

2. The public finances under Mr Brown

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Summary

- 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.

2.1 Introduction: Brown's fiscal objectives

The 2007 Budget will be Gordon Brown's eleventh as Chancellor of the Exchequer and is expected to be his last before replacing Tony Blair as Prime Minister. During his decade at the Treasury, Mr Brown has outlined four main objectives for fiscal policy:¹

¹ Page 7 of HM Treasury, *Analysing UK Fiscal Policy*, November 1999 (<http://www.hm-treasury.gov.uk/media/CC5/BA/90.pdf>).

- to ensure that tax and public spending decisions do not imply an unsustainable and potentially damaging rise in public sector debt;
- to ensure that future taxpayers are not left to pay for public spending undertaken today from which they cannot be expected to benefit;
- to avoid any bias against investment spending if and when public spending as a whole has to be restrained;
- to allow changes in government borrowing to ‘support’ monetary policy in helping to stabilise economic activity and keep inflation on target.

Reflecting these objectives, Mr Brown had several complaints to make about his inheritance from the Conservatives:

In 1997, the Government was faced with a large structural deficit, low net investment, rising public debt and falling public sector net worth. This situation had come about in part as a result of a lack of clear and transparent fiscal objectives, together with fiscal reporting that did not permit full and effective public and parliamentary scrutiny.²

With no track record of his own, Mr Brown saw a new fiscal framework as a way to help convince people that he would avoid repeating what he saw as the mistakes of the Conservative era (and of previous Labour Chancellors). The Treasury has described the objective as ‘constrained discretion’ – in other words, making a credible commitment to long-term goals of sustainability and intergenerational fairness while retaining the ability to respond flexibly to economic developments.

Hence, two important elements of Mr Brown’s new fiscal framework were:

- the **Code for Fiscal Stability**, which sets out the broad principles of fiscal policy, as well as requiring the Treasury to be transparent about its goals and record; and
- publicly stated **fiscal rules**, which turn broad principles of ‘sound’ fiscal policy into specific operational targets against which success or failure can be judged.

The fiscal rules make Mr Brown’s four broad objectives for fiscal policy more concrete:

- The **golden rule** requires the public sector to borrow only what it needs to pay for capital investment, and to finance its remaining current spending from tax and other revenues. In other words, the government has to keep the current budget (revenues minus current spending) in balance or in surplus. To help monetary policy manage demand in the economy appropriately, the rule has to be met on average over the economic cycle rather than every year.
- The **sustainable investment rule** requires the Government to keep the public sector’s debt (net of its financial assets) at a ‘stable and prudent’ level. The Treasury defines this as less than 40% of national income (GDP) at the end of each financial year of the current economic cycle, but has not yet announced how ‘stable and prudent’ is to be defined over subsequent economic cycles.

² Pages 133–4 of E. Balls and G. O’Donnell, *Reforming Britain’s Economic and Financial Policy*, HM Treasury / Palgrave, 2002.

We will discuss the rules and the fiscal framework in more detail in Chapter 3 and the challenges of the 2007 Comprehensive Spending Review (CSR) in Chapter 7. In this chapter, we look at the state of the public finances when Mr Brown took office in 1997 (Section 2.2) and at how they have evolved over the past 10 years (Section 2.3). We then assess how Mr Brown's bequest to his successor will compare with his inheritance from Kenneth Clarke (Section 2.4). We then turn to Mr Brown's plans for the next five years, describing how he expects the public finances to evolve, comparing his plans with the last presented by Mr Clarke (Section 2.5) and quantifying the uncertainties that lie around all public finance forecasts (Section 2.6). Finally, we turn to assessing whether Mr Brown has met his objective of using fiscal policy to support monetary policy (Section 2.7). Section 2.8 concludes.

2.2 Brown's inheritance

Mr Brown became Chancellor at a time when the Conservatives were still trying to eliminate the large budget deficit that opened up in the early 1990s. Although Chancellor Nigel Lawson had achieved budget surpluses in 1988–89 and 1989–1990 (the first time this had occurred in any year since 1970–71), with hindsight these turned out to be the result of an unsustainable economic boom that had temporarily boosted tax revenues and cut social security bills. The recession of the early 1990s exposed the underlying weakness of the fiscal position, which had been exacerbated by increases in public spending and tax cuts in the run-up to the 1992 election. Adjusting for the level of economic activity, the underlying 'structural' budget balance³ deteriorated from a surplus of 1.5% of national income in 1981–82 to a deficit of 5.7% by 1992–93. The recession meant that the headline budget deficit was even bigger, with public sector net borrowing hitting 7.8% of national income in 1993–94.

Britain's exit from the European Exchange Rate Mechanism in September 1992 prompted a significant rebalancing of macroeconomic policy. Looser monetary policy – lower interest rates and a weaker exchange rate – was accompanied by a big fiscal tightening. Mr Clarke, who became Chancellor in May 1993, raised taxes and cut public spending as shares of national income, almost halving the structural budget deficit between 1992–93 and 1996–97. This in turn helped stabilise public sector net debt, which reached a high of 43.6% of national income in 1996–97 – well above its trough at the end of the Lawson boom but little different from the level that the Conservatives had recorded in their first year in office (1979–80 when net debt was 43.9% of national income). Mr Clarke forecast in his November 1996 Budget that over the next five years revenues would continue to rise and spending fall as shares of national income. This would get the budget back into surplus by 2000–01 and pull public sector net debt back towards 40%.

This set the scene for Labour's inheritance. In 1996–97, the Conservatives' last year in office, the public sector spent 40.8% of national income, while government revenues totalled 37.3% of national income. This left a gap of 3.5% of national income to be covered by public sector net borrowing, which, if sustained, would have left net debt climbing towards 70% of national income (assuming 5% nominal growth in the economy). A fifth of this borrowing financed

³ The budget balance that would be recorded if economic activity were at its sustainable 'trend' level, consistent with stable inflation. See Section 3.2.

investment, leaving a current budget deficit of 2.8% of national income. The Treasury estimates that part of this deficit was explained by the automatic impact of weak economic activity on tax revenues and welfare spending, but that there was still an underlying ‘structural’ current budget deficit of 2.3% of national income. This would have to be reduced if Mr Brown were to comply with his ‘golden rule’.

By international standards, Labour inherited a relatively large budget deficit but a debt level in the middle of the industrial country league table. Using internationally comparable figures, in 1996 the UK’s structural general government deficit of 3.5% of national income was the sixth highest of the 22 major industrial countries for which we have comparable data for a broad range of fiscal indicators. General government net financial liabilities (the broadest OECD net debt measure) stood at 40.6% of national income, the tenth highest of the same 22 countries.⁴

2.3 The Brown decade

The evolution of the public finances

In its 1997 manifesto, Labour promised to keep to the tight spending plans laid down by Mr Clarke for two years. Mr Brown kept that promise and reduced spending further in his third year in office, thanks partly to unintended departmental underspending. Despite beginning to spend more in the run-up to the 2001 election, public spending ended Labour’s first term 3.3% of national income lower than it started (Figure 2.1). Most of the decline was in current spending, but public sector net investment also dropped, from 0.7% of national income to 0.4%. Notwithstanding Mr Brown’s complaints about underinvestment by the Conservatives, public sector net investment was lower on average in Labour’s first term – at 0.6% of national income – than in any other four-year period since the Second World War.

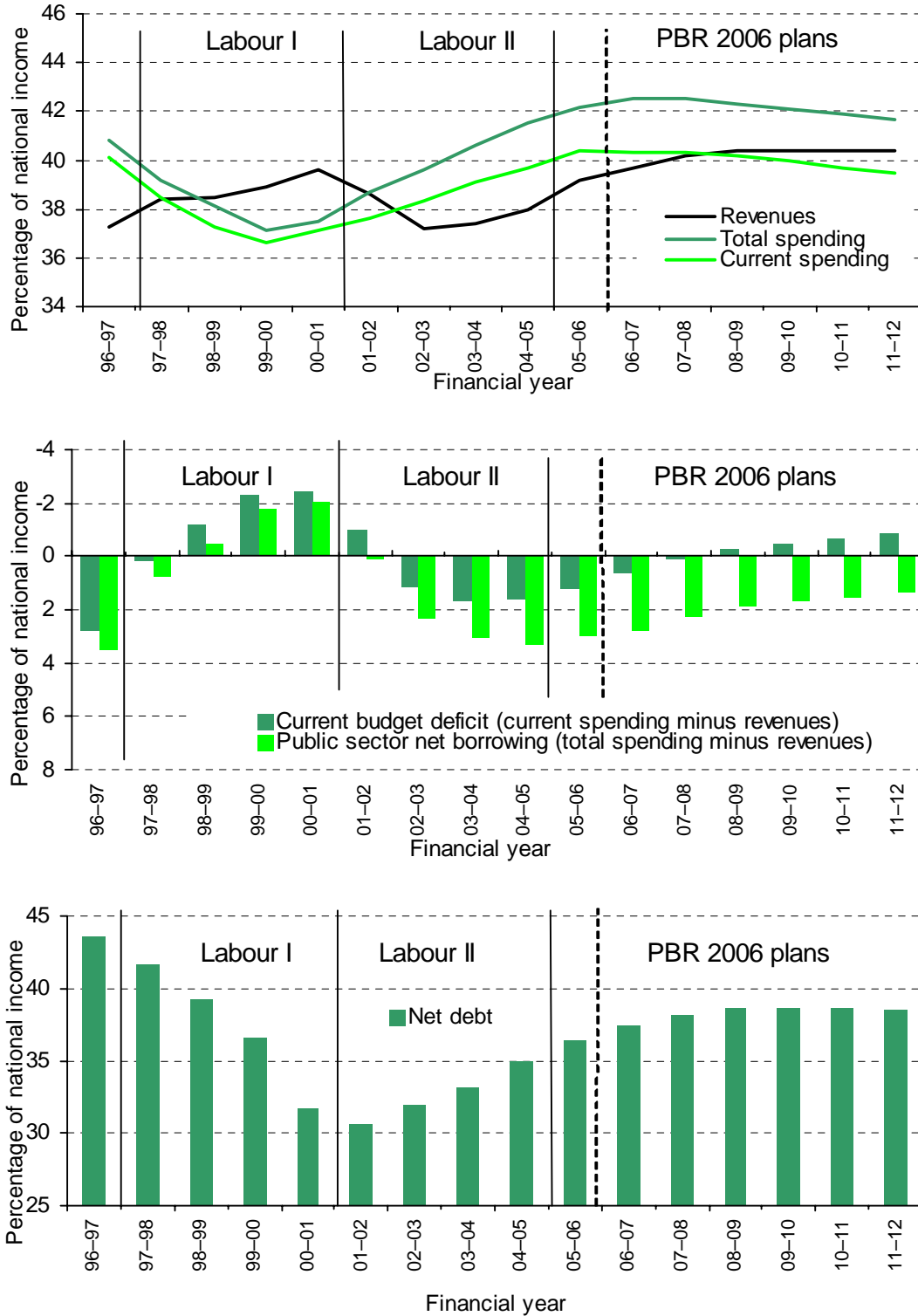
Over the same four years of Labour’s first term, government revenues rose by 2.3% of national income, thanks to ongoing increases in fuel and tobacco duties (put in place by the Conservatives and then accelerated and maintained by Mr Brown until the November 1999 Pre-Budget Report), Budget measures such as the abolition of repayable dividend tax credits (reducing the returns received from UK equities by pension funds and charities) and above-average economic growth, combined with the Chancellor’s decision not to raise income tax thresholds as quickly as incomes, which meant that a progressively larger proportion of people’s incomes was taxed at higher rates, which boosts tax revenues (a phenomenon known as ‘fiscal drag’).

