Alistair Darling's mini-Budget: can he afford it?

Robert Chote
Carl Emmerson

The Institute for Fiscal Studies

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1. Introduction

The government's decision on 13 May 2008 to increase the personal income tax allowance by £600 and to reduce the effective upper-rate threshold by the same amount for 2008–09 is estimated to cost £2.7 billion (just under 0.2% of national income). The Chancellor, Alistair Darling, told the House of Commons: 'I am able to finance this proposal through borrowing this year ensuring that we do not take money out of the economy at this time'.[1]

The government maintains that the tax cut:

- is affordable within the constraints laid down by its fiscal rules; and
- will provide a useful stimulus to the economy at a time when economic growth is slowing.

This Briefing Note briefly assesses these claims.

2. The tax cut and the fiscal rules

The government has set itself two fiscal rules that constrain how much it can borrow and to what purpose:

- The **sustainable investment rule** requires the government to keep public sector debt (net of short-term financial assets) at a 'stable and prudent' level. The 2008 Budget said: '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'.[2]

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[1] http://www.hm-treasury.gov.uk/newsroom_and_speeches/speeches/statement/Speech_statement_130508.cfm.

[2] http://www.hm-treasury.gov.uk/media/6/0/bud08_chapter2.pdf, paragraph 2.40. Like the Treasury, we ignore the impact of the nationalisation of Northern Rock on the debt ratio in presenting forecasts and judging whether the sustainable investment rule is adhered to.

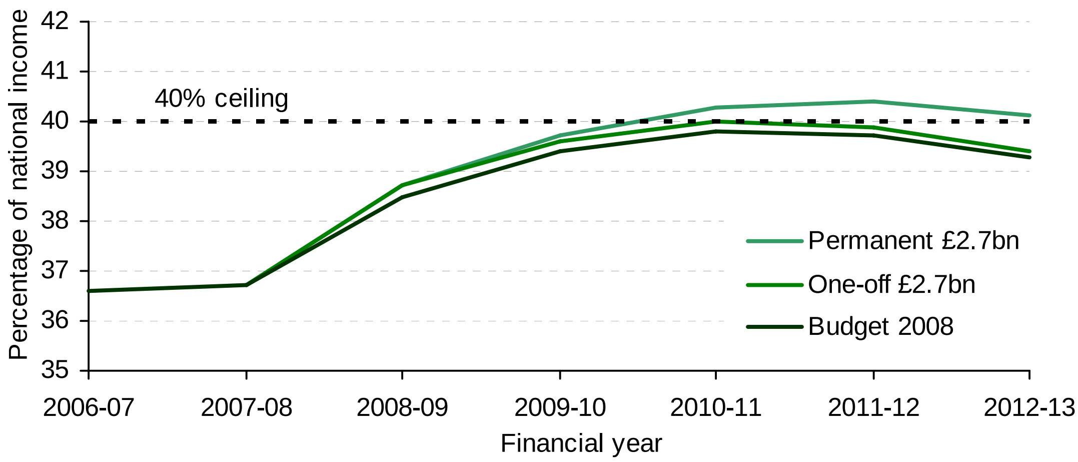
- The **golden rule** requires the public sector to borrow only to pay for capital investment, and to finance its remaining 'current' spending from revenues. In other words, the government has to keep the current budget (revenues minus current spending) in balance or in surplus. The rule has to be met on average over the economic cycle rather than every year.

The Treasury laid out its latest forecasts for public sector net debt and the current budget balance in the Budget in March. These show public sector net debt rising from 37.1% of national income in 2007–08 to a peak of 39.8% in 2010–11, falling back to 39.3% in 2012–13. The current budget balance is expected to move from a deficit of 0.6% of national income in 2007–08 to a surplus of 1.0% in 2012–13.

Figure 1 shows the Treasury's Budget forecasts for public sector net debt, alongside two alternative scenarios in which:

- there is a one-off increase in borrowing of £2.7 billion in 2008–09, reflecting the Treasury's stated costing of the one-off tax cut; and
- there is a permanent increase in borrowing of £2.7 billion in 2008–09, rising by 2.75% a year thereafter in line with the government's long-term RPI inflation forecasts. This reflects the fact that failing to renew the increase in the personal allowance – or to do something similar – would leave millions of families worse off in 2009–10 than they would be if the 2008–09 system were uprated as usual. On the evidence of recent weeks, this is something that the government may wish to avoid.

Figure 1. Public sector net debt (Budget 2008 forecast baseline)



Notes: 'One-off £2.7bn' increases debt by £2.7 billion in cash terms in all years from 2008–09 onwards. 'Permanent £2.7bn' adds a further £2.7 billion, uprated by 2.75% a year, to debt in each year from 2009–10 onwards.
Sources: HM Treasury, *Public Sector Finances Databank*, *21st April 2008* (http://www.hm-treasury.gov.uk/media/3/2/psfd_210408.xls); HM Treasury, *Budget 2008* (http://www.hm-treasury.gov.uk/budget/budget_08/report/bud_bud08_repindex.cfm).

