3. IFS public finance forecasts

In his Pre-Budget Report last November, the Chancellor conceded that the impact of a weak economy on tax revenues would force him to borrow more this year and next. But, over the medium term, he predicted that the economy would bounce back – and that the public finances would bounce back with it.

This chapter details the January 2003 IFS public finance forecasts and compares them with the Treasury's November 2002 Pre-Budget Report (PBR) projections. Taking the two fiscal rules and the degree of caution that the Chancellor has previously chosen to incorporate into his plans, we consider whether he will need to announce reductions in public spending or further tax increases.

Our main conclusions are as follows:

1. In the short run, our forecasts are very similar to those in the PBR. In 2002–03, we forecast public sector net borrowing of £22.1 billion, slightly higher than the PBR forecast of £20.1 billion. In 2003–04, we forecast public sector net borrowing of £25.2 billion, compared with £24.5 billion forecast in the PBR.
2. In the medium term, we believe that the public finances will be weaker than the PBR suggested in November, even if the economy behaves much as the Treasury expects. In 2005–06, we forecast public sector net borrowing of £28 billion, compared with the PBR forecast of £19 billion.
3. Nonetheless, we believe the Chancellor can credibly claim that both the golden rule and the sustainable investment rule will have been met comfortably over the current economic cycle, which is projected to end in 2005–06.
4. If the Chancellor sticks by his PBR forecast of a surplus on current budget in 2005–06 of 0.4% of national income, he could say that there is no need for any further tax increases. But looking forward into the next economic cycle, our forecasts imply that spending cuts or tax increases will be required if the golden rule is to continue to be met.
5. Spending cuts would sit oddly with both the government's stated objectives and its previous actions. Tax increases, therefore, seem more likely.
6. The scale of tax increases required depends on how cautious the government wants to be. To expect to continue to meet the golden rule exactly would require tax increases of around £4 billion. But in the past, the Chancellor has been more cautious and sought to overachieve the golden rule by around 0.7% of national income on average. To do this would require tax increases of around £11 billion.

3.1 Borrowing in 2002–03

In 2001–02, government revenues came in lower than forecast either by the Treasury in the November 2001 PBR or by IFS in the January 2002 Green Budget. Public spending also came in lower than the Treasury expected, but slightly higher than forecast by IFS. The net effect was to leave public sector net borrowing in balance, compared with the £1.4 billion deficit predicted by the Treasury and the £1.6 billion surplus predicted by IFS.[1]

Receipts have continued to come in lower than expected during the current financial year. In the PBR last November, the Treasury cut its April Budget forecast for current receipts in 2002–03 by £7.5 billion to £399.7 billion, as shown in Table 3.1. On the spending side, it revised its Budget forecast for total managed expenditure up by £1.4 billion to £419.8 billion. This largely reflected the carrying forward of last year's underspending in departmental expenditure limits, plus a £1 billion special allocation to help finance a possible conflict in Iraq.

Table 3.1. Comparison of Green Budget and HM Treasury forecasts for government borrowing, 2002–03 (£ billion)

	Budget, Apr. 02	Pre-Budget Report, Nov. 02	Green Budget, Jan. 03	Differences in Green Budget forecast relative to:	
				Budget	PBR
Current receipts	407.2	399.7	396.6	–10.6	–3.1
Total managed expenditure	418.4	419.8	418.7	0.3	–1.1
Of which:					
Departmental expenditure limits	239.7[b]	241.3	240.3	0.6	–1.0
Annually managed expenditure	178.7[b]	178.5	178.4	–0.3	–0.1
Public sector net borrowing[a]	11.2	20.1	22.1	10.9	2.0
Net investment	14.4	14.3	13.3	–1.1	–1.0
Surplus on current budget[a]	3.2	–5.7	–8.8	–12.0	–3.1

[a] Includes windfall tax and associated spending.
[b] DEL and AME forecast adjusted for accounting changes introduced between the Budget and the Spending Review. For more details, see table B14 on page 202 of the 2002 Pre-Budget Report.
Sources: Treasury forecasts – HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm), and HM Treasury, *Financial Statement and Budget Report*, HC592, London, 2002 (www.hm-treasury.gov.uk/budget/bud_bud02/budget_report/bud_bud02_repindex.cfm).

