

# 1. Summary

## **Planning the public finances**

The Chancellor's tax and spending decisions are constrained by two self-imposed rules. The golden rule states that borrowing should only pay for investment, while the sustainable investment rule limits public debt to no more than 40% of national income. Both have to be satisfied over the economic cycle, but not every year.

The Treasury judges progress against the golden rule by looking at the average surplus on the current budget (which excludes investment spending) since the beginning of the present economic cycle in 1999–2000. Large surpluses in the early years mean the golden rule is likely to be overachieved comfortably in the current cycle. But more important in framing the Budget should be whether the present stance of fiscal policy is consistent with meeting the golden rule looking forward.

In the past, the Chancellor has sought to overachieve the golden rule by around 0.7% of national income. Treasury estimates suggest that this is enough to ensure that the golden rule would still be met if the trend level of economic activity consistent with stable inflation had been overestimated by 1%. In the 2002 Pre-Budget Report, the Chancellor forecast that the cyclically adjusted surplus would return to this level by 2007–08, but this prediction may be unduly reliant on factors such as ambitious forecasts for corporation tax receipts.

The sustainable debt rule is not currently as binding as the golden rule, with the Treasury expecting the debt-to-GDP ratio to rise only fractionally to 33% by 2007–08. The debt measure used does not include all government liabilities – for example, some arising from the Private Finance Initiative. We estimate that if all capital spending under PFI deals signed to date were funded conventionally, public sector net debt would be 3.8% of national income higher by March 2006.

If the UK were to join the Euro, fiscal policy might be further constrained by the Stability and Growth Pact and the Excessive Deficits Procedure in the Maastricht Treaty. The former requires member countries to aim in the medium term for a budget balance 'close to balance or surplus'. The latter requires general government gross debt below 60% of GDP and a budget deficit of less than 3% of GDP (unless it is both exceptional and temporary or it is demonstrably declining towards these levels). The golden rule is by no means perfect, but a balanced-budget rule would make it more difficult to carry out investment that benefits future generations.

But the Stability and Growth Pact might be interpreted in a less restrictive way by the time the UK joins the Euro – if it joins at all. The European Commission has suggested that the balanced-budget rule should be assessed with reference to where the economy stands in the economic cycle and that it should have scope to spread the cost of beneficial investment and tax reforms that raise employment or growth potential across generations. This would

bring the Stability and Growth Pact slightly closer to the UK rules. In any event, the UK's fiscal position is relatively strong in comparison with those of most Eurozone countries.

### **IFS public finance forecasts**

In the Pre-Budget Report (PBR) last November, the Chancellor conceded that the unexpected weakness of the economy was depressing tax revenues and that this would force him to borrow more than he had expected this year and next. But over the medium term, he predicted that the economy would bounce back to its trend and that the public finances would return pretty much to the path he had expected in last April's Budget.

In the short run, our forecasts are very similar to those in the PBR. In 2002–03, we forecast public sector net borrowing of £22.1 billion, slightly higher than the PBR forecast of £20.1 billion. In 2003–04, we forecast public sector net borrowing of £25.2 billion, again slightly higher than the £24.5 billion forecast in the PBR. We expect deficits on the current budget of £8.8 billion this year (compared with the Treasury's £5.7 billion) and £5.1 billion next year (compared with the Treasury's £4.9 billion).

But in the medium term, we believe the public finances will be weaker than the PBR suggested in November, even if the economy behaves much as the Treasury expects. In part, this is because we do not expect that the loss of revenue that the Treasury attributes to the stock market and the plight of financial companies will recover as sharply as the Chancellor predicts. Hence, for example, we are less optimistic about the medium-term path of corporation tax revenues. By 2005–06, we forecast public sector net borrowing of £28 billion, compared with the PBR forecast of £19 billion.

Nonetheless, we believe the Chancellor can credibly claim that both the golden rule and the sustainable investment rule will have been met comfortably over the current economic cycle, which is projected to end in 2005–06. We expect the government to overachieve the golden rule over the current cycle by around £31 billion, compared with the £46 billion the Chancellor predicted in November.

But looking forward into the next cycle, our forecasts imply that spending cuts or tax increases will be required if the golden rule is to continue to be expected to be met. If the Chancellor sticks by his PBR forecasts, then he might well argue that no fiscal tightening is necessary. But if our forecasts are correct, he would be unlikely to be able to avoid such measures for long without undermining the credibility of the fiscal rules that he has set such store by. In that event, spending cuts would sit oddly with both the government's stated objectives and its previous actions. Tax increases would, therefore, seem more likely.

