Public finances

If Labour backbenchers were hoping for a big giveaway Budget to kick off the government’s re-election campaign, they should have been sorely disappointed. Gordon Brown offered some modest sweeteners to pensioners, motorists and homeowners, but what he gave with one hand he took away with the other.

This was a far cry from the £3.6 billion net giveaway the Chancellor announced in his Budget a couple of months before the 2001 general election. Since then, his forecasts for the public finances have turned out to be repeatedly overoptimistic, giving him much less scope to be generous than he had four years ago.

The biggest giveaways this time were a £200 “one-off” payment to council-tax-paying households with someone aged 65 or over (costing £800m in 2005–06), a six month delay in raising fuel duties in line with inflation (costing £235m), and a permanent doubling of the threshold for stamp duty on properties to £120,000 (costing £250m).

These were paid for with a predominantly one-off hit on North Sea oil companies (raising £1,100m), a package of anti-tax avoidance measures (raising around £650m) and the abolition of stamp duty relief for commercial properties in disadvantaged areas (saving £340m).

The net impact of the Budget measures on the public finances is a tightening of £265m next year, but this becomes a net giveaway as the tax hit on oil companies diminishes. The giveaway in future years could end up being larger still if the Chancellor feels it necessary to repeat this year’s one-off handout to pensioners, as past experience suggests he might.

The Chancellor’s limited room for manoeuvre in the Budget was underlined by the fact that he had to revise down his 2004–05 forecast for the current budget balance – the measure that matters for his famous “golden rule” – for the sixth Budget or Pre-Budget Report running.

He predicted in December’s Pre-Budget Report that he would face a £12.5bn shortfall this year between government revenues and non-investment spending, compared to the £10.5bn he expected in last year’s Budget and £1bn the year before that. He now forecasts a current budget deficit of £16.1bn, in line with the £15.9bn predicted in the IFS Green Budget in January. Like us he now believes that revenues are going to come in weaker and current spending higher than he thought in December.

Current spending is higher than expected this year in part because government departments have used up some of their unspent budgets from previous years, contributing to a £2bn overspend compared to December’s forecast. The government also expects to make a bigger payment to the EU than it thought this year, although part of this is forecast to be clawed back in 2006–07.

On the revenue side, corporation tax and other smaller taxes are expected to bring in more this year than thought in December, while VAT and income tax produce less. Taxes overall are expected to bring in £100m more this year than forecast in the Pre-Budget Report, but this is more than offset by a £1.4bn shortfall forecast in other receipts – notably the profits of state-owned enterprises.

Unlike the IFS Green Budget, the Chancellor predicted that the extra borrowing on the current budget this year will disappear next year. Despite the downward revision this year, his forecasts for the current budget balance over the rest of the period to 2009–10 are almost the same as those he published in December.
So the key question confronting whoever is Chancellor after the election remains the same after the Budget as before it. Is it plausible to expect the current budget balance to improve by 2.2% of national income – £25bn in today’s money – by 2009–10? In particular is it prudent to expect revenues to go up by £27bn over the same 5-year period without fresh tax raising announcements?

On the Chancellor’s forecasts he meets his golden rule – to balance the current budget over the economic cycle – with £6bn to spare over this cycle. This is smaller than the £8bn he predicted just three months ago despite ensuring that his one-off hit on oil companies falls in the current cycle. This £6bn margin is half the Treasury’s average error in forecasting borrowing over one year. We estimate that on the Treasury’s own forecasts and historic forecasting errors that the Chancellor now has a 65% chance of meeting the golden rule over the current cycle. So it is clearly touch-and-go whether or not the rule will be met.

Looking forward into the next cycle the Chancellor remains confident that he will gradually build up current budget surpluses ensuring that the rule is met however long the next cycle lasts. But we think that to achieve these forecasts – and thus to expect to continue to meet the rule with as much confidence as the last Budget – would require him to raises taxes or cut spending by £11bn a year during the next economic cycle which the Treasury believes will begin in April 2006.