Weaker receipts and higher spending imply higher borrowing. The Budget had forecast public sector net borrowing of £11.2 billion and a surplus on the current budget of £3.2 billion. The PBR showed public sector net borrowing of £20.1 billion and a current budget deficit of £5.7 billion.

[1] See Appendix A for a breakdown of the November 2001 Pre-Budget Report and the January 2002 IFS Green Budget forecast for 2001–02.

Table 3.2. Comparison of Green Budget and HM Treasury forecasts for government borrowing, 2002–03 and 2003–04 (£ billion)

	2002–03		2003–04	
	PBR Nov. 2002	*Gr. Budget Jan. 2003*	*PBR Nov. 2002*	*Gr. Budget Jan. 2003*
Inland Revenue				
Income tax (gross of tax credits)	114.1	110.0[h]	123.0	118.5[h]
Corporation tax (CT)[a]	29.3	28.5[h]	30.8	30.0[h]
Tax credits[b]	–3.5	n/a	–4.9	n/a
Petroleum revenue tax	1.1	1.1	1.3	1.3
Capital gains tax	2.0	2.0	1.4	1.4
Inheritance tax	2.4	2.4	2.6	2.6
Stamp duties	8.2	7.8	8.6	8.2
Social security contributions	65.5	65.0	75.4	75.1
Total Inland Revenue (net of tax credits)	**219.1**	**216.8**	**238.3**	**237.1**
Customs and Excise				
Value added tax (VAT)	64.5	63.7	67.3	67.0
Fuel duties	22.4	22.4	23.1	23.1
Tobacco duties	8.2	8.2	7.8	8.2
Spirit duties	2.2	2.2	2.4	2.4
Wine duties	1.9	1.9	1.9	1.9
Beer and cider duties	3.1	3.1	3.1	3.1
Betting and gaming duties	1.3	1.3	1.3	1.3
Air passenger duty	0.8	0.8	0.8	0.8
Insurance premium tax	2.1	2.1	2.2	2.2
Landfill tax	0.5	0.5	0.7	0.7
Climate change levy	0.9	0.9	0.9	0.9
Aggregates levy	0.2	0.2	0.4	0.4
Customs duties and levies	2.0	2.0	1.9	1.9
Total Customs and Excise	**110.1**	**109.3**	**113.8**	**113.9**
Vehicle excise duties	4.4	4.4	4.8	4.8
Oil royalties	0.5	0.5	0.0	0.0
Business rates[c]	18.0	18.0	18.2	18.2
Council tax	16.6	16.6	17.8	17.8
Other taxes and royalties[d]	10.9	10.9	12.3	12.3
Total taxes and social security contribns[e]	**379.6**	**376.5**	**405.1**	**404.1**
Accruals adjustments on taxes	–0.6	–0.6	3.4	3.4
Less Own resources contribution to EU	–3.0	–3.0	–2.4	–2.4
Less Public corporations' CT payments	–0.2	–0.2	–0.2	–0.2
Tax credits[f]	1.2	1.2	0.6	0.6
Interest and dividends	4.1	4.1	4.1	4.1
Other receipts	18.6	18.6	19.7	19.7
Current receipts	**399.7**	**396.6**	**430.3**	**429.3**
Current spending	**405.5**	**405.4**	**435.2**	**434.4**
Current balance[g]	**–5.7**	**–8.8**	**–4.9**	**–5.1**
Net investment	14.3	13.3	19.6	20.1
Public sector net borrowing[g]	**20.1**	**22.1**	**24.5**	**25.2**

[a] National accounts measure: gross of enhanced and payable tax credits. [b] Includes enhanced and payable company tax credits. [c] Includes district council rates in Northern Ireland. [d] Includes money paid into the National Lottery Distribution Fund. [e] Includes VAT and 'traditional own resources' contributions to EC budget. Cash basis. [f] Excludes children's tax credit and other tax credits that score as a tax repayment in the National Accounts. [g] Includes expenditure associated with the windfall tax. [h] Net of tax credits.

Note: For more details of the IFS forecast in 2002–03, see Table A.3 in Appendix A.

Sources: Treasury forecasts from HM Treasury, *Pre-Budget Report 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr02/prebud_pbr02_index.cfm) – this table is similar to table B12 on page 197); authors' calculations.

IFS now forecasts receipts this year of £396.6 billion, a further £3.1 billion below the Treasury's PBR prediction. We also expect total managed expenditure to come in £1.1 billion below the PBR forecast, at £418.7 billion. This implies a deficit on the current budget of £8.8 billion and public sector net borrowing of £22.1 billion, worse than the PBR forecast by £3.1 billion and £2.0 billion respectively.

