion lower than the Treasury forecasted in October 2007 and £3.9 billion lower than we forecast in January 2008. For more details on the components of these forecasts and out-turns, see Appendix A.

Table 6.1. Comparison of forecasts for government borrowing, 2007–08

£ billion	**HM Treasury PBR forecast, October 2007**	**IFS Green Budget forecast, January 2008**	**Estimate, PBR, November 2008**
Current receipts	551.2	548.7	547.5
Current expenditure[a]	559.5	559.5	554.2
Net investment	29.7	29.7	29.9
Total managed expenditure	589.2	589.2	584.1
Public sector net borrowing	38.0	40.5	36.6
Surplus on current budget	–8.3	–10.8	–6.7

a. In line with the National Accounts, depreciation has been included as current expenditure.
Sources: Out-turn figures for 2007–08 from HM Treasury, *2008 Pre-Budget Report*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm). Forecasts from HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 (http://www.hm-treasury.gov.uk/pbr_csr07_index.htm) and table 5.2 of R. Chote, C. Emmerson and G. Tetlow, 'Green Budget public finance forecasts', in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2008*, IFS Commentary 104 (http://www.ifs.org.uk/budgets/gb2008/08chap5.pdf).

Borrowing in 2008–09

Table 6.2 provides an overview of the Treasury's and the January 2009 Green Budget baseline projections for receipts, spending and borrowing in the current financial year. The November 2008 PBR revised down the Treasury's previous, Budget 2008, forecast for receipts in 2008–09 by £29.5 billion. The 2009 Green Budget baseline forecast for 2008–09 is that receipts will be a further £6.6 billion lower than PBR 2008 expected. Our baseline estimate for current spending and net investment in 2008–09 is that they will be the same as the Treasury's PBR forecast. Therefore, our baseline forecast for the current

Table 6.2. Comparison of forecasts for government borrowing, 2008–09

£ billion	Budget, Mar. 08	PBR, Nov. 2008	Green Budget, Jan. 09	Differences in Green Budget forecast relative to: Budget	PBR
Current receipts	575	545.5	538.9	–36.1	–6.6
Current expenditure[a]	585	586.7	586.7	+1.7	0.0
Net investment	33	36.5	36.5	+3.5	0.0
Total managed expenditure	618	623.2	623.2	+5.2	0.0
Public sector net borrowing	43	77.6	84.3	+41.3	+6.6
Surplus on current budget	–10	–41.2	–47.8	–37.8	–6.6

a. In line with the National Accounts, depreciation has been included as current expenditure.
Sources: Treasury forecasts from HM Treasury, *2008 Pre-Budget Report*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm) and HM Treasury, *Budget 2008: Financial Statement and Budget Report*, March 2008 (http://www.hm-treasury.gov.uk/bud_bud08_repindex.htm).

budget deficit in 2008–09 is that it will be £6.6 billion larger (at £47.8 billion) than the PBR 2008 forecast suggested. Similarly, we expect borrowing in 2008–09 to be £6.6 billion higher than the Treasury's forecast (at £84.3 billion).

Receipts and spending in 2008–09

The 2009 Green Budget forecast for receipts in 2008–09 is £6.6 billion lower than the Treasury's 2008 PBR projection. Table 6.3 shows the forecast for receipts in 2008–09 (and also that for 2009–10) broken down into the constituent taxes. For most taxes, we expect revenues in 2008–09 to be in line with the Treasury's PBR forecast.

There are four significant exceptions to this – income tax, value added tax (VAT), capital gains tax and stamp duty – and in all of these cases we forecast lower revenues than the 2008 PBR. (In the case of corporation tax revenues, we forecast that receipts will be £0.1 billion higher than the PBR.)

Our model for income tax suggests that income tax revenues will be £4.1 billion lower than forecast in the 2008 PBR. One reason why our model is forecasting low growth in income tax receipts is that we have assumed particularly low growth in taxable incomes among the top 1% of individuals, who the Treasury forecasts will contribute 23.1% of income tax revenues this year.[1] Figures for income tax receipts in January 2009 – set to be released by the Office for National Statistics on 19 February 2009 – will give a clear indication of the likely level of these receipts in 2008–09 and the extent to which bonuses and self-assessment payments have been affected by the turmoil in financial markets seen since August 2007. (Similarly, figures on corporation tax will also shed much light on the likely impact on these revenues in 2008–09.)

For VAT, we forecast that revenues will be £1.1 billion lower than forecast in the November 2008 PBR. Though the PBR did forecast that VAT revenues would fall in cash terms over the remaining months of 2008–09, the cash fall in VAT receipts that has occurred in the last two months of 2008 relative to the same months in the previous year was even greater than this PBR projection.

[1] Source: Table 2.4 of HM Revenue and Customs statistics (http://www.hmrc.gov.uk/stats/income_tax/menu.htm).

Table 6.3. Comparison of Green Budget and HM Treasury forecasts for current receipts, 2008–09 and 2009–10

£ billion	*2008–09*		*2009–10*	
	PBR Nov. 2008	**Green Budget Jan. 2009**	**PBR Nov. 2008**	**Green Budget Jan. 2009**
Income tax (net of tax credits)	151.2	147.1	145.2	143.4
National Insurance contributions	97.7	97.7	100.8	100.5
Value added tax (VAT)	82.6	81.5	72.6	70.5
Corporation tax (net of tax credits)	44.9	45.0	41.7	40.0
Petroleum revenue tax	2.6	2.6	1.5	1.5
Fuel duties	25.1	25.1	26.2	26.2
Capital gains tax	4.9	3.9	2.4	2.4
Inheritance tax	3.1	3.1	2.4	2.4
Stamp duties	8.3	7.6	6.9	6.7
Tobacco duties	8.2	8.2	8.2	8.2
Spirits duties	2.3	2.3	2.5	2.5
Wine duties	2.8	2.8	2.9	2.9
Beer and cider duties	3.4	3.4	3.3	3.3
Betting and gaming duties	1.5	1.5	1.4	1.4
Air passenger duty	1.9	1.9	1.9	1.9
Insurance premium tax	2.3	2.3	2.5	2.5
Landfill tax	0.9	0.9	1.2	1.2
Climate change levy	0.7	0.7	0.7	0.7
Aggregates levy	0.4	0.4	0.3	0.3
Customs duties and levies	2.6	2.6	2.8	2.8
Total HM Revenue and Customs	**447.1**	**440.5**	**427.5**	**421.4**
Vehicle excise duties	5.8	5.8	6.0	6.0
Business rates	23.5	23.5	24.6	24.6
Council tax[a]	24.6	24.6	25.7	25.7
Other taxes and royalties[b]	15.7	15.7	15.9	15.9
Net taxes and NI contributions[c]	**516.6**	**510.1**	**499.6**	**493.6**
Accruals adjustments on taxes	–3.1	–3.1	2.5	2.5
Less Own resources contribution to EU budget	–4.3	–4.3	–4.8	–4.8
Less PC corporation tax payments	–0.2	–0.2	–0.2	–0.2
Tax credits adjustment[d]	0.7	0.7	0.7	0.7
Interest and dividends	7.7	7.7	8.1	8.1
Other receipts[e]	28.0	28.0	29.5	29.5
Current receipts	**545.5**	**538.9**	**535.5**	**529.4**

a. PBR figures are based on stylised assumptions rather than government forecasts, as council tax increases are determined annually by local authorities, not by the government.
b. Includes VAT refunds and money paid into the National Lottery Distribution Fund.
c. Includes VAT and the traditional ‘own resources’ contributions to the EU budget.
d. Tax credits that are scored as negative tax in the calculation of ‘Net taxes and NI contributions’ but expenditure in the National Accounts.
e. Includes gross operating surplus and rent; net of oil royalties and business rates payments by local authorities.
Sources: PBR forecasts from HM Treasury, *2008 Pre-Budget Report*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm); this table is similar to table B13 on page 203. Authors’ calculations.

