

1. Summary

Chapter 2: The public finances under Mr Brown

- When the Conservatives lost the 1997 election, they were still trying to eliminate the large budget deficit that opened up in the early 1990s. Kenneth Clarke had roughly halved the budget deficit he inherited as Chancellor in 1993 by the time Gordon Brown took over at the Treasury.
- Mr Brown continued to strengthen the fiscal position during Labour's first term by cutting public spending and increasing tax revenues as shares of national income. The fiscal position then weakened in Labour's second term as rapid increases in public spending coincided with an unexpected drop in tax revenues.
- Mr Brown has increased taxes and intends to slow spending growth to improve the fiscal position in Labour's third term. If his Chancellorship ends in 2007, he will leave the public finances stronger than he found them, although most industrial countries have recorded bigger improvements over the same period.
- Trends in public debt and the structural budget balance under Mr Brown do not compare favourably with the first decade under Conservative Chancellors from 1979. But this partly reflects higher investment. The position also worsened for four more years under the Tories; Mr Brown believes he has turned the corner.
- Net tax increases announced by Mr Brown since 1997 will bring in more than £17 billion in 2007–08. Adding Conservative policy changes that Mr Brown maintained, his decision not to adjust tax allowances for above-inflation earnings growth, and economic developments since 1997, there is forecast to be a total rise in tax revenue since 1996–97 equivalent to £40 billion, or £1,300 per family.
- Mr Brown hopes to return the current budget balance to the black and to halt the recent rise in public sector debt over the next five years. His forecasts suggest this will require cuts in public spending worth 0.8% of national income, or £10 billion in today's terms, plus an increase in the tax burden of a similar amount.

Chapter 3: The fiscal rules and policy framework

- Designing fiscal rules requires a trade-off between sophistication on the one hand and simplicity and transparency on the other. The golden rule and sustainable investment rule – like any fiscal rules that could be applied in practice – are not optimal, but they still have value as rules of thumb.
- Many economists outside government no longer see compliance with the fiscal rules as a good guide to the health of the public finances. This presumably reflects concern that the Chancellor 'moved the goalposts' to make the golden rule easier to meet when downward

revisions to his public finance forecasts eroded the margin by which he expected to meet the rules after 2001.

- The Treasury could be argued to have pursued a rolling five-year target to achieve a current budget surplus of 0.7% of national income. This target was missed significantly in 2005–06 and is also set to be missed in coming years.
- The likely arrival of a new Chancellor later this year may be a golden opportunity to tweak the fiscal rules for the better. Sensible changes would include making the golden rule symmetric, forward-looking and less reliant on the ability to identify economic cycles. The Treasury's fiscal forecasting could also be made more transparent or perhaps even delegated to an independent body.

Chapter 4: The economic outlook

- Over the past 10 years, growth and inflation have been relatively stable by the standards of previous decades. But this may be sowing the seeds of future volatility by encouraging consumers and the government to borrow more.
- The Treasury has recently revised up its central estimate of the UK economy's potential growth rate over the next few years from 2½% to 2¾%, but assumes a more 'cautious' rate of 2½% when forecasting the public finances. However, 2½% looks a reasonable central forecast, rather than an obviously cautious one.
- House prices have risen sharply over the past decade, and some falls are rather likely in the next few years. The rise in prices to date has made housing less affordable for younger households and has driven borrowing higher. Disposable income – net of essential spending – looks set to grow only modestly.
- We are more pessimistic than the Treasury about economic growth in the next couple of years. Compared with the Treasury, we expect a smaller contribution from net exports, weaker investment growth next year and weaker consumer spending growth through to 2009.

Chapter 5: Green Budget public finance forecasts

- The current budget deficit is likely to be £1.3 billion bigger this year, and £1.9 billion bigger next year, than forecast in the December 2006 Pre-Budget Report. But we are around £1½ billion more optimistic than the Treasury about the current budget balance by 2011–12, assuming that the economy evolves as the Treasury expects.
- If the Chancellor is correct in his provisional judgement that 2006–07 is the last year of a decade-long economic cycle, the golden rule would be met over this period with £7 billion to spare. Public sector net debt would also remain below the 40% of national income ceiling set out in the sustainable investment rule.
- We believe that the golden rule is more likely than not to be met over the next economic cycle, as long as it lasts five years or more. Despite forecasting slightly higher public

sector debt than the Treasury over the next five years, we also believe that debt is more likely than not to remain below 40% of national income.