If this had been a typical pre-election Budget the necessary tightening would have been even bigger. So although there may be relatively little for his backbenchers to cheer about, Mr Brown’s relatively parsimonious pre-election package has, in this respect at least, satisfied the Hippocratic oath: “above all do no harm”.

**Distributional analysis**

Higher taxes on North Sea oil companies and a package of tax avoidance measures helped the Chancellor fund pre-election giveaways for his favoured groups – parents and pensioners – and to offer help to home-buyers and motorists.

The main permanent tax changes affecting households were increases in elements of the child tax credit in line with earnings until 2007, an immediate doubling of the stamp duty threshold for residential house sales to £120,000, and an above-inflation rise in the threshold for inheritance tax to £300,000 by 2007.

As previously announced, duty on spirits is frozen, but those on beer, wine and cigarettes rise with inflation. Air passenger duty and vehicle excise duty for the least polluting cars will both be frozen.

The rise in the child tax credit will help around 3.5 million low to middle income families with children, and help the Government keep relative child poverty on a downward trend.

The rise in the stamp duty threshold – the first in 12 years – will mean 300,000 fewer house sales are liable for stamp duty. The Chancellor hopes that this will appeal to home buyers, but the main impact may be to increase the price of houses within this band, in which case it will be homeowners that will be the main beneficiaries.

The fraction of first-time buyers paying stamp duty should fall from three quarters to a half, still double the number in 1997, though. The rise in the inheritance tax threshold will benefit the 37,000 estates each year which attract the taxman’s attention.

The other give-aways, though, are short lived, and well timed to coincide with an election later this year: fuel duties will not go up now, but they will rise in September, and again next April, as the Treasury has restated its commitment to increase fuel duties at least as fast as inflation. And pensioners who pay council tax will get £200 later this year, but on current plans they will get no extra help in 2006.

Overall, this Budget followed Gordon Brown’s well-established pattern, with pensioners and low-income families with children the key beneficiaries. But the size of the give-away was relatively small, reflecting the nature of the public finances. In total, direct give-aways to households cost only £1.4 bn in 2005/6, falling to £0.9 bn in 2007/8.
The impact of the most important of these give-aways is shown below. The Figure shows the average change in disposable incomes for households in 10 equal-sized groups ranked according to their income.

With the significant tax rises announced yesterday affecting only businesses, few households will find themselves directly worse off than expected (although all taxes are eventually paid by individuals).

The immediate gains are strongly skewed towards the bottom of the income distribution, although the poorest pensioners will not gain from the help with council tax because they already receive a full rebate. Not reflected in the figures are the gains and losses from changes announced in the 2004 Pre-Budget Report: low-income pensioners and parents will benefit in April from above-inflation increases in the pension credit, tax allowances for pensioners and the child tax credit, but pre-announced changes will lower the incomes of better-off families with children as other parts of the child tax credit system will be frozen.

Although this was obviously a pre-election Budget, the disadvantage facing the Labour party as it finalises its campaigning strategy for the general election is that both opposition parties are taking Gordon Brown’s fiscal forecasts as a starting point for their tax and spend plans.

Both the Liberal Democrats and Conservatives can credibly promise either to implement the Budget giveaways, or spend the money on their own priorities. In particular, the £4 billion of tax cuts offered by the Conservatives can be offered in addition to, not instead of, those announced in the Budget: if the Conservatives win an election later this year, pensioners would see their council tax bills fall this year by £200 thanks to Gordon Brown, and would then see them halved in 2006 thanks to Oliver Letwin’s first Budget.

**Gains from main measures directly affecting households in Budget 2005**

Sources: IFS calculations based on the 2002–03 Family Resources Survey and the 2001–02 Expenditure and Food Survey.

ENDS

**Notes to editors:**

1. Contact IFS on 020 7291 4800 or 07730 667013.