Institute for Fiscal Studies

Press Release

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Tax rises and spending cuts will hurt, but little room for Budget easing

The IFS Green Budget forecast is that **the government will need to borrow slightly less in 2010–11** (£2.9 billion) than the Office for Budget Responsibility (OBR) forecasts. But this is in the context of a deficit which we expect to be at £145.6 billion this year. Having set out his fiscal consolidation plan, it is important that Chancellor George Osborne resist the temptation to engage in any significant net giveaway in the Budget.

While last week's growth figures were disappointing, this year's **IFS Green Budget** highlights that any fiscal loosening aimed at helping the economy could be ineffective if it prompts an offsetting monetary tightening, and risks undermining investor confidence that the remainder of the fiscal consolidation plan, in which the Chancellor has set such store, will be delivered.

We are delighted to have once again produced the Green Budget in collaboration with **Barclays Capital** and **Barclays Wealth**. We are very grateful to them for their support and for the chapters they have contributed. We are also grateful to the **Economic and Social Research Council** for supporting much of the day-to-day research at IFS that underpins the analysis in this volume.

If the economy evolves as the OBR expects over the next few years, and if the government adheres to its tight spending plans, then we expect borrowing to continue to be slightly below the OBR's forecast. We forecast that borrowing will be 0.2% of national income lower than the OBR forecast in 2015–16, a very small difference relative to the **large planned fiscal consolidation**.

But there are considerable risks to this forecast, in particular on the downside. Any forecast **improvement in the public finances should be banked** to give additional headroom against these risks. In particular, two risks that might materialise are:

First, the economy might not grow as quickly as the OBR expects, and even if it does the public finances might not bounce back as strongly as it forecasts.

Michael Dicks of Barclays Wealth and Simon Hayes of Barclays Capital expect **the economy to grow at a similar rate to that forecast by the OBR in 2011**, but with the risks skewed to the downside. Over the medium term, they forecast less growth than the OBR forecasts. This is based on estimates that show the future potential output of the UK economy to be lower than the OBR expects, and that show that this potential will take longer to reach. If the economy were to evolve along the Barclays central scenario, we forecast that the public finances would not strengthen as much as the OBR expects. Under this forecast for the economy, we project a deficit on the cyclically-adjusted current budget of 0.4% of national income in 2015–16, which would mean that **current policy would not be consistent with the Chancellor's fiscal mandate**.

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Embargo

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Under the Barclays 'optimistic' scenario, the public finances would evolve in a similar way to that expected by the OBR (and the fiscal mandate would be met), but the outlook is much worse under the Barclays 'pessimistic' scenario, under which we forecast **public sector net debt would still be rising in 2015–16**.

Second, the planned spending cuts might prove formidably hard to deliver.

The last time the UK government attempted to implement real cuts to spending on public services (in the 1990s), it was successful at sticking to its cash plans, but lower-than-expected inflation meant that the planned real cuts were not delivered as quickly as intended. The current government's planned cuts to public spending are far greater than those attempted in the 1990s, and **achieving these more ambitious spending cuts will be more difficult**. In some parts of the public sector – such as in the Home Office and the Ministry of Justice – a combination of the depth of the spending cuts and low labour turnover means that a downsizing of the workforce on the scale implied by the Spending Review will be difficult to achieve cost-effectively on the proposed timescale.

Overall, with such large downside risks to the public finances, **having alternative plans to hand could prove useful.** The government should review its spending settlements in a couple of years' time in light of any changes to the economic and fiscal outlook, or particular difficulties faced by departments in delivering spending cuts that are palatable to the government and the wider public.

Other conclusions from the report include:

On spending:

- The five years from April 2011 are set to be the tightest five-year period for public spending since at least the Second World War. Out of 29 leading industrial countries, only Ireland and Iceland are forecast by the IMF to deliver sharper falls in spending.