For stamp duty revenues, we take account of the Treasury PBR forecast that housing transactions in 2008–09 will be running at just below half their 2007–08 levels, the latest data from the Nationwide house price index, which suggest that prices fell 15.9% in 2008, and the roughly 30% fall in the FTSE-100 index seen over the first nine months of this financial year. Combined, these suggest that stamp duty revenues will be £0.7 billion lower than forecast in the 2008 PBR.

For capital gains tax (CGT), we simply interpolate the Treasury's projected decline from £5.3 billion in 2007–08 to £2.4 billion in 2009–10, giving a projection of £3.9 billion in 2008–09. This is lower than the £4.9 billion forecast by the Treasury, but we note that a similar-sized fall in the stock market in 2001 led to a similar-sized decline in CGT revenues that the Treasury is forecasting over the two years, but that this decline crystallised sooner. There is also some downside risk to this forecast arising from the fact that the October 2007 PBR reforms to CGT increased the marginal tax rate on shareholding gains for many individuals.[2]

We assume that current spending will be in line with the Treasury's forecast from PBR 2008. This forecast that current spending in 2008–09 would be £586.7 billion – slightly above the Treasury's Budget 2008 forecast of £585 billion.

Over the first nine months of this financial year, central government current spending has been running 5.8% above the level seen in the same months last year. The PBR forecast implies the same increase over last year's level for the year as a whole.[3] This suggests that the PBR forecast might be considered likely to be accurate. However, the relatively large errors in the forecasts for current spending in 2007–08 made by both the October 2007 PBR and the January 2008 IFS Green Budget (as shown in Table 6.1) highlight the uncertainty around these forecasts.

We also assume that the Treasury's PBR forecast for public sector net investment of £36.5 billion is correct, and therefore that total managed expenditure (TME) will be the same as the £623.2 billion forecast by the Treasury.

Borrowing in 2009–10

The November PBR contained a considerable upwards revision to the forecast for public sector net borrowing in 2009–10 – from forecast borrowing of £38 billion to forecast borrowing of £118.3 billion (a rise of £80.3 billion, see Table 6.4). Of this deterioration, £16.3 billion is the direct impact of the fiscal stimulus measures contained in the PBR. The remainder is almost entirely due to downwards revisions to the forecasts for underlying tax receipts. Part of the fiscal stimulus package in 2009–10 represents an increase in planned public sector net investment as some programmes have been shifted forward from 2010–11. This means that the deterioration in the forecast current budget between the 2008 Budget and the 2008 PBR – while still considerable – is slightly smaller, at £73.9 billion.

[2] A detailed discussion can be found in S. Adam, 'Capital gains tax', in R. Chote, C. Emmerson, D. Miles and J. Shaw (eds), *The IFS Green Budget: January 2008*, IFS Commentary 104 (http://www.ifs.org.uk/budgets/gb2008/08chap10.pdf).

[3] For IFS analysis of the monthly ONS/HM Treasury press releases on the public finances, see http://www.ifs.org.uk/publications/browse?type=pf.

Table 6.4. Comparison of forecasts for government borrowing, 2009–10

£ billion	Budget, Mar. 08	PBR, Nov. 08	Green Budget, Jan. 09	Differences in Green Budget forecast relative to: Budget	PBR
Current receipts	608	535.5	529.4	–78.6	–6.1
Current expenditure[a]	612	613.4	613.7	+1.7	+0.3
Net investment	35	40.4	40.4	+5.4	0.0
Total managed expenditure	647	653.8	654.1	+7.1	+0.3
Public sector net borrowing	38	118.3	124.7	+86.7	6.4
Surplus on current budget	–4	–77.9	–84.3	–80.3	–6.4

A, In line with the National Accounts, depreciation has been included as current expenditure.
Sources: As Table 6.2.

The 2008 Green Budget forecasts a further slight deterioration in both public sector net borrowing and the current budget. We forecast a current budget deficit of £84.3 billion and net borrowing of £124.7 billion, which are both £6.4 billion worse than the Treasury's November 2008 PBR forecast.

Receipts and spending in 2009–10

The November 2008 PBR revised down current receipts in 2009–10 by £72.5 billion relative to the forecast made in the March 2008 Budget. An estimated £12.4 billion of this revision represented discretionary tax cuts aimed at reducing the depth and the length of the current recession. The largest slice of this was £8.6 billion arising from the temporary VAT cut – the total cost of this cut was estimated by the Treasury to be £12.4 billion, with £3.8 billion of this falling in 2008–09. However, most of the downwards revision came from underlying tax receipts. In particular, forecasts for underlying income tax, National Insurance (NI) contributions, VAT, corporation tax and stamp duties were all revised down substantially.[4]

On the spending side, there was a relatively small upwards revision to current expenditure of £1.4 billion between the March 2008 Budget and the November 2008 PBR. Within this, there was a £5.9 billion rise in forecast expenditure on social security benefits (with only a small fraction of this being due to PBR policy measures), which was largely offset by a £3.8 billion fall in central government debt interest payments due to lower interest rates than assumed previously. The PBR also revised up planned investment spending by £5.4 billion to £40.4 billion, from the £35 billion that had been forecast in the Budget. Further details of the changing outlook for the public finances between the March 2008 Budget and the November 2008 PBR can be found in Chapter 3.

Relative to the Treasury's forecast from the 2008 PBR, the 2009 Green Budget forecast for 2009–10 is that receipts will be £6.1 billion lower and spending £0.3 billion higher. The latter reflects the debt interest payments that will be required to service the additional borrowing that we forecast will be necessary in 2008–09 (discussed above).

As shown in Table 6.3, the three biggest discrepancies between the January 2009 Green Budget forecast and the November 2008 PBR forecast for receipts in 2009–10 are for receipts of VAT, income tax and corporation tax. We forecast that VAT revenues will be

[4] For more details, see page 203, table B13 of HM Treasury, *2008 Pre-Budget Report*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm).

£2.1 billion below the PBR forecast, which is despite the fact that we have a similar outlook for VAT receipts in 2008–09 and that our estimates suggest that the temporary VAT cut will cost slightly less than the Treasury estimates. [5]

We forecast that income tax receipts will be £1.8 billion below the PBR forecast, less of a shortfall than the £4.1 billion we project for 2008–09. Our forecast for corporation tax receipts (which, due to the timing of tax payments, are dependent on both lagged and contemporaneous corporate profits) is on the basis that in nominal terms corporate profits in 2008–09 and 2009–10 exhibit falls in line with Morgan Stanley's central forecast of 14.7% and 19.2% respectively. Since this growth rate is below that implied by the Treasury's forecast for growth in underlying corporation tax receipts, the 2009 Green Budget baseline forecast for corporation tax receipts in 2009–10 is £40.0 billion, £1.7 billion lower than the Treasury's 2008 PBR forecast.