With revenues rising and spending falling, by the time of the 2001 election the total budget balance and the current budget balance had both moved into surplus. The structural budget surplus reached 1.5% of national income in 1999–2000 and 2000–01, equalling the biggest structural surplus achieved by the Conservatives, in 1981–82, the year after Geoffrey Howe’s controversially tight Spring 1981 Budget. Meanwhile, public sector net debt fell from 43.6% of national income in 1996–97 to 31.7% of national income in 2000–01, aided in part by the

⁴ See Table 2.2 for more details.

£22.47 billion (2.2% of national income in 2000–01) received from the 20-year auction of 3G mobile phone licences.

Figure 2.1. Revenues, spending, budget balances and debt



Sources: HM Treasury, *Pre-Budget Report 2006*, London, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm); HM Treasury, *Public Sector Finances Databank*, December 2006 (http://www.hm-treasury.gov.uk/media/A5B/FD/pfd_dec06.xls).

Mr Brown had described his determination to reduce borrowing in his early years in office as ‘prudence for a purpose’.⁵ The purpose became clear after 1999 – and especially as Labour’s second term unfolded. Public spending reversed its earlier decline, with health, education, and lower-income pensioners and families with children the main beneficiaries of the Chancellor’s largesse (for more details, see Chapter 7). But as spending rose by 4.0% of national income over the course of Labour’s second term, tax revenues weakened unexpectedly when the stock market fell in 2000 and 2001, reducing tax payments by financial sector firms and their employees. The tax-raising Budget of April 2002 helped begin to reverse the decline, but government revenues still ended Labour’s second term 1.6% of national income lower than they began it (even though the net impact of policy announcements during the second term was to increase taxes significantly).

The combination of higher spending and weaker tax revenues reversed the strengthening in the public finances seen during Labour’s first term. The current budget balance moved from a surplus of 2.5% of national income at the end of the first term to a deficit of 1.6% at the end of the second. The swing in the overall budget balance was even larger, reflecting the fact that public sector net investment had at last begun to increase. The return to budget deficits began to push public sector net debt up again, reaching 35.0% of national income in 2004–05.

Years two and three of Labour’s third term are set to see public spending grow more slowly as a share of national income than in the previous years of plenty, reflecting the more cautious plans laid down in the 2004 Spending Review for 2006–07 and 2007–08. The Treasury expects the broadest measure of public spending, total managed expenditure (TME), to reach 42.5% of national income this year, up from 41.5% in 2004–05. But, as we shall discuss in the next section, despite the planned slowdown in spending growth, IFS and other independent commentators argued in the run-up to the 2005 election that the government would have to announce further tax increases or cuts in spending plans if it wished to meet its fiscal rules with the degree of comfort it had sought in the past.

Mr Brown rejected any such suggestion, claiming during the campaign that ‘People say we won’t meet our fiscal rules. Once again, with the public finances strong, we will prove them wrong’.⁶ But, with the election out of the way, the Chancellor has announced a succession of net tax increases – in the 2005 Pre-Budget Report, the 2006 Budget and the 2006 Pre-Budget Report – sufficient in total to raise an extra £6 billion in 2007–08. Thanks also to a rebound in corporation tax receipts and a gradual increase in the income tax burden as people drift into higher tax brackets, revenues are expected to rise from 38.0% of national income in 2004–05 to 39.7% this year – an increase equivalent to £22 billion in today’s money since the election.

With revenues growing more quickly than spending, the current budget deficit is expected to have narrowed from 1.6% of national income in 2004–05 to 0.6% of national income this year, with net borrowing falling from 3.3% to 2.8% of national income over the same two years. But public sector net debt will still have edged up from 35.0% of national income to 37.5%.

⁵ Mr Brown’s 1998 Budget Speech: ‘I said that this would be a Budget based on prudence for a purpose and that guides us also in our approach to public spending’ (http://www.hm-treasury.gov.uk/budget/budget_1998/bud98_speech.cfm).

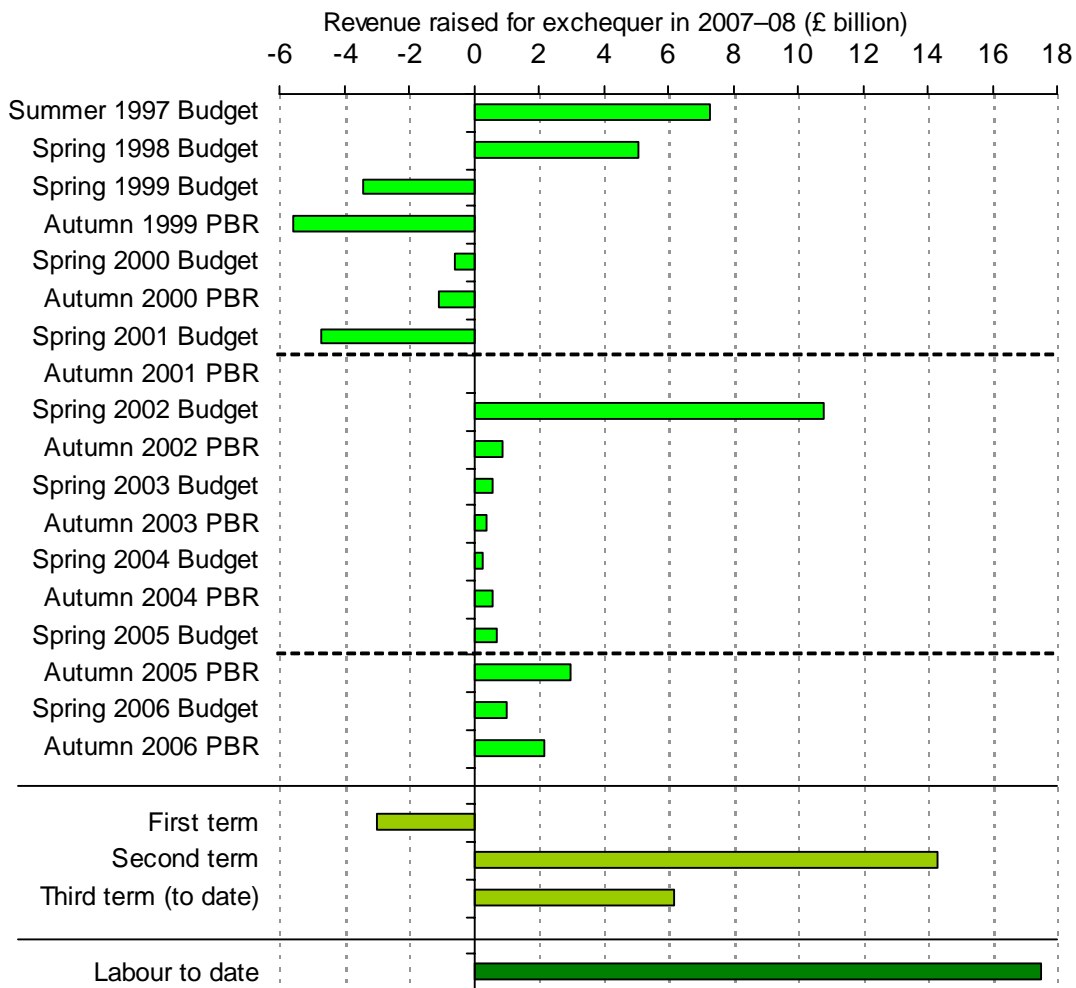
⁶ ‘Row over £11bn black hole’, *Guardian*, 22 April 2005.

Labour's revenue-raising

Looking over Labour's first decade as a whole, government revenues will have risen by 2.4% of national income between 1996–97 and 2006–07, with a further increase expected next year of 0.5% of national income. Where has the money come from?

Figure 2.2 shows the impact of tax measures announced in each of Mr Brown's 18 Budgets and Pre-Budget Reports to date on revenues in 2007–08.