The graph shows that if the tax cut had been announced at the time of the Budget, the Treasury would presumably have forecast that public sector net debt would hit the 40% ceiling in 2010–11 (measuring the net debt ratio to the nearest tenth of a percentage point as usual). If it wished to be more precise, it could claim to expect to remain £600 million below the ceiling in 2008–09 terms. However, if the government were unable to claw back the cost of this ‘one-off’ giveaway in future years, net debt would be forecast to break through the ceiling in 2010–11, peaking a year later at 40.4% of national income – a breach of a little over £5 billion in 2008–09 terms. The Treasury would thus expect to break the sustainable investment rule as currently defined.

This would clearly be embarrassing to Mr Brown, who has set much store by adherence to his fiscal rules, both as Chancellor and as Prime Minister. Having said this, there would be little direct economic significance to such a breach, as long as it were not seen as a signal that the government was content to see a significant further increase in the debt burden. The margin by which net debt is expected to overshoot or undershoot the 40% ceiling under these scenarios is also very small compared with the average error in forecasting net debt over this time horizon. To all intents and purposes, there would remain a roughly 50:50 chance of the rule being breached in each case.

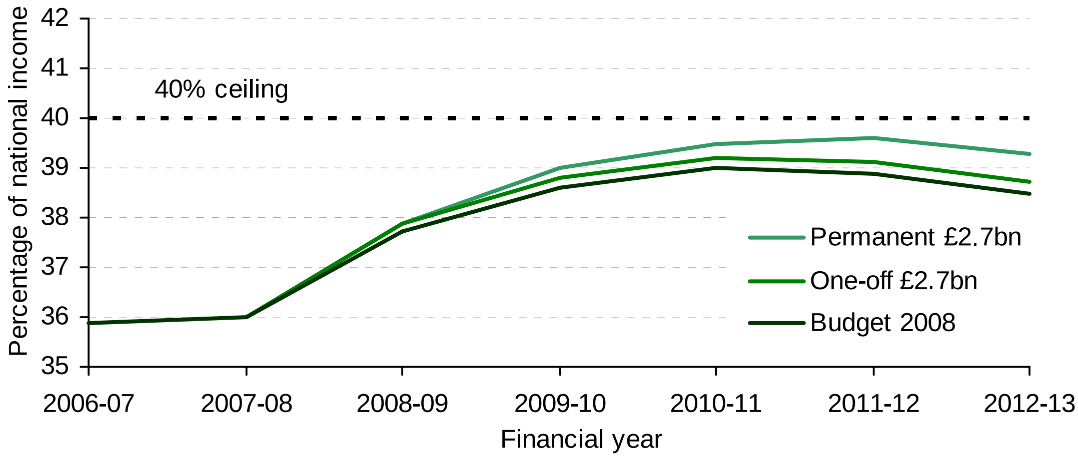
However, the tax cut announced on 13 May will not be the only factor prompting a change to the Treasury’s fiscal forecasts between now and the Pre-Budget Report in the autumn. One important development will be a change in the treatment of financial services in the National Accounts.[3] Experimental estimates by the Office for National Statistics (ONS) suggest that incorporating ‘financial intermediation services indirectly measured’ (FISIM) in the National Accounts will increase the headline measure of national income by 2.0% in 2007 and by between 1.3% and 1.9% in earlier years.[4]

Figure 2 shows the profile for public sector net debt under the same three scenarios, but with the measured level of national income increased by 2% from 2007–08 onwards, in line with the ONS’s latest experimental estimates of FISIM. This lifts the debt ceiling by the equivalent of £12 billion in 2008–09 terms and means that the Treasury would not expect net debt to exceed 40% under any of the three scenarios: it peaks at 39.2% if the addition to borrowing to pay for the tax cut is for one year only and at 39.6% if it is permanent. This implies that it would remain below the ceiling by £12.4 billion if the tax cut is ‘one-off’ and by £6.5 billion if it is permanent, in 2008–09 terms.

[3] http://www.hm-treasury.gov.uk/media/9/9/bud08_chapterb.pdf, box B9.

[4] http://www.statistics.gov.uk/pdfdir/fisim0308.pdf.