- But judging the Chancellor's adherence to the golden rule depends crucially on his method of identifying the economic cycle. Using a statistical filter, rather than the Treasury's judgement, Morgan Stanley identifies a seven-year cycle from 2003–04 to 2009–10. Over this period, the golden rule would be broken by £66 billion.
- In today's terms, we expect the current budget balance to be roughly £21 billion stronger in five years' time than it is now. Of this improvement, £13 billion reflects a rise in the tax burden and £8 billion cuts in public spending after 2007–08. We expect public sector net debt to rise by 1% of national income by 2011–12.
- By announcing £6 billion of new tax increases and pencilling in an £8 billion cut in public spending since the 2005 election, the Chancellor has followed our advice from earlier Green Budgets – although by delaying he may have helped diminish the credibility of the fiscal rules. We see no need for further tax increases at present, as long as he is able to stick to his PBR spending projections.
- If history is any guide, at some point the Treasury's fortunes as a fiscal forecaster will take a turn for the better. But whoever is Chancellor should be wary of spending any unexpected revenue that materialises or giving it away in tax cuts. As in the current cycle, this would risk the need for retrenchment later.

Chapter 6: Funding issues and debt management

- In recent years, the UK government's cost of borrowing has been falling in both nominal and real terms, even though the amount it has borrowed has been rising and has consistently exceeded its own forecasts. In the light of this, we should not expect a big impact on the cost of debt if the government needs to issue a few billion pounds more in gilts than its central forecasts over the next few years.
- Modelling the impact of random factors on different debt issuance strategies provides strong reasons to favour a strategy involving greater issuance of long-dated conventional and long-dated indexed debt.
- Lengthening maturity and duration of public sector debt has not been offset by a shortening of the maturity or duration of private sector debt – in fact, quite the opposite. It is likely that this has affected – though probably not weakened – the transmission mechanism of monetary policy.
- Despite the potentially large cost that the ultimate holders of longevity risk might need to be compensated with, it is not at all clear that this reflects a market failure. There remains a rather weak case for government action in this area.
- Removing the ability of non-financial companies to deduct interest payments from the measure of profits on which they pay corporation tax might allow the rate of corporation tax to be cut from 30% to 20% with no net loss of revenue.

Chapter 7: Challenges for public spending

- The 2007 Comprehensive Spending Review looks set to be a very 'Challenging Spending Review'. The projections set out in the December 2006 Pre-Budget Report would, if implemented, reduce public spending by 0.5% of national income over the three years to be covered by the review – £7 billion in today's terms.
- These projections may prove incompatible with two key government aspirations: to improve public services and reduce poverty in the UK and overseas.
- Meeting the 2010–11 child poverty target would probably cost at least an extra £4½ billion. Finding this within the PBR spending projections would require difficult choices over other areas of spending. Even if spending in areas such as defence and environmental protection were frozen in real terms, the government would still have to allocate the NHS less than the minimum recommended by the 2002 Wanless Review or cut education spending as a share of national income.
- The most plausible scenario may be one where the Chancellor announces tight initial 2007 CSR settlements in the hope of topping them up at a later stage, as he has done with past reviews. Decisions to increase tax credits to meet the child poverty target could also be deferred to later Budgets and Pre-Budget Reports.
- Unless revenues or spending come in more favourably than expected, the Chancellor might have to choose between fresh tax increases or downplaying the child poverty target. Keeping spending constant as a share of national income in the CSR would require an extra £7 billion a year in today's terms by 2010–11.

Chapter 8: Public services performance

- The output of public services is complex, multi-dimensional and difficult to measure.
- Using National Accounts measures, the output of the health and education sectors has been rising but productivity has not. However, these output measures may not be accurately capturing changes in the quality of services. Accounting for quality change typically increases measured output growth.
- Short-term falling productivity may not, however, be a problem. Increased output, even without productivity gains, may be desirable, and productivity improvements may be difficult to achieve in some sectors.
- To get an accurate picture of performance, measures should, as far as possible, incorporate non-targeted outputs in addition to those that are subject to performance targets.