We are also forecasting lower NI contributions and stamp duty revenues in 2009–10 than the Treasury. However, the total difference is for receipts of these two taxes to be £½ billion below that forecast by the Treasury, so the differences are relatively small.

6.3 Medium-term prospects

Over the medium term, we expect the near-term gap between the Green Budget and PBR current budget balance forecasts to widen beyond 2009–10 to the end of the forecast horizon (Tables 6.5 and 6.6). The Green Budget forecasts a deficit £6.4 billion – or 0.4% of national income – bigger than the PBR in 2009–10, a gap that widens in nominal terms to £23 billion – or 1.3% of national income – in 2013–14. These differences are likely to be small relative to the uncertainties around both forecasts, judging from past forecasting performance and also from the fact that the current outlook is more uncertain than usual.

Over the coming five years, we expect the current budget balance to move from a 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 (£48 billion in today's terms), 1.8% of national income (£26 billion) comes from a forecast fall in current spending and 1.5% of national income (£22 billion) from a forecast increase in the tax burden. Over the same period, the PBR has the same reduction in current spending, but with a 0.8% of national income (£12 billion) larger forecast increase in the tax burden.

For current spending and public sector net investment, we assume that the Treasury keeps to the cash spending totals set out in the November 2008 PBR for 2011–12, 2012–13 and 2013–14. This leads to spending continuing to fall as a share of national income and, as described in Chapter 9, given realistic assumptions about social security, debt interest and other 'annually managed expenditure', would lead to no real increase in resources being available for public-service spending departments. Our baseline forecast is for debt to be higher than the PBR forecast (see Table 6.6). This implies that debt interest payments would also be likely to be higher than the Treasury has assumed. If this were to be the case, keeping to the same overall cash spending plans as laid out in PBR 2008 would, under our baseline forecast, imply tighter plans for spending on public services as more spending would need to be devoted to servicing the stock of debt.

[5] Estimates provided in Chapter 10 suggest that over the whole 13 months this change will cost £12.0 billion rather than the PBR estimate of £12.4 billion.

Table 6.5. Medium-term public finance forecasts under Pre-Budget Report 2008 assumptions – £ billion

£ billion	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14
Green Budget forecasts						
Current budget						
Current receipts	538.9	529.4	564	604	645	685
Current expenditure[a]	586.7	613.7	650	675	702	729
Surplus on current budget	**–47.8**	**–84.3**	**–86**	**–71**	**–57**	**–44**
Capital budget						
Net investment	36.5	40.4	33	33	33	33
Public sector net borrowing	**84.3**	**124.7**	**119**	**104**	**90**	**77**
HM Treasury forecasts						
Current budget						
Current receipts	545.5	535.5	576	621	664	708
Current expenditure[a]	586.7	613.4	649	675	702	729
Surplus on current budget	**–41.2**	**–77.9**	**–73**	**–54**	**–37**	**–21**
Capital budget						
Net investment	36.5	40.4	33	33	33	33
Public sector net borrowing	**77.6**	**118.3**	**105**	**87**	**70**	**54**

a. In line with the National Accounts, depreciation has been included as current expenditure.
Sources: Authors' calculations. Treasury forecasts from HM Treasury, *2008 Pre-Budget Report*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm); this table is similar to table B10 on p. 198.

Table 6.6. Medium-term public finance forecasts under Pre-Budget Report 2008 assumptions – % of national income

% of national income	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14
Green Budget forecasts						
Current budget						
Current receipts	36.8	35.8	36.4	36.9	37.2	37.3
Current expenditure[a]	40.1	41.5	41.9	41.2	40.5	39.7
Surplus on current budget	**–3.3**	**–5.7**	**–5.5**	**–4.3**	**–3.3**	**–2.4**
Capital budget						
Net investment	2.5	2.7	2.1	2.0	1.9	1.8
Public sector net borrowing	**5.8**	**8.4**	**7.7**	**6.4**	**5.2**	**4.2**
Public sector net debt	**41.6**	**49.1**	**54.6**	**58.2**	**60.7**	**62.1**
HM Treasury forecasts						
Current budget						
Current receipts	37.3	36.2	37.2	37.9	38.3	38.6
Current expenditure[a]	40.1	41.4	41.9	41.2	40.5	39.7
Surplus on current budget	**–2.8**	**–5.3**	**–4.7**	**–3.3**	**–2.2**	**–1.1**
Capital budget						
Net investment	2.5	2.7	2.1	2.0	1.9	1.8
Public sector net borrowing	**5.3**	**8.0**	**6.8**	**5.3**	**4.1**	**2.9**
Public sector net debt	**41.2**	**48.2**	**52.9**	**55.6**	**57.1**	**57.4**

a. In line with the National Accounts, depreciation has been included as current expenditure.
Sources: Authors' calculations. Treasury forecasts from HM Treasury, *2008 Pre-Budget Report*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm); this table is similar to table B11 on p. 198.

Keeping to these spending totals would be likely to have implications for the government's aspirations, such as those to reduce child poverty, to earnings-index the basic state pension and to improve public services.

On the receipts side, the Green Budget forecast is for lower growth in receipts as a share of national income in each year after 2009–10 than forecast in the November 2008 PBR. Over this period, we forecast that in nominal terms receipts will grow by 6.7% a year on average; in contrast, the PBR forecasts that they will grow by 7.2% a year on average. This compares with assumed average annual growth in nominal national income of 5.5% a year. The next subsection discusses the composition of receipts in more detail.

The Green Budget forecasts for net investment are in line with the PBR ones throughout the forecast period. Consequently, the profile for public sector net borrowing over the medium term tracks that of the current budget, with borrowing in every year being higher under the Green Budget forecasts than under the PBR forecasts.

The higher borrowing forecasts mean that we have higher forecasts than the Treasury for public sector net debt right through to 2013–14. Our forecast suggests that public sector net debt will move above 60% of national income in 2012–13 and continue to rise.