Figure 2.2. Revenue raised in 2007–08 by Labour-announced measures



Notes: 2007–08 terms. Measures defined as taxation using National Accounts definitions. Hence, only a proportion of the cost of the new tax credits is scored as a tax cut. The escalators on tobacco and fuel duty that were announced by the Conservatives and increased by Labour are assumed to have been intended to run to 2001–02. The cost to the exchequer of abolishing these escalators is attributed to the Autumn 1999 Pre-Budget Report. For more details of classifications prior to January 2001, see table 3.1 of A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2001*, IFS Commentary 83 (<http://www.ifs.org.uk/budgets/gb2001/chap3.pdf>).

Sources: Announcements from HM Treasury, *Financial Statement and Budget Report*, various years; HM Treasury, *Pre-Budget Report*, various years.

Mr Brown began his Chancellorship with substantial net tax-raising measures in his first two Budgets. But these were more than offset by net tax cuts in the remaining five Budgets and Pre-Budget Reports of Labour's first term (including the abandonment of the fuel and tobacco escalators in the November 1999 Pre-Budget Report). This adds up to a net giveaway next

year from all measures announced in Labour's first term of 0.2% of national income, or £3.0 billion in 2007–08 terms.

The tax measures in Labour's second term were dominated by the increase in National Insurance contributions in the post-election April 2002 Budget, with relatively small net revenue-raisers in the remaining Budgets and Pre-Budget Reports contributing to a net tax increase from all measures announced in the second term worth £14.3 billion next year.

The three Budgets and Pre-Budget Reports since the 2005 election have been relatively significant revenue-raisers, bringing in a further £6.2 billion next year. This means that all the tax measures announced by Mr Brown to date will bring in 1.3% of national income (£17.5 billion) next year, compared with the situation if he had simply increased tax thresholds and allowances by the default amounts used in presenting the public finances (for example, increasing income tax allowances in line with inflation).

But, as Table 2.1 shows, the tax measures announced by Mr Brown account for less than half the increase in revenue of 2.9% of national income (£40 billion, or around £1,300 per family) that, on Treasury figures, we will have seen between 1996–97 and next year.

Table 2.1. Contributions to changes in government revenue (2007–08 terms)

	Policies taking effect 1997–98 to 2006–07		Policies to take effect in 2007–08		Total policies taking effect 1997–98 to 2007–08	
	% of national income	Cash equivalent	% of national income	Cash equivalent	% of national income	Cash equivalent
<i>Announcements</i>						
Conservative	+0.7%	+£10.0bn	none	none	+0.7%	+£10.0bn
Labour 1 st term	–0.2%	–£3.0bn	none	none	–0.2%	–£3.0bn
Labour 2 nd term	+1.0%	+£14.0bn	+0.0%	+£0.3bn	+1.0%	+£14.3bn
Labour 3 rd term	+0.1%	+£1.0bn	+0.4%	+£5.1bn	+0.4%	+£6.2bn
All announcements	+1.6%	+£22.0bn	+0.4%	+£5.4bn	+2.0%	+£27.5bn
Fiscal drag	+2.0%	+£27.6bn	+0.2%	+£2.8bn	+2.2%	+£30.3bn
Economic cycle	+0.2%	+£2.3bn	+0.0%	+£0.6bn	+0.2%	+£2.9bn
Other factors	–1.3%	–£18.2bn	–0.1%	–£1.8bn	–1.5%	–£20.1bn
Total	+2.4%	+£33.6bn	+0.5%	+£6.9bn	+2.9%	+£40.5bn

Notes: As Figure 2.2.

Sources: As Figure 2.2. Fiscal drag estimated using HM Treasury estimate of 0.2% a year from paragraph A24 of HM Treasury, *End of Year Fiscal Report*, December 2003 (http://www.hm-treasury.gov.uk/media/324/70/end_of_year_352%5B1%5D.pdf). Impact of economic cycle estimated using figures in table A.5 of HM Treasury, *ibid*.

An additional 0.7% of national income (£10 billion) will come from measures that were announced by the Conservatives before 1997, notably the above-inflation increases in fuel and tobacco duty that Mr Brown initially chose to maintain. The conventional assumption that income tax allowances and thresholds rise in line with prices rather than real earnings (and equivalent assumptions for other taxes) brings in 2.2% of national income (£30 billion) – and indeed the Chancellor has chosen not to offset much of this fiscal drag with policy measures (the most important exception being the decision in the 2005 pre-election Budget to announce a big increase in the lowest threshold for stamp duty on property transactions). Labour's

announced measures, the Conservative policies they chose to maintain and acquiescence in fiscal drag will together raise revenue by 4.2% of national income (£58 billion) next year.

Less in the Chancellor's control, another 0.2% of national income (£3 billion) will come from above-trend economic growth. And, offsetting these revenue increases, other economic developments will have cost the Chancellor 1.5% of national income (£20 billion) next year. In particular, these reflect the weak performance of the stock market and the associated fall in the profitability of financial companies, which adversely affected tax payments by firms and individuals in that sector.

2.4 Brown's bequest

The public finances have waxed and waned during Mr Brown's Chancellorship, strengthening during Labour's first term, weakening during its second, and now strengthening again early in its third. Given this pattern, we should be wary of focusing too closely on the fiscal position in any particular year. But it is nonetheless interesting to compare how the key fiscal indicators stood in Mr Clarke's last year as Chancellor (1996–97) with the way the Treasury forecasts that they will stand in what is expected to be Mr Brown's last year (2006–07).

As Table 2.2 shows, Mr Brown will likely leave the public finances stronger than he found them. He expects to spend 1.7% of national income more this year than Mr Clarke did in his final year (£22 billion more in 2006–07 terms), with most of the increase (1.5% of national income or £19 billion) being investment rather than current spending. But Mr Brown has also increased tax and other revenues by an even larger 2.4% of national income (£31 billion), which has paid for the extra spending and also allowed him to cut borrowing by 0.7% of national income (£9 billion). Mr Brown is still having to borrow this year to pay for some of his non-investment spending, but to a much lesser degree than Mr Clarke did: at 0.6% of national income, the current budget deficit is 2.2% of national income (£29 billion) smaller this year than the 2.8% deficit in 1996–97.

Turning to the government's balance sheet, we see that public sector net debt is expected to be 6.1% of national income (£80 billion) lower this year than it was in 1996–97, with the annual cost of debt interest also falling, by 1.6% of national income (£21 billion). Critics have argued that the government understates its true debt position by ignoring public sector pension liabilities and commitments made under the Private Finance Initiative. We discuss this criticism in Section 3.3.

These borrowing comparisons flatter Mr Brown slightly because economic activity was a little weaker in 1996–97 than it is expected to be in 2006–07, which depressed tax revenues and pushed up welfare bills for Mr Clarke. But the stronger economy is estimated to account for only 0.3% of national income (£4 billion) of the improvement in the budget balances between 1996–97 and 2006–07, so the structural position is also stronger now than it was at the end of the Conservative era. Similarly, public sector net debt is lower than it was a decade ago, whether or not the state of the economy is taken into account.

Table 2.2. Key fiscal indicators: 1996–97 versus 2006–07

<i>% of national income unless otherwise stated Rankings: among 22 OECD member countries with consistent data for 1996 and 2006 for all measures</i>	Brown's inheritance (1996–97)	Brown's bequest (2006–07)
Debt		
Public sector net debt <i>Place in OECD league table</i>	43.6% <i>10th highest debt</i>	37.5% <i>11th highest debt</i>
Borrowing		
Public sector net borrowing: total	3.5%	2.8%
Public sector net borrowing: structural <i>Place in OECD league table</i>	3.0% <i>6th highest borrowing</i>	2.6% <i>5th highest borrowing</i>
Current budget deficit: total	2.8%	0.6%
Current budget deficit: structural	2.3%	0.4%
Spending		
Total public spending <i>Place in OECD league table</i>	40.8% <i>12th highest spending</i>	42.5% <i>10th highest spending</i>
Public sector net investment	0.7%	2.2%
Central government debt interest <i>Place in OECD league table</i>	3.6% <i>13th highest debt interest</i>	2.1% <i>9th highest debt interest</i>
Revenues		
Tax and other revenues <i>Place in OECD league table</i>	37.3% <i>15th highest revenues</i>	39.7% <i>13th highest revenues</i>

Note: OECD figures relate to general government rather than public sector and include data from all OECD countries other than the Czech Republic, Ireland, South Korea, Poland, Slovakia and Switzerland.