Figure 2. Public sector net debt (Budget 2008 baseline, adjusted for FISIM)



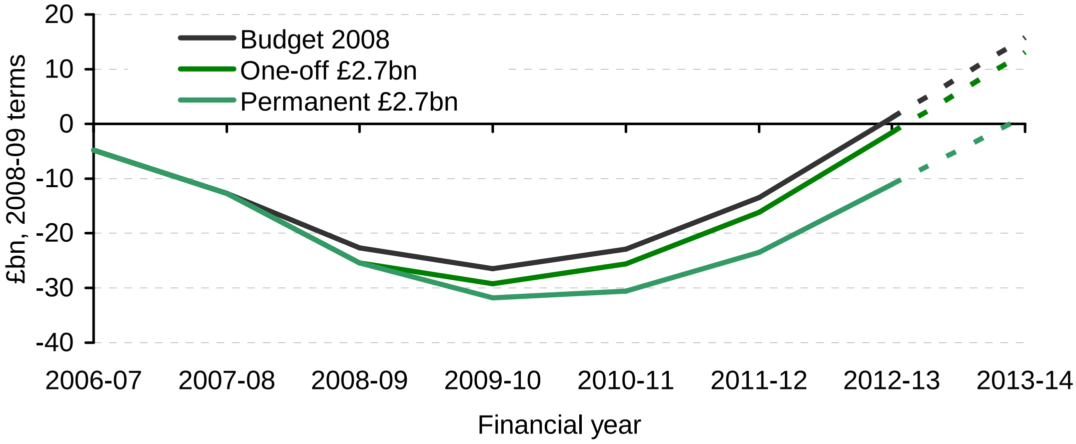
Notes: As Figure 1. GDP assumed to be 1.9% higher in 2006–07 and 2.0% higher from 2007–08 onwards.
Sources: As Figure 1; Office for National Statistics, *Financial Intermediation Services Indirectly Measured 4th Quarter 2007*, 31 March 2008 (http://www.statistics.gov.uk/pdfdir/fisim0308.pdf).

In addition to the FISIM adjustment, the Blue Book may include other revisions to national income, which on past performance are more likely to be upward than downward, further increasing the government's room for manoeuvre. Conversely, independent forecasts suggest that the Treasury may have to revise down its estimates of economic growth over the next couple of years, which would depress tax revenues and push up borrowing – as well as lowering the expected level of national income. We estimate that if the economy grows in line with the International Monetary Fund's latest World Economic Outlook forecasts, the forecast for net debt would be about 0.5% of national income higher in 2009–10 than it otherwise would be. This would partially offset the favourable revision arising from the FISIM adjustment. Other adjustments – for example, reflecting asset price changes – could have a similar effect. The bottom line is that we cannot yet know whether or not the Treasury would, in the absence of new tax increases or spending cuts, be forced to predict a breach of the 40% ceiling in the Pre-Budget Report.

Turning to the golden rule, we can assess the impact of temporary and permanent £2.7 billion tax cuts – which directly reduce the government's current budget balance – on the cumulative balance over the economic cycle. This has to be zero or positive at the end of the cycle for the golden rule to be met.

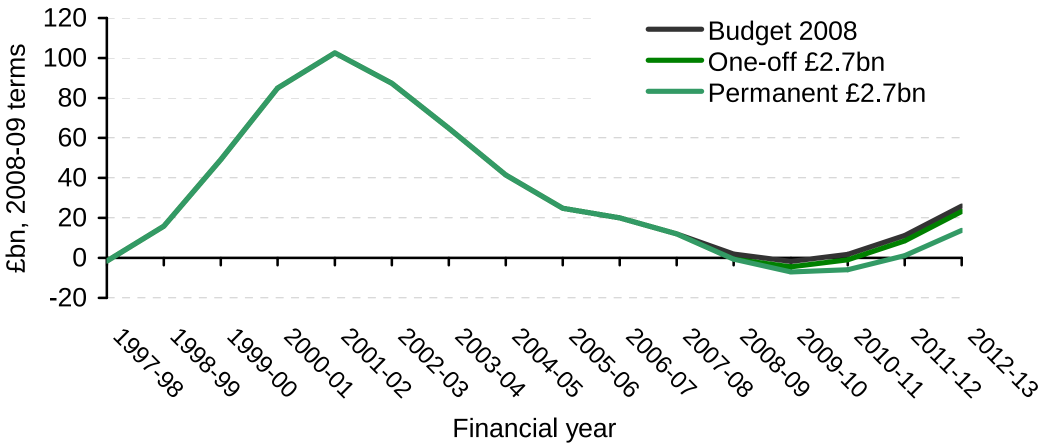
The Treasury's provisional view is that the last economic cycle closed in 2006–07 and in the past it has treated the last year of one cycle as the first year of the next. Figure 3 shows the cumulative current budget balance from 2006–07 forecast by the Treasury in Budget 2008, alongside the two tax-cut scenarios. The Budget forecasts require the new cycle to be at least seven years long for the deficits expected in the near term to be offset by later surpluses, thus complying with the golden rule. Under both tax-cut scenarios, the cycle would need to be one year longer to meet the golden rule. This is the case whether or not national income is adjusted to incorporate FISIM (assuming that the dating of the cycle remains unchanged).

