

Press Release

Borrowing set to undershoot official forecasts, but downside risks limit room for manoeuvre

The IFS Green Budget suggests that, even relative to major planned cuts, **Whitehall departments will underspend by more than £3 billion this year.**

The result of the underspend is that the Government will borrow slightly less in 2011–12 (£2.9 billion) than the latest official forecast. We are also more optimistic about future tax receipts than the OBR, meaning that if the economy broadly evolves as the OBR expects then **borrowing could be £9 billion lower in 2016–17** than the official forecast. But significant downside risks to the public finances, combined with long-term pressures from an ageing population, suggest that the Chancellor has **little scope for a significant permanent fiscal loosening** relative to current plans.

The risks to our central forecast are very much on the downside. Should the Eurozone break up, or the economy do much worse than forecast for other reasons, then future borrowing would be increased and **one – or both – of the Chancellor's fiscal targets would be broken.**

The case for a significant short-term fiscal stimulus to boost the economy is stronger than it was a year ago. There seems little prospect that it would prompt an offsetting monetary tightening in the present climate. But a small loosening would be likely to deliver only a small boost to the economy, while a big one might risk undermining investor confidence.

We are delighted to have produced this year's Green Budget in collaboration with **Oxford Economics**. We are also very grateful to the **Economic and Social Research Council** for supporting this work and for funding much of the day-to-day research at IFS that underpins the analysis in this report.

Oxford Economics' forecast for 2012 is bleak. They expect the economy to grow by just 0.3% over the year, compared with the OBR's projection of 0.7%. Thereafter they remain a little more pessimistic than the OBR, but they expect a different, and more tax-rich, composition of growth. So fiscal forecasts based on Oxford Economics' baseline scenario are similar to those based on OBR's economic forecasts.

But they are clear that the risks are very much skewed to the downside. **A Eurozone crisis would see the UK back into deep recession** with GDP falling both this year and next. Even with a rapid recovery this would set national debt on course to rise above 90% of national income and in such a scenario the Chancellor might be best advised to abandon his fiscal targets.

The overwhelming issue remains the sheer scale of the fiscal consolidation. Our latest estimates, based on official figures, suggest that since the **financial crisis and recession began a £114 billion hole in the public finances has become apparent.** This is £23 billion more than was thought last March. This is what caused the Chancellor to pencil in two more years of severe spending cuts, in 2015–16 and 2016–17, to allow him to remain on course to meet his fiscal mandate (that is, to expect non-investment spending to be covered by

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tax receipts by the end of the forecast horizon, after adjusting for the ups and downs of the economic cycle).

The sheer scale of the cuts is daunting, and almost without historical or international precedent. They represent the biggest sustained cuts seen in the UK since the Second World War. Perhaps the only relevant example of such deep cuts being delivered elsewhere in recent decades is Ireland in the late 1980s. **By the end of 2011–12 a mere 6% of the planned cuts to non-investment public service spending will have been implemented.** How deliverable the remainder will prove to be, remains to be seen.

On the other hand **these cuts come after the largest sustained period of increases in public service spending since the Second World War.** If implemented the planned cuts would, by 2016–17, take public service spending back to its 2004–05 real-terms level and to its 2000–01 level as a proportion of national income.

Looking forward, demographic change will put pressure on health and pension spending, both of which are forecast to rise as a proportion of national income. Some taxes may not be robust to future behaviour change. Even once the immediate fiscal repair job is done, **further hard choices over tax and spending are likely to be needed.**

Given the scale of the changes being implemented, the uncertainty over the effects of the cuts, and the need for long term planning, **there is a strong case for the government holding its next Spending Review no later than Autumn 2013.**

Other key conclusions from the IFS Green Budget report include:

Withdrawal of Child Benefit from higher-income families is being proposed in a way which is neither efficient nor fair. First, by effectively withdrawing all Child Benefit as soon as a parent's income passes the higher rate threshold (rather than withdrawing it gradually as income rises), a so-called 'cliff-edge' is created. The starkest implications of this would be that 170,000 families could increase their net income by reducing their pre-tax income; and a further 200,000 families could find themselves with a lower net income after a rise in pre-tax income to above the higher-rate threshold. Second, Child Benefit withdrawal would effectively be based upon the income of the higher-income member of a family. It does not seem plausible that this is the best criterion with which to judge a family's ability to cope without Child Benefit. One-earner families with a pre-tax income of £43,000 a year would lose out, while couples in two-earner families could each earn almost this amount and be unaffected by the reform.

The Government's proposal could be tweaked to get rid of the cliff-edge easily and at relatively little cost, by introducing a gradual Child Benefit withdrawal starting at the higher-rate threshold. The most coherent solution may be to integrate Child Benefit with the Child Tax Credit (and its planned replacement, Universal Credit): a pre-existing system of means-testing for families with children, which features no cliff-edge and bases withdrawal on family income.

