IFS Green Budget 2006

The Chancellor of the Exchequer would need to raise taxes by around £2½ billion to get the public finances back onto the path he was hoping for in last year’s Budget – even if he carries out the £8½ billion of spending cuts he has tentatively pencilled in for the 2007 Comprehensive Spending Review, according to forecasts by economists at the independent Institute for Fiscal Studies in the 2006 Green Budget.

The Green Budget is widely regarded as the most authoritative analysis of the issues facing the Chancellor in making his tax and spending decisions for the forthcoming Budget. The Green Budget is once again produced in collaboration with Morgan Stanley, which has contributed analyses of the economic outlook and debt management policy. Financial support for the Green Budget is also provided through the Economic and Social Research Council’s Centre for the Microeconomic Analysis of Public Policy at IFS.

The Green Budget baseline forecasts suggest that government borrowing is likely to be higher than the Treasury expects. As a result, on existing policies the Chancellor is set to break his ‘golden rule’ by an economically insignificant £0.7 billion over what the Treasury now estimates to be a 12-year economic cycle (1997–08 to 2008–09) rather than meeting it with £12.8 billion to spare as the Pre-Budget Report implied. Public finance forecasts in the last four Pre-Budget Reports have been overoptimistic.

The Morgan Stanley authors forecast that the economy is unlikely to grow as quickly as the Treasury hopes over the next two to three years, which would reduce the rebound in tax revenues and increase government borrowing even further. They also have different estimates of the dates of the current and previous economic cycles.

Last year’s Green Budget argued that the Chancellor would need to announce tax increases or spending cuts worth £11–13 billion to get the public finances back on track. December’s Pre-Budget Report moved in this direction, with a £3 billion tax increase and projections showing public spending falling by 0.7% of national income over the three years of the forthcoming Comprehensive Spending Review (worth £8½ billion in today’s terms).
The Chancellor is expected to set the overall spending figures for the review in either the 2006 or 2007 Budget. He has made it clear to MPs that he will not necessarily adopt the figures in the Pre-Budget Report. If he were to adopt these figures, he would reverse the increase in spending as a share of national income planned for the current Spending Review. This could be hard to square with the Government’s stated objectives for health, education, overseas aid and poverty.

Other conclusions from chapters in the Green Budget include:

- The Treasury’s decision to move the start-date of the economic cycle earlier was conveniently timed in terms of making the golden rule easier to meet, but otherwise the case for doing so was little stronger than in recent years. This has helped undermine the credibility of the fiscal framework and strengthened the case for reform. *(The fiscal policy framework, Robert Chote, Carl Emmerson & Christine Frayne, IFS)*

- There are downside risks to the Treasury’s growth forecasts in the medium term, from weak productivity growth, inadequate saving and the current account deficit. In the short term, strong investment is an upside risk, but labour and housing market developments pose risks on the downside. *(The economic outlook, David Miles, Melanie Baker & Vladimir Pillonca, MS)*

- Under plausible scenarios for health, education and overseas aid, the Pre-Budget Report projections leave other spending growing at just 0.8% a year in real terms in the three years to 2010–11. This compares with 3.8% over the years to date covered by Labour’s spending reviews. *(Public spending pressures, Robert Chote, Carl Emmerson & Christine Frayne, IFS)*

- We expect net debt to reach 39.3% of national income in 2008–09. On past forecasting performance, this implies at least a 44% chance that net debt will breach the 40% of national income debt ceiling laid down in the sustainable investment rule by the last year of the current economic cycle. *(Public finance forecasts, Robert Chote, Carl Emmerson & Christine Frayne, IFS)*

- The likelihood that long-term real interest rates will rise suggests that the Debt Management Office should lock in low real rates of interest now. Higher issuance of long-dated index-linked debt could also support cost effective wider pension provision *(Funding issues and debt management, David Miles & Niki Anderson)*

- Measures announced in the Pre-Budget Report should reduce the problems caused by the need to recover over-payments, but leave some families waiting longer for help and facing higher compliance
costs. But if these measures fail to solve the problems, a move back to fixed awards may be the only remaining solution. *(Tax credits: fixed or beyond repair? Mike Brewer, IFS)*

- Any change in the R&D tax credit for small and medium-sized enterprises is likely to increase the uncertainty and/or complexity associated with claiming relief. The evidence for the National Employer Training Programme’s likely effectiveness in improving the UK’s productivity performance is not very strong so far. *(Productivity policy, Laura Abramovsky, Emla Fitzsimons, Alissa Goodman, Rachel Griffith, Rupert Harrison and Helen Simpson, IFS)*

- Tax competition and decisions of the European Court of Justice may threaten the Treasury medium term corporation tax revenue projections. Fears of further increases in North Sea oil taxation may deter investment. Lessons should be learnt from recent changes in the starting rate of corporation tax. *(Company taxation, Steve Bond, IFS)*

- Measures to ‘protect revenues’ announced since Budget 2002 are estimated to raise £4½bn this year. The Government is increasing the profile of its campaign against ‘unacceptable’ avoidance, but lack of clarity could make the UK less attractive to internationally mobile firms and individuals. *(Tax Avoidance, Steve Bond, Malcolm Gammie & John Whiting, IFS & TLRC)*

ENDS

Notes to editors:

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2. The IFS Green Budget 2006 will be launched on the morning of Wednesday 25th January 2006. Please contact Bonnie Brimstone (020 7291 4800, 07730 667013 or bonnie_b@ifs.org.uk) for details if you would like to register to attend.