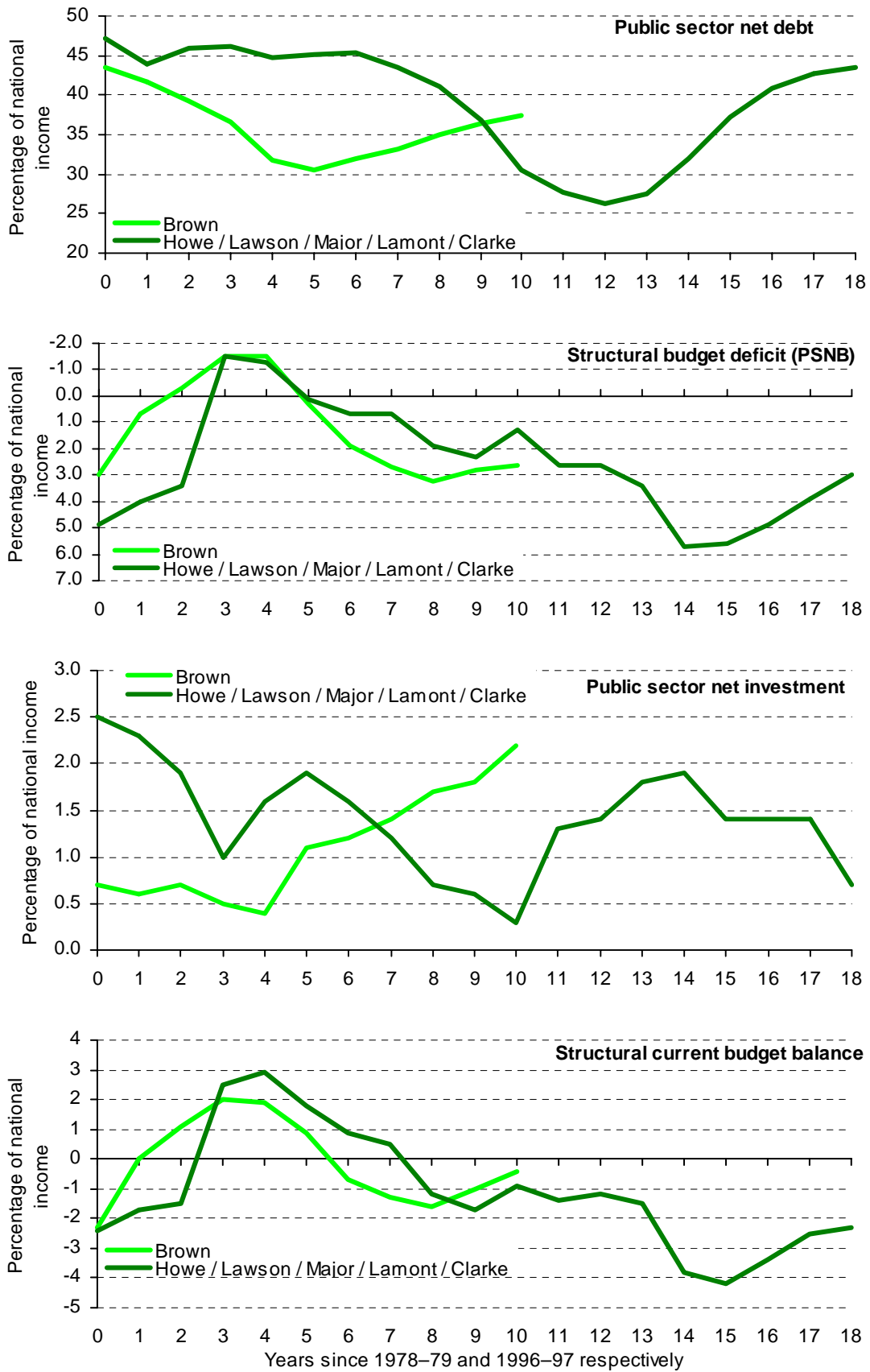
Sources: OECD, *Economic Outlook No. 80*, November 2006

(http://www.oecd.org/document/18/0,2340,en_2649_201185_20347538_1_1_1_1,00.html); HM Treasury, *Public Sector Finances Databank*, December 2006 (http://www.hm-treasury.gov.uk/media/A5B/FD/pfd_dec06.xls); Office for National Statistics.

However, the improvements in debt, borrowing and structural budget balances have occurred at a time when most other industrialised countries have also been strengthening their public finances – indeed, many more so. Out of the 22 OECD countries for which we have comparable data on a wide range of indicators, 15 reduced their debt and 17 improved their structural budget balances by more than the UK between 1996 and 2006.

Figure 2.3 compares the evolution of the public finances during Labour's first decade with the Conservative record after 1979. On the face of it, the comparison is not flattering to Mr Brown. Having inherited a smaller public sector net debt than the Conservatives in 1979, after 10 years Mr Brown now finds himself for the first time with a higher debt burden than the Conservatives had after the same number of years in office. In addition, having inherited a smaller structural budget deficit than the Conservatives, and having reached the same peak structural surplus in his third year in office, Mr Brown has also presided over a bigger deterioration than the Conservatives over the subsequent seven years.

Figure 2.3. Deficits, debt and investment: Labour vs Conservatives



Source: HM Treasury, *Public Sector Finances Databank*, December 2006 (http://www.hm-treasury.gov.uk/media/A5B/FD/pfd_dec06.xls).

But this in part reflects Mr Brown's willingness to borrow more to increase net investment from the low level he inherited. As Figure 2.3 shows, net investment actually fell over his first four years as Chancellor, but it has since increased every year and it is now three times higher than the level he inherited. By comparison, net investment fell sharply during the Conservatives' first decade (although this in part reflected the privatisation of capital-intensive industries). If we exclude borrowing to finance investment, we see that the current budget deficit has been smaller over the last couple of years than it was in the equivalent period under the Conservatives, both parties having inherited similar levels.

Whether the performance of the public finances has been stronger during the first decade under Labour or during the first decade under the Conservatives depends on which indicator one looks at. But under the Conservatives the worst was certainly yet to come, while Mr Brown doubtless hopes that for Labour things can only get better.

The Conservatives overestimated the strength of the fiscal position in the late 1980s by misjudging the amount of spare capacity in the economy – in part thanks to the misfortune of inaccurate National Accounts data. They then compounded their problems with tax cuts and spending increases they could ill-afford in the run-up to the April 1992 election. They finally addressed their fiscal problem with tax increases and spending cuts after 1993. This may have contributed to their poor performance at the ballot box in 1997.

Labour too overestimated the underlying strength of the fiscal position in the early 2000s by assuming a rapid bounce-back in tax revenues from the financial sector, which had been inflated and then deflated by the gyrations of the stock market. Mr Brown delayed the adjustment that IFS and other independent commentators thought necessary until after the 2005 election. Mr Brown would argue that he has been able to do so while still meeting his 'golden rule'; but, as we shall see in Chapter 3, the suspicion that he has only been able to do so by 'moving the goalposts' has undermined the credibility of the fiscal rules.

Although there are parallels between the ways in which the two parties have managed the public finances, it seems reasonable to argue that, over their full 18 years, the Conservatives both had worse luck and made more serious lapses of judgement than Labour has to date. As a result, by 1996–97 Mr Clarke had only been able to climb halfway out of a deep fiscal hole, while in 2006–07 Mr Brown will hope to have climbed halfway out of a much shallower one.

2.5 Brown's plans and forecasts

Mr Brown expects to spend 42.5% of national income this year (40.3% of national income on current spending and 2.2% on public sector net investment). With revenues forecast at 39.7% of national income, this leaves a current budget deficit of 0.6% of national income (£7.9 billion) and public sector net borrowing of 2.8% of national income (£37.5 billion).

How does the Treasury hope that the public finances will evolve over the next five years – and how do its projections compare with Mr Clarke's aspirations at the end of his period as Chancellor, as implied by the forecasts in his November 1996 Budget?

By way of preamble, we should note that, in principle, the Pre-Budget Report is an interim forecast and does not necessarily indicate what the Treasury hopes will happen. For that, we need to wait for any policy measures to be announced in the Budget. But, in practice, Mr

Brown has eroded the distinction between the Budget and Pre-Budget Report, with the latter recently having contained more significant policy changes than the Budget (see Figure 2.2). So it seems reasonable to treat the Pre-Budget Report forecasts as a reasonable proxy for the Treasury's desired path.

According to the Pre-Budget Report, the current budget is predicted to move steadily from the deficit of 0.6% of national income this year to a surplus of 0.8% of national income in 2011–12. Over this period, revenues are expected to rise by 0.7% of national income while current spending is projected to fall by 0.8% of national income (the figures do not add because of rounding). Public sector net investment is expected to be unchanged at 2.2% of national income. Net debt is forecast to rise from 37.5% of national income this year to a peak of 38.7% in 2010–11 before dropping back to 38.5% in 2011–12.