Breakdown of medium-term revenue projections

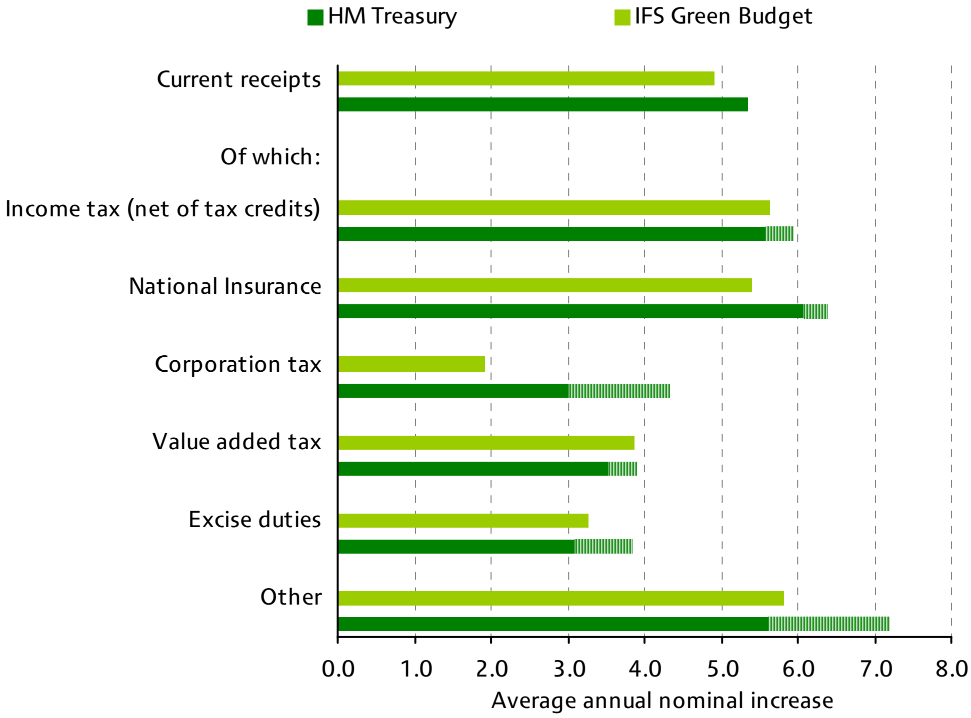
Figure 6.1 shows the average annual nominal growth rate for each major component of tax revenues under the Green Budget projection over the period from 2008–09 to 2013–14. These are compared with the Treasury's November 2008 projections. Comparing the two medium-term projections is hampered by a lack of availability of detailed forecasts from the Treasury, since the PBR only shows limited information on the composition of its medium-term revenue projections and rounds revenues from each of the categories to the nearest 0.1% of national income. As a result, a lower and upper bound on the Treasury's projection are shown in the graph (the range between these bounds being shown by the striped region).

Overall, the Green Budget projection is for slightly lower growth in tax (and non-tax) revenues from a slightly lower base (as detailed in Table 6.3). Between 2008–09 and 2013–14, the Green Budget forecasts show slightly weaker growth in NI contributions and, in particular, corporation tax. On all the other categories of taxes, the January 2009 IFS Green Budget projection is for growth in receipts in line with that projected in the Treasury's 2008 PBR.

Figure 6.2 provides more detail on the differences in outlook for revenues from corporation tax and petroleum revenue tax over the medium term. The PBR forecasts that these receipts will fall from 3.2% of national income in 2008–09 to 2.9% of national income in 2009–10. After this, receipts are forecast to climb to, and remain around, 3.1% of national income.

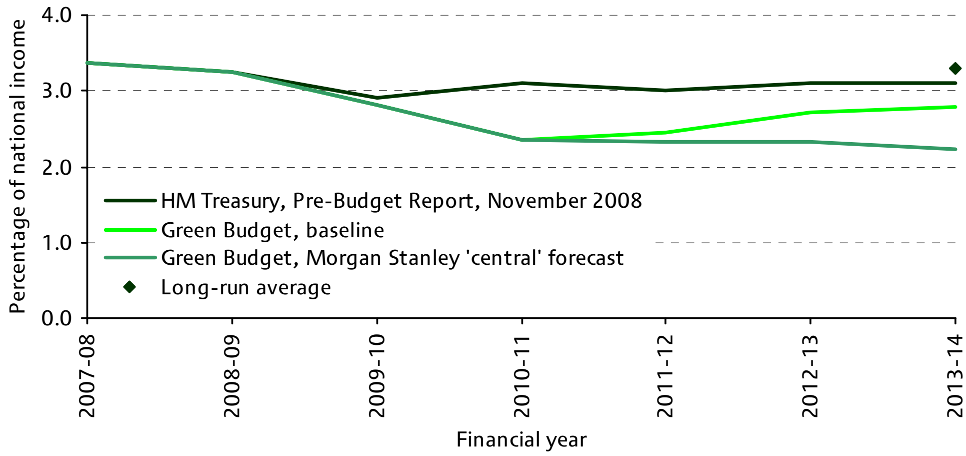
The Green Budget baseline assumes that instead these receipts will decline to 2.8% of national income in 2009–10 and then fall further to 2.4% in 2010–11 in line with the forecast implied by Morgan Stanley's projection for growth in corporate profits. Thereafter, the Green Budget baseline forecast assumes that corporation tax receipts recover gradually over time. For this, we assume that underlying revenues climb towards an assessment of the long-run average level of corporation tax receipts. This is the average seen over recent years, adjusted downwards in line with the fact that the 4%

Figure 6.1. PBR and IFS forecasts for revenue growth, 2008–09 to 2013–14



Note: Corporation tax includes petroleum revenue tax.
Sources: Authors' calculations. Treasury forecasts from HM Treasury, *2008 Pre-Budget Report*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm).

Figure 6.2. Forecasts for corporation tax receipts under HM Treasury and Green Budget assumptions



Notes: Corporation tax includes petroleum revenue tax. Morgan Stanley central forecast is for lower nominal national income in all years from 2009–10 onwards than HM Treasury Pre-Budget Report forecasts suggest.
Sources: Authors' calculations. Treasury forecasts from HM Treasury, *2008 Pre-Budget Report*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm).

decline in trend output that the Treasury estimates has occurred between Summer 2007 and Summer 2009 is likely to lead to a disproportionate decline in the hitherto relatively profitable financial sector. For this, we assume that the size of the financial sector is reduced by one-eighth from 8% of national income to 7% of national income. This reduces long-run corporation tax receipts as the financial sector has historically contributed about a quarter of corporation tax revenues.[6]

A more pessimistic view of the outlook for corporation tax receipts is shown by the Morgan Stanley 'central' forecast (discussed in more detail in Section 6.4). This suggests that after falling to 2.2% of national income, these revenues would stabilise at that level, which would be 0.9% of national income (£13 billion in today's terms) below the medium-term PBR 2008 forecast.

Uncertainties around the baseline Green Budget forecast

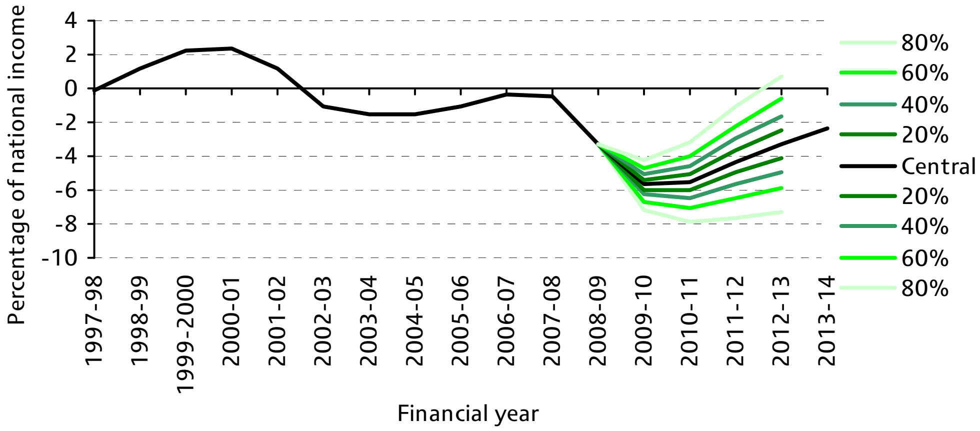
Public finance forecasts are by their nature uncertain and it is important to acknowledge this uncertainty when presenting them, in particular when interpreting point estimates for future deficits and debt. The further ahead forecasts are made, the larger the degree of uncertainty. Figure 6.3 presents a probabilistic fan chart for the Green Budget forecast for the evolution of the current budget over the next four years, with the forecast for 2008–09 taken as given. The fan chart assumes that the Green Budget forecasts will be right on average (and so are the best forecasts available) and that they are as accurate as the Treasury's forecasts have been in the past. If the Green Budget forecasts were less accurate than the Treasury's, the fan charts would be wider, while if they were more accurate then the fan charts would be narrower.

