

2. The public finances under Labour

Robert Chote, Carl Emmerson and Gemma Tetlow (IFS)

Summary

- Labour inherited, by international standards, a big budget deficit and an average public sector debt burden. More than a decade later, the structural budget deficit and the debt burden have both been reduced. But of 21 comparable industrial country governments, 19 have done more to improve their structural budget balances and 16 have done more to reduce their debt burdens than the UK has.
- Since taking office, Labour has announced net tax increases that will raise 1.3% of national income (£18.8 billion in today's terms) this year. This has contributed to a total increase in the tax burden of 2.1% of national income (£29.5 billion). This is being used to increase public sector investment and cut government borrowing.
- To strengthen the public finances over the next five years, Labour plans to allow the tax burden to increase by 1.0% of national income (£14 billion) and to cut public spending by 0.5% of national income (£7 billion). If delivered, this would take the tax burden to a 24-year high and public spending to an eight-year low.
- Over the next five years, Labour plans to take 48% of the 'proceeds of growth' in tax, up from 45% under Labour to date and 30% under the Conservatives from 1979. Real national income is expected to rise by £5,500 per family by 2012–13, with roughly £2,600 being taken in tax and £2,900 being left in individuals' pockets.

2.1 Introduction: Labour's fiscal objectives

The 2008 Budget will be Alistair Darling's first since taking over from Gordon Brown as Chancellor of the Exchequer last year and the twelfth since the Labour Government took office in 1997. Labour has outlined four main goals for its fiscal policy:¹

- to avoid an unsustainable and potentially damaging rise in public sector debt;
- to ensure that future taxpayers are not left to pay for spending that does not benefit them;
- to avoid a bias against investment when public spending as a whole has to be squeezed;
- to 'support' monetary policy in stabilising the economy and keeping inflation on target.

In 1997, with no track record of his own, Mr Brown saw a new fiscal policy framework as a way to help convince people that he would avoid what he saw as the fiscal laxity and bias against investment of previous Chancellors. The key elements were

¹ Page 7 of HM Treasury, *Analysing UK Fiscal Policy*, November 1999 (<http://www.hm-treasury.gov.uk/media/E/E/anfiscalp99.pdf>).

- 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 Labour’s four broad objectives for fiscal policy more concrete:

- The **golden rule** requires the public sector to borrow only 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 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 short-term financial assets) at a ‘stable and prudent’ level. For now, the Treasury defines this as less than 40% of national income (GDP) at the end of each financial year of the current economic cycle.

We discuss these rules and the fiscal framework in more detail in Chapter 3. In this chapter, we look at the state of the public finances when Labour took office in 1997 (Section 2.2) and at how they have evolved over the past 11 years (Section 2.3). We then assess how the current position compares with Labour’s inheritance (Section 2.4) and how the Treasury expects it to evolve over the next five years (Section 2.5). Section 2.6 quantifies the uncertainties that lie around the Treasury’s public finance forecasts. Section 2.7 concludes.

2.2 Labour’s inheritance

Labour took office at a time when the Conservatives were still trying to eliminate the large budget deficit that had opened up in the early 1990s. Adjusting for the level of economic activity, the ‘structural’ budget balance² had deteriorated from a surplus of 1.5% of national income in 1981–82 to a deficit of 5.6% by 1992–93. The impact of the recession on revenues and spending meant that the overall deficit was even bigger, reaching 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. After the 1992 election, Chancellor Norman Lamont announced significant tax-raising measures, and Kenneth Clarke, who became Chancellor in May 1993, continued this process and also cut public spending as a share of national income. This almost halved the structural budget deficit between 1992–93 and 1996–97 and, along with strong economic growth, helped stabilise public sector net debt, which peaked at 43.3% of national income in 1996–97. Mr Clarke forecast in his November 1996 Budget that revenues would continue to rise and spending

² The budget balance that would be recorded if economic activity were at its sustainable ‘trend’ level, consistent with stable inflation. See Section 3.2.

would continue to fall as shares of national income. This would get the budget back into surplus by 2000–01 and pull public sector net debt back down towards 40%.

