5. Green Budget public finance forecasts

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Summary

- 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.

5.1 Introduction

This chapter presents the IFS public finance forecasts and discusses them in the context of the fiscal rules. Section 5.2 presents the 2007 Green Budget forecasts for 2006–07 and 2007–08, using as a baseline the assumption that the economy evolves as the Treasury predicted in the December 2006 Pre-Budget Report. Section 5.3 looks at the medium-term prospects for the public finances (up to 2011–12), also based on the 2006 PBR macroeconomic assumptions. Section 5.4 compares our baseline forecasts with forecasts based on the alternative macroeconomic assumptions outlined by Morgan Stanley in Chapter 4. Finally, Section 5.5 examines whether the Chancellor will meet his fiscal rules under our forecasts and what this implies for tax and spending decisions in the next and future Budgets.

5.2 Short-term projections

In 2005–06, current spending came in almost £7 billion higher and receipts around £2 billion higher than either the Treasury expected in the December 2005 PBR or we expected in the January 2006 Green Budget, as shown in Table 5.1. This includes a reclassification of the treatment of receipts of the BBC licence fee and the current expenditure that it finances, which added £3 billion to both receipts and current expenditure – without this, spending would have been up £4 billion and revenues down £1 billion.[1] This left the public sector current deficit £4.5 billion bigger than either we or the Treasury expected, although lower-than-forecast public sector net investment meant that public sector net borrowing overshot our forecasts by only £0.5 billion. For more details on the components of the forecasts and out-turns, see Appendix A.

Table 5.1. Comparison of forecasts for 2005–06

£ billion	HM Treasury PBR forecast, December 2005	IFS Green Budget forecast, January 2006	Estimate, PBR, December 2006
Current receipts	483.0	483.1	485.3
Current expenditure[a]	493.6	493.6	500.4
Net investment	26.3	26.3	22.4
Public sector net borrowing	37.0	36.8	37.5
Surplus on current budget	–10.6	–10.5	–15.1

[a] Includes depreciation.

Sources: Out-turn figures for 2005–06 from HM Treasury, *Pre-Budget Report 2006*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/report/prebud_pbr06_repindex.cfm). Forecasts from HM Treasury, *Pre-Budget Report 2005*, Cm. 6701, December 2005 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr05/prebud_pbr05_index.cfm), and table 5.2 of R. Chote, C. Emmerson, R. Harrison and D. Miles (eds), *The IFS Green Budget: January 2006*, IFS Commentary 100 (http://www.ifs.org.uk/budgets/gb2006/index.php).

[1] Source: Paragraph 3.36, page 27, of HM Treasury, *End of Year Fiscal Report*, 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/assoc_docs/prebud_pbr06_adfiscal.cfm).

Borrowing in 2006–07

Table 5.2 presents an overview of the Treasury's and the January 2007 Green Budget baseline forecasts for 2006–07. Between the March 2006 Budget and December 2006 PBR, the Treasury increased its spending forecast slightly more than its revenue forecast, pushing its current budget deficit forecast from £7.0 billion at Budget time to £7.9 billion in the PBR. The January 2007 Green Budget forecast is for a slightly bigger deficit of £9.2 billion, with our spending forecast higher than the Treasury's by a slightly larger margin than our revenue forecast is. With the same forecast for public sector net investment as the Treasury, we predict public sector net borrowing £1.3 billion higher than the Treasury expects, at £38.1 billion.

Table 5.2. Comparison of forecasts for government borrowing, 2006–07

£ billion	Budget, Mar. 06	PBR, Dec. 06	Green Budget, Jan. 07	Differences in Green Budget forecast relative to:	
				Budget	PBR
Current receipts	516.4	517.9	518.5	2.1	0.6
Current expenditure[a]	523.5	525.7	527.7	4.2	2.0
Net investment	28.8	28.9	28.9	0.1	0.0
Total managed expenditure	552.3	554.6	556.6	4.3	2.0
Public sector net borrowing	35.8	36.8	38.1	2.3	1.3
Surplus on current budget	–7.0	–7.9	–9.2	–2.2	–1.3

[a] In line with the National Accounts, depreciation has been included as current expenditure.
Sources: Treasury forecasts from HM Treasury, *Pre-Budget Report 2006*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/report/prebud_pbr06_repindex.cfm), and HM Treasury, *Financial Statement and Budget Report*, HC968, March 2006 (http://www.hm-treasury.gov.uk/budget/budget_06/bud_bud06_index.cfm).

Receipts and spending in 2006–07

The January 2007 Green Budget forecast for receipts in 2006–07 is just £0.6 billion higher than the Treasury's December 2006 forecast. The breakdown of the receipts forecasts into constituent taxes is shown in Table 5.3, which also includes forecasts for 2007–08. Due to strong receipts so far in 2006–07, the Green Budget forecasts that VAT and stamp duty revenues will each come in higher than the PBR forecast (by £0.8 billion and £0.3 billion respectively), while due to weak in-year growth we expect income tax revenues to come in slightly lower (£0.5 billion).

The Green Budget forecasts that current spending (including depreciation) will be £2.0 billion higher than the PBR, which had in turn revised up the previous Budget 2006 forecast by £2.2 billion. To meet the PBR forecast, current spending growth would have to slow in the final three months of this financial year, relative both to the first seven months up to the PBR and (less dramatically) relative to the two months that have elapsed since the PBR. Despite net investment also running above the level consistent with the PBR forecasts, the Green Budget prediction here is in line with the PBR forecasts – the level of net investment has been consistently revised down both during and after the end of the financial year in recent years.

Table 5.3. Comparison of Green Budget and HM Treasury forecasts for government borrowing, 2006–07 and 2007–08

