

# 1. Summary

## Chapter 2: The public finances under Labour

- Labour inherited, by international standards, a big budget deficit and an average public sector debt burden. More than a decade later, the structural budget deficit and the debt burden have both been reduced. But of 21 comparable industrial country governments, 19 have done more to improve their structural budget balances and 16 have done more to reduce their debt burdens than the UK has.
- Since taking office, Labour has announced net tax increases that will raise 1.3% of national income (£18.8 billion in today's terms) this year. This has contributed to a total increase in the tax burden of 2.1% of national income (£29.5 billion). This is being used to increase public sector investment and cut government borrowing.
- To strengthen the public finances over the next five years, Labour plans to allow the tax burden to increase by 1.0% of national income (£14 billion) and to cut public spending by 0.5% of national income (£7 billion). If delivered, this would take the tax burden to a 24-year high and public spending to an eight-year low.
- Over the next five years, Labour plans to take 48% of the 'proceeds of growth' in tax, up from 45% under Labour to date and 30% under the Conservatives from 1979. Real national income is expected to rise by £5,500 per family by 2012–13, with roughly £2,600 being taken in tax and £2,900 being left in individuals' pockets.

## Chapter 3: The fiscal rules and policy framework

- Designing fiscal rules requires a trade-off between precision on the one hand and simplicity and transparency on the other. The golden rule and sustainable investment rule are not optimal as currently applied and could be improved. But they still have significant potential value as rules of thumb.
- Many economists outside government no longer see compliance with the fiscal rules as a good guide to the health of the public finances. In part this reflects concern that Gordon Brown, when Chancellor, 'moved the goalposts' to make the golden rule easier to meet.
- Using the Treasury's start and end dates for economic cycles, it met the golden rule over the previous economic cycle with £19 billion to spare and appears on course to meet it over the new cycle, provided the cycle is sufficiently long. However, using other plausible methods to date the cycle, the golden rule has already been broken under Labour.
- It would be sensible to make the golden rule symmetric, forward-looking and less reliant on the need to date the economic cycle precisely. The Treasury's fiscal forecasting could be made more transparent or perhaps even delegated to an independent body.

- There seems to be no appetite among the main political parties to reduce the burden of public sector debt significantly. But most industrial countries have done more to reduce their debt since 1997 than the UK and more than one in three OECD countries now have net holdings of financial assets rather than net debt.
- The taxpayer has provided guarantees worth up to £55 billion to Northern Rock's creditors. But if Northern Rock is nationalised, or if the Office for National Statistics determines that the government is in effective control of the company, around £100 billion could be added to public sector net debt.
- Were this to occur, the government should be able to unwind most (or perhaps even all) of the increase once Northern Rock's mortgage book has been sold. Whether a fiscal policy response is required should be determined by the long-term impact on public sector net debt rather than any short-term impact. Meanwhile, the Treasury should present public sector net debt figures including and excluding the impact of commitments made to Northern Rock.

## **Chapter 4: The economic outlook**

- The economic outlook for the next few years is worse than it has been for some time. Our central forecast is that there will be a moderate slowdown in the UK economy over the coming fiscal year followed by a rather weak recovery in 2009. This implies two years of growth below the economy's long-run trend rate.
- We expect weaker consumer spending for the next few years as the incentives to save increase and the availability and price of credit make borrowing less easy.
- Although we expect slower domestic demand growth in the next year or so, growth is also likely to slow in the economies of the UK's major trading partners (particularly the euro area and the US). Without a very sharp depreciation in sterling, net trade is not likely to boost growth in the UK.
- This forecast for the UK economy differs somewhat from that of the Treasury. In particular, we forecast somewhat weaker GDP growth than the Treasury in fiscal years 2008–09 and 2009–10. Thereafter, we actually project slightly stronger growth than the Treasury does.

## **Chapter 5: Green Budget public finance forecasts**

- Public sector net borrowing and the current budget deficit are likely to be £2.5 billion bigger this year, and £4.8 billion bigger next year, than forecast in the October 2007 Pre-Budget Report.
- Assuming that the economy evolves largely as the Treasury expects, but with corporation tax receipts only bouncing back to their long-term average by 2012–13 and with weaker growth in stamp duty revenues from both property and share transactions, by 2012–13 we are around 0.5% of national income – or £8 billion in today's terms – less optimistic than the Treasury about the current budget balance.