This set the scene for Labour's inheritance. In 1996–97, the Conservatives' last year in office, total spending by the public sector (known as total managed expenditure, TME) was 40.6% of national income, while government revenues totalled 37.1% of national income. This left 3.5% of national income to be covered by public sector net borrowing. If sustained, this would have left net debt climbing significantly for the foreseeable future. A fifth of this borrowing financed investment, leaving a current budget deficit of 2.8% of national income. The Treasury estimates that part was explained by the impact of weak economic activity on tax revenues and welfare spending, but that there was still a 'structural' current budget deficit of 2.2% of national income. This would have to be reduced if Mr Brown were to comply with his 'golden rule' over the medium term.

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 was the seventh 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) was the tenth highest of the same 22 countries.³

2.3 Labour's record to date

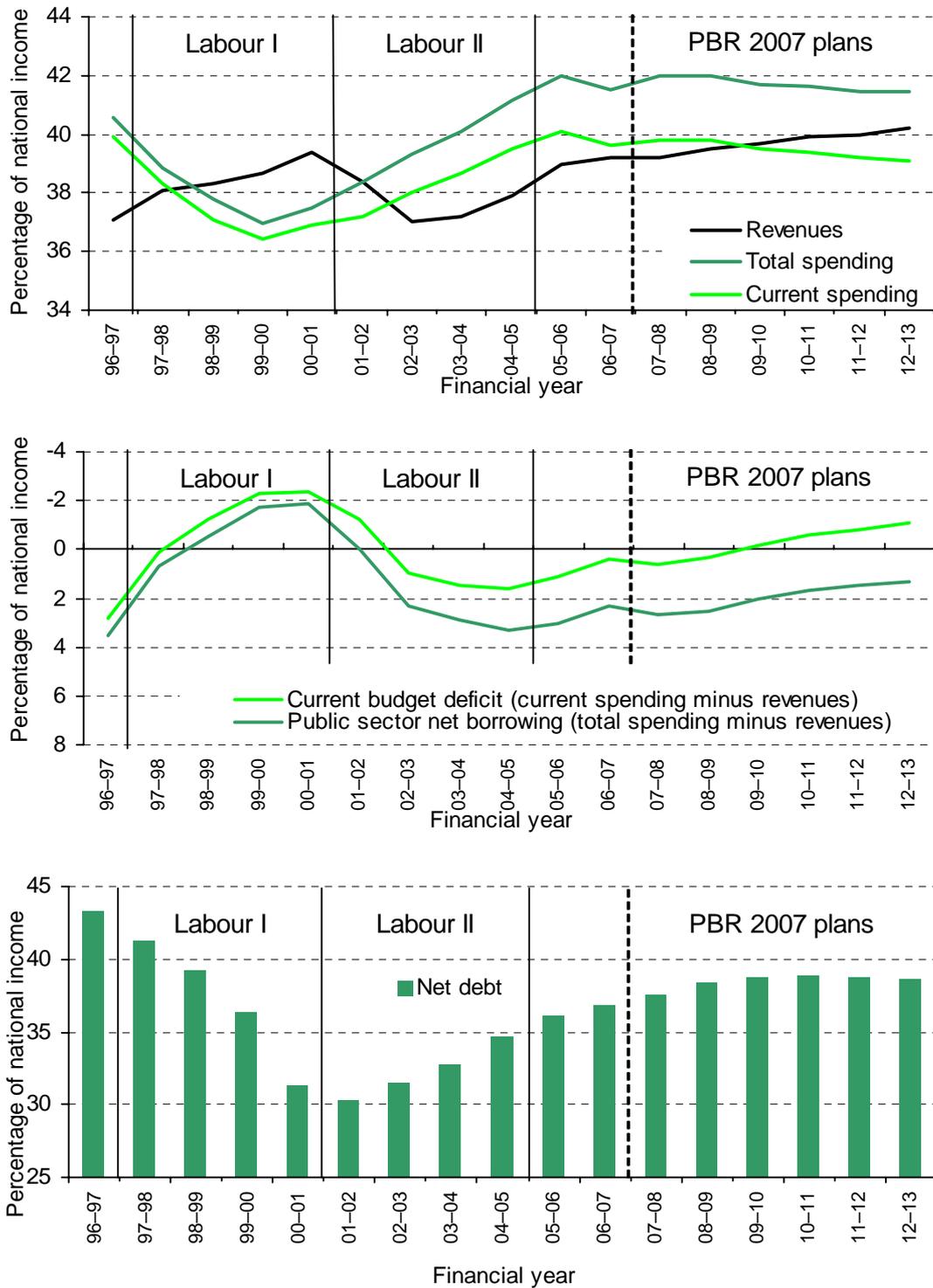
The evolution of the public finances

In its 1997 manifesto, Labour promised to keep to the tight spending plans laid down by Mr Clarke for two years. Mr Brown broadly kept that promise and reduced spending further in his third year at the Treasury, thanks partly to unintended departmental underspending. Despite beginning to spend more in the run-up to the 2001 election, public spending (TME) ended Labour's first term 3.2% 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 just 0.5%. 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 real increases in fuel and tobacco duties (initiated 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, and above-average economic growth. Mr Brown also decided 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 (a process known as 'fiscal drag').

³ See Table 2.2 for more details.

Figure 2.1. Revenues, spending, budget balances and debt



Sources: HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 (http://www.hm-treasury.gov.uk/pbr_csr/pbr_csr07_index.cfm); HM Treasury, *Public Sector Finances Databank*, December 2007 (http://www.hm-treasury.gov.uk/media/B/2/pfd_211207.xls).

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 total budget balance reached 1.7% of national income in 1999–2000, comprising an estimated 1.4% of structural surplus and a further 0.3% from cyclical factors. Meanwhile, public sector net debt fell from

43.3% of national income in 1996–97 to 31.4% of national income in 2000–01, aided in part by the proceeds from auctioning 3G mobile phone licences (£22½ billion, 2.3% of national income at the time).