£ billion	2006–07		2007–08	
	PBR Dec. 2006	*Green Budget Jan. 2007*	*PBR Dec. 2006*	*Green Budget Jan. 2007*
Income tax (net of tax credits)	141.5	141.0	151.4	150.7
National Insurance contributions	88.5	88.5	94.3	93.7
Value added tax (VAT)	76.2	77.0	80.1	81.2
Corporation tax (net of tax credits)	47.4	47.4	53.2	52.6
Petroleum revenue tax	2.3	2.3	1.9	2.0
Fuel duties	23.7	23.7	25.2	25.2
Capital gains tax	4.0	4.0	4.9	4.5
Inheritance tax	3.6	3.6	4.1	3.9
Stamp duties	12.7	13.0	13.8	14.2
Tobacco duties	8.0	8.0	8.0	8.0
Spirits duties	2.3	2.3	2.4	2.4
Wine duties	2.4	2.4	2.5	2.6
Beer and cider duties	3.3	3.3	3.4	3.5
Betting and gaming duties	1.4	1.4	1.4	1.5
Air passenger duty	1.1	1.1	2.0	2.0
Insurance premium tax	2.3	2.3	2.4	2.4
Landfill tax	0.8	0.8	0.9	0.9
Climate change levy	0.7	0.7	0.7	0.7
Aggregates levy	0.3	0.3	0.3	0.3
Customs duties and levies	2.3	2.3	2.3	2.4
Total HM Revenue and Customs	**424.7**	**425.4**	**455.4**	**454.9**
Vehicle excise duties	5.1	5.1	5.5	5.4
Business rates	21.5	21.5	22.3	22.2
Council tax[a]	22.5	22.5	23.8	23.8
Other taxes and royalties[b]	13.3	13.3	14.5	14.0
Net taxes and NI contributions[c]	**487.1**	**487.8**	**521.4**	**520.3**
Accruals adjustments on taxes	3.2	3.2	2.3	2.3
Less Own resources contribution to EU budget	–4.4	–4.4	–4.4	–4.4
Less PC corporation tax payments	–0.2	–0.2	–0.2	–0.2
Tax credits adjustment[d]	0.6	0.6	0.7	0.7
Interest and dividends	5.3	5.3	6.1	6.1
Other receipts[e]	26.2	26.2	27.9	27.9
Current receipts	**517.9**	**518.5**	**553.8**	**552.7**

[a] PBR figures are based on stylised assumptions rather than government forecasts, as council tax increases are determined annually by local authorities, not by the government.
[b] Includes VAT refunds and money paid into the National Lottery Distribution Fund.
[c] Includes VAT and the traditional 'own resources' contributions to the EU budget.
[d] Tax credits that are scored as negative tax in the calculation of 'Net taxes and NI contributions' but expenditure in the National Accounts.
[e] Includes gross operating surplus and rent; net of oil royalties and business rates payments by local authorities.
Sources: PBR forecasts from HM Treasury, *Pre-Budget Report 2006*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/report/prebud_pbr06_repindex.cfm); this table is similar to table B13 on page 234. IFS calculations.

Borrowing in 2007–08

The Treasury revised its forecast for the current budget balance in 2007–08 from a surplus of £1 billion in the March 2006 Budget to a deficit of £1.5 billion in the December 2006 PBR. It revised its receipts forecast fractionally higher, thanks to tax increases in the PBR offsetting a weakening of underlying receipts. But this was more than offset by an upward revision to the spending forecast, reflecting the impact of higher-than-expected inflation and lower-than-expected earnings growth on tax credit and benefit spending projections. The January 2007 Green Budget forecasts a current budget deficit of £3.4 billion, some £1.9 billion worse than the Treasury's PBR prediction. Our public sector net borrowing forecast is worse than the PBR's by a similar margin, at £33.2 billion.

Table 5.4. Comparison of forecasts for government borrowing, 2007–08

£ billion	Budget, Mar. 06	PBR, Dec. 06	Green Budget, Jan. 07	Differences in Green Budget forecast relative to:	
				Budget	PBR
Current receipts	553	553.8	552.7	–0.3	–1.1
Current expenditure[a]	551.9	555.2	556.2	4.3	1.0
Net investment	31	29.8	29.8	–1.2	0.0
Total managed expenditure	582.8	585.0	586.0	3.2	1.0
Public sector net borrowing	30	31.3	33.2	3.2	1.9
Surplus on current budget	1	–1.5	–3.4	–4.4	–1.9

[a] In line with the National Accounts, depreciation has been included as current expenditure.

Sources: Treasury forecasts from HM Treasury, *Pre-Budget Report 2006*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/report/prebud_pbr06_repindex.cfm), and HM Treasury, *Financial Statement and Budget Report*, HC968, March 2006 (http://www.hm-treasury.gov.uk/budget/budget_06/bud_bud06_index.cfm).

Receipts and spending in 2007–08

The December 2006 PBR revised up the March 2006 Budget current receipts forecasts for 2007–08 by around £1 billion. This represents a downward revision of underlying receipts, as the PBR policy decisions (notably higher air passenger duty and anti-avoidance measures) are expected to raise an additional £2 billion. The Green Budget forecasts that current receipts will be £552.7 billion in 2007–08, which is £1.1 billion below the PBR forecast.

Table 5.3 breaks down the receipts forecast tax by tax. The Green Budget forecasts lower income tax, National Insurance contributions, corporation tax, capital gains tax and inheritance tax than the Treasury, but these are in part offset by higher VAT, petroleum revenue tax, stamp duty, alcohol duties, betting and gaming duties, and customs duties and levies receipts. Just as the overall receipts forecast is close to the PBR forecast, there is also little substantial difference on a tax-by-tax basis, with the largest difference being the £1.1 billion additional VAT revenue that the Green Budget forecasts.

The Green Budget forecasts current spending (including depreciation) £1.0 billion higher than the PBR, due to higher social security spending and the assumption that the AME margin (the unallocated reserve) will be set to £1 billion as in previous years.

5.3 Medium-term prospects

Over the medium term, we expect the near-term gap between the Green Budget and PBR current budget balance forecasts to narrow and then reverse (Tables 5.5 and 5.6). The Green Budget forecasts a deficit £1.9 billion bigger than the PBR in 2007–08, but a surplus £1.4 billion bigger than the PBR for 2011–12. Given the uncertainties around both forecasts (judging from past forecasting performance), this is not a significant difference.

Table 5.5. Medium-term public finance forecasts under Pre-Budget Report 2006 assumptions

£ billion	2006–07	2007–08	2008–09	2009–10	2010–11	2011–12
Green Budget forecasts						
Current budget						
Current receipts	518.5	552.7	583.2	615.4	649.8	686.1
Current expenditure[a]	527.7	556.2	583.0	610.1	638.1	670.8
Surplus on current budget	**–9.2**	**–3.4**	**0.2**	**5.4**	**11.7**	**15.4**
Capital budget						
Net investment	28.9	29.8	31.0	33.0	35.0	36.8
Public sector net borrowing	**38.1**	**33.2**	**30.8**	**27.6**	**23.3**	**21.4**
HM Treasury forecasts						
Current budget						
Current receipts	517.9	553.8	586	616	647	681
Current expenditure[a]	525.7	555.2	582	609	637	666
Surplus on current budget	**–7.9**	**–1.5**	**4**	**7**	**10**	**14**
Capital budget						
Net investment	28.9	29.8	31	33	35	36
Public sector net borrowing	**36.8**	**31.3**	**27**	**26**	**24**	**22**

[a] In line with the National Accounts, depreciation has been included as current expenditure.