The black line shows the central Green Budget forecast – it is assumed that there is a 50% chance that the outcome will lie above this line and a 50% chance that it will lie below, as the central forecasts are (by definition) assumed to be right on average. The darkest green lines on either side of the central forecast denote the range of outcomes within which there is a 20% probability that the outcomes will lie. As uncertainty increases with the time horizon, these lines fan out. To the extent to which the current economic circumstances make the outlook more uncertain than typically, the fans in these figures should be considered as being too narrow.

The central forecast for 2009–10 is for a current budget deficit of 5.7% of national income and Figure 6.3 indicates that there is a 20% probability that the actual outcome will be a deficit of between 6.0% and 5.4% of national income. In 2012–13, the central forecast is for a deficit of 3.3% of national income – but the greater uncertainties in forecasting four years in advance mean that we can only be 20% certain that the outcome will lie within the much larger range of –4.1% to –2.5% of national income. The 40%, 60% and 80% lines bound the ranges within which there is a 40%, 60% or 80% probability that the outcome will eventually lie. Therefore, there is a 10% probability that the outcome will lie above the upper 80% line and a 10% probability that it will lie below the lower one. Under the Green Budget baseline forecast, there is an estimated 15% probability that, on unchanged policies, the current budget will be in surplus in 2012–13, but a 19% probability that it will be in deficit by more than 6% of national income.

[6] Financial companies, excluding life assurance, paid 27% of mainstream corporation tax in 2006. Source: Table 11.2 of HMRC statistics (http://www.hmrc.gov.uk/stats/corporate_tax/menu.htm). Financial services were 7.6% of GDP in 2007. Source: ONS National Accounts Blue Book.

Figure 6.3. Probabilities of current budget balance outcomes (Green Budget baseline)



Notes: Central projections are taken from Table 6.6 and assume that the Green Budget projection for 2008–09 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 W04/29, 2004 (http://www.ifs.org.uk/publications/3163).

A key conclusion of this analysis is that the difference between the central projections in the Green Budget and the PBR for budget balances and therefore for net debt is less significant than the uncertainty that lies around either, given past forecast performance.

6.4 Alternative macroeconomic assumptions

This section presents alternative forecasts under three different sets of macroeconomic assumptions from Morgan Stanley – a central scenario, a more pessimistic scenario and a more optimistic scenario.

Table 6.7 presents both the underlying economic growth and the assumed level of the economy relative to trend used by the Treasury and those presented by Morgan Stanley, as well as the five sets of public finance forecasts – the Treasury's PBR forecasts, the Green Budget baseline forecasts, the Green Budget forecasts under the Morgan Stanley central macro forecasts, the Green Budget forecasts under the Morgan Stanley 'pessimistic case' forecast and the Green Budget forecasts under the Morgan Stanley 'optimistic case' forecast.

The Treasury forecasts that national income will shrink by ¼% in 2008–09 and a further ½% in 2009–10. After that, it projects growth of 2% in 2010–11 and 3% a year thereafter. This path leads to the estimated output gap not being closed until one year after the end of the forecast horizon, in 2014–15.

Under the first alternative Green Budget scenario (the Morgan Stanley central case), there is slightly weaker growth in 2008–09, slightly stronger growth in 2009–10, and similar growth in 2010–11 and 2011–12. From 2012–13 onwards, the economy is forecast to grow less strongly, as it is estimated that the economy will already have returned to trend activity (and in fact would move slightly above trend from 2011–12 onwards).

Table 6.7. Public finance forecasts under various macroeconomic scenarios

	2008–09	2009–10	2010–11	2011–12	2012–13	2013–14
Treasury Pre-Budget Report forecasts						
GDP growth	–¼	–½	2	3	3	3
Output gap (% of potential GDP)	–0.3	–1.5	–1.9	–1.3	–0.7	–0.1
Public finance forecasts (% of GDP)						
Current budget surplus	–2.8	–5.3	–4.7	–3.3	–2.2	–1.1
Cyclically-adjusted current budget surplus	–2.8	–4.4	–3.4	–2.3	–1.6	–1.0
Net borrowing	5.3	8.0	6.8	5.3	4.0	2.9
Net debt	41.2	48.2	52.9	55.6	57.1	57.4
Green Budget baseline						
GDP growth	–¼	–½	2	3	3	3
Output gap (% of potential GDP)	–0.3	–1.5	–1.9	–1.3	–0.7	–0.1
Public finance forecasts (% of GDP)						
Current budget surplus	–3.3	–5.7	–5.5	–4.3	–3.3	–2.4
Cyclically-adjusted current budget surplus	–3.2	–4.9	–4.3	–3.3	–2.7	–2.2
Net borrowing	5.8	8.4	7.7	6.3	5.2	4.2
Net debt	41.6	49.1	54.6	58.2	60.7	62.1
Morgan Stanley central case						
GDP growth	–½	–¼	2	3	2¼	2½
Output gap (% of potential GDP)	0.0	–1.5	–1.0	0.2	0.6	0.6
Public finance forecasts (% of GDP)						
Current budget surplus	–3.3	–5.7	–5.3	–4.6	–4.2	–3.9
Cyclically-adjusted current budget surplus	–3.6	–4.9	–4.5	–4.5	–4.5	–4.3
Net borrowing	5.7	8.4	7.4	6.7	6.1	5.8
Net debt	41.4	49.2	54.5	59.0	63.9	67.7
Morgan Stanley ‘pessimistic case’						
GDP growth	–¾	–2½	1	2	1½	2
Output gap (% of potential GDP)	1.0	–2.0	–1.4	–0.1	0.7	1.2
Public finance forecasts (% of GDP)						
Current budget surplus	–3.3	–6.5	–7.5	–7.5	–7.5	–7.5
Cyclically-adjusted current budget surplus	–4.2	–5.7	–6.4	–7.2	–7.8	–8.3
Net borrowing	5.7	9.3	9.7	9.7	9.6	9.6
Net debt	41.5	53.9	64.2	74.0	82.6	90.5
Morgan Stanley ‘optimistic case’						
GDP growth	–0	1¼	3	3¾	3	3½
Output gap (% of potential GDP)	–0.6	–1.4	–0.8	0.4	0.7	1.4
Public finance forecasts (% of GDP)						
Current budget surplus	–2.5	–4.7	–2.8	–0.5	0.8	1.8
Cyclically-adjusted current budget surplus	–3.5	–4.7	–2.0	0.2	0.7	1.3
Net borrowing	5.0	7.4	4.9	2.4	1.1	0.0
Net debt	40.2	45.6	47.3	46.6	45.7	43.6

Sources: Authors’ calculations; Morgan Stanley; Treasury forecasts from HM Treasury, *2008 Pre-Budget Report*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm).