Table 3.2 compares our revenue forecasts for 2002–03 and 2003–04 with those of the PBR. Ours are gloomier for this year because we expect lower income tax, corporation tax, stamp duty and VAT receipts than projected in the PBR.

We also have a lower forecast for public spending, dominated by a predicted underspend of £1 billion on capital spending within departmental expenditure limits. This reflects the fact that public sector net investment has proved difficult to deliver during the year to date.[2] We also assume that the £0.1 billion in the annually managed expenditure margin in 2002–03 at the time of the November 2002 PBR will not be spent.

3.2 Borrowing in 2003–04

Wherever possible, our forecasts for 2003–04 are based on the same macroeconomic assumptions that underlie the 'cautious' forecasts in the 2002 PBR, including the assumption that the trend rate of economic growth is 2½%.

We assume that no new measures are announced in the Spring 2003 Budget. But, as discussed in Chapter 4, the government might decide to increase further the generosity of payments to lower-income families with children to increase its chance of hitting its child poverty target.

We forecast receipts of £429.3 billion in 2003–04, £1 billion lower than the £430.3 billion in the PBR. This is a smaller undershoot than we forecast in 2002–03 because we expect stronger revenue growth than the Treasury for a number of taxes, such as tobacco duties. But we do expect weaker receipts from corporation tax and stamp duty than the PBR, as we are less confident that the loss of revenue attributed by the Treasury to the performance of financial companies will be recouped.

On the expenditure side, we forecast current spending of £434.4 billion next year, £0.8 billion less than in the PBR. This is because we assume that the AME margin for 2003–04 will be set to £1.0 billion, rather than the £1.8 billion in the PBR. As shown in Table 2.4 in Chapter 2, this is line with recent Budget practice. But we forecast that net investment spending will be £0.5 billion higher than the PBR forecast, at £20.1 billion, because we assume that half the £1 billion underspend we forecast for this year will be carried forward and spent in 2003–04, with the remainder spent in 2004–05.

With our projections of lower receipts and lower spending than in the PBR partially offsetting each other, our predictions for borrowing are little different

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[2] For more details, see IFS Public Finances Bulletin, 21 January 2003 (www.ifs.org.uk/press/pub_fin.shtml).

from the Treasury's November forecasts. For 2003–04, we expect a deficit on the current budget of £5.1 billion (compared to the Treasury's £4.9 billion) and public sector net borrowing of £25.2 billion (compared to the Treasury's £24.5 billion).

3.3 Medium-term prospects

Our forecasts for the current budget balance and public sector net borrowing this year and next are not very far out of line with those in the PBR. But looking further ahead, we are rather less optimistic. As with our short-term forecasts, our medium-term projections (shown in Table 3.3 later) are based on similar macroeconomic assumptions to those the Treasury used in the PBR. Further details can be found in Appendix A.

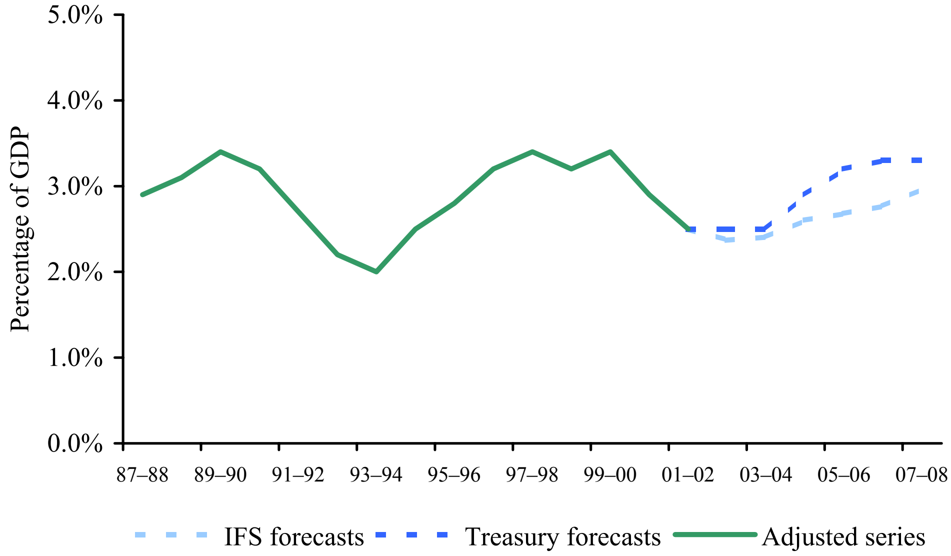
One of the key uncertainties in projecting the outlook for the public finances is the path of corporation tax revenues, traditionally one of the hardest taxes to forecast. As discussed in Section 2.2, in recent years the Treasury has forecast strong growth in corporation tax receipts, taking them to a level that by historical standards appears rather high.