Sources: Authors' calculations. Treasury forecasts from HM Treasury, *Pre-Budget Report 2006*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/report/prebud_pbr06_repindex.cfm); this table is similar to table B8 on page 229.

Over the coming five years, we expect the current budget balance to move from a deficit of 0.7% of national income in 2006–07 to a surplus of 0.9% of national income in 2011–12. Of this 1.6% of national income improvement (£21 billion in today's terms), 1.0% of national income (£13 billion) comes from a rising tax burden and 0.6% of national income (£8 billion) from cuts in spending. Over the same period, the PBR has a slightly smaller improvement (from a fractionally stronger starting point to a fractionally weaker end point).

The forthcoming Comprehensive Spending Review (CSR), due later this year, will set out firm plans for departmental spending for the years 2008–09, 2009–10 and 2010–11. We use the cash values for spending in those years as projected in the PBR as an indication of the most likely trajectory of spending over those years. With current spending increasing by just 1.9% per year in real terms (i.e. slower than the rate of growth of the economy – see Table 7.2), this results in forecast current spending falling from 40.4% of national income in 2007–08 to 39.8% in 2010–11. For 2011–12, the Green Budget forecasts that current spending will remain constant as a share of national income, rather than falling further to 39.6% as the PBR assumes. As a result, current spending in that year would be nearly £4 billion higher in today's terms than in the PBR forecast.

Green Budget forecasts show public sector current receipts closing their gap with the PBR forecast by around 2009–10 and thereafter growing at a faster rate than the Treasury expects. Receipts are forecast to rise from 39.7% of national income in 2006–07 to 40.7% in 2011–12; the biggest increase is set to occur between this year and 2007–08, largely due to policy changes increasing revenues, including increases to North Sea oil taxes introduced in the December 2005 PBR. The next section discusses the composition of receipts in more detail.

Table 5.6. Medium-term public finance forecasts under Pre-Budget Report 2006 assumptions

% of national income	2006–07	2007–08	2008–09	2009–10	2010–11	2011–12
Green Budget forecasts						
Current budget						
Current receipts	39.7	40.1	40.2	40.4	40.5	40.7
Current expenditure[a]	40.4	40.4	40.2	40.0	39.8	39.8
Surplus on current budget	**–0.7**	**–0.3**	**0.0**	**0.4**	**0.7**	**0.9**
Capital budget						
Net investment	2.2	2.2	2.1	2.2	2.2	2.2
Public sector net borrowing	**2.9**	**2.4**	**2.1**	**1.8**	**1.5**	**1.3**
Public sector net debt	**37.6**	**38.4**	**39.1**	**39.3**	**39.1**	**38.9**
HM Treasury forecasts						
Current budget						
Current receipts	39.7	40.2	40.4	40.4	40.4	40.4
Current expenditure[a]	40.3	40.3	40.2	40.0	39.8	39.6
Surplus on current budget	**–0.6**	**–0.1**	**0.3**	**0.5**	**0.6**	**0.8**
Capital budget						
Net investment	2.2	2.2	2.2	2.2	2.2	2.2
Public sector net borrowing	**2.8**	**2.3**	**1.9**	**1.7**	**1.5**	**1.3**
Public sector net debt	**37.5**	**38.2**	**38.6**	**38.7**	**38.7**	**38.5**

[a] In line with the National Accounts, depreciation has been included as current expenditure.

Sources: Authors' calculations. Treasury forecasts from HM Treasury, *Pre-Budget Report 2006*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/report/prebud_pbr06_repindex.cfm); this table is similar to table B9 on page 229.

The Green Budget forecasts for net investment are in line with the PBR ones until 2011–12, when we expect net investment to be slightly higher than the Treasury does. Consequently, the profile for public sector net borrowing over the medium term tracks that of the current budget, with borrowing being higher under the Green Budget forecasts until 2009–10, but lower in 2010–11 and 2011–12.

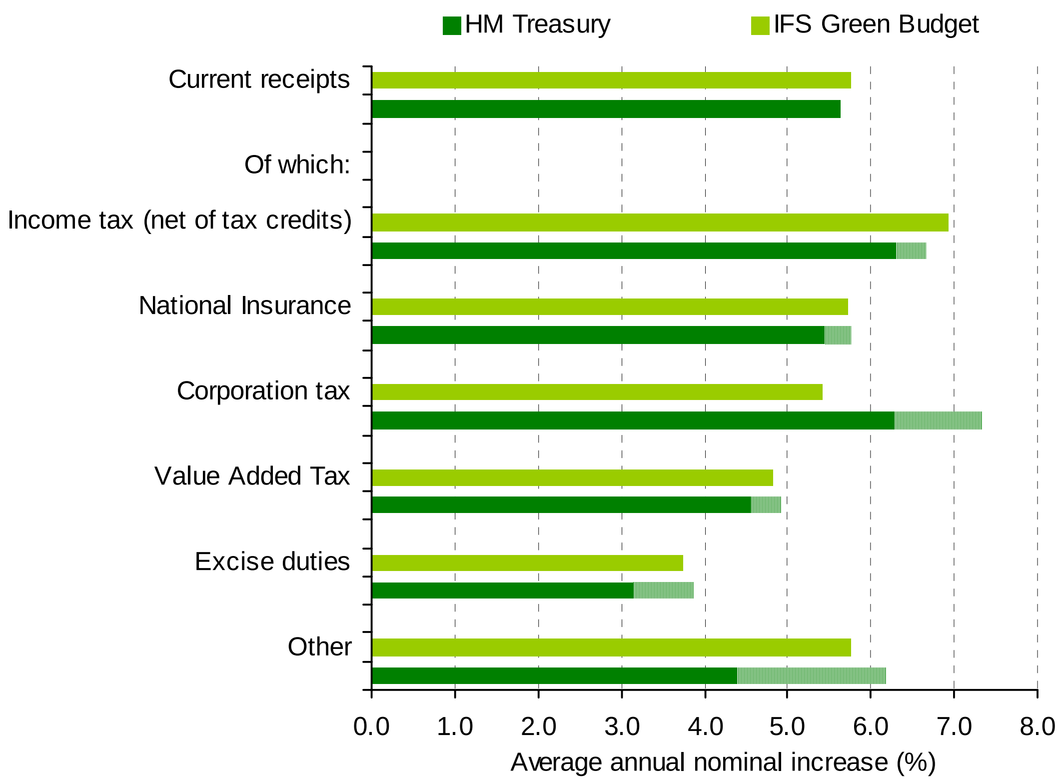
The higher borrowing forecasts from the Green Budget for the years 2006–07 to 2009–10 mean that we have slightly higher forecasts than the Treasury for public sector net debt right through to 2011–12. As discussed in Section 3.3, the sustainable investment rule requires that public sector net debt be kept below 40% for all the years of the current cycle. The Treasury expects the cycle to end in 2006–07 and has not yet announced how it will assess compliance with the rule over the next cycle. Nevertheless, under both the Treasury and the Green Budget scenarios, debt is set to remain under the 40% ceiling throughout the next five years, although the smallest margin of error in any particular year is only 0.7% of national income in 2009–10 under the Green Budget forecasts compared with 1.3% of national income in the PBR.