Mr Brown had described his determination to reduce borrowing as ‘prudence for a purpose’.⁴ The purpose became clear after 1999. The government reversed its earlier cuts in public spending, with health, education, and lower-income pensioners and families with children the main beneficiaries. However, as spending rose by 3.8% of national income over 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 1.5% of national income lower than they began it (even though the net effect of new policy measures during the second term had been to raise revenue).

The combination of higher spending and weaker tax revenues unwound the improvement in the public finances seen during Labour’s first term. The current budget balance moved from a surplus of 2.4% 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 34.7% of national income in 2004–05.

The 2004 Spending Review began to slow the increase in spending, with the Treasury’s original plans showing real increases declining from 4.2% in 2005–06 to 2.6% in 2006–07 and 2.8% in 2007–08. In fact, spending growth came in at a higher-than-intended 4.3% in 2005–06 and then slowed more sharply than intended to 2.1% in 2006–07. The Treasury now expects spending growth to rebound to 3.8% this year, giving an average increase of 3.4% a year over the three years of the review – slightly more than the 3.2% set down in the original plans. The Treasury expects this to leave the broadest measure of public spending, TME, at 42.0% of national income this year, up from 41.2% in 2004–05.

Even on the basis of the slower spending growth originally planned for Spending Review 2004, IFS and other independent commentators argued in the run-up to the 2005 election that the government would have to announce further tax-raising measures or cut spending as a share of national income 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’.⁵ But, with the election out of the way, it became clear that the government was indeed on course to breach its rules and Mr Brown duly announced net tax increases in the 2005 Pre-Budget Report, the 2006 Budget and the 2006 Pre-Budget Report, followed by a relatively neutral 2007 Budget (at least in the medium term) and Mr Darling’s relatively neutral package in the 2007 Pre-Budget Report. Taken together, these post-election tax

⁴ 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).

⁵ ‘Row over £11bn tax black hole’, *Guardian*, 22 April 2005 (<http://www.guardian.co.uk/guardianpolitics/story/0,,1466066,00.html>).

increases will be sufficient to raise an extra £7.4 billion this year (£200 per family). Adding in the impact of a rebound in corporation tax receipts and a gradual increase in the income tax burden as people drift into higher tax brackets, revenues in total are expected to rise from 37.9% of national income in 2004–05 to 39.2% this year (an increase equivalent to £19 billion since the election).