- In today's terms, we expect the current budget to be in surplus by £8 billion in five years' time, roughly £18 billion stronger than it is now. Of this improvement, £9 billion reflects a rise in the tax burden and £9 billion cuts in public spending after 2007–08.
- Despite this, we believe that without a further tightening the golden rule would be more likely to be missed than met unless the economic cycle that the Treasury believes began in 2006–07 runs for 10 years or more.
- We also forecast higher public sector net debt than the Treasury, expecting it to rise by 3½% of national income by 2012–13. In the absence of new policy announcements, we believe that it is more likely than not that debt will breach the 40% of national income ceiling that Mr Brown chose to adhere to when he was Chancellor – even ignoring the potential impact of Northern Rock.
- If the Chancellor wants to keep net debt below 40% of national income and maintain the improvement in the current budget balance that he was looking for in the PBR, we believe that he would need to announce tax increases worth around £8 billion. This seems unlikely, given the government's political constraints and the outlook for the economy. But there is scope for the Bank of England to offset the impact of a modest fiscal tightening on growth and inflation, so taking some action to underpin the fiscal position now would be prudent.

## Chapter 6: Funding, debt management, and credit market problems

- As in recent years, the government is likely to have to borrow more over the next five years than the Treasury currently thinks. But the government still faces an environment that is favourable for issuing gilts at relatively low cost.
- Yields on shorter-dated gilts are exceptionally low, which argues for skewing issuance away from medium-dated towards shorter-dated bonds.
- Short-dated gilt yields are low in part because of turbulence in financial markets – the so-called 'credit crunch'. If this continues, it would pose significant difficulties for mortgage lenders. We consider a number of possible strategies to alleviate this problem, including the creation of an agency to buy or lend against the collateral of mortgage-based securities issued by banks and building societies.
- Mortgage contracts that (i) link monthly repayments to consumer prices or house prices, and (ii) involve borrowers and lenders sharing the risk of house price changes, should be both attractive and commercially viable.

## Chapter 7: Pressures on public spending

- Public spending is set to grow only half as quickly over the three years covered by the 2007 Comprehensive Spending Review (CSR) as over the 'years of plenty' covered by

the previous four spending reviews. In a number of areas, the CSR spending plans may be insufficient to achieve stated policy goals.

- Health is set to see spending increase much less quickly than it has done over recent years. The CSR proposes to spend between £6 billion and £10 billion less on health in 2010–11 than Sir Derek Wanless's reviews have suggested would be necessary to progress towards a world-class health service.
- Education spending will stop rising as a share of national income under the CSR plans. If spending continues to increase at the rate planned in the CSR, the government would only meet its goal of matching the 2005–06 level of spending per pupil in the private sector in 2020–21 – a lag of 15 years.
- The local government settlement between 2008 and 2010, and the prospect of 'capping' for councils that propose cash-terms increases in council tax rates above 5%, put pressures on local services. These could be particularly tight in 2010–11, when the main grant is set to be cut in real terms.
- The government would need to spend around £3.4 billion more than it is currently forecasting on tax credits and social security benefits in 2010–11 if it were to give itself a 50:50 chance of meeting its child poverty target for that year.

## **Chapter 8: Public sector pay and pensions**

- The public sector pay bill has been increasing since the beginning of this decade, reflecting both higher public sector employment and rising levels of public sector pay. As it squeezes spending, the government is attempting to slow pay growth in the public sector. It claims that to do so is important in controlling inflation.
- The case for using a public sector pay policy to help target inflation is weaker than some recent government statements have suggested. It is certainly not the case that public sector pay increases have to be held to 2% just because the UK has a 2% inflation target. Over time, public sector pay will need to reflect productivity improvements across the whole economy.
- The Bank of England believes that pay increases of around 4½% a year across the whole economy would be consistent with the inflation target. Headline public sector pay increases consistent with the inflation target will generally be lower because of relatively high 'pay drift' for some groups of public sector workers.
- Relatively generous public sector pensions mean that a public sector worker is on average around 12% better off than a private sector worker on the same basic salary. This gap has grown over the past decade as a result of private sector retrenchment. The government has made modest progress on reform, but unfunded public pension liabilities continue to grow. The gap between public and private sectors does not look sustainable. The case for further reform is strong.
- The 'staging' of a number of pay review body recommendations last year has delivered modest, but strictly one-off, savings. There would be significant risk to the credibility of

the pay review body process if the government were to make a habit of not implementing recommendations. This would have long-term costs.