Breakdown of medium-term revenue projections

Figure 5.1 shows the average annual nominal growth for each major component of tax revenues under the Green Budget projection over the period from 2006–07 to 2011–12. These are compared with the Treasury's December 2006 projections. Comparing the two medium-term projections is hampered by a lack of availability of detailed forecasts from the Treasury, since the PBR only shows limited information on the composition of its medium-term revenue projections and rounds revenues from each of the categories to the nearest 0.1% of national income. As a result, a lower and an upper bound on the Treasury's projection are shown in the graph (the range between these two bounds being shown by the striped region).

Overall, the Green Budget projection is for very slightly higher growth in tax (and non-tax) revenues, from a slightly higher base. Between 2006–07 and 2011–12, the Green Budget forecasts show stronger growth in income tax (net of tax credits). In contrast, the Green Budget forecast is for lower growth in revenues from corporation tax than the PBR, with

Figure 5.1. PBR and IFS forecasts for revenue growth, 2006–07 to 2011–12



Note: Corporation tax includes petroleum revenue tax.
Sources: Authors' calculations; Treasury forecasts from HM Treasury, *Pre-Budget Report 2006*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/report/prebud_pbr06_repindex.cfm).

Box 5.1. Company earnings and corporation tax revenues

By Graham Secker (Morgan Stanley)

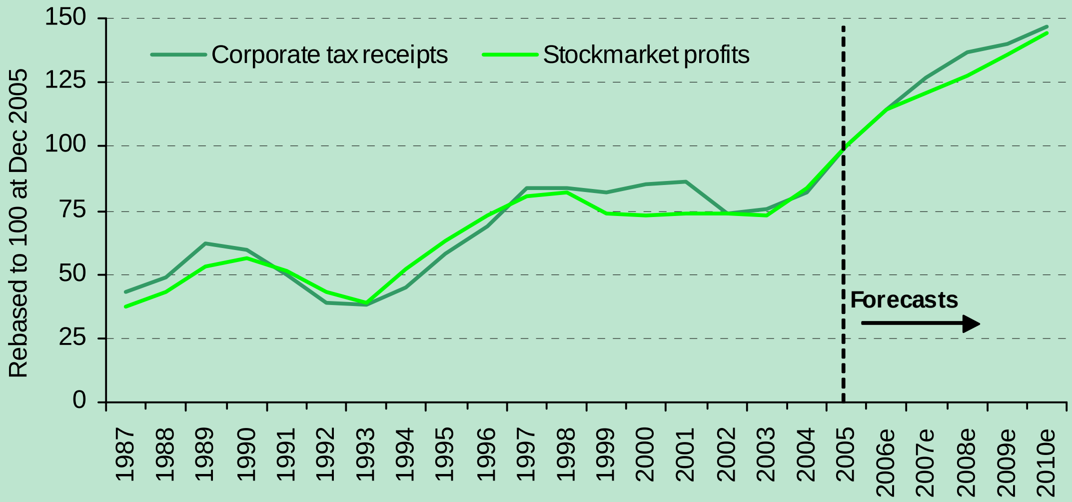
Strong global economic growth and high levels of corporate profitability have produced a very strong environment for corporate earnings over the last few years. This has also fed through into strong growth in corporate tax receipts, although the government consistently overestimated corporation tax receipts during most of its second term. Although growth in corporate profits (and by default tax receipts) is beginning to slow, it should still come in at around 14–15% for 2006, down from over 20% in the previous year.

Going forward, the Treasury's forecast of corporate tax receipt growth is now lower than in previous years, with expectations of 11%, 8% and 3% for the next three years respectively. This compares with our medium-term projection for growth in stock-market profits of 6% per annum, which is the average earnings growth of the UK stock market since 1960.

In the December 2005 PBR, the forecasts were for total corporate tax receipt growth of 30% in 2005–06, 21% in 2006–07 and 11% in 2007–08. In the latest PBR, these forecasts are now 26%, 14% and 11% growth respectively. The overall impact on total forecast corporate tax receipts by 2007–08 is considerable; in effect, the Treasury has revised down its expectation for total corporate tax receipts in 2007–08 by £12.1 billion which includes a shortfall in non-North-Sea corporate tax receipts of £9.1 billion – in both cases, this equates to around a 17% shortfall.

In the last two Green Budgets, we have included a graph showing how much more optimistic the Treasury is about growth in corporate tax receipts than we are in corporate earnings growth. In Figure 5.2, we update this analysis; it is apparent that HMT's view on corporate tax receipts and Morgan Stanley's view on stock-market earnings are now much more aligned with one another than in previous years. This is due both to HMT's downgrades to its growth forecasts for the last couple of years and corporate earnings that have come in stronger than we were expecting.

Figure 5.2. Treasury forecasts for corporation tax revenues and Morgan Stanley forecasts for UK stock-market growth



Note: Stock-market profits from 2005 onwards are based on Morgan Stanley forecasts.
Sources: ONS; MSCI; Morgan Stanley Research.

revenues from this source forecast to reach 3.8% of national income, rather than the 4.1% expected by the PBR. With the economy forecast to be on trend in the years after 2007–08, the Green Budget forecast is for underlying corporation tax (adjusted for policy changes and a forecast decline in North Sea oil yields in the medium term) to stay constant as a share of national income (see Box 5.1). With each of the other categories, the Green Budget projection for revenue growth lies within the possible range of projected revenue growth from the PBR.