- The UK government has decided that in England NHS spending should be protected from cuts and higher education teaching should be cut dramatically. The Scottish Parliament appears to have made similar spending decisions to those in England. The Welsh Assembly has chosen to cut NHS spending to lighten the load elsewhere, while the Northern Ireland Assembly seems to be planning to cut schools spending more than higher and further education. Across the UK, investment spending is to be cut much more deeply than current spending, and on average the cuts will be front-loaded.

- Since 2008, public sector workers seem to have been paid more, on average, than their equivalents in the private sector even after taking account of the higher qualifications among public sector workers. The planned two-year public sector pay freeze should, therefore, not lead to widespread recruitment problems, but some public sector vacancies, especially in London and the South East, will be hard to fill. Public sector pensions remain much more generous than those in the private sector.

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- Assessing the distributional impact of changes to spending on public services is hard. Studies that have aimed to evaluate such impacts, including that produced by the Treasury alongside the Spending Review, have assumed that the value of a public service is equal to the cost of providing it. But the problems with this approach mean that the results should be interpreted cautiously. The Treasury should publish much more detail about its analysis, and be more consistent in choosing which measures are included and excluded.

On tax:

- There are very significant economic benefits to be had from a more coherent and better-designed **tax system**. Successive governments have failed to present a coherent tax strategy and tax policymaking has suffered from a lack of direction, imposing substantial costs on the real economy. This government should make clear where it sees the shape of the tax system in the medium term and the purpose and direction of each of the major taxes. The ways in which HM Treasury and HM Revenue and Customs work together, and the extent of parliamentary scrutiny of tax policy, should be reviewed to improve the quality of tax policymaking.

- The **Patent Box**, which will reduce the corporate tax rate on the income derived from patents to 10% from April 2013, will cost over £1 billion a year in lost revenue which will benefit a handful of firms. The policy is poorly targeted at promoting research, distorts the decision to invest in patentable technologies, and will add unnecessary complexity to the tax system. Much of its cost will be deadweight, accruing to activities that would have occurred in the absence of the policy. The jury is still out on whether the policy is the best way to encourage firms to retain the real activity associated with mobile intellectual property in the UK.

- We should have a single, visible price of carbon for all parts of the economy in order to reduce carbon dioxide emissions as efficiently as possible. But we remain far from this ideal, and the situation will not be improved by planned changes. The government has set itself a new goal to increase the proportion of tax revenues that come from **green taxes**. While this is on course to be met, it should not be taken as a good guide to a government's environmental credentials. A '**fair fuel stabiliser**' would help stabilise household finances, but official estimates suggest that it would make the public finances more uncertain. It would also be very difficult to implement in practice.

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Changes already planned for April 2011:

- **Households will be hit by an average £200 a year loss from tax increases and benefit cuts due in April**. The changes hit high-income households hardest, but those dependent on means-tested benefits will be hit by the decision to raise benefits in line with the consumer price index (3.1%) rather than the higher retail price index or Rossi index (4.6% and 4.8% respectively). There will also be big changes in marginal tax rates for some, with 500,000 people being taken out of income tax altogether by the rise in the tax allowance, but around 750,000 more people becoming higher-rate taxpayers as a result of a reduction in the level of income at which the higher rate starts to bite. A further 850,000 would be brought into the higher-rate bracket by 2015–16 if the government reaches its ambition of a £10,000 allowance.

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Notes to Editors:

1. The Green Budget 2011 will be launched at 10am on Wednesday 2 February 2011 at the British Museum. Press places are still available and full event information can be found here: http://www.ifs.org.uk/events/637

2. The report will go live on the IFS website at 10am. For embargoed copies of the report before that time, please contact: Chantal Crevel-Robinson at IFS: 020 7291 4800, chantal@ifs.org.uk

3. If you have any press queries or wish to arrange an interview, please contact Bonnie Brimstone at the IFS Press Office: 07730 667013

4. Past Budget documentation, including our 2010 Green Budget and 2010 Spending Review and Budget analysis, can be found at: http://www.ifs.org.uk/budgets

IFS hosts two ESRC Research Centres.

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