With revenues growing more quickly than spending, the Treasury forecasts that the current budget deficit will narrow from 1.6% of national income in 2004–05 to 0.6% of national income this year, with net borrowing forecast to fall from 3.3% to 2.7% of national income over the same three years. But if the Treasury's forecasts for this year prove to be correct, public sector net debt will still have risen from 34.7% of national income to 37.6%.

How has Labour raised extra tax revenue since 1997?

Looking over Labour's period in office to date, the Treasury expects government revenues to have risen by 2.1% of national income between 1996–97 and 2007–08, equivalent to £29.5 billion in today's terms. This increase in revenue is the net effect of four factors:

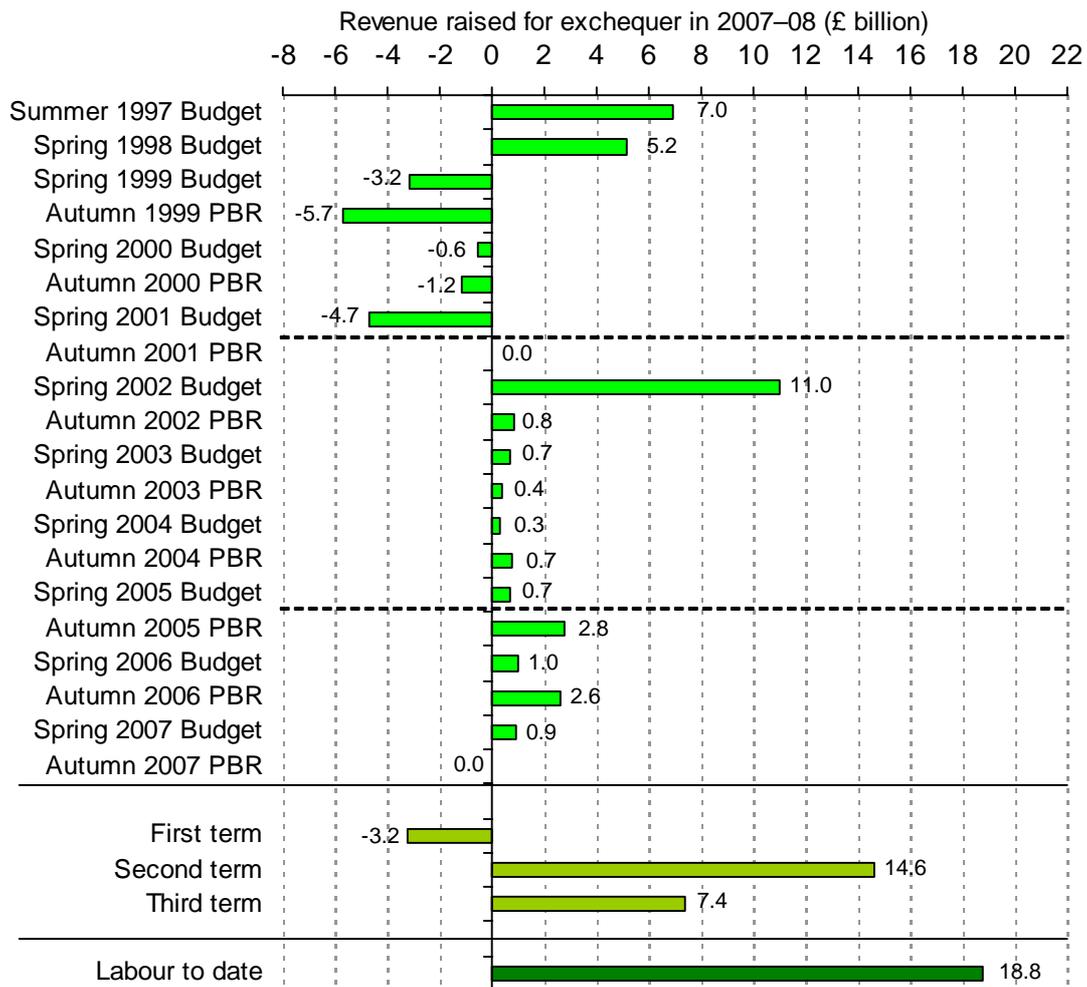
- explicit net tax increases announced by Labour and inherited from the Conservatives;
- fiscal drag: the decision not to raise thresholds and allowances in line with growth in the underlying tax base – for example, through not increasing income tax thresholds in line with growth in (taxable) incomes;
- the economic cycle: national income is thought to be stronger this year relative to the level consistent with stable inflation than in 1996–97;
- other economic factors, including the composition of national income and the health of the financial sector.