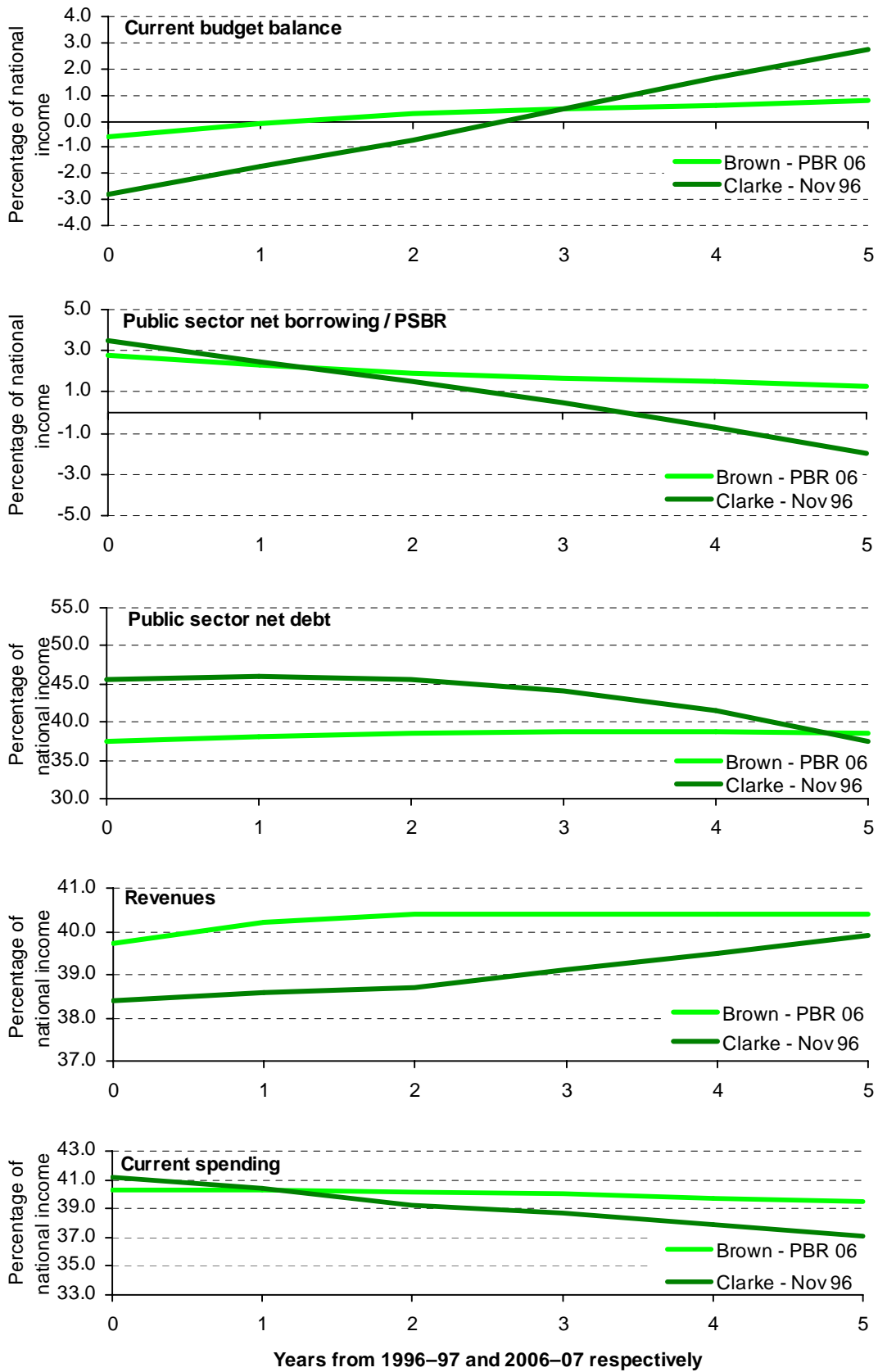
Figure 2.4 shows the Treasury's forecast trajectories over forthcoming years for various public finances aggregates, starting from 1996–97 for Mr Clarke and 2006–07 for Mr Brown. It can be seen that Mr Clarke laid out his plans from a weaker starting point in 1996–97 than Mr Brown is doing in 2006–07. But Mr Clarke was also aiming for a bigger current budget surplus and a slightly smaller debt burden after five years, and therefore pencilled in a bigger policy tightening over the five years than Mr Brown is doing now. Mr Clarke was looking for a bigger cut in spending and a bigger tax increase than Mr Brown is now anticipating (which Mr Clarke sought to achieve, in part, by the introduction of yearly escalators on tobacco and fuel duties at least until 2001–02), although Mr Clarke has admitted that he probably would not have been as tough as his forecasts suggested if the Conservatives had been re-elected.⁷ On health spending, for example, nearly every year under the Conservatives saw spending considerably exceed the plans that were made in the preceding Budget or Autumn Statement.⁸ It should be borne in mind that Figure 2.4 shows Mr Clarke's forecasts as of 1996 – subsequent revisions to both the fiscal aggregates and national income mean that spending, revenues, debt and the current budget deficit are all now thought to have been smaller as shares of national income in 1996–97 than they appeared at the time.

How does Mr Brown expect the improvement in the public finances over the next five years to come about? In marked contrast to the previous Budget and Pre-Budget Report, and thanks mostly to stronger-than-expected economic growth, the Treasury now believes that economic activity is running only 0.2% below the level consistent with stable inflation (the 'output gap'). So only a small part of the forecast improvement in the current budget balance will come about automatically as the economy enjoys above-trend growth this year and next (see Table 2.3). Most of the expected improvement is structural, both for spending and revenues.

⁷ Source: L. Elliot, 'Still papering over the cracks', *Guardian*, 20 March 2001 (<http://society.guardian.co.uk/commongood/comment/0,,459713,00.html>).

⁸ A. Dilnot and P. Johnson (eds), *Election Briefing 1997*, IFS Commentary 60, 1997.

Figure 2.4. Fiscal forecasts: Brown 2006 vs. Clarke 1996



Sources: HM Treasury, *2006 Pre-Budget Report*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm); HM Treasury, *Financial Statement and Budget Report 1997-98*, November 1996.

Table 2.3. Current budget balance: cyclical and structural

	Economic growth	Output gap (% potential output)	Current budget balance (% national income)			Net borrowing (% national income)
			Cyclical	Structural	Total	
2006–07	2¾%	–0.2	–0.2	–0.4	–0.6	2.8
2007–08	2¾%	0	–0.2	0.1	–0.1	2.3
2008–09	2½%	0	0	0.3	0.3	1.9
2009–10	2½%	0	0	0.5	0.5	1.7
2010–11	2½%	0	0	0.6	0.6	1.5
2011–12	2½%	0	0	0.8	0.8	1.3

Source: Tables B1 and B3 of HM Treasury, *2006 Pre-Budget Report*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm).

Spending

The 2004 Spending Review began a deceleration of public spending growth after the rapid increases seen during Labour's second term. Next year is the last to be covered by the 2004 review and is expected to see current (and total) spending growing by 2.7% in real terms – the lowest real increase since 1999–2000 – and sufficient only to hold it constant as a share of national income. Thereafter, as we explain in more detail in Chapter 7, the Treasury has pencilled in cuts in spending as a share of national income over the three years to be covered by the 2007 Comprehensive Spending Review.

Firm spending totals for the 2007 CSR are expected in the Budget. In the Pre-Budget Report, the Treasury once again pencilled in slower growth in real public spending than in the economy in 2008–09, 2009–10 and 2010–11. Real growth in current spending averaging 2.0% a year is projected to cut spending by 0.6% of national income (£7 billion in today's terms). This would return current spending as a share of national income to its level in 2004–05. In addition, the Treasury also for the first time pencilled in an assumption for current spending growth in 2011–12, the first year beyond the 2007 CSR. This would cut current spending by a further 0.2% of national income, bringing the total cut to 0.8% of national income (£10 billion).

Revenues

Revenues are expected to rise by 0.7% of national income (£10 billion) over the next five years. The increase is expected to come predominantly from taxes on incomes and profits, partially offset by a decline in revenue from taxes on spending and North Sea oil production. Of this increase, 0.1% of national income is cyclical and 0.6% structural. Most of the increase (0.5% of national income) is expected in the coming year alone and will come from income tax, corporation tax and 'other receipts' (mostly profits and rent from public bodies).

As usual, the forecast incorporates an ongoing structural increase in revenues arising from 'fiscal drag'. This reflects the Treasury's conventional forecasting assumption that tax allowances and thresholds rise in line with retail prices. As earnings typically rise more quickly, this implies a continuous rise in the share of national income taken in income tax as more people find larger proportions of their income being taxed at higher rates. (We would see a similar phenomenon on a smaller scale – relative to national income – for taxes such as

capital gains tax and stamp duty on properties, where the tax base tends to grow more quickly than the rise in thresholds assumed for forecasting purposes.)

The Treasury estimates that fiscal drag increases current receipts by 0.2% of national income a year, which implies an increase of at least 0.75% of national income after five years once rounding is taken into account.⁹ This accounts for most if not all of the 0.8% of national income increase in revenue from income tax and National Insurance contributions (NICs) over the forecast horizon – and indeed most of the increase in revenues overall.

Table 2.4. Revenue changes projected in PBR 2006 (% of national income)

	2006–07	2011–12	Change
Income tax & NICs	17.6	18.4	+0.8
Corporation tax	3.1	3.4	+0.3
North Sea revenues	0.8	0.7	–0.1
VAT & excise duties	8.8	8.5	–0.3
Other taxes & royalties	7.0	7.2	+0.2
Net taxes & NICs	37.3	38.1	+0.8
Other receipts etc.	2.3	2.3	No change
Current receipts	39.7	40.4	+0.7

Note: Components may not add to totals due to rounding.

Source: Table B14 of HM Treasury, *2006 Pre-Budget Report*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm)

One impact of fiscal drag is to increase the number of higher-rate income taxpayers. In 2006–07, with a higher-rate threshold of £38,335, HMRC estimates that there will be 3.25 million higher-rate taxpayers.¹⁰ Had the higher-rate threshold been increased in line with average earnings over the last 10 years, the threshold would have been £44,175 and there would have been almost 1 million fewer higher-rate taxpaying individuals.

The assumption that fiscal drag proceeds uninterrupted over the Treasury’s forecasting horizon is not a new one – for example, Mr Clarke’s November 1996 Budget made the same assumption. But, as the Treasury acknowledges, assuming that the tax burden continues to increase for the foreseeable future would be unrealistic. It therefore assumes in its *Long Term Public Finance Report* that revenues and their composition remain broadly unchanged as shares of national income over the longer term.¹¹ This implies ‘a comprehensive form of “real indexation”’,¹² which presumably means tax allowances and thresholds rising in line with growth in the relevant tax base, i.e. often faster than prices.

The Treasury may indeed believe that, over the short to medium term, exploiting fiscal drag – with the increase in marginal (as well as average) income tax rates for many people that this implies – is the most sensible way to raise the extra revenues that it requires to meet the

⁹ Paragraph A24 of HM Treasury, *End of Year Fiscal Report*, December 2003 (http://www.hm-treasury.gov.uk/media/324/70/end_of_year_352%5B1%5D.pdf).

¹⁰ Table 2.1 of HMRC Statistics (http://www.hmrc.gov.uk/stats/income_tax/table2-1.xls).

¹¹ Paragraph 5.20, page 50, of HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, December 2004 (http://www.hm-treasury.gov.uk/media/8F5/85/pbr04long-term_473.pdf).

¹² Footnote 13, page 51, of HM Treasury, *Long-Term Public Finance Report: An Analysis of Fiscal Sustainability*, December 2004 (http://www.hm-treasury.gov.uk/media/8F5/85/pbr04long-term_473.pdf).

golden rule looking forward. But the Treasury, both now and in the past, does not make this case explicitly, and we should be clear that this would be a policy choice and not an economically neutral assumption – indeed, it only arises from the particular way in which the tax system is written in legislation. There are other ways that the public finances could be strengthened.