- Public sector pay is much lower relative to private sector pay in London and the South East than in other parts of the country. If the government wishes to broadly equalise the quality of public services across the country, it should increase public sector pay more quickly in areas where it is relatively low.

## Chapter 9: Aviation taxes

- Aviation is responsible for a rapidly-growing proportion of greenhouse gas emissions. Emissions, noise pollution and congestion all provide economic rationales for aviation taxes.
- Unfortunately, international agreements prevent fuel for international flights being taxed. But taxes on tickets, passengers and flights are all permissible.
- The government proposes putting a tax on flights from November 2009, replacing the current tax on passengers, air passenger duty (APD). This should allow it to target the level of emissions more effectively than APD does at the moment.
- A reformed aviation duty on flights would strengthen incentives for aircraft to fly as fully-loaded as possible and could also be extended relatively easily to freight flights, although the revenue from taxing freight flights would likely be small.
- To be targeted precisely on the external costs of aviation, the rates of a new aviation duty might in principle have to vary by aircraft type, aircraft emissions and departure airport, as well as by distance travelled. But the more sophisticated the tax is, the more complicated it will be to administer and comply with.
- To the extent that the new tax would be passed on to passengers, if the revenue raised were to remain the same there would be both winners and losers. The winners from a relatively sophisticated aviation duty would be those flying short distances on full, clean, quiet planes from airports away from residential areas.
- Reforms to aviation taxation are likely to be followed by the inclusion of aviation in the EU Emissions Trading Scheme. The interaction of the domestic tax with this system will need careful consideration.

## Chapter 10: Capital gains tax

- The government's proposal in the Pre-Budget Report to abolish taper relief and the distinction between business and non-business assets was a welcome step in the direction of making capital gains tax (CGT) simpler and less distortionary.
- It would, however, probably be a good idea to sacrifice some of the gains in simplicity to make CGT even less distortionary, by applying reduced rates to corporate equity to reflect corporation tax already paid, and perhaps by re-introducing relief for inflation.

- There is a strong case for aligning CGT rates with the tax rates on earnings and dividend income. Higher CGT rates might discourage saving, investment and entrepreneurship, but these could be encouraged in better-targeted ways.
- Owners of business assets are understandably upset to see the withdrawal of a tax break from which they had expected to benefit, but it is not clear in many cases that the proposed regime is less favourable than when they bought the asset in the first place. The government could have offered transitional relief, but this would have re-complicated the system and created problems of its own.
- Announcing a reform without consultation, creating additional uncertainty by agreeing to rethink it in the face of intense lobbying, and then delaying the results of the rethink, are not the hallmarks of competent tax reform. It is hard to believe that whatever changes to CGT finally emerge this year will be the last.
- The announcement of a £200 million ‘entrepreneurs’ relief’ to be introduced in April 2008 will be a welcome reprieve for many owner-managers of small businesses, but reintroduces complexities and inefficient distortions similar to those inherent in taper relief.

## **Chapter 11: Corporation tax and entrepreneurship**

- Labour has changed corporation tax rates in seven of its 11 years in office and plans to change them again next year and in 2009–10. This has caused considerable uncertainty and upheaval, particularly for the owners and managers of companies with profits below £50,000 per year.
- Throughout Labour’s time in office, the tax and National Insurance system has provided incentives to be self-employed rather than employed, and incorporated rather than unincorporated. The introduction (at 10%) and subsequent reduction (to 0%) of a ‘starting’ rate of corporation tax on those with profits below £10,000 substantially increased the incentive for small businesses to incorporate. Many new companies were set up as a result, but it is not clear how many were the type of ‘entrepreneurial’ businesses the government wanted to encourage.
- The removal of the starting rate, together with the planned increase in the small companies’ rate in 2008–09 and 2009–10, suggests that the government has now acknowledged that creating tax incentives that favour one legal form over another may not be the most sensible way to encourage entrepreneurship.
- The government’s experiment with the 0% starting rate may have alerted people to the tax incentives favouring incorporation, even though they are no longer as large as they were. Stemming the continued tide of incorporations may require further increases in – and perhaps even the abolition of – the small companies’ rate. This may be no bad thing, as the economic rationale for a distortion in the tax system in favour of companies with low profits is far from clear.