In this section, we assess the relative importance of these factors. Given the length of time we are looking at and the fact that the Treasury only assesses the revenue impact of Budget measures over a three-year period at the time they are introduced, such a decomposition can only involve tentative estimates. That said, and beginning with the explicit policy measures, Figure 2.2 shows the net impact that the various tax increases and tax cuts announced in Labour's 20 Budgets and Pre-Budget Reports to date will have on revenues in 2007–08.

We can see that 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 this year of 0.2% of national income, or £3.2 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 £14.6 billion this year.

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, and from HM Treasury, *Pre-Budget Report*, various years.

The first four Budgets and Pre-Budget Reports after the 2005 election were revenue-raisers, with the two Pre-Budget Reports being particularly significant. Combined with the more modest revenue-raising measures in the 2007 Budget and Pre-Budget Report, they will bring in a further £7.4 billion this year.

This means that the combined effect of all the tax measures announced by Labour to date will be to bring in 1.3% of national income (£18.8 billion) this year, compared with what would have happened if tax thresholds and allowances had simply been increased by their default amounts.

As Table 2.1 shows, the tax measures announced by Messrs Brown and Darling will raise around 1.3% of national income this year, to which we can add the 0.7% of national income

raised by the policy measures Labour inherited from the Conservatives and chose to maintain (notably, the above-inflation increases in fuel and tobacco duty that continued until 1999).

The second factor that has boosted tax receipts over the last 11 years is the phenomenon known as fiscal drag. In presenting its analysis of the public finances, the Treasury conventionally assumes that income tax allowances and thresholds rise in line with prices rather than earnings. However, as earnings tend to grow in real terms over time, this definition of ‘unchanged policy’ will see revenues increase as a share of national income over time as people migrate into higher tax brackets. Acquiescing in this ‘fiscal drag’ (which also occurs in other taxes where allowances fail to keep pace with underlying growth in the tax base) is, in effect, a policy choice. If unchecked since 1996–97, fiscal drag would have raised an estimated 2.2% of national income (£30.9 billion). In fact, fiscal drag *has* gone largely unchecked, which helps explain why the number of people paying income tax has risen from 25.7 million in 1996–97 to 31.6 million in 2007–08 and why the number paying it at the higher rate has risen from 2.1 million to 3.7 million over the same period.⁶

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

	Impact on revenues in 2007–08	
	% of national income	Cash equivalent
<i>Announcements</i>		
Conservative	+0.7%	+£9.3bn
Labour 1 st term	–0.2%	–£3.2bn
Labour 2 nd term	+1.0%	+£14.6bn
Labour 3 rd term	+0.5%	+£7.4bn
All announcements	+2.0%	+£28.0bn
Fiscal drag	+2.2%	+£30.9bn
Economic cycle	+0.2%	+£2.5bn
Other factors	–2.3%	–£32.0bn
Total	+2.1%	+£29.5bn

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/9/B/end_of_year_352\[1\].pdf](http://www.hm-treasury.gov.uk/media/9/B/end_of_year_352[1].pdf)). Impact of economic cycle estimated using figures in table A.5 of HM Treasury, *ibid*.