The second alternative Green Budget scenario (the Morgan Stanley 'pessimistic case') assumes that the economy shrinks by ¾% in 2008–09 and then by 2½% in 2009–10. After that, the economy recovers only very slowly, and yet is forecast to be back above trend in 2012–13.

The final alternative Green Budget scenario (the Morgan Stanley 'optimistic case') assumes that the economy grows by 1¼% in 2009–10 and then is able to grow by 3% or more – i.e. faster than estimated growth in trend activity – throughout the period from 2010–11 through to 2013–14.

The Green Budget public finance forecasts using the Morgan Stanley central scenario show a similar current budget deficit in 2008–09, 2009–10 and 2010–11 to that under the Green Budget baseline scenario. However, because there is less estimated spare capacity in the Morgan Stanley central economic forecast than in the PBR 2008 economic forecast, this similar current budget deficit represents a greater cyclically-adjusted current budget deficit. For later years, both the current budget and the cyclically-adjusted current budget remain further below the Green Budget baseline and the current budget balance does not return to a deficit of less than 4% of national income until the last year of the forecast horizon.

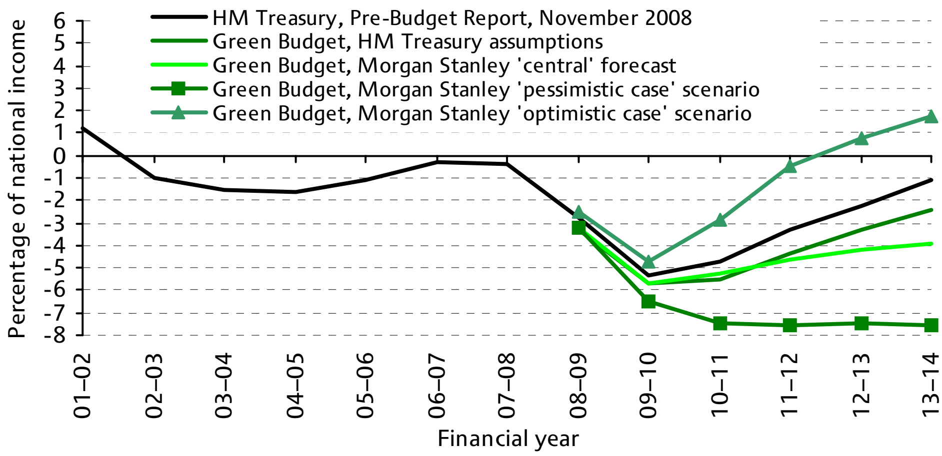
Under the Morgan Stanley 'pessimistic case' scenario, there is a larger current budget deficit from 2009–10 onwards than under the Morgan Stanley central scenario. By the end of the forecast period under this scenario, the current budget deficit is still running at 7.5% of national income.

A significantly more pleasing possible outcome for the public finances is suggested under the Morgan Stanley 'optimistic case' scenario. This would see the current budget returning to surplus as soon as 2012–13, and a balance on public sector borrowing by the end of the forecast horizon.

These forecasts for the current budget surplus are also compared in Figure 6.4.

Under the Morgan Stanley 'central case' scenario, net debt follows a similar path to that under the Green Budget baseline scenario through to 2011–12, but then increases more quickly. By the end of the forecast horizon, net debt is approaching 70% of national

Figure 6.4. Current budget balance forecasts

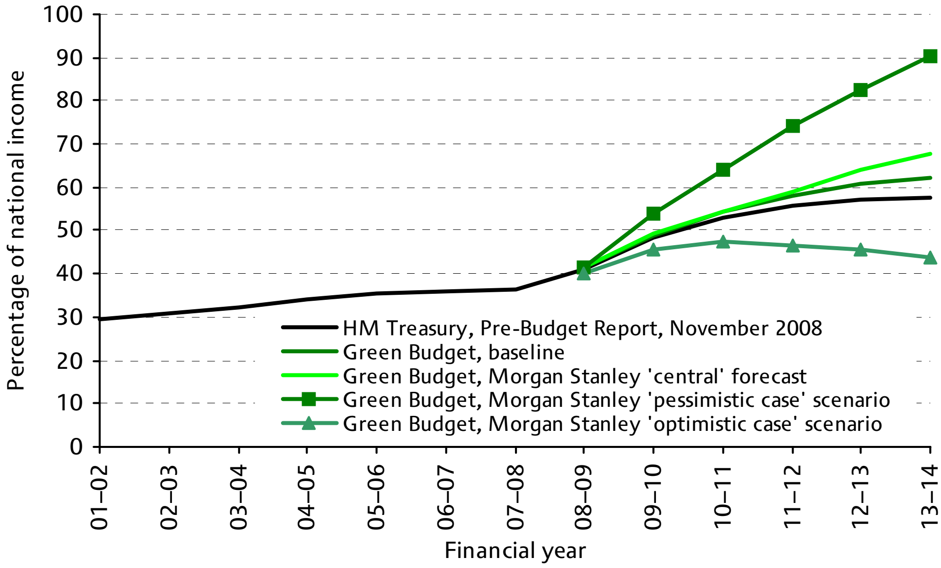


Sources: Authors' calculations; Morgan Stanley; Treasury forecasts from HM Treasury, 2008 Pre-Budget Report, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm).

income. Under the Morgan Stanley 'pessimistic case' scenario, net debt is forecast to move above 70% of national income as soon as 2011–12 and is projected to be above 90% of national income by the end of the forecast horizon. Under this scenario, the government would undoubtedly be forced to implement a combination of tax increases and spending cuts in order to stop investors fearing that debt is being allowed to develop along an explosive path. Under the Morgan Stanley 'optimistic case' scenario, net debt starts to fall as soon as the end of 2010–11, although even under this scenario it still reaches a peak of 47.3% of national income (which would be the highest level since 1977–78), and is still above 40% of national income at the end of the forecast horizon despite an overall public sector balance being achieved in 2013–14.

These forecasts are compared in Figure 6.5.

Figure 6.5. Public sector net debt forecasts



Sources: Authors' calculations; Morgan Stanley; Treasury forecasts from HM Treasury, *2008 Pre-Budget Report*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm).

6.5 The Budget judgement

The November 2008 PBR was, in effect, two unusually large Budgets sandwiched together. The first was a giveaway Budget, cutting taxes and increasing spending in 2008–09 and 2009–10 to try to make the recession shorter and shallower than it otherwise would be. The second was a takeaway Budget, cutting public spending and increasing tax revenues as shares of national income from 2010–11 onwards to reduce the structural budget deficit and arrest the rise in public sector debt.