In last year's IFS Green Budget, we said, 'Due to the difficulties in forecasting corporation tax in the current environment, we take the November 2001 PBR forecasts, although … it would be helpful if the Treasury published further discussion of what is driving the forecast increase in revenues in the medium term.'[3] The Treasury has not published further details of its forecasts. In the January 2003 Green Budget, we assume that the Treasury's forecast growth in corporate tax revenues will not materialise. Instead, we assume that, as the economy returns to trend, corporate tax receipts will return to their average level of recent years. This implies annual nominal growth in underlying corporation tax receipts of around 8.5% a year to March 2008. This is lower than the growth rate implied by recent Treasury forecasts.

Figure 3.1 shows non-North-Sea corporation tax receipts adjusted for changes to the corporation tax system from 1987–88 to 2001–02, along with the Treasury and IFS projections for 2002–03 to 2007–08. The recent average in adjusted corporation tax receipts is 2.9% of national income. By 2007–08, when the economy is still forecast to be at trend, the Treasury expects corporation tax receipts of 3.3% of national income – a level only achieved in the past at the peak of the economic cycle. We forecast corporation tax receipts of just over 2.9% in 2007–08 (when the economy is assumed to be at trend output). The difference between the two projections equals 0.3% of national income, or £3.5 billion in today's prices.

[3] Page 25 of A. Dilnot, C. Emmerson and H. Simpson (eds), *The IFS Green Budget: January 2002*, Commentary no. 87, IFS, London, 2002 (www.ifs.org.uk/gbfiles/gb2002.shtml).

Figure 3.1. Non-North-Sea corporation tax receipts and forecasts as a percentage of national income



Notes: The adjusted series shows our estimates of the tax revenue that the current tax system would have raised in previous years. It takes account of the fact that tax rates have been reduced in two steps from 33% to 30% and that the introduction of a quarterly payments system boosted revenues temporarily between 1999–2000 and 2002–03.
Sources: Inland Revenue, *Inland Revenue Statistics*, London, 2002; HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm); Inland Revenue, 'A Modern System for Corporation Tax Payments', Press Release IR 9, 17 March 1998.

On VAT receipts, the Treasury has introduced a new strategy for combating VAT fraud and avoidance. It expects that this will produce more than £2 billion a year in additional revenues by 2005–06. In order to be cautious, the Treasury has only assumed that £1.4 billion extra is collected by 2005–06.[4] Our forecasts take a more cautious approach and assume that none of this revenue materialises. Offsetting this, at least to some extent, is the fact that our forecasts assume that the ratio of VAT receipts to consumer spending remains constant over time, whereas the Treasury forecasts assume a gradual decline. Our medium-term forecasts, like those of the Treasury, are for VAT receipts to be stable, at around 6.1% of national income.

Over the medium term, we expect receipts overall to be lower than the Treasury forecast in the PBR, despite our very similar forecast for 2003–04 (see Table 3.3). By 2005–06, when the economy is predicted to return to trend, we forecast that receipts will be £6.5 billion lower than forecast in the PBR, at £486.5 billion. We expect a slightly lower shortfall of £6.1 billion in 2007–08, when the current planning period for the public finances ends.

[4] HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm).