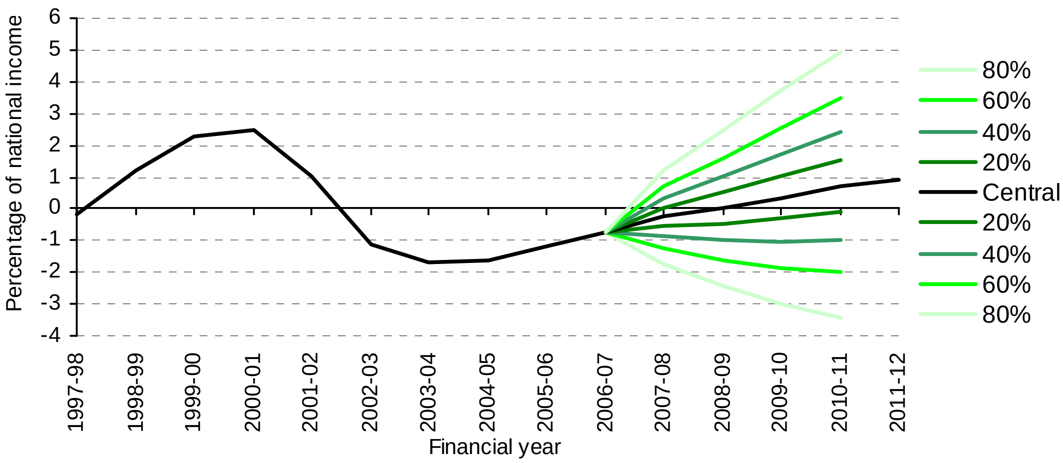
Uncertainties around the baseline Green Budget forecast

Public finance forecasts are by their nature uncertain and it is important to acknowledge that uncertainty when presenting them. The further ahead forecasts are made, the larger the degree of uncertainty. Figures 5.3 and 5.4 present probabilistic fan charts for the Green Budget forecasts for the next four years, with the forecast for 2006–07 taken as given. The fan charts assume that the Green Budget forecasts will be right on average (and so are the best forecasts available) and that they are as accurate as the Treasury's forecasts have been in the past. If the Green Budget forecasts were more inaccurate than the Treasury's, the fan charts would be wider, while if they were more accurate then the fan charts would be narrower.

In each graph, the black line shows the central Green Budget forecast – it is assumed that there is a 50% chance that the outcome will lie above this line and a 50% chance that it will lie below, as the central forecasts are (by definition) assumed to be right on average. The darkest green lines on either side of the central forecasts denote the range of outcomes within which there is a 20% probability that the outcomes will lie. As uncertainty increases with the time horizon, these lines fan out.

The central forecast for 2007–08 is for a current budget deficit of 0.3% of national income and Figure 5.3 indicates that there is a 20% probability that the actual outcome will be a deficit of between 0.5% and 0.0% of national income. In 2010–11, the central forecast is for a

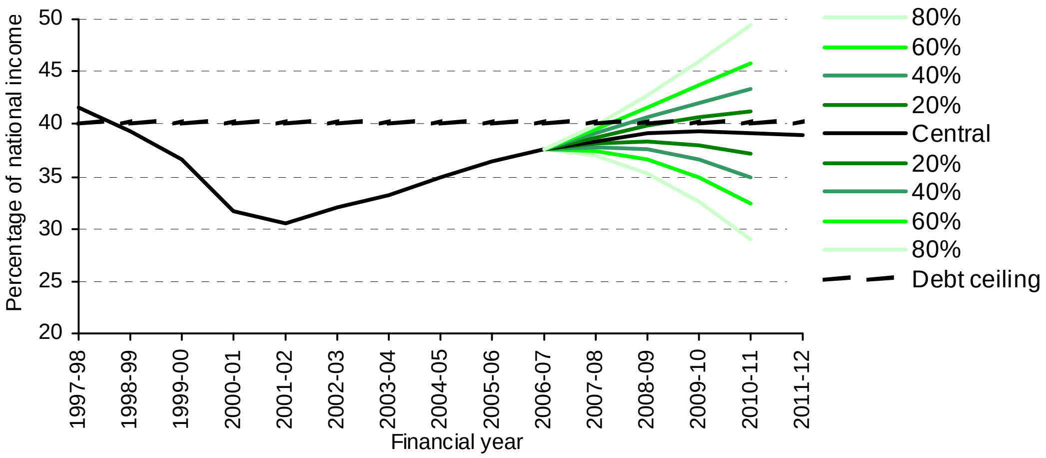
Figure 5.3. Probabilities of current budget balance outcomes (Green Budget baseline)



Notes: Central projections are taken from Table 5.6 and assume that the Green Budget projection 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).

surplus of 0.7% of national income – but the greater uncertainties in forecasting four years in advance mean that we can only be 20% certain that the outcome will lie within the much larger range of –0.1% to 1.6% of national income. The 40%, 60% and 80% lines bound the ranges within which there is a 40%, 60% or 80% probability that the outcome will eventually lie. Therefore there is a 10% probability that the outcome will lie above the upper 80% line and a 10% probability that it will lie below the lower one. There is an estimated 41% probability that, on unchanged policies, the current budget would still not be back in surplus in 2010–11.

Figure 5.4. Probabilities of public sector net debt outcomes (Green Budget baseline)



Notes: Central projections are taken from Table 5.6 and assume that the Green Budget projection for 2006–07 is correct and that any cumulative variation in public sector net borrowing from that forecast in the Green Budget projection directly adds to public sector net debt. The second-order impact of changes in debt interest is ignored. 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).

With the economic cycle due to end during 2006–07, Figures 5.3 and 5.4 implicitly assume that the forecasts for this year are met and that, therefore, both fiscal rules are met over the current cycle. Judging whether or not the golden rule is to be met over the next cycle depends on the length of the next cycle, whereas the Treasury assumes for forecasting purposes that this cycle will be the last. Similarly, it is not possible to assess the probability of the sustainable investment rule being missed over the next cycle, as the Treasury has not yet defined how it will be judged (as discussed in Chapter 3). However, it is possible to estimate the probability that net debt will exceed 40% in any given year, whether or not that is the benchmark against which compliance with the sustainable investment rule will be judged. We estimate that the probability of net debt breaching 40% increases from 6% in 2007–08 to 44% in 2010–11.

A key conclusion of this analysis is that the difference between the central projections in the Green Budget and the PBR – for both budget balances and net debt – is much less significant than the uncertainty that lies around either, given past forecast performance.