2.6 Uncertainty and the Treasury's fiscal forecasts

As Mr Brown and previous Chancellors have discovered to their cost, forecasting the public finances is a difficult business. The main problem is that small errors in forecasts for spending or revenues can imply proportionately much bigger errors in forecasts of budget balances – the difference between the two. So when the Treasury predicts that the current budget balance will strengthen by 1.4% of national income over the next five years (and public sector net borrowing by 1.5% of national income over the same period), how confident should we and Mr Brown be that this will actually be the outcome?

The Chancellor has repeatedly argued that his forecasts are cautious. But, unlike the Bank of England in its pursuit of the inflation target, he shies away from explicit discussion of the confidence that can be attached to his forecasts and the implications that has for his decisions. We have argued for some time that the Treasury should emulate the Bank and publish its fiscal forecasts in a way that makes clear the uncertainty that lies around the central estimate. The Treasury has consistently rejected this suggestion, arguing that it is difficult to do and that it is sufficient to publish average forecasting errors alongside its predictions.

Lessons from past experience

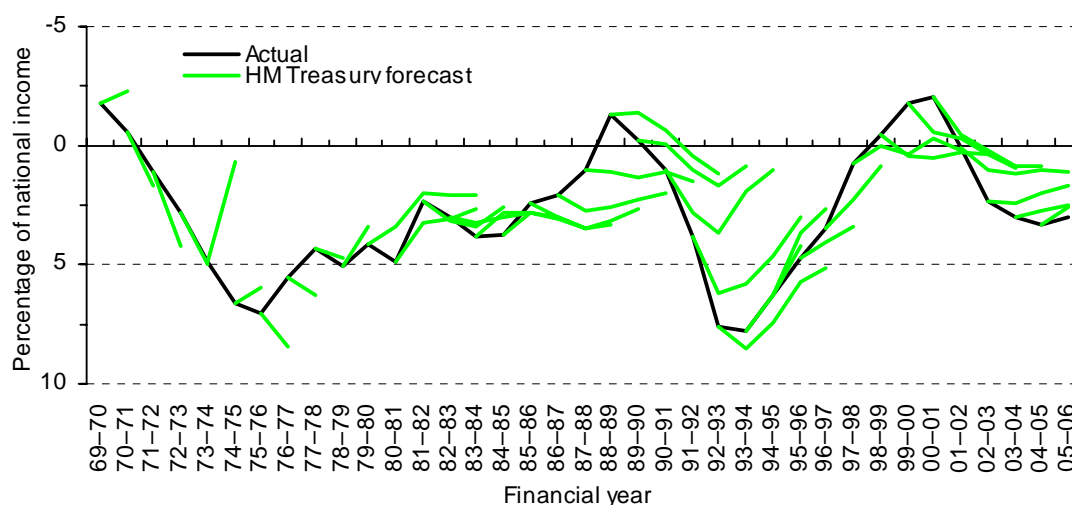
The Treasury's past forecasting errors are a good place to start in assessing the confidence we should have in its current predictions. If we are happy to assume that its forecasting performance in the future will be the same as that in the past, we can calculate the probability that the outcome will differ by a given amount in one direction or the other from the central forecast.

Figure 2.5 shows how Treasury forecasts of changes in public sector net borrowing since the early 1970s have compared with what actually happened. We can see that the errors are relatively large and that they are also serially correlated: in other words, an over-optimistic forecast tends to be followed by another over-optimistic one and a pessimistic forecast by another pessimistic one (as shown by the fact that the forecast lines tend not to cross the actual borrowing line in the graph).

The Treasury's average absolute error in forecasting public sector net borrowing one, two, three and four years ahead for the period from 1977–78 to 2005–06 is shown in Table 2.5. This shows that even one year ahead, the average absolute error is 1% of national income, or £13 billion in today's prices.¹³

¹³ IFS forecasts show errors of similar magnitude. See C. Giles and J. Hall, 'Forecasting the PSBR outside government: the IFS perspective', *Fiscal Studies*, 19, 83–100, 1998 (http://www.ifs.org.uk/publications.php?publication_id=2250).

Figure 2.5. Treasury public sector net borrowing forecasts



Source: Authors' calculations, from data contained in HM Treasury, *End of Year Fiscal Report*, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/assoc_docs/prebud_pbr06_adfiscal.cfm).

Table 2.5. Treasury errors in forecasting public sector net borrowing

Time period	Average absolute error (% of national income)	Average absolute error (£ billion)
One year ahead	1.0	13
Two years ahead	1.5	20
Three years ahead	2.0	26
Four years ahead	2.5	33

Notes: Figures in £ billion are calculated assuming HM Treasury forecast for national income in 2006–07 of £1,305 billion. Average absolute error is given over the period 1977–78 to 2005–06 for one year ahead, 1981–82 to 2005–06 for two years ahead, 1982–83 to 2005–06 (excluding 1996–97 to 1999–2000) for three years ahead, and 1983–84 to 2005–06 (excluding 1984–85 to 1986–87 and 1997–98 to 2000–01) for four years ahead.

Sources: HM Treasury, *End of Year Fiscal Report*, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/assoc_docs/prebud_pbr06_adfiscal.cfm); authors' calculations.

Errors in forecasting public sector net borrowing can arise either from errors in forecasting the strength and composition of economic growth or from errors in predicting tax revenues and spending for any given level and composition of national income. Errors in forecasting economic growth have been relatively unimportant in explaining the Treasury's errors in forecasting the budget balance over a horizon of at least up to four years.¹⁴

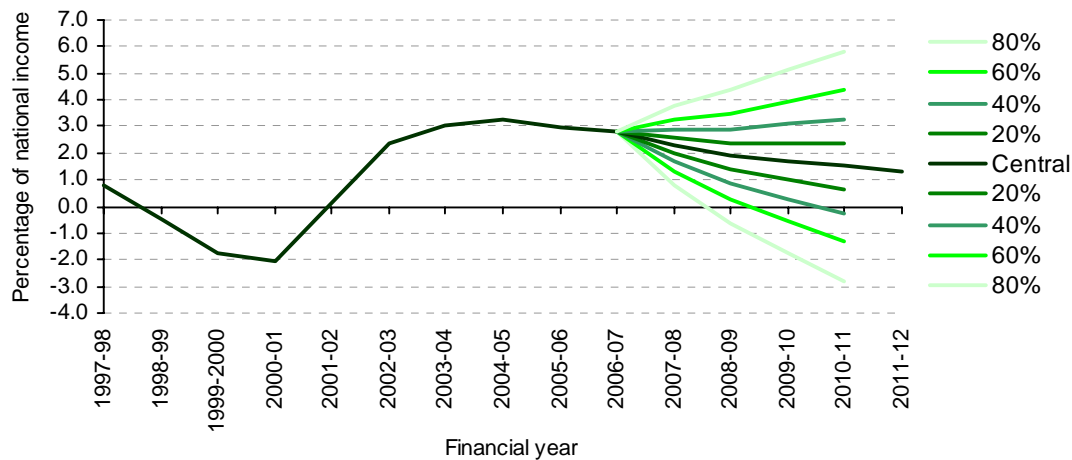
If we assume that the Treasury's latest forecasts will be as accurate as its past ones and that errors are normally distributed, we can put confidence intervals around the projections. Figures 2.6, 2.7 and 2.8 show confidence intervals around the central projections for net borrowing, the current budget balance and net debt respectively over the next four years. By assumption, it is just as likely that things will turn out better than the Treasury expects as that they will turn out worse than expected. Looking at the Treasury's one-year- and two-year-ahead forecasts back to 1970, under previous governments the predictions were slightly more

¹⁴ See table B13 of HM Treasury, *Pre-Budget Report 1998* (<http://archive.treasury.gov.uk/pub/html/prebudgetNov98/index.html>).

likely to be pessimistic than optimistic, but the average error is very small, at 0.1% of national income. In the period since the current government introduced its fiscal rules, the Treasury claims that its forecasts have been deliberately cautious. This is consistent with the fact that forecasts for public sector net borrowing one year ahead have been on average 0.2% of national income too pessimistic. But forecasts two years ahead are as likely to have been over-optimistic as unduly pessimistic.¹⁵

The main source of caution in the public finance forecasts is the assumption that the trend growth rate of the economy is a quarter of a percentage point lower than the Treasury's central view. This means that the level of national income assumed for 2011–12 is 1¼% lower than the Treasury's true expectation.¹⁶ If the Treasury's central view of trend growth is correct, this would lead us to expect its borrowing forecasts to become increasingly pessimistic over time relative to the true outcome – reaching an expected difference of around 0.9% of national income by 2011–12. It would be more transparent if the Treasury dealt with the need for caution explicitly when explaining its policy decisions rather than trying to incorporate deliberate bias in its forecasts. As we have yet to see whether the supposedly cautious growth assumption will produce unduly pessimistic forecasts on average over a long period, we assume for the time being in calculating the probability distribution of future outcomes that future Treasury forecasts will be unbiased.

Figure 2.6. Probabilities for net borrowing outcomes



Sources: Central projections are taken from HM Treasury, *2006 Pre-Budget Report*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm) and assume that the forecast for 2006–07 is correct; methodology for computing fan charts taken from C. Emmerson, C. Frayne and S. Love, 'Updating the UK's Code for Fiscal Stability', IFS Working Paper W04/29, 2004 (http://www.ifs.org.uk/publications.php?publication_id=3163).