Adding together these elements, the broadest definition of the revenue increase for which government policy can directly be held responsible is an estimated 4.2% of national income (£58.9 billion). The remaining factors explaining the change in government revenues as a share of national income over the last 11 years are changes in the strength of the economy relative to the level consistent with stable inflation and other factors in the economy. The exchequer will receive an estimated further 0.2% of national income (£2½ billion) as a result of above-trend economic growth on average over the period since 1996–97. Offsetting these revenue increases, other economic developments will have cost the exchequer an estimated 2.3% of national income (£32 billion) this year. These other factors include episodes of weak stock market performance and the associated fall in the profitability of financial companies

⁶ http://www.hmrc.gov.uk/stats/income_tax/table2-1.xls.

(which adversely affected tax payments by firms and individuals in that sector) and weak earnings growth given the overall health of the economy.

This gives a total increase in revenues as a share of national income of £29.5 billion since Labour came to power. This is more than £10 billion lower than the £40.5 billion estimate published in last year's Green Budget⁷ and reflects the fact that the Treasury has downgraded its forecast for nominal tax receipts in 2007–08 despite having increased its forecast for nominal national income in the same year. This downgrading to the forecast for receipts was as a result of difficulties faced by the financial sector arising from large price changes in the credit markets (see Chapter 6).

2.4 Performance relative to the Conservatives

The public finances strengthened during Labour's first term and weakened during its second. The picture so far during the third term is mixed: the deficit has been shrinking but debt has still been rising. Given this fluctuating pattern, we should be wary of focusing too closely on the position in any particular year. But it is nonetheless interesting to compare the position now in 2007–08 to that when the Conservatives left office in 1996–97.

As Table 2.2 shows, Labour expects to spend 1.4% of national income more this year than the Conservatives did in their final year (£20 billion more in 2007–08 terms), with the extra money devoted to investment rather than current spending. But Labour has increased tax and other revenues by an even larger 2.1% of national income (£30 billion). This has paid for the extra spending and has also allowed Labour to cut borrowing by 0.8% of national income (£11 billion). The government is still having to borrow this year to pay for some of its non-investment spending, but to a much lesser degree than the Conservatives did: at 0.6% of national income, the current budget deficit is much smaller than that recorded in 1996–97.

Turning to the government's balance sheet, public sector net debt is expected to be 5.7% of national income (£80 billion) lower this year than it was in 1996–97, with the annual cost of debt interest also falling, by 1.3% of national income (£18 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 in Section 3.3.

The comparisons of borrowing flatter Labour because economic activity was weaker in 1996–97 than it is expected to be in 2007–08, which automatically depressed tax revenues and pushed up welfare bills for the Conservatives. Adjusting for the state of the economy, the structural budget deficit is only 0.1% of national income smaller now than it was in 1996–97. But public sector net debt is significantly lower now than in 1996–97, even on a structural basis.

The improvements in debt, borrowing and the structural budget balances have occurred at a time when most other industrialised countries have also been strengthening their public finances – indeed, many of them more so. Out of the other 21 OECD countries for which we

⁷ Source: Table 2.1 of R. Chote, C. Emmerson, A. Leicester and D. Miles (eds), *The IFS Green Budget: January 2007*, IFS Commentary 102 (<http://www.ifs.org.uk/budgets/gb2007/07chap2.pdf>).

have comparable data on a wide range of indicators, 16 reduced their debt and 19 improved their structural budget balances by more than the UK between 1996 and 2007.

Figure 2.3 compares the evolution of the public finances during Labour's first decade with the Conservative record after 1979. At first glance, the comparison is not flattering to Labour. Having inherited a lower level of net debt than the Conservatives in 1979, after 10 years Labour finds itself 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 structural surplus three years later, Labour has presided over a slightly bigger deterioration than the Conservatives over the subsequent seven years.