5.4 Alternative macroeconomic assumptions

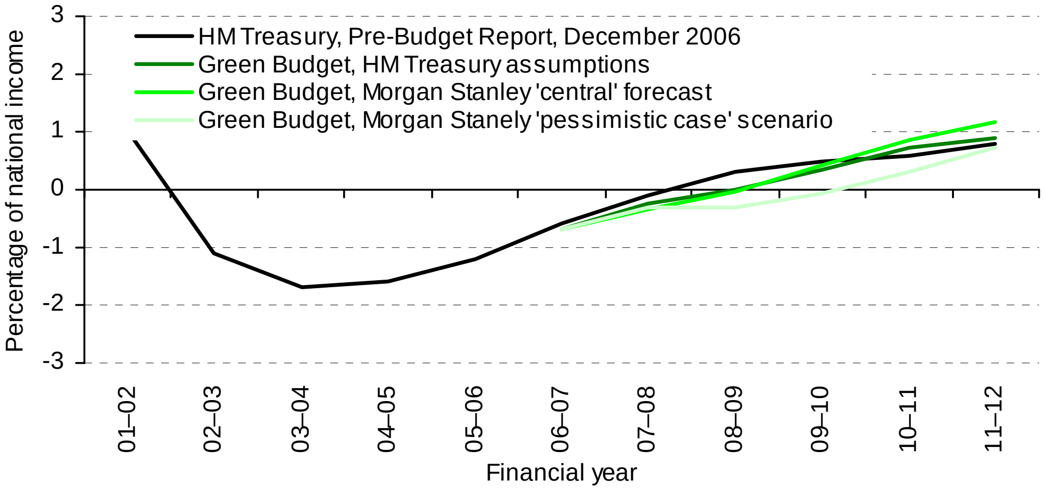
The Green Budget baseline forecasts are, as far as possible, based on the same macroeconomic assumptions that underlie the Treasury's forecasts from the Pre-Budget Report (although we are hindered somewhat by the Treasury's refusal to publish some of the economic assumptions on which its fiscal forecasts are based – for example, growth in average earnings). This section presents alternative forecasts under two different sets of macroeconomic assumptions from Morgan Stanley – the central case and the 'pessimistic case' described in Chapter 4.

Table 5.7 presents the underlying growth in national income and trend level assumptions used by the Treasury and presented by Morgan Stanley. It also shows the four sets of public finance forecasts: the Treasury's PBR forecasts, the baseline Green Budget forecasts using the Treasury's macro scenarios, the Green Budget forecasts under the central Morgan Stanley macro forecasts and the Green Budget forecasts under the 'pessimistic case' Morgan Stanley macro forecasts.

The PBR macro scenario has the output gap (trend GDP minus actual GDP) averaging zero in 2007–08 from –0.2% in 2006–07. From 2008–09 onwards, GDP is set to increase at ¼ percentage point below the trend rate of growth, at 2½% a year. The Morgan Stanley central forecast shows the output gap not closing until 2009–10. Higher growth in the years that follow leads to an increasingly positive output gap. The two macro scenarios have similar levels of nominal growth overall, but with more real growth and less inflation over the full five-year forecasting horizon in the Morgan Stanley scenario. Section 4.5 describes the Morgan Stanley scenarios in more detail.

The public finance forecasts are shown in Figures 5.5, 5.6 and 5.7 for the overall current budget balance, the cyclically adjusted current budget balance and public sector net debt respectively. The Green Budget public finance forecasts using the Morgan Stanley central case show a similar cyclically adjusted and overall surplus on the current budget to the

Figure 5.5. Current budget balance forecasts



Sources: Authors' calculations; Treasury forecasts from HM Treasury, *Pre-Budget Report 2006*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/report/prebud_pbr06_repindex.cfm).

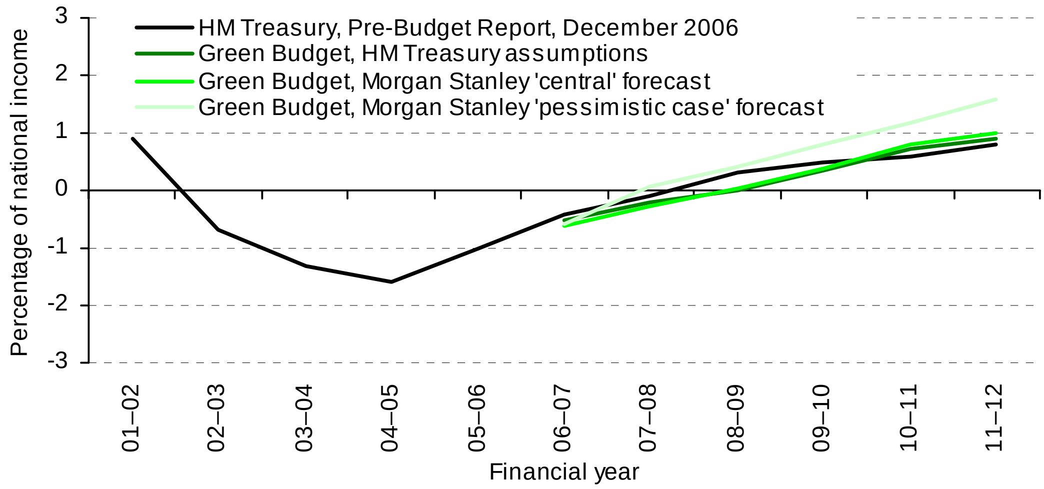
Table 5.7. Public finance forecasts under various macroeconomic scenarios

	2006–07	2007–08	2008–09	2009–10	2010–11	2011–12
Treasury Pre-Budget Report forecasts (PBR macro assumptions)						
GDP growth	2¾	2¾	2½	2½	2½	2½
Output gap (% of potential GDP)	–0.2	0.0	0.0	0.0	0.0	0.0
Public finance forecasts (% of GDP)						
Current budget surplus	–0.6	–0.1	0.3	0.5	0.6	0.8
Cyclically adjusted current budget surplus	–0.4	–0.1	0.3	0.5	0.6	0.8
Net borrowing	2.8	2.3	1.9	1.7	1.5	1.3
Net debt	37.5	38.2	38.6	38.7	38.7	38.5
Green Budget baseline (PBR macro assumptions)						
GDP growth	2¾	2¾	2½	2½	2½	2½
Output gap (% of potential GDP)	–0.2	0.0	0.0	0.0	0.0	0.0
Public finance forecasts (% of GDP)						
Current budget surplus	–0.7	–0.3	0.0	0.4	0.7	0.9
Cyclically adjusted current budget surplus	–0.5	–0.2	0.0	0.4	0.7	0.9
Net borrowing	2.9	2.4	2.1	1.8	1.5	1.3
Net debt	37.6	38.4	39.1	39.3	39.1	38.9
Alternative Green Budget scenario I (Morgan Stanley central case)						
GDP growth	2¾	2¼	2½	2¾	2½	2¾
Output gap (% of potential GDP)	0.1	–0.1	–0.1	0.1	0.1	0.3
Public finance forecasts (% of GDP)						
Current budget surplus	–0.7	–0.3	0.0	0.4	0.9	1.2
Cyclically adjusted current budget surplus	–0.6	–0.3	0.0	0.4	0.8	1.0
Net borrowing	2.9	2.5	2.2	1.8	1.3	1.0
Net debt	37.3	38.8	39.2	39.3	39.1	38.5
Alternative Green Budget scenario II (Morgan Stanley 'pessimistic case')						
GDP growth	2¾	1¾	2	2¼	2¼	2¼
Output gap (% of potential GDP)	0.0	–0.8	–1.2	–1.2	–1.2	–1.2
Public finance forecasts (% of GDP)						
Current budget surplus	–0.7	–0.3	–0.3	–0.1	0.3	0.7
Cyclically adjusted current budget surplus	–0.6	0.1	0.4	0.8	1.2	1.6
Net borrowing	2.9	2.5	2.5	2.3	1.9	1.5
Net debt	37.3	38.9	39.5	40.1	40.3	40.2