Table 3.3. Medium-term public finances forecasts, based on cautious macroeconomic assumptions (£ billion)

	2002–03	2003–04	2004–05	2005–06	2006–07	2007–08
IFS forecasts						
Current budget						
Current receipts	396.6	429.3	459.1	486.5	514	542
Current expenditure[a]	405.4	434.4	461.5	490.6	518	546
Surplus on current budget[b]	**–8.8**	**–5.1**	**–2.4**	**–4.0**	**–4**	**–5**
Capital budget						
Net investment	13.3	20.1	22.4	24.1	27	30
Public sector net borrowing[b]	**22.1**	**25.2**	**24.8**	**28.1**	**31**	**35**
HM Treasury forecasts						
Current budget						
Current receipts	399.7	430.3	463	493	521	548
Current expenditure[a]	405.5	435.2	459.7	487.5	513	538
Surplus on current budget[b]	**–5.7**	**–4.9**	**3**	**5**	**8**	**10**
Capital budget						
Net investment	14.3	19.6	21.9	24.1	27	30
Public sector net borrowing[b]	**20.1**	**24.5**	**19**	**19**	**19**	**20**

[a] In line with the National Accounts, depreciation has been included as current expenditure.
[b] Includes spending financed by the windfall tax.
Sources: Treasury forecasts from HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm) – this table is similar to table B5 on page 190; authors' calculations.

In forecasting spending, we take the Treasury's current departmental expenditure limits to 2005–06, with an additional £0.5 billion of capital spending in both 2003–04 and 2004–05. We also assume that the AME margin will be set to £2.0 billion in 2004–05 and £3.0 billion in 2005–06, as shown in Table 2.4 of Chapter 2. This implies £1.5 billion of additional spending in 2004–05 and £2.5 billion of additional spending in 2005–06. We also take account of any differences in debt interest spending arising from previous differences in borrowing levels. The result is that, in 2005–06, we forecast current spending of £490.6 billion, £3.1 billion higher than the PBR forecast.

Forecasting public spending in 2006–07 and 2007–08 is more difficult. It requires an assumption about the level of funds that the Chancellor will wish to allocate in the 2004 Spending Review. The PBR assumes that departmental expenditure limits excluding expenditure on the NHS will fall as a share of national income. With annually managed expenditure, the PBR assumes annual growth of '1¾ per cent in real terms in line with its recent trend',[5] which is lower than expected GDP growth.

The PBR therefore assumes that non-NHS spending will fall as a share of national income. It remains to be seen whether this is consistent with the government's stated objectives of reducing child poverty and delivering 'world-class' public services. The Chancellor might decide that more funds are required to meet the government's objectives, as he did in the April 2002 Budget. It seems appropriate that these decisions be left until the 2004 Budget,

[5] Paragraph B20 on page 187 of HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm).

by which point more information on how the government is progressing towards its objectives will be available. In the mean time, we assume that all non-NHS current spending grows in line with national income in 2006–07 and 2007–08. As shown in Table 3.3, this implies current spending of £546 billion in 2007–08, some £8 billion above the PBR estimate.

With lower forecasts for receipts and higher forecasts for spending, we believe that the public finances will be weaker in the medium term than the Treasury currently projects. In 2005–06, we forecast a deficit on the current budget of £4.0 billion rather than the surplus of £5 billion forecast by the Treasury. In 2007–08, we project a current deficit of £5 billion, while the Treasury has a current surplus rising to £10 billion. We expect public sector net borrowing to rise to £28.1 billion in 2005–06 and then to £35 billion in 2007–08, whereas the Treasury has it rising only from £19 billion to £20 billion over the same period.

Table 3.4. Medium-term public finances forecasts, based on cautious macroeconomic assumptions (% of national income)

	2002-03	2003-04	2004-05	2005-06	2006-07	2007-08
IFS forecasts						
Current budget						
Current receipts	38.0	39.2	39.6	39.9	40.1	40.4
Current expenditure[a]	38.8	39.6	39.9	40.2	40.4	40.7
Surplus on current budget[b]	**–0.8**	**–0.5**	**–0.2**	**–0.3**	**–0.3**	**–0.3**
Average surplus on current budget since 1999–2000[b]	**1.1**	**0.8**	**0.6**	**0.5**	**0.4**	**0.3**
Capital budget						
Net investment	1.3	1.8	1.9	2.0	2.1	2.2
Public sector net borrowing[b]	**2.1**	**2.3**	**2.1**	**2.3**	**2.4**	**2.6**
Public sector net debt	**31.2**	**32.4**	**33.2**	**34.1**	**35.1**	**36.5**
Output gap[c]	–1.3	–1.0	–0.3	0.0	0.0	0.0
HM Treasury forecasts						
Current budget						
Current receipts	38.3	39.3	40.0	40.4	40.7	40.8
Current expenditure[a]	38.8	39.7	39.7	40.0	40.0	40.1
Surplus on current budget[b]	**–0.5**	**–0.4**	**0.3**	**0.4**	**0.6**	**0.7**
Average surplus on current budget since 1999–2000[b]	**1.2**	**0.8**	**0.6**	**0.7**	**0.7**	**0.7**
Capital budget						
Net investment	1.4	1.8	1.9	2.0	2.1	2.2
Public sector net borrowing[b]	**1.9**	**2.2**	**1.6**	**1.6**	**1.5**	**1.5**
Public sector net debt	**31.0**	**32.1**	**32.4**	**32.6**	**32.7**	**33.0**
Output gap[c]	–1.3	–1.0	–0.3	0.0	0.0	0.0