Table 2.2. Key fiscal indicators: 1996–97, 2007–08 and change over time

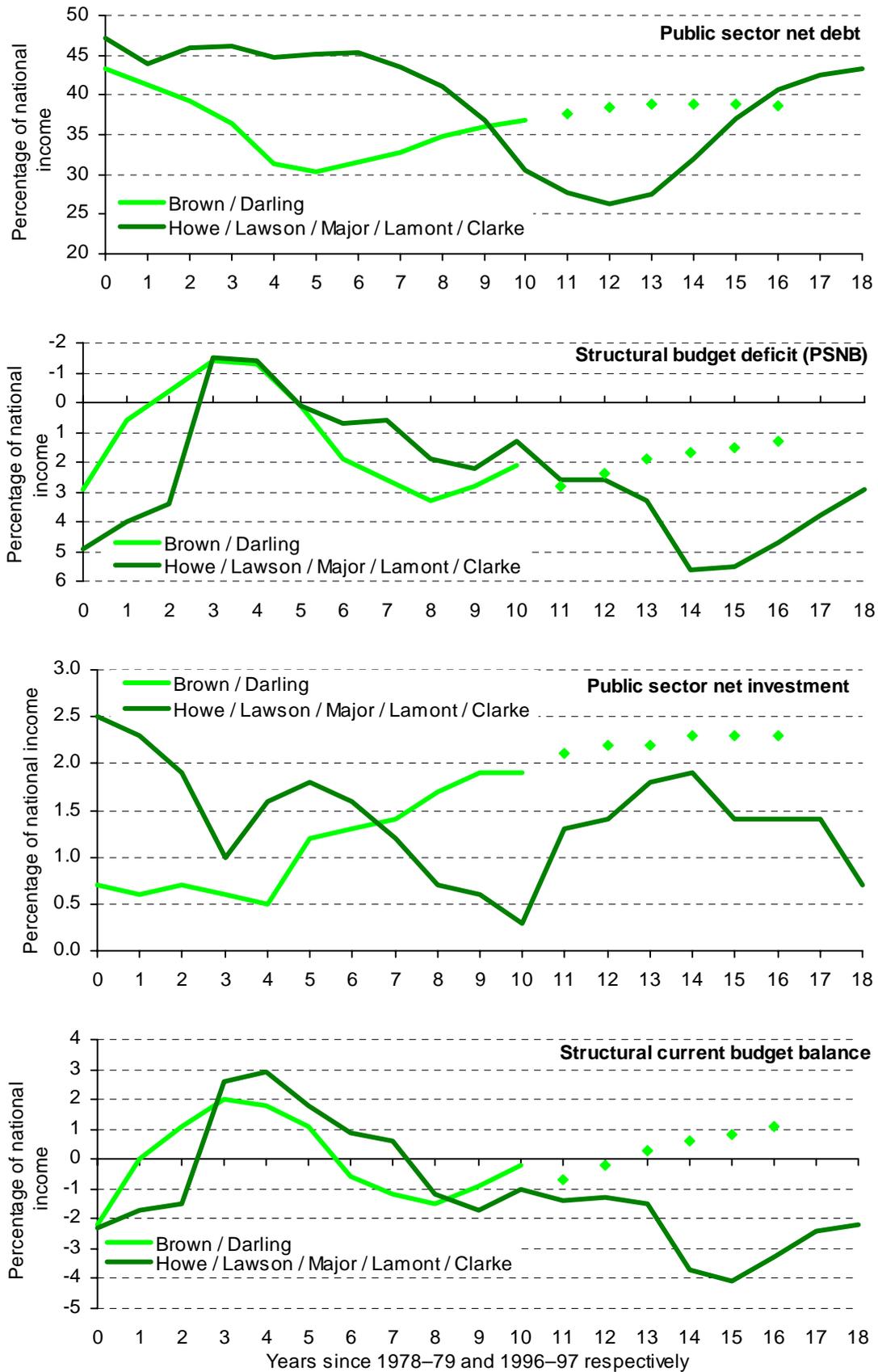
<i>% of national income unless otherwise stated Rankings: among 22 OECD member countries with consistent data for 1996 and 2007 for all measures</i>	Labour's inheritance (1996–97)	Current position (2007–08)	Change, 1996–97 to 2007–08 (% points)
Spending			
Total public spending <i>Place in OECD league table</i>	40.6% <i>16th highest spending</i>	42.0% <i>10th highest spending</i>	+1.4 <i>2nd largest increase</i>
Public sector net investment	0.7%	2.1%	+1.4
Central government debt interest <i>Place in OECD league table</i>	3.5% <i>14th highest debt interest</i>	2.2% <i>8th highest debt interest</i>	-1.3 <i>18th largest reduction</i>
Revenues			
Tax and other revenues <i>Place in OECD league table</i>	37.1% <i>17th highest revenues</i>	39.2% <i>14th highest revenues</i>	+2.1 <i>4th largest increase</i>
Borrowing			
Public sector net borrowing: total	3.5%	2.7%	-0.8
Public sector net borrowing: structural <i>Place in OECD league table</i>	2.9% <i>7th highest borrowing</i>	2.8% <i>4th highest borrowing</i>	-0.1 <i>20th largest reduction</i>
Current budget balance: total	-2.8%	-0.6%	+2.2
Current budget balance: structural	-2.2%	-0.7%	+1.5
Debt			
Public sector net debt <i>Place in OECD league table</i>	43.3% <i>10th highest debt</i>	37.6% <i>8th highest debt</i>	-5.7 <i>17th largest reduction</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, Switzerland and Turkey.