## Chapter 12: Taxation of companies' foreign profits

- In June 2007, the Treasury and HM Revenue & Customs proposed moving away from taxing the dividends that UK companies receive from their foreign subsidiaries (having given a credit for any foreign taxes paid on those dividends) to a system in which foreign dividends are exempt from UK taxation altogether.
- Moving to an exemption system should increase the after-tax profitability of UK multinationals by allowing them to compete for control of firms in low-tax countries on a level playing field with multinationals in other exemption countries. The tax system would be less likely to distort investment decisions unhelpfully.
- An exemption system is more likely to be compatible with EU law than the current 'credit' system. In principle, an exemption system should also be simpler and cheaper for companies to comply with, but the government's reforms involve unnecessary complexity that would probably squander these potential gains. The proposed exemption system could be simpler if: exemption for foreign dividends included as few exceptions as possible; dividends arising from small and large shareholdings were dealt with on the same basis; and if no distinction were drawn between small, medium and large company recipients.
- The document also proposes changes to the definition of controlled foreign company income, which potentially have wide-ranging impact. The current *entity*-based regime would be replaced by an *income*-based regime. This would broaden the category of foreign income that the UK government attempts to tax (largely passive income) and increase the scope for capturing such income.

## Chapter 13: Tax simplification

- The government has reaffirmed its commitment to simplify the tax system, but attempts by this and previous governments to deliver real and long-lasting reductions in complexity have usually come to nothing and the volume of tax legislation has grown inexorably.
- The rewrite of direct tax legislation, initiated under the last Conservative government and still in progress, uses simpler language but at much greater length and without resolving any of the underlying complexity in the legislation.
- The abolition of buildings allowances, the reform of capital gains tax and proposals for adopting simpler 'principles-based' anti-avoidance legislation are three measures that offer the prospect for some simplification of existing rules.
- Each proposal, however, has met with opposition. In the first two cases, those adversely affected by the proposals have objected. The third case has prompted concerns that it will create uncertainty and confer too much discretion on HM Revenue & Customs. Each proposal illustrates a variety of trade-offs that have to be made between simplicity and other legitimate aims of particular measures.

- Real simplification is difficult to achieve without more fundamental consideration of what, who and how we tax. Tackling complexity requires that we recognise what is complex and why, and focus on what can sensibly be done about it.
- In this respect, the government's approach of identifying particular elements of the tax system for review is a useful start. Ultimately, however, government must be clear as to its policy goals. One can then judge whether it is its goals that are complicated – possibly too complicated – or just its methods.

## **Chapter 14: The impact of tax and benefit reforms to be implemented in April 2008**

- Several big changes to the tax, tax credit and National Insurance systems were announced in last year's Budget and Pre-Budget Report to be implemented this April. These involve tax cuts and tax credit increases worth £14 billion in the coming fiscal year, offset by tax increases of roughly the same amount. This is the biggest set of changes to be implemented in any one year under Labour.
- Households at the top and bottom of the income distribution will gain most from the changes to personal taxes and tax credits, while those in the middle will see very little impact. But increases in taxes that we cannot allocate to specific households (such as corporation tax) are likely to reduce these gains at the top and bottom of the income distribution and may result in net losses in the middle.
- The reforms to the direct tax system are a welcome simplification of the structure of marginal rates, although further simplification would be desirable. Cutting the marginal rate for basic-rate taxpayers will improve incentives to work and to save very slightly for many individuals, but the package will not reduce the very high marginal tax or deduction rates faced by those with the weakest work incentives.
- Taking this April's changes into account, the tax and benefit reforms since 1997 will have increased the incomes of the poorest tenth of the population by 12.4% (£1,300 a year) and reduced those at the top by 5.5% (£4,200 a year) on average. Despite facing higher net taxes, a household in the middle of the top tenth of the income distribution has still enjoyed an increase in real post-tax income of around 20% between 1997 and 2006.