The key judgement – or, more accurately, judgements – in this year's Budget will be to decide whether or not to provide more of the same in both respects:

- First, should the government aim to increase the size of the short-term fiscal stimulus? And, if so, how?
- Second, should it announce measures now that will do more to strengthen the public finances once the economy has stabilised? And, if so, what?

The average view among independent forecasters is that the recession will be deeper and longer than the Treasury expected at the time of the PBR in November. This in itself would further increase its forecasts for government borrowing and debt – at least temporarily – by reducing tax revenues and increasing social security spending. The government is unlikely to contemplate offsetting any such deterioration by bringing forward its planned fiscal tightening; it is more likely to be wondering whether to add to it through a second fiscal stimulus package.

Whether that would be a good idea is a question that extends beyond the scope of the Green Budget. The government needs to think not just about tax and spending measures in isolation, but – together with the Bank of England – about the appropriate mix of fiscal policy changes, further interest rate cuts, less orthodox methods of monetary loosening ('quantitative easing') and further interventions in the financial sector designed to encourage banks to lend to individuals and businesses. If further discretionary fiscal easing were deemed a necessary and desirable part of the mix, then public support for that judgement by the Bank of England would certainly help to reassure people that it was economically rather than politically motivated.

The various options for fiscal easing were discussed extensively at the time of the PBR: increases in investment spending, increases in spending on public services, cuts in taxes, and increases in social security benefits and tax credits. The mix chosen would depend on how quickly the government would want it to take effect, how quickly it would want it to be reversed, and what impact it would wish it to have. The PBR stimulus package was explicitly designed to be 'timely, temporary and targeted'. This was one of the attractions of the VAT reduction, which was relatively quick to implement and to reverse. The choice of policies now may be affected strongly by whether the government wishes merely to increase the stimulus in the coming fiscal year, 2009–10, or whether it wishes to extend the stimulus for longer.

Additional capital spending would seem unlikely to play the major role in any new package. The fact that the government brought forward only a relatively modest amount of capital spending in the PBR testifies to the difficulty that officials see in getting good-quality investment projects moving quickly enough to play this role. Meanwhile, additional spending on public services has the problem that it is hard to reverse – it becomes incorporated in the baseline for future plans.

Tax cuts are an option. Chapter 10 argues that the temporary VAT reduction is likely to be more effective as a stimulus measure than some of its critics suggest. Even so, deepening or extending the reduction does not seem feasible or sensible respectively. The short-term impact on economic activity from cutting other taxes that only impart a stimulus by increasing incomes – rather than by changing the timing of spending as well – may be dulled if people save a relatively large proportion of the proceeds.

Increasing tax credit and social security payments would be vulnerable to the same problem, but poorer households are more likely to spend extra income than richer ones. One option would be to announce temporary payments to households receiving particular benefits; another would be to announce permanent increases and to recoup the revenue elsewhere once the fiscal tightening gets under way. We describe one possible reform in this spirit below. But, once again, an important consideration would be whether the government believes that the money could be delivered to people quickly enough to ensure that the stimulus was well-timed.

If the government were to decide to deliver a further fiscal stimulus – or even just to accommodate any automatic increase in borrowing if the economy performs less strongly than in the PBR forecast – this would make it even more important to reassure voters and investors that it is determined to get the public finances back into good shape as soon as it is safe and sensible to do so. This brings us to the second judgement – whether more needs to be done to strengthen the public finances from 2010–11 onwards.

The surge in borrowing and debt predicted in the PBR has forced the government temporarily to abandon its golden rule and sustainable investment rule. Indeed, Chapter 3 suggests that it may be 20 years or so before it would be in a position to readopt them in their original form. In the meantime, the Treasury has set itself a 'temporary operating rule: to set policies to improve the cyclically-adjusted current budget each year, once the economy emerges from the downturn, so it reaches balance and debt is falling as a proportion of GDP once the global shocks have worked their way through the economy in full'.[7] In practice, the Treasury has interpreted this in the PBR as meaning that the cyclically-adjusted current budget balance should be back in balance and debt falling by 2015–16. As we describe in Chapters 2 and 3, on the Treasury's own forecasts this requires a combination of spending cuts and tax increases raising 2.6% of national income (or around £38 billion in today's terms) by that year.

Our central forecast, based as far as possible on the macroeconomic assumptions used in the PBR and described earlier in this chapter, does not show the public finances improving rapidly enough to achieve this objective on the government's current policy plans and projections. By 2013–14, we estimate that revenues would be running around 1.3% of national income or £18 billion in today's terms lower than the Treasury expects. The current budget balance and public sector net borrowing would be adrift by similar amounts, reflecting our assumption that spending will evolve broadly in line with the PBR forecasts (with the exception of modest additional debt interest payments in 2009–10 and 2010–11). Simple extrapolation suggests that the gap at the end of the Treasury's PBR 'illustrative projections' in 2015–16 might be 1.5% of national income or £22 billion in today's money.

In the absence of any offsetting policy changes, this would push net debt above 62% of national income in 2013–14. Adopting the analysis in Chapter 3, and assuming (i) that government borrowing costs remain at current levels and (ii) that the structural deterioration in borrowing remains 1.5% of national income beyond 2015–16, public sector net debt would peak at 62.5% of national income in 2014–15, with debt interest payments in that year absorbing an extra 0.2% of national income. Public sector net debt would then remain around 60% of national income well into the longer term, as shown in Figure 6.6.

The broad message is that for this or a future government 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. There is considerable uncertainty around this estimate. But the cost of doing nothing, should action be required, is larger than the cost of announcing a tightening, only to find that it is not needed and can subsequently be reversed (or a fiscal loosening implemented in some other way). As discussed in Chapter 5, the widespread belief that the government did not conduct fiscal policy in the spirit of its own fiscal rules

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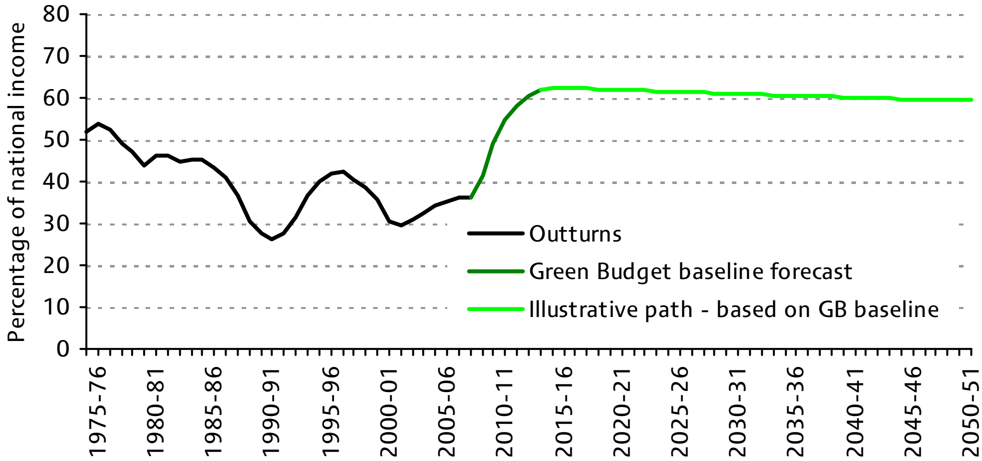
[7] Page 4, paragraph 1.13 of HM Treasury, *2008 Pre-Budget Report*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm).

during its second term, combined with the fact that the new temporary operating rule does not place much constraint on fiscal policy, means that it is particularly important that the government tries to retain as much confidence in its intentions as possible.