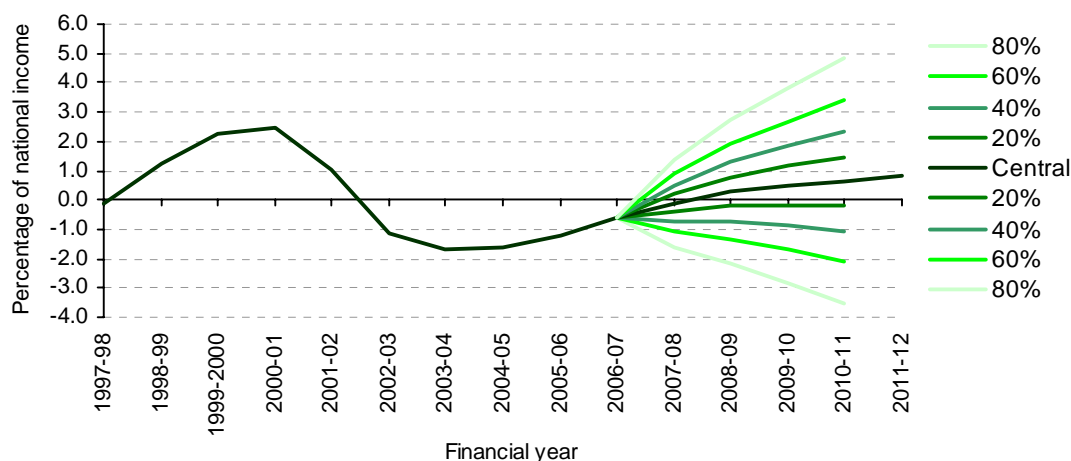
¹⁵ Table 2.2 of HM Treasury, *End of Year Fiscal Report*, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/assoc_docs/prebud_pbr06_adfiscal.cfm).

¹⁶ Source: Paragraph B.23, page 221, of HM Treasury, *2006 Pre-Budget Report*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm).

Figure 2.6 shows the probabilities of different outcomes for public sector net borrowing, based purely on the Treasury’s latest forecasts and its past forecasting performance. We assume that the Treasury’s projection for 2006–07 is correct, but that there is uncertainty thereafter. The presentation is analogous to the Bank of England’s inflation and growth forecasts in its quarterly *Inflation Report*.¹⁷ The ‘central’ estimate is the Pre-Budget Report forecast shown in Figure 2.1. Figure 2.6 shows that there is a 20% probability that the outcome will lie within the darkest bands either side of the central forecast, a 40% probability that it will lie between the next darkest bands, and so on. It shows, for example, that in 2010–11, there is around a one-in-three chance on past performance that the deficit will have been eliminated.

Similarly, Figure 2.7 shows the probability distribution around the Treasury’s central Pre-Budget Report forecast for the current budget balance. It suggests that there is a slightly greater than 40% chance that the current budget will still be in deficit in four years’ time rather than recording the surplus of 0.6% of national income predicted in the Pre-Budget Report. There is a more than 30% chance that there will be no improvement in the current budget balance over the next four years.

Figure 2.7. Probabilities for current budget balance outcomes

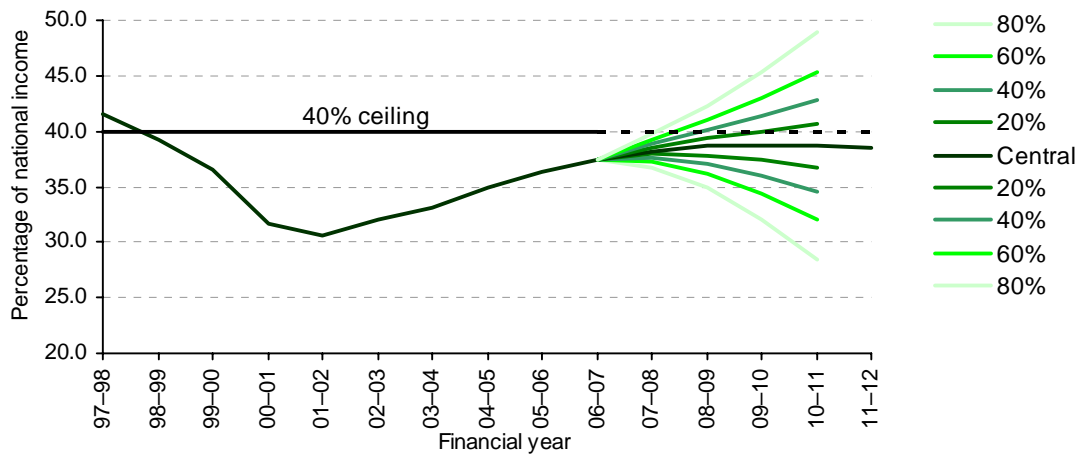


Sources: As Figure 2.6.

Figure 2.8 shows a similar probability distribution around the Treasury’s central forecast for public sector net debt. This distribution also takes into account the fact that the direction of forecasting errors tends to be correlated from one year to the next, as shown in Figure 2.5. As we shall discuss in the next chapter, Figure 2.8 suggests that the probability of public sector net debt breaching the 40% of national income ceiling established by the sustainable investment rule rises from a little over 30% in 2008–09 to 40–45% in the following two years, again based purely on the Treasury’s past forecasting performance.

¹⁷ <http://www.bankofengland.co.uk/publications/inflationreport/index.htm>.

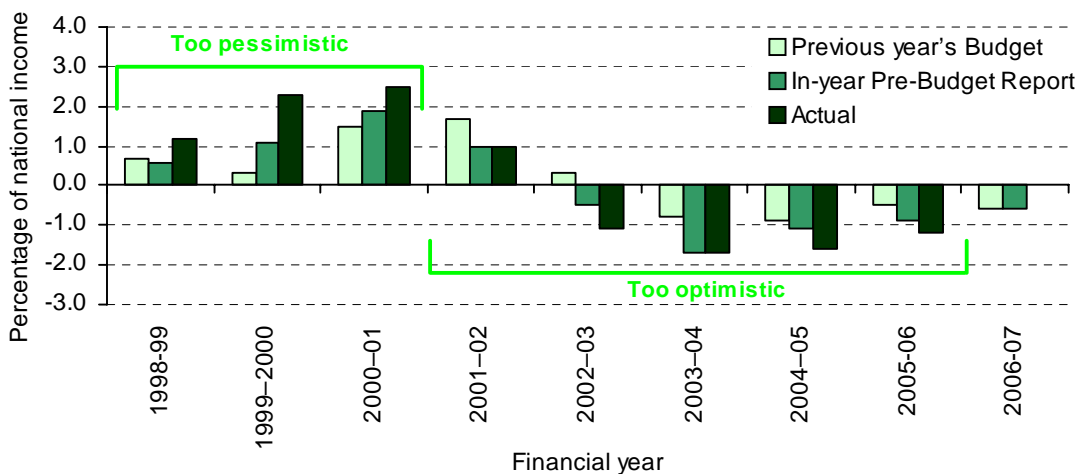
Figure 2.8. Probabilities for public sector net debt outcomes



Note: Assumes that any cumulative variation in public sector net borrowing from that forecast by the Treasury directly adds to public sector net debt. The second-order impact of changes in debt interest is ignored.
Sources: As Figure 2.6.

The estimates of previous Treasury forecasting errors used in this analysis are likely to be underestimates of the true forecasting error. This is because the forecasts for borrowing have not been adjusted for subsequent tax and spending decisions. In practice during periods where (underlying) borrowing was exceeding expectations, Chancellors would have been more likely to engage in a fiscal tightening than a fiscal loosening. For example, the two Budgets of 1993 contained significant tax-raising measures aimed at bringing revenues closer to previous expectations. This suggests that, if anything, the probability bands shown in Figures 2.6, 2.7 and 2.8 should be wider. It would be very useful if the Treasury published information on previous forecasting errors that have been adjusted for subsequent policy announcements.

Figure 2.9. Treasury current budget balance forecasts



Sources: HM Treasury, various Budgets and Pre-Budget Reports.

As mentioned above, forecasting errors tend to be correlated from one year to the next. We can see this for the current government's short-term forecasts of the current budget balance in Figure 2.9. In the Budget of March 1999, the Treasury forecast a current budget surplus in 1999-2000 of 0.3% of national income. The eventual out-turn was 2.3% of national income.

Hence the Treasury's year-ahead Budget forecast for the current budget balance was 2% of national income too pessimistic in 1999–2000. In subsequent years, it was about 1% of national income too pessimistic in 2000–01, ¾% too optimistic in 2001–02, 1½% too optimistic in 2002–03, 1% too optimistic in 2003–04, ¾% too optimistic in 2004–05 and ¾% too optimistic in 2005–06.

Asked to explain the serial over-optimism of the Treasury's public finance forecasts in recent years, Jon Cunliffe, Second Permanent Secretary at the Treasury responsible for macroeconomic policy and international finance, told the Treasury Select Committee in December 2005 that 'There is a tendency for forecast errors to be correlated with the economic cycle, so when you have a positive output gap there is a tendency for forecast errors to be one way and when you have a negative output gap there is a tendency for forecast errors to be the other way'.¹⁸ This is consistent with the switch from undue pessimism to over-optimism in 2001–02. With the Treasury now expecting that the output gap will close in the current financial year, this suggests that the Treasury's forecasting fortunes may turn again soon. However, if there is indeed this predictable relationship between errors in the Treasury's public finance forecasts and its contemporaneous estimates of the output gap, it should be possible to improve the forecasts by taking this into account.

2.7 Fiscal monetary coordination

Mr Brown has said that one of his objectives for fiscal policy is to allow changes in government borrowing to 'support' monetary policy in helping to stabilise economic activity and keep inflation on target. He cites as evidence that this has been achieved that 'net borrowing increased to allow fiscal policy to support monetary policy as the economy moved below trend in 2001'.¹⁹ The implication is that on most occasions, monetary and fiscal policy should tighten together or loosen together, rather than moving in opposite directions. Presumably, this is designed to reduce the swings in real interest rates necessary to keep inflation on target as economic activity fluctuates above and below trend.