Sources: Morgan Stanley; Treasury forecasts from HM Treasury, *Pre-Budget Report 2006*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/report/prebud_pbr06_repindex.cfm).

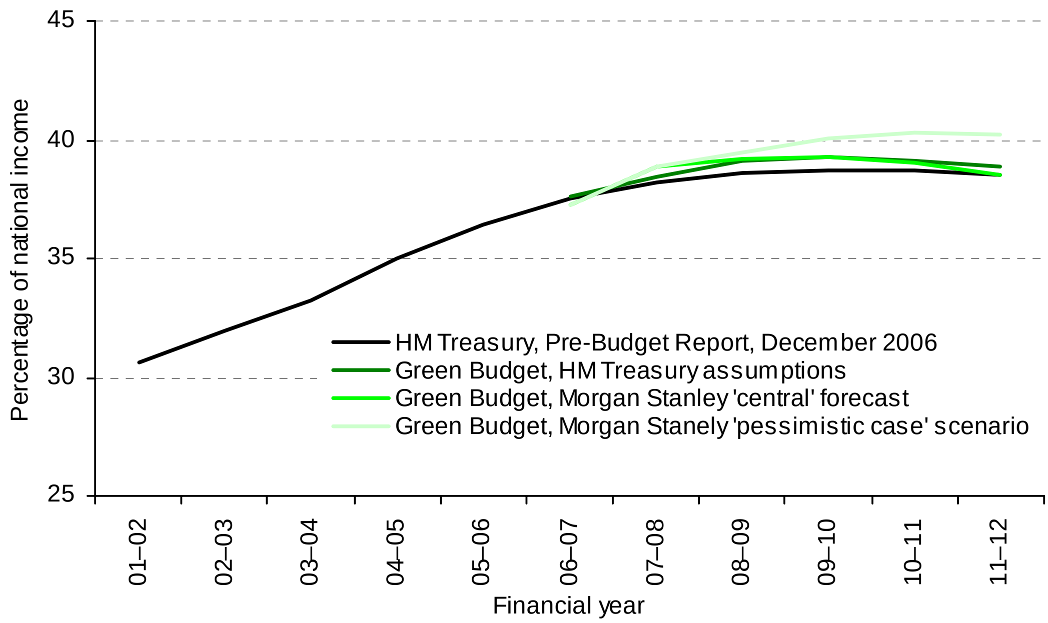
baseline forecasts (though the Morgan Stanley central case forecast implies a slightly higher deficit in 2007–08 and a slightly higher surplus in 2010–11 and 2011–12). Borrowing is slightly higher in 2007–08 and 2008–09 due to relative underperformance of the economy and this is reflected in higher debt levels. Debt reaches 39.3% of national income by 2009–10. Thereafter, higher growth brings down borrowing and 2011–12 sees debt below that in the baseline forecast.

Figure 5.6. Cyclically adjusted current budget balance forecasts



Sources: Authors' calculations; Treasury forecasts from HM Treasury, *Pre-Budget Report 2006*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/report/prebud_pbr06_repindex.cfm).

Figure 5.7. Public sector net debt forecasts



Sources: Authors' calculations; Treasury forecasts from HM Treasury, *Pre-Budget Report 2006*, Cm. 6984, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/report/prebud_pbr06_repindex.cfm).

The Morgan Stanley 'pessimistic case' scenario forecasts a higher deficit in 2008–09 than the baseline forecast and, unlike the other forecasts, implies that the current budget will not be back in surplus until 2010–11. This is because this scenario assumes that an output gap of around 1% of national income persists in the medium term. This negative output gap means that the cyclically adjusted current budget surplus is higher under this scenario than under either the baseline scenario or the Morgan Stanley central scenario.

Net debt is higher under the Morgan Stanley 'pessimistic case' scenario than under the baseline scenario as a result of the larger current budget deficits in 2008–09 and 2009–10 and smaller surpluses in 2010–11 and 2011–12. In fact, under the 'pessimistic case' scenario, net debt would exceed the currently defined sustainable investment rule debt ceiling of 40% of national income in 2009–10, 2010–11 and 2011–12. Net debt is forecast under this scenario to peak in 2010–11 at 40.3% of national income.

5.5 The fiscal rules and the budget judgement

As we describe in Chapter 3, the golden rule requires that the current budget be in balance or surplus over the years that constitute an economic cycle. In the December 2006 PBR, the Treasury said that it now expected a 10-year cycle to run from 1997–98 to 2006–07. Over the nine years that have already elapsed, there has been a cumulative surplus of £16.3 billion on the current budget, thanks to the large surpluses in the first half of the cycle. In the absence of any revisions, the golden rule will be met as long as the current budget is in deficit by no more than £16.3 billion in 2006–07. As the Green Budget forecasts a £9.2 billion deficit, we expect the rule to be met with £7.1 billion to spare.