Chapter 9: VAT fraud and evasion

- VAT revenue losses through evasion jumped sharply in 2005–06, reaching £12.4 billion or 14.5% of potential VAT revenues. HM Revenue and Customs estimates that missing trader and carousel frauds account for less than a quarter of these losses, but that they have been growing rapidly despite its best efforts.
- HMRC estimates that the VAT gap increased by £2.7 billion in 2005–06, with missing trader fraud increasing by around £1 billion. If the jump in the VAT gap is genuine, either missing trader fraud is significantly higher than HMRC suggests or there has been an abrupt, significant and unexplained rise in other VAT fraud.
- Carousel frauds exploit opportunities provided by the VAT zero-rating of exports. The vulnerability of the VAT systems of EU member countries has increased as a result of the abolition of internal EU frontiers at the end of 1992.
- The UK government has sought EU agreement to extend reverse charging for certain categories of transaction, and, if agreed, this may help to check the growth in carousel fraud. But the underlying problem is unlikely to be resolved without a fundamental reform to the VAT treatment of international transactions, which would end the zero-rating of exports.

Chapter 10: Taxation of multinationals and the ECJ

- Recent cases at the European Court of Justice have prompted changes to UK Controlled Foreign Companies rules and a broader consultation on the taxation of foreign profits.
- The tax treatment of dividend income from overseas subsidiaries of UK companies is a complex but increasingly important area of the corporation tax system, given the growing importance of multinational firms.
- The announced review is welcome and should be wide-ranging. It should consider the option of replacing the UK's complex credit system with the simpler exemption system used in many other EU countries. Estimating the potential cost of this to the exchequer is extremely difficult and a matter of some debate.
- Corporate tax rates have fallen faster in other EU countries than in the UK over the last decade, and particularly since 1999; this has contributed to growing concerns about the impact of UK corporation tax on business investment and location choices.

Chapter 11: Environmental taxation

- The government has implemented several tax reforms in recent years that have improved environmental incentives, most notably: linking vehicle excise duty and company car tax rates to the emissions ratings of vehicles; imposing an energy tax on businesses; and developing domestic and international emissions trading.

- Despite these reforms, receipts from environmental taxes have fallen as a share of national income since 1999. The measures announced in the Pre-Budget Report will do little to reverse this. However, the UK still takes a higher share of national income from green taxes than the OECD average.
- The decline in green tax revenue as a share of national income is largely due to the government's decision to abandon annual above-inflation increases in fuel duty. Raising green tax revenues substantially through the existing tax system will be difficult without significantly higher rates of fuel duty.
- Longer-term reforms may dramatically alter the structure of green taxes. But increasing green taxes may conflict with government targets for fuel poverty (or poverty in general) or with the desire to promote business competitiveness.

Chapter 12: Supporting couples with children through the tax system

- The tax and tax credit system treats some married or cohabiting couples with children less generously than if the parents live (or claim to live) apart. Some 'couple penalty' or 'couple premium' is inevitable if you want to be proportionately more generous to people on lower incomes and if you assess entitlement to help according to family rather than individual circumstances.
- But critics variously argue that the current system is inefficient in lifting couples with children out of poverty, that it encourages parents to live apart to the detriment of their children and that it gives insufficient support to couples where one partner gives up work to care for young children.
- We assess three recent proposals to alter the tax treatment of couples with children in order to ameliorate one or more of these perceived problems. Reflecting the different objectives that motivate them, these proposals would have different effects on family incomes and financial work incentives.
- Increasing the working tax credit for all couples with children would particularly help low-income one-earner couples, but would discourage them from increasing their income, for example through adding an earner or working longer hours.
- Increasing the working tax credit only for two-earner couples would reverse a recent trend by strengthening the incentive for low- to middle-income couples to have both adults in work, but would also discourage such families from seeking increases in income through other means.
- A transferable personal allowance for families with a child under 6 would benefit the majority of one-earner couples with a young child, regardless of income, but would act to discourage such families from having both adults in work.
- All three proposals would reduce the 'couple penalty' in the tax credit system because they give extra support to couples with children but not to lone-parent families.