Whether this is an appropriate goal for the coordination of monetary and fiscal policy is debatable. The Chancellor sets fiscal policy twice a year in the Budget and Pre-Budget Report, while the Bank of England meets monthly to set nominal interest rates in pursuit of the inflation target over an approximately two-year time horizon. If the Treasury understands how the Bank will react to fiscal policy changes – which is presumably one reason why it has a representative at meetings of the Monetary Policy Committee – it can in effect determine the mix of monetary and fiscal policy at any given time.

If the Treasury tightens fiscal policy, it might reasonably expect the Bank to set a lower interest rate to hit the inflation target than it otherwise would. And there may be occasions when such a 'rebalancing' of monetary and fiscal policy is thought desirable. For example, some commentators have at various times urged tax increases or spending cuts in order to encourage the Bank to keep interest rates lower than they otherwise would be, in the hope that

¹⁸ <http://www.publications.parliament.uk/pa/cm200506/cmselect/cmtreasy/uc739-ii/uc73902.htm>.

¹⁹ Source: Page 19 of HM Treasury, *2006 Pre-Budget Report*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm).

this will push down the exchange rate and boost the competitiveness of the internationally traded (and especially the manufacturing) sector. Mr Brown has shown no appetite for such an approach, perhaps on the reasonable grounds that there is no reliably predictable relationship between the monetary/fiscal mix and the exchange rate. Indeed, tightening fiscal policy could strengthen the exchange rate if it attracts capital inflows by boosting investor confidence in macroeconomic management.

But let us assume that it is desirable for monetary and fiscal policy to move in the same direction most of the time. In part, this will happen automatically if below-trend economic activity encourages lower interest rates and also increases borrowing through the workings of the ‘automatic stabilisers’ – weaker tax revenues and higher social benefit spending. But the Chancellor can enhance this effect through changes in the structural budget balance.

This would appear to have happened over most of the past 10 years. In its *End of Year Fiscal Report*, the Treasury shows this by comparing the change in real interest rates that occurred in each year with the change in public sector net borrowing (PSNB) and with the change in the cyclically adjusted change in PSNB which strips out the estimated impact of the economic cycle on borrowing. As shown in column 1 of Table 2.6, there have been five years in which real interest rates have been increased (a monetary tightening) and five years in which real interest rates have been reduced (a monetary loosening). As column 3 shows, in four of the five years that monetary policy was tightened, so too was fiscal policy; and in three of the five years in which monetary policy was loosened, so too was fiscal policy. This is true whether or not the automatic stabilisers are taken into account.

Table 2.6. Monetary and fiscal policy working in the same direction?

	Change in demand resulting from:				
	(1) Real interest rate	(2) PSNB	(3) Cyclically adjusted PSNB	(4) Policy measures – short run	(5) Policy measures – medium run
1997–98	tighten	tighten	tighten	tighten	tighten
1998–99	tighten	tighten	tighten	tighten	tighten
1999–2000	loosen	tighten	tighten	loosen	loosen
2000–01	tighten	tighten	tighten	loosen	loosen
2001–02	loosen	loosen	loosen	loosen	loosen
2002–03	loosen	loosen	loosen	loosen	tighten
2003–04	loosen	loosen	loosen	loosen	loosen
2004–05	tighten	loosen	loosen	loosen	loosen
2005–06	loosen	tighten	tighten	loosen	loosen
2006–07	tighten	tighten	tighten	tighten	tighten

Sources: Change in real interest rate and change in cyclically adjusted net borrowing taken from chart 2.2, page 8, of HM Treasury, *End of Year Fiscal Report*, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/assoc_docs/prebud_pbr06_adfiscal.cfm). Change from policy announcements taken from Budgets and Pre-Budget Reports from July 1997 to December 2006.

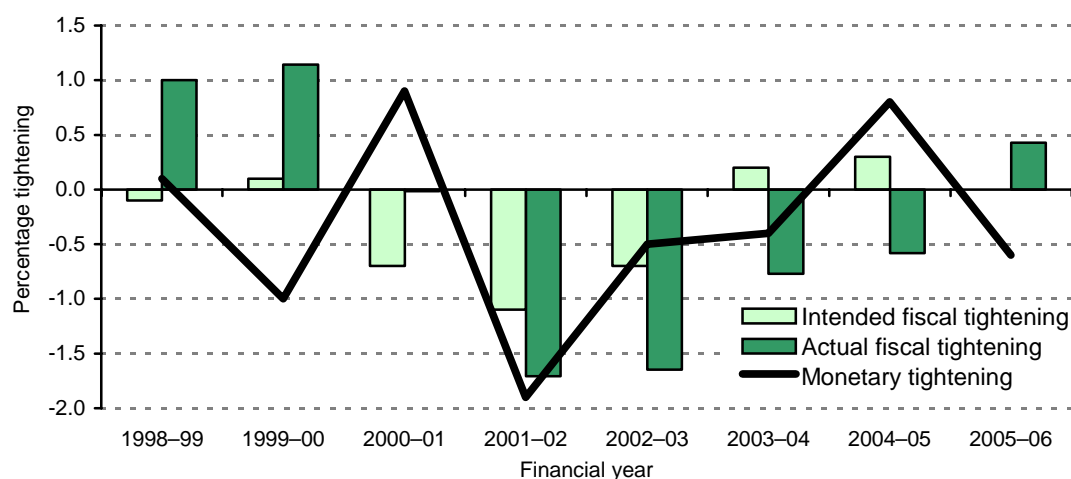
But showing that the change in cyclically adjusted borrowing is negatively correlated with changes in real interest rates (i.e. that rises in borrowing are associated with falls in real interest rates) is not sufficient to demonstrate that fiscal policy has actively supported monetary policy in the way that Mr Brown intends. If, for example, there had been

phenomena other than the economic cycle that have influenced both the state of the public finances and interest rate decisions, then this would be likely to lead to a negative correlation between changes in structural borrowing and changes in real interest rates.

Such a correlation might still remain even if fiscal policy decisions announced over the period in question actually worked in the opposite direction to monetary policy. An example is to imagine an asset price cycle that strongly affects individuals' incomes and therefore both demand in the economy and tax receipts. This could be relevant to the period since April 1997, given the rise and subsequent fall in the stock market and the fortunes of the financial sector. If a Chancellor announced new tax cuts when real interest rates were rising and tax increases when real interest rates were falling, as long as the tax changes were smaller than the overall impact of the asset price cycle on the government's finances, he or she would still be able to point to a period in which borrowing fell when real interest rates were rising and borrowing rose when real interest rates were falling. But it would be difficult to argue that fiscal policy had really 'supported' monetary policy in the way that Mr Brown intends.

We can assess this in part by comparing the change in structural borrowing that the Chancellor intended over the year ahead at the time of each recent Budget with that which actually occurred. Figure 2.10 shows that monetary and fiscal policy did both loosen after 2001 as the Chancellor claims, but that the loosening in fiscal policy was partly unintended at the time – the weakness of the stock market led to unexpected weakness in tax revenues (and hence unexpected looseness in fiscal policy). An alternative explanation for some Treasury forecast errors is that it has underestimated how powerful the automatic stabilisers are.

Figure 2.10. Intended and unintended fiscal policy changes



Notes: Fiscal tightening refers to the change in cyclically adjusted net borrowing. Monetary tightening refers to the change in the real interest rate.

Sources: HM Treasury, *Public Sector Finances Databank*, December 2006 (http://www.hm-treasury.gov.uk/media/A5B/FD/pfd_dec06.xls); successive Budgets; HM Treasury, *End of Year Fiscal Report*, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/assoc_docs/prebud_pbr06_adfiscal.cfm).

It is important to remember that the Monetary Policy Committee takes a forward-looking approach to setting monetary policy. As a result, the forecast change in cyclically adjusted public borrowing is likely already to have been considered in current interest rate decisions. Table 2.6 also shows the impact of Budget and Pre-Budget Report decisions on borrowing

both in the current year (column 4) and in the longer term (column 5). This shows that even using this better measure of changes in the fiscal stance, on average, Mr Brown can still claim to have used fiscal policy to support monetary policy. On three of the five occasions when real interest rates were rising, the impact of new measures announced in Budgets and Pre-Budget Reports were to increase borrowing (in both the short and medium terms). In addition, on all five occasions when real interest rates were falling, the impact of measures announced in Budgets and Pre-Budget Reports was to increase borrowing in the current year (although on one of these occasions the medium-term impact was to reduce borrowing).

2.8 Conclusion

Mr Brown began his decade as Chancellor defying the stereotypes conjured up by previous Labour occupants of the post: he cut spending and increased tax revenues sharply, pulling the public finances back into the black. But after 1999 it became clear that he could not deliver the quality of public services and the reduction in child and pensioner poverty that he sought without substantially higher public spending. Unfortunately, as the resulting spree got underway, the downturn in the stock market punched a hole in his tax revenues, and the strengthening of the public finances with which he began was swiftly reversed despite a big tax increase after the 2001 election. Continued weakness in revenues means that the Chancellor has already had to raise taxes repeatedly since the 2005 election as well as pencilling in spending cuts over the next few years, albeit much smaller than those with which he began his Chancellorship.

After 10 years at Number 11, he should leave the public finances in stronger shape than that in which he inherited them – although having presided over a smaller improvement than most industrial countries over the same period. He now faces the prospect of his first general election as Prime Minister with the tax burden rising and public spending falling. The tightening is less draconian than that on which the Conservatives fought the 1997 election, and Mr Brown doubtless hopes that the electorate will smile more favourably upon his efforts now than it did on those of his predecessors then.