The tax increases required depend on how cautious the government wants to be. To expect to meet the golden rule exactly would, we estimate, require tax increases of around £4 billion. But in the past, the Chancellor has been more cautious and sought to overachieve the golden rule by around 0.7% of national income on average. To expect to do this would require tax increases of around £11 billion.

## **What do the child poverty targets mean for child tax credit?**

The government has pledged to eradicate child poverty within a generation. As an intermediate target, it has also set itself the goal of reducing the number of children in poverty by at least a quarter by 2004. In practice, this means reducing by a quarter the number of children in households that have incomes below 60% of the median, which can be measured either before or after housing costs. Like the government, we focus on the latter measure. There were 4.2 million children in poverty on this definition in the base year of 1998–99, which implies a target of around 3.1 million in 2004–05.

By 2000–01 (the last year for which we have data), the number of children in poverty on this definition had fallen to 3.9 million. So if the government is to hit its target, child poverty must fall by a further 0.8 million. This is an average of 200,000 a year, which is faster than it has fallen to date. Whether this will happen depends not only on the financial support that the government offers low-income families, but also on the impact of economic and demographic factors on their incomes and on the median income against which they are compared.

The child tax credit, to be introduced in April 2003, will represent the majority of government support for children and is the government's main instrument for targeting child poverty. Our best estimate is that existing tax and benefit reforms will take 800,000 children out of poverty between 2000–01 and 2004–05, but that the rise in the median income from earnings growth will 'move the goalposts' and put 200,000 of them back in. This estimate implies that the government would fall 200,000 short of its target on the after-housing-costs measure, although there are considerable uncertainties around this prediction. (We assume that population, employment rates and household composition do not change, and that average earnings rise in line with recent trends.)

If our estimates are correct, the government could argue that it is on course to hit its target on the before-housing-costs measure of poverty. But what could it do to expect to meet the target on the after-housing-costs measure? We estimate that taking a further 200,000 children out of poverty could be achieved by raising the per-child element of the child tax credit by £3 per week (on top of the increase in line with average earnings that has already been promised) at a cost of £1 billion. Out of the options that we consider, this is the most cost-effective, as it is the best-targeted at reducing poverty.

## **Income tax and National Insurance contributions**

The income tax and National Insurance systems in the UK have become steadily more similar over the past 40 years. Gordon Brown's decision to raise National Insurance from April – in part by requiring an employee contribution for the first time on all earnings above the upper earnings limit of £30,940 a year – is another step in this direction.

Labour promised in the 1997 election campaign, and again in 2001, not to raise the basic or top rates of income tax. But the distributional impact of April's increases in employer and employee National Insurance contribution rates will be similar to a 2p increase in the lower, basic and higher rates of income tax. Differences arise because income tax is levied on income from

sources other than earnings, whereas National Insurance is paid only on earnings. The self-employed are also unaffected by the rise in the employer contribution rate.

Given the erosion of the ‘contributory principle’ originally used to justify National Insurance – namely, that people’s social benefit entitlements were meaningfully linked to what they paid in – there now seems little economic justification for separate income tax and National Insurance systems. But this, and previous, governments appear to believe – for now at least – that voters are happier to pay more National Insurance than more income tax.

This suggests that further gradual alignment of the two systems might be more likely than wholesale integration. Closing the gap between the earnings level at which employee National Insurance contributions drop from 11% to 1% (£30,940) and the income level at which income tax rises from 22% to 40% (£35,115) is an obvious next step and would also raise significant extra revenues for the Treasury. Revenue could also be raised by further increases in the rates of employer or employee National Insurance. The latter could be done solely on earnings above £30,940 if the Chancellor wanted to raise revenue in a very progressive way.

### **Company taxation and innovation policy**

Last August, the government issued a consultation document on further reform to the corporation tax system. The objective of the proposals is to align the calculation of taxable profits more closely with the measurement of profits in company accounts. But replacing the current system of capital allowances with a deduction for the depreciation charge in accounts could see big winners and losers among different sectors. Other proposals would have implications for the extent to which companies could offset losses in one part of their business against profits elsewhere.

In 1997, the UK government increased the taxation of dividend income for pension funds and some other institutional investors, with the goal of boosting investment. The USA is now proposing to reduce the taxation of dividends with partly the same objective. It is doubtful that the changes in either country will have much impact on investment or share prices. But the US reform would benefit US citizens who hold shares directly, with the wealthiest gaining most.