Local government spending (excluding education) is on course to fall by around 10% in real terms between 2009–10 and 2011–12. These cuts are not evenly distributed. Spending cuts are larger, absolutely and proportionally, in areas with relatively high spending (generally the urban and poorer parts of England) than in areas with relatively low spending (generally the more affluent rural and suburban districts). This means cuts are larger in London

and the northern regions of England than in southern regions. Spending on planning and development has been especially hard hit and is planned to fall by 43% over these two years. So far, spending on social care has been relatively protected, falling by just 4%.

Devolution of corporation tax rate setting to Northern Ireland was one of the proposals of a recent government review; a decision is expected this year. There are suggestions that Scotland and Wales would like similar powers. The extent to which this would boost investment is uncertain and any benefits must be weighed against substantial reductions to revenues (and therefore cuts to public spending in those nations). Moving in this direction would significantly complicate the UK corporate tax system, has the potential to increase avoidance activity and could lead to harmful tax competition within the UK, reducing revenues more than planned. Implementing devolution would at best be a calculated risk, with unknown long-term consequences for the UK tax system.

Tax reform to support long-term growth should be high on the government's agenda. The current tax system is overly complex, distorts decisions and has more of a negative effect on economic activity than is necessary. Personal taxes and benefits could be reformed to improve work incentives for those around the age of retirement, and for mothers of school age children. The design of business taxes is particularly important. By discouraging investment in the UK and favouring some forms of investment and finance over others, corporation tax has direct effects on economic activity. Moving to a system that exempts a 'normal' return to capital from taxation would reduce these problems. Replacing business rates with a land value tax, meanwhile, would remove a damaging bias against property-intensive production. The economic case for replacing much of road fuel taxation with a national congestion charge is overwhelmingly strong.

The 50p income tax rate introduced in 2010 is due to be reviewed by HMRC, who have been asked by the Chancellor to estimate its impact on tax revenues and to report to him in time to inform his Budget 2012 decisions. They will not be able to provide him with a robust estimate of its long-term revenue effects. The Treasury's previous analysis suggests that a very considerable degree of behaviour change, avoidance and evasion will be sparked by the 50p rate. Just considering its impact on revenues is too narrow a basis for making an assessment.

Spending on overseas aid is due to rise much faster than any other government budget. Spending is planned to rise from £8.45 billion in 2010 to £12 billion in 2013. Unlike many comparable countries, the UK appears to be on course for meeting the target of spending 0.7% of national income on overseas development assistance by 2015 (and in fact to meet this in 2013). Recent reviews have focussed spending on fewer countries, and much more than before is going through multilateral institutions. There remains a need for more transparency and accountability over how decisions are made and how effectively the money is spent.

The public sector pay freeze, and two further years of 1% pay increases, will return public sector pay to broadly the same place, relative to private sector pay, as before the recession. This is because private sector pay responded quickly to the new economic conditions. Public sector pay did not. The case for (carefully) moving towards more regional differentiation in public sector pay looks strong. There is a big estimated premium – up to 18% – to working in the public sector in some regions. No such premium exists in London and the South East.

Public pension reforms look as if they will deliver more coherent public service pensions with pension ages linked to the state pension age, and pensions based on average rather than final salary. The move from RPI to CPI indexation looks as if it will result in major savings in the future. In terms of the more recent reforms a reduction in generosity for high flyers is offset by an increase in generosity, on average, to lower paid workers.

Paul Johnson, IFS director, said, “The Chancellor faces his third budget with the economy and public finances in considerably weaker shape than he had hoped a year ago. While it looks as though central government is going to underspend against tight spending plans, this neither leaves much space for any permanent fiscal loosening nor avoids the fact that the vast majority of the planned – and unprecedentedly big – public service cuts are still to come. His room for manoeuvre is further curtailed by risks that the economy might do even worse than expected, especially if the Eurozone should break up.

“But he needs to get other policy decisions right. Planning for the next spending review needs to start soon. The tax system needs reforming to help promote growth in the medium run. Ill thought out plans for withdrawing Child Benefit from higher-rate taxpayers need to be revised. Time needs to be taken if real evidence of the effect of the 50p income tax rate is to be gathered. Getting all these sorts of policies right is the surest way to improve economic and fiscal performance in the medium term.”

Professor Paul Boyle, Chief Executive of the Economic and Social Research Council which funded the research said, “As the Chancellor prepares for the spring Budget and the economy is being debated at all levels of our society, it is important to ensure that rigorous and independent academic analysis is undertaken on the UK economy. In forecasting the UK economy we need to consider and evaluate the contributions of current fiscal strategies and look to develop new approaches for growth. It is for this reason the Economic and Social Research Council supports the launch of the IFS Green Budget report.”

ENDS

Notes to Editors:

1. The Green Budget 2012, edited by Carl Emmerson, Paul Johnson and Helen Miller, will be launched at 10am on Wednesday 1st February 2012 in Beveridge Hall, Senate House. To reserve your place please contact Bonnie Brimstone at bonnie_b@ifs.org.uk;
2. For embargoed copies of the report or other queries, contact: Bonnie Brimstone at IFS: 07730 667013, bonnie_b@ifs.org.uk;
3. This and previous editions of the Green Budget, can be found at: <http://www.ifs.org.uk/budgets>