[a] In line with the National Accounts, depreciation has been included as current expenditure.
[b] Includes spending financed by the windfall tax.
[c] Measured as a percentage of trend output rather than actual output.
Sources: Treasury forecasts from HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm) – this table is similar to table B5 on page 190; authors' calculations.

Table 3.4 shows the IFS and Treasury forecasts as percentages of national income. The higher borrowing forecast by IFS translates into debt being 0.2 percentage points higher in 2002–03 than the 31.0% of national income that the Treasury expects. By 2007–08, the IFS forecast is for debt to stand at

36.5% of national income, which is 3.5 percentage points higher than the 33.0% forecast by the Treasury. Nevertheless, under both the Treasury's and IFS's forecasts, net debt is set to stay below the 40% level stipulated by the sustainable investment rule.

Our forecasts suggest that there will have been an average surplus on the current budget of 0.5% of national income between 1999–2000 and 2005–06 – the Treasury's estimate of the current economic cycle – as shown in Table 3.4. In cash terms, the cumulative surplus of £31 billion is less than the £46 billion the Chancellor predicted in the PBR, but over the current economic cycle, the golden rule is still comfortably overachieved. However, we see the present cycle ending in 2005–06 with the current budget in deficit to the tune of 0.3% of national income, compared with the surplus of 0.4% and rising expected by the Treasury. Our projections therefore imply that further tax increases or spending cuts will be needed to ensure that the golden rule is not missed looking forward.

3.4 The Budget judgement

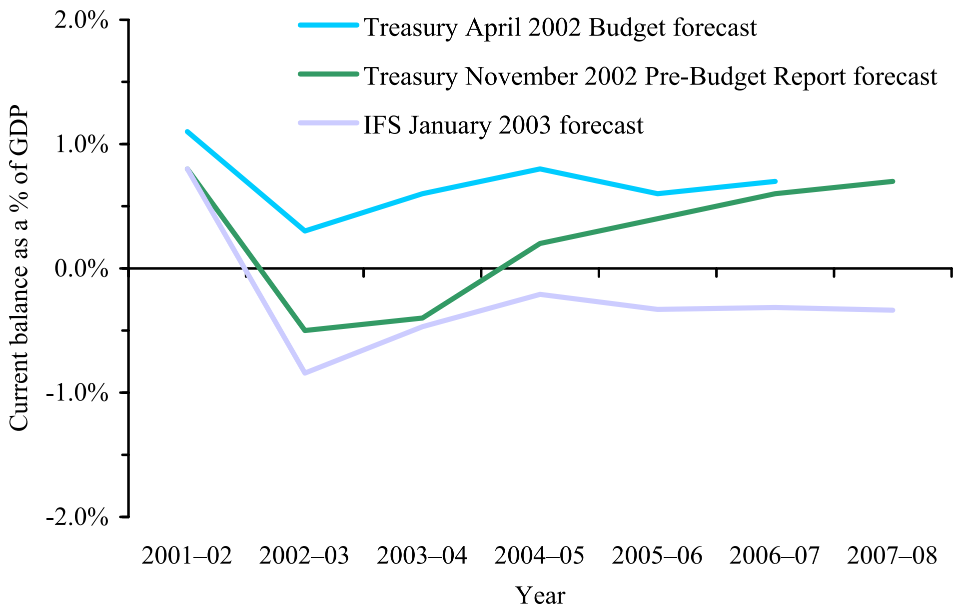
The current budget balances forecast in the April 2002 Budget, the November 2002 Pre-Budget Report and the January 2003 IFS Green Budget are shown in Figure 3.2. The PBR predicts that the golden rule will continue to be met, but with less room to spare than looked likely at the time of the April 2002 Budget. We expect the current budget to remain in deficit. The large current budget surpluses seen in 1999–2000, 2000–01 and 2001–02 would still allow the government to claim that the golden rule had been met over the current economic cycle. But our forecast implies that the current budget will remain in deficit from 2005–06 onwards during a period when the economy is operating at trend. Without tax increases or spending cuts at some point, the golden rule will be missed.