The changes to North Sea taxation announced in the 2002 Budget and Pre-Budget Report raise extra revenue from this sector. They provide some welcome simplification and are in line with the principles of efficient resource taxation. But they could have gone further. The rules have been changed frequently in the past in response to revenue needs and changes in the oil price. A stable tax regime that could cope automatically with changing oil prices would help investment planning in the sector.

Cutting stamp duty on share transactions would reduce distortions and may contribute to the Chancellor’s goal of boosting UK productivity. Stamp duty lacks investment allowances, and is therefore more likely to deter investment than other capital taxes. It reduces the efficiency of the stock market by raising transaction costs and may increase share price volatility. It also distorts merger

and acquisition activity, producing a bias towards overseas rather than UK ownership of companies.

### **Childcare subsidies**

Over the last decade, several initiatives have been undertaken to help families with the costs of childcare, both on distributional grounds and to encourage parents into paid work. Among them is the childcare credit in the working families' tax credit, which will be transferred to the new working tax credit in April. The Chancellor has said that he wants to do more to help 'parents to make real and effective choices on balancing work and family life'. Chapter 7 considers ways of extending the scope and generosity of the childcare credit.

Options for reform might include: increasing the proportion of childcare costs that can be claimed; raising the cash ceiling on claims; extending the subsidy to 'informal' childcare provided by family and friends; allowing parents to claim if they work less than 16 hours a week; and making the means-testing of the credits more generous.

Costing these reforms is difficult, as it is hard to predict how many parents would take up an expanded credit and to what extent they would change their employment behaviour and use of paid childcare. Covering a greater proportion of formal childcare costs or extending coverage to informal care could be very expensive if the change encouraged much greater use of subsidised childcare. There is also a danger that parents could claim more money from the government without any significant increase in childcare use.

This suggests that any expansion of the childcare credit would have to be designed in such a way as to promote value for money. Such options could include: lowering the weekly ceilings on subsidised childcare spending; specifying the value of the credit per hour of childcare; linking the maximum subsidy to the main carer's working hours; or linking eligibility to the employment and earnings of the main carer.

### **Measuring public sector efficiency**

The government has staked its political credibility on delivering clear improvements in public services. Substantially increased resources are being ploughed into areas such as health, education and transport. The challenge for spending departments now is to ensure that these resources are used as efficiently as possible. To help achieve these improvements, the 2002 Spending Review set out performance targets in around 130 Public Service Agreements, covering both outcomes in particular services and the efficiency with which these outcomes are achieved.

In April 2000, the Treasury's Public Services Productivity Panel proposed a new approach to measuring the efficiency of police authorities, drawing on two techniques: stochastic frontier analysis and data envelopment analysis. The government has also commissioned research into their possible use to assess local authorities.

The results of applying these efficiency measurement techniques are sensitive to a number of factors, including: which inputs and outputs are considered;

errors in measuring these inputs and outputs; and the statistical assumptions made. While these methods are potentially useful, the results should be treated cautiously, as should their application as part of a system to affect providers' performance incentives.

### **The distributional effects of fiscal reforms since 1997**

The government has carried out many reforms to the tax and benefit system since coming to office in May 1997. Comparing the system as it will operate next year with that which Labour inherited (adjusted for inflation and statutory uprating) suggests that there have been around £51.7 billion of revenue-raising measures and £53.3 billion of revenue-reducing measures. This leaves a net 'giveaway' of around £1.6 billion, or about £1.50 per household per week.

Analysing the distributional impact of such changes, IFS research traditionally focuses on measures that directly affect household incomes and spending. This shows a progressive pattern, varying from a boost of more than 15% to the incomes of the poorest tenth of the population to a loss of nearly 3% for the richest tenth. The average impact is an increase in income of around 2%.

But focusing on those tax and benefit changes that are relatively easy to allocate to individual households shows a much more generous net 'giveaway' than taking all tax and benefit changes into account. Ultimately, all taxes have to be paid by individuals and including those that we do not model would reduce incomes on average by 1.7%, wiping out much of the average net gain.

Taxes formally on business are one category that is excluded from our traditional distributional analysis. But assessing what 'taxes on business' are – and whether they have risen – is not easy. If we focus on taxes levied on company profits, the net impact of Labour's reforms since 1997 is an estimated tax increase of around £4 billion in 2002–03, falling to an estimated £1.4 billion in the next year, as the transition to quarterly payments of corporation tax ends. Extending our distributional analysis by attributing this tax increase to households owning shares – who tend to be on relatively high incomes – might make Labour's reforms look even more progressive. We estimate that the same is true of the increases Labour has implemented for stamp duty on house purchases since 1997.