Figure 6.6. Illustrative projection for public sector net debt under the Green Budget baseline



Notes: Authors' calculations based on HM Treasury assumptions about further fiscal tightening in 2014–15 and 2015–16 from Pre-Budget Report 2008 and Green Budget baseline forecasts described above. The illustrative profile assumes that non-debt-interest spending and revenues remain constant as a share of national income from 2015–16 onwards. Average debt servicing costs are assumed to remain at 4.32% from 2013–14 onward, which implies that debt interest payments decline as a share of national income as the level of debt falls. This implies a strengthening of the current budget over time.
Source: Historic data from HM Treasury, *Public Sector Finances Databank*, December 2008 (http://www.hm-treasury.gov.uk/d/public_finances_databank.xls). Projections from 2008–09 onwards are authors' calculations.

Whether or not such a fiscal tightening would be sufficient to adhere to the 'temporary operating rule' depends on whether the Treasury has correctly assessed the underlying health of the public finances in the wake of the credit crunch. As the alternative macroeconomic scenarios described earlier illustrate, there are risks in both directions:

- Morgan Stanley's central scenario assumes that economic growth will be similar to that expected in the PBR in the short term, but weaker thereafter. If this scenario unfolds, we estimate that borrowing and debt would be higher at the end of the forecasting horizon than under the Treasury's macroeconomic scenario – although not dramatically so. But, importantly, this scenario implies that economic activity would have risen significantly above its sustainable level. This means that the headline increase in borrowing through to 2013–14 would understate the structural deterioration and the need for policy tightening. The pessimistic scenario shows a similar problem, on a bigger scale.
- Morgan Stanley's optimistic scenario paints a much prettier picture. Crucially, it implies that the credit crunch will not have led to a permanent loss of productive potential and that the economy can sustain a much stronger recovery. Under this scenario, it would turn out that the Treasury had overreacted in the PBR and that there was no need to put in place such a large structural tightening over the next few years to keep the public finances on a sustainable and acceptable path.

A further important uncertainty is whether the taxpayer will be left with a huge bill to pay for the government's interventions in the financial system. Chapter 8 argues that the long-term cost to the taxpayer may well be small – and that there may even be a profit – but that the downside risks of big losses are considerable. Analysis by Ben Broadbent of Goldman Sachs suggests that the taxpayer could be left with a loss of around £120 billion or 8% of national income.[8] This is, of course, a very large amount of money, but the annual cost of paying interest on this extra debt – assuming that borrowing rates remain at current levels – would add only around £5 billion to the level of borrowing each year. This is not trivial, but it is not large compared with the other costs of the credit crunch.

As we suggest in Chapter 3, the greatest source of anxiety in the Treasury is probably the possibility that the UK government may suddenly cease to be able to borrow as cheaply as it has been able to do in recent years. This would make the fiscal arithmetic much more unpleasant and the case for additional tightening measures – not just to bring about the tightening sought in the PBR, but to go further – much stronger. Chapter 7 suggests there is no need to panic and that there are good reasons to expect borrowing costs to remain subdued, but the possibility does suggest that the government should do what it can to reassure investors that it is ready to take the unpleasant steps that are necessary to bring debt down as quickly as it is safe to do so.

The bottom line from all this is that there is a compelling case for the government to announce measures now that would at least help bring about the scale of policy tightening sought in the PBR, once the economy has stabilised.

In principle, an additional fiscal tightening could be achieved by cuts in spending plans, fresh tax increases or a combination of the two.

If the additional tightening were to be achieved entirely through cuts in spending plans, this could be equivalent to reducing the growth rate of total public spending over the three years of the next spending review and the two subsequent years by 0.6 percentage points a year – in other words, from 1.1% to 0.5% on average in 2011–12, 2012–13 and 2013–14 and from 1.3% to 0.7% in 2014–15 and 2015–16. As we saw in Chapter 9, further cuts in spending plans over Spending Review 2010 would probably require real cuts on average in departmental budgets, once largely unavoidable increases in social security spending and debt interest payments are taken into account.

But, as we noted in Chapter 3, the PBR forecasts show an apparent desire by the government to return total spending and total tax revenues to broadly their pre-crisis levels as shares of national income by the end of the forecasting horizon. Our forecasts suggest that it will achieve this on spending, but that there will be a decline in the broad measure of the tax burden. This may suggest that the government would prefer to respond to a revenue shortfall primarily with revenue-raising measures. This would clearly be difficult politically (as would cutting spending further), but it is perhaps worth remembering that the tax increases in the PBR were only a tenth the size of those announced in the 1993 Budgets combined, the last time a government – and a Conservative one at that – confronted a similar need for substantial fiscal tightening.

In the PBR, the government chose to raise revenue primarily through increases in National Insurance rates and – to a lesser degree – increases in income tax rates for those on incomes above £100,000. We also know that the government considered increasing the standard rate of VAT to 18.5%, which would have had the added advantage of making the stimulus package more powerful by further reducing the price of purchases during

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[8] Goldman Sachs client note, 21 January 2009.

the temporary cut relative to the price of purchases after it expires. Presumably, much of the focus would remain on these taxes if more revenue were needed.

As Chapter 11 explains, the government has needed to increase marginal income tax rates quite significantly on people with incomes above £100,000 to bring in a relatively small amount of additional revenue. We are carrying out further analysis of the potential to raise revenue from taxing high incomes, but it seems highly unlikely that this avenue alone could be relied upon to provide the bulk of the necessary tightening.

One possibility canvassed in Chapter 10 would be to pre-announce a broadening of the UK's unusually narrow VAT base – in other words, removing existing zero and reduced rates and taxing all consumer spending currently subject to those rates at the standard rate. This would be desirable on efficiency grounds, as it would remove economically costly distortions to people's spending decisions and firms' production decisions.

Zero and reduced rates are often justified as a way to help the less well-off (who spend a higher proportion of their budgets on zero- and reduced-rate items), but the bulk of the cash gains go to better-off households who consume more of these items in absolute terms. Because zero and reduced rates are an unnecessarily costly way of redistributing to the less well-off, we could raise revenue even after compensating poorer families on average for doing so. Chapter 10 suggests that a reform of this sort could raise more than £10 billion in extra revenues while protecting poorer families.

If the government felt that the timing was appropriate, such a reform could also contribute to a fiscal stimulus package if the compensatory increases in benefits and tax credits were paid to poorer families in advance of the tax increase. Our central estimate is that an additional tightening on top of this would also be required. Having moved to a uniform rate of VAT, then if the objective was to raise additional funds in approximate proportion to families' living standards and to introduce minimal additional distortions, a good way of doing this would be to increase this uniform rate of VAT from 17½%. Each 1 percentage point rise would raise around £6 billion a year in today's terms.