So if the government has to raise taxes or cut spending, which is it likely to choose? Cutting public spending significantly would seem inconsistent with the government's stated objectives, as it would involve big cuts in either transfer payments or spending on public services.

Within transfer payments, the largest recipient groups are families with children and pensioners. Meeting the government's target for reducing child poverty by one-quarter by 2004–05 might require further increases in spending (see Chapter 4). The government has also pledged increases in support to those aged 65 or over, including the introduction of the pension credit in October 2003. Reductions in other transfer payments – for example, disability or unemployment benefits – are possible but would need to reduce recipients' incomes significantly to make substantial savings.

Looking at public services, the recent July 2002 Spending Review announced supposedly fixed spending plans covering all departmental expenditure limits to March 2006, apart from the NHS, where the settlement runs until March 2008. Changing these plans so soon would sit very uncomfortably with the government's commitments to sustained increases in public spending in order to deliver world-class public services.

Figure 3.2. Current budget surplus as a percentage of national income



Sources: Treasury forecasts from HM Treasury, *Pre-Budget Report: 2002*, Cm. 5664, London, 2002 (www.hm-treasury.gov.uk/Pre_Budget_Report/prebud_pbr02/prebud_pbr02_index.cfm), and HM Treasury, *Financial Statement and Budget Report*, HC592, London, 2002 (www.hm-treasury.gov.uk/budget/bud_bud02/budget_report/bud_bud02_repindex.cfm); authors' calculations.

Tax increases therefore seem more likely, particularly given the choices the Chancellor has made in the past: the July 1997 Budget increased taxes in order to reduce borrowing, while the April 2002 Budget increased taxes in order to increase public spending.

How big do these tax increases need to be? Let us assume that the Chancellor wants to end the current economic cycle in 2005–06 in a position that would not require him to make any further tax increases or spending cuts to hit the golden rule over the following economic cycle. This would imply a current budget balance in that year. If he sticks by his PBR forecast of a surplus on current budget in 2005–06 of 0.4% of national income, the Chancellor could say that there is no need for any further tax increases. But, on our forecasts, he would need to close the current deficit of 0.3% of national income that we expect for that year. This would require a tax increase of about £4 billion, effective by April 2005.

But in the past, the Chancellor has been more cautious than this. He has sought to build caution into his projections by aiming for a current surplus of around 0.7% of national income on average, sufficient to ensure that the golden rule is met even if the Treasury has overestimated the level of trend output by 1%. On the basis of his PBR forecast, this could be seen as requiring a tax increase of around £3 billion to raise the projected current surplus in 2005–06 from 0.4% of national income to 0.7%. But the Chancellor might also point out that he expects the surplus to rise to 0.7% of national income in any event by

2007–08, even without the economy moving above trend. So again there is no need for tax increases.

But on our forecast, the Chancellor would need to raise taxes by around £11 billion to move from a current deficit of 0.3% of national income to a current surplus of 0.7% – and thereby restore the level of caution he has sought in the past with regard to the golden rule. We do not expect the underlying budget position to improve of its own accord beyond 2005–06, in part because we are not as confident as the Treasury that the revenues lost from the stock market and the troubles of the financial sector will bounce back. In addition, we expect spending to grow more quickly than the economy in the 2004 Spending Review – although the Chancellor will not have to make a firm decision on this until next year. A rise in spending as a share of national income would offset fiscal drag, the natural tendency for revenues to rise as a share of national income as people move into higher tax brackets.

To conclude, if the Chancellor believes that the forecasts he made in the PBR are still realistic – and that the recent weakening of the public finances is a temporary phenomenon – he could argue that there is no need for significant tax increases. He might well add that with the outlook for the world economy fragile, now is not the time for a tightening of fiscal policy that could put too much of the burden of supporting the UK economy on interest rates.

But we believe that the outlook for the public finances is weaker than the PBR suggested. If the golden rule is expected to be met going forwards, then taxes would need to rise. Now may not be the ideal time for this, but rises cannot be delayed for too long without undermining the credibility of those very rules in which the Chancellor places such store.

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