Whether or not the golden rule is met over the next cycle depends, amongst other things, on the length of the cycle. Table 5.8 presents the surplus on the current budget over the current and the next cycle, according to the Green Budget baseline forecasts. If the next cycle starts in 2006–07, and includes that year (see Section 3.2), then it would not be until 2010–11 that the current budget is cumulatively in surplus. So, if the Green Budget baseline forecast is correct,

Table 5.8. The golden rule under the Green Budget baseline forecast

% of national income	**2006–07**	**2007–08**	**2008–09**	**2009–10**	**2010–11**	**2011–12**
Surplus on current budget	–0.7	–0.3	0.0	0.4	0.7	0.9
Cycle 1 (1997–98 to 2006–07)						
Average surplus since 1997–98	0.1	n/a	n/a	n/a	n/a	n/a
Cumulative surplus (£ billion)	7.1	n/a	n/a	n/a	n/a	n/a
Cycle 2 (from 2006–07)						
Average surplus since 2006–07	–0.7	–0.5	–0.3	–0.1	0.0	0.2
Cumulative surplus (£ billion)	–9.2	–12.5	–12.3	–7.7	1.8	13.7
Morgan Stanley estimated cycle (2003–04 to 2009–10)						
IFS baseline forecast						
Average surplus since 2003–04	–1.3	–1.1	–0.9	–0.7	n/a	n/a
Cumulative surplus (£ billion)	–67.6	–70.8	–70.7	–66.1	n/a	n/a

Note: Figures rounded to one decimal place.

the golden rule would be met over the next economic cycle as long as it lasts at least five years. On the Treasury's methodology, no cycle since the early 1970s has lasted less than six years, which suggests that the golden rule is more likely than not to be met over the next cycle.

Using a statistical filter[2] to date economic cycles, Morgan Stanley judge that a cycle began at the end of 2003 and will close in the financial year 2009–10. Over this cycle, we estimate that the Treasury would breach the golden rule by around £66 billion, because deficits recorded from 2003–04 to 2006–07 would not be outweighed by surpluses in subsequent years. On the Treasury's own forecasts, the cumulative deficit on the current budget over these years would be £57 billion. These large misses underline the fact that reasonable differences of opinion over the dating of the cycle can have very significant consequences for the perceived health of the public finances. It strengthens the case, as we argued in Chapter 3, for an interpretation of the golden rule that does not require precise estimates of the output gap and the dating of the cycle. If the Treasury were suddenly to agree with the dating of the cycle provided by this statistical filter, it would be inappropriate to tighten fiscal policy sufficiently to meet it over an estimated cycle running from the end of 2003 to 2009–10.

Using the Treasury's method for estimating the output gap, the sustainable investment rule looks like it could be more constraining over the next few years than the golden rule. As we explained in more detail in Chapter 3, the sustainable investment rule constrains the Chancellor to keep public sector net debt at a 'stable and prudent' level. Over the current cycle, this has been defined as keeping debt below 40% of national income at the end of each year of the cycle, though the Chancellor has not yet stated how this rule will be judged over the next cycle.

Table 5.9 shows the probability that net debt exceeds 40% of national income in each of the next four years under the alternative forecasts. These figures assume for each scenario that the forecast is right on average and is as accurate as the Treasury's forecasts have been in the past. Under all four scenarios, there is at least a 40% chance that net debt will exceed 40% of national income in 2009–10. Under Morgan Stanley's 'pessimistic case' scenario, there is a 50:50 chance that this will happen. This suggests that, whilst the sustainable investment rule has not appeared to constrain the Chancellor as much as the golden rule over the current economic cycle, it will become more constraining as we move into the next cycle.

Table 5.9. The sustainable investment rule under the alternative forecasts: percentage chance of net debt exceeding 40% of national income

% chance	HMT Pre-Budget Report forecast	Green Budget baseline	Morgan Stanley central	Morgan Stanley pessimistic
2007–08	6.2	9.0	16.1	16.7
2008–09	31.5	37.7	39.2	43.0
2009–10	40.1	44.4	44.8	50.5
2010–11	43.5	45.7	45.3	51.6

Source: As Figure 5.3 and Table 5.7.

[2] Hodrick–Prescott filter with lambda=1,600 (see Table 4.3).

So what do recent out-turns and our forecasts imply for the Budget judgement this year?

As we discuss in Chapter 3, through most of Labour's second term we argued in successive Green Budgets that the Chancellor would need to announce spending cuts and/or tax increases worth around 1% of national income (£13 billion in today's terms) to bring about the improvement in the public finances he was looking for (i.e. to achieve a current budget surplus of around 0.7% of national income in five years) and to meet the golden rule with the desired cushion over an economic cycle then estimated to run from 1999–2000 to 2005–06.

The Chancellor rejected this advice right into the 2005 election campaign, but within a couple of months of Labour's victory it was clear that he was on course to breach the rule. Mr Brown promptly added two good years for the public finances to the beginning of the economic cycle, putting him back on course to meet it. In the 2005 Pre-Budget Report, he pencilled in an £8 billion spending cut over the entire period to be covered by the 2007 Comprehensive Spending Review and announced a £3 billion tax increase. In the 2006 Budget and Pre-Budget Report, he continued to pencil in the projected spending cut (and in fact extended the period during which public spending is pencilled in to grow less quickly than expected growth in the economy by one more year to 2011–12) and announced another £3 billion of tax increases.

Delaying the necessary adjustment and re-dating the cycle at a particularly opportune moment has both economic and political significance. It has helped undermine the credibility of the fiscal rules as a meaningful discipline on the Chancellor's decision-making. It has also meant that Mr Brown will now be presiding over a rising tax burden and cuts in public spending at precisely the point at which he hopes to take over from Tony Blair as Prime Minister and then seek his own mandate.

Looking ahead, the Treasury's forecasts for tax revenues are much more realistic than they were prior to the 2005 Pre-Budget Report. Indeed, there is little difference between our forecasts for the current budget balance and the Treasury's over the next few years. We therefore see no need for further significant tax increases at this stage, assuming that the Chancellor confirms that the Comprehensive Spending Review will implement the spending cuts projected in the Treasury's last three forecasts. This would be sufficient to give the Chancellor a better-than-evens chance of meeting his fiscal rules over this cycle and the next (although, as we argue in Chapter 3, there is a compelling case for reforming them). To cut taxes or increase the spending plans (without a corresponding tax increase) would require a longer economic cycle to meet the golden rule, increase the chances of breaching the debt ceiling and threaten further damage to the credibility of the fiscal framework.

As we discuss in Chapter 7, a key challenge for Mr Brown will be to achieve his goals for health, education and poverty reduction within a constrained spending envelope. He may well allocate the available money to health and education (still implying slower growth for them than in recent years) and hope that revenues come in more buoyantly than expected in future years, providing money to spend on anti-poverty measures. This is not implausible – the Treasury's revenue forecasts have been over-optimistic for six years now, and history suggests that at some point it will be due for a run of better luck. But whoever is Chancellor then needs to be wary of repeating the history of recent years: spending the proceeds of good fortune early in the economic cycle only to find themselves having to retrench later on.