Figure 3. Cumulative forecast current budget surplus, cycle beginning in 2006–07



Notes: 'One-off £2.7bn' increases current budget deficit by £2.7 billion in cash terms in 2008–09. 'Permanent £2.7bn' adds £2.7 billion, uprated by 2.75% a year, to the current budget deficit in each year from 2008–09 onwards. Current budget surplus assumed to remain constant beyond the forecast period (shown by the dotted rather than solid line).
Sources: As Figure 1.

Figure 4. Cumulative forecast current budget surplus, cycle beginning in 1997–98



Notes: As Figure 3.
Sources: As Figure 1.

If the Treasury decides that national income did not break decisively above the level consistent with stable inflation in 2006–07, it may take the view that we are still in the economic cycle that it believes to have begun in 1997–98. Figure 4 shows the cumulative current budget balance over this cycle. The Budget forecasts imply that the golden rule would be narrowly breached if the cycle ends in 2009–10; the tax-cut scenarios show it narrowly breached if the cycle ends in 2008–09, 2009–10 or 2010–11. This is true with or without adjusting for FISIM (again assuming that the dating of the cycle remains unchanged).

As with the projections for public sector net debt, the margins by which the rule is or is not breached are very small by comparison with the average forecasting error over this time horizon. And, once again, there would be little direct economic impact from a breach of this size. The damage for the government would presumably be largely reputational.

3. The tax cut and macroeconomic management

The government argues that the announcement of the tax cut on 13 May will provide a useful stimulus to the economy at a time when growth is slowing. The Prime Minister said on 16 May:

> At times when the economy needs to be moved forward it is right to borrow so that fiscal policy can support monetary policy. It is what is happening in America, it is what is happening in other countries as a result of the need to deal with the world economic situation. So these are the right decisions both for the future of the economy and the right decisions that we have made this week to put extra money into the economy.[5]

However, by giving the Bank of England independence to set interest rates in pursuit of an inflation target, Mr Brown has in effect left the Bank to decide the appropriate overall level of spending in the economy. If the tax cut boosts people's spending, the Monetary Policy Committee will presumably set interest rates slightly higher than it otherwise would have done to deliver the same outlook for inflation. This will have distributional consequences, as tax cuts and interest rate increases affect different people in different ways. But it is not obvious that it will have any significant impact on the economy.

Mervyn King, the Governor of the Bank of England, said on 14 May that it would be for the committee to determine the likely impact of the move on growth and inflation – and thus, presumably, any impact on interest rates. But he added:

> It's a relatively modest measure; it amounts to 0.3% increase in household incomes; approximately 0.2 percentage points worth of GDP. But the impact of that on spending is not easy to judge, because of course we won't know until November exactly what measures the Chancellor will or will not be taking in order to make the change he announced yesterday consistent with sticking to the fiscal rules.[6]

[5] http://www.number-10.gov.uk/output/Page15580.asp.

[6] http://www.bankofengland.co.uk/publications/inflationreport/conf140508.pdf.

Charlie Bean, the Bank's chief economist, added that the measure might also affect the potential level of economic activity that the economy could sustain without inflationary pressure.

4. Conclusion

The decision to announce a £2.7 billion 'unfunded tax cut' for 2008–09 will temporarily increase government borrowing and permanently increase public sector net debt from the levels we would otherwise have seen. If the government finds it difficult to avoid maintaining all or part of the giveaway in future years, the impact on the debt level will be correspondingly larger.

Other things being equal, the tax cut would lead the Treasury to predict that net debt would hit or breach its ceiling of 40% of national income in the next few years. Likely downward revisions to forecasts for economic growth would also push the expected level of net debt higher as a share of national income.

However, we can expect an offsetting effect from upward revisions to official estimates of national income in this year's Blue Book from the Office for National Statistics. These revisions are doubtless justified on statistical grounds, but if they take place at exactly the time at which the Treasury would otherwise have had to forecast a breach, they would fuel the perception that Mr Brown is willing to shift his fiscal goalposts when they become inconvenient.

Many economists have long ago ceased to regard the fiscal rules as a meaningful constraint on the government's tax and spending decisions. So the tax cut may affect the credibility of the government's management of the public finances more through its impact on broad perceptions than through its precise impact on the variables that the government claims to be targeting.

Gordon Brown spent many years in Opposition and as Chancellor seeking, with considerable success, to dispel the stereotype of Labour governments as putting short-term advantage ahead of the health of the public finances. Whatever the precise impact of this latest measure, some more of this hard work has surely been undone.