Sources: OECD, *Economic Outlook No. 82*, December 2007

(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 2007 (http://www.hm-treasury.gov.uk/media/B/2/pfd_211207.xls); Office for National Statistics.

Figure 2.3. Debt, deficits and investment: Labour vs Conservatives



Source: HM Treasury, *Public Sector Finances Databank*, December 2007 (http://www.hm-treasury.gov.uk/media/B/2/pfd_211207.xls).

However, this in part reflects Labour’s willingness to borrow more to increase net investment. As Figure 2.3 shows, net investment actually fell over Labour’s first term, but it has since increased and is now nearly three times higher than the level inherited from the Conservatives. 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, the current budget deficit has followed a remarkably similar pattern over the first 10 years of Labour to that over the first 10 years of the Conservatives, both parties having inherited similar levels. Labour recorded a stronger fiscal position in its first two years, while the Conservatives recorded a slightly stronger position from years 3 to 8. Looking forwards, the Chancellor believes that a very different pattern will be seen, with the current budget moving into surplus, whereas under the Conservatives a large deficit emerged.

2.5 Labour’s plans and forecasts

Labour expects to spend 42.0% of national income this year (39.8% on current spending plus 2.1% on public sector net investment). With revenues forecast at 39.2% of national income, this leaves a current budget deficit of 0.6% of national income (£8.3 billion) and public sector net borrowing of 2.7% of national income (£38 billion).

How does the Treasury hope that the public finances will evolve over the next five years?

In principle, the Pre-Budget Report is an interim forecast and does not necessarily indicate what the Treasury hopes will happen. For that, we supposedly need to wait for the Budget. But, in practice, Messrs Brown and Darling have removed any distinction between the Budget and Pre-Budget Report, with the latter recently having contained more significant policy changes, at least in terms of their net impact on the public finances, than the Budget (see Figure 2.2). So it seems reasonable to treat the Pre-Budget Report forecasts as a fair proxy for the Treasury’s desired path for the public finances.

According to the 2007 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 1.1% of national income in 2012–13. Over this period, revenues are expected to rise by 1.0% of national income while

Table 2.3. Current budget balance: cyclical and structural

	Economic growth (%)	Output gap (% of potential output)	Current budget balance (% of national income)			Net borrowing (% of national income)
			Cyclical	Structural	Total	
2007–08	3	0.2	0.1	–0.7	–0.6	2.7
2008–09	2	–0.3	–0.1	–0.2	–0.3	2.5
2009–10	2¾	0	0	0.2	0.2	2.0
2010–11	2½	0	0	0.6	0.6	1.7
2011–12	2½	0	0	0.8	0.8	1.5
2012–13	2½	0	0	1.1	1.1	1.3

Source: Tables B1 and B3 of HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 (http://www.hm-treasury.gov.uk/pbr_csr/report/pbr_csr07_repindex.cfm).

current spending is projected to fall by 0.7% of national income. Meanwhile, public sector net investment is forecast to rise by 0.2% of national income (giving a cut in total spending of 0.5% of national income). Net debt is forecast to rise from 37.6% of national income this year to a peak of 38.9% in 2010–11 before dropping back to 38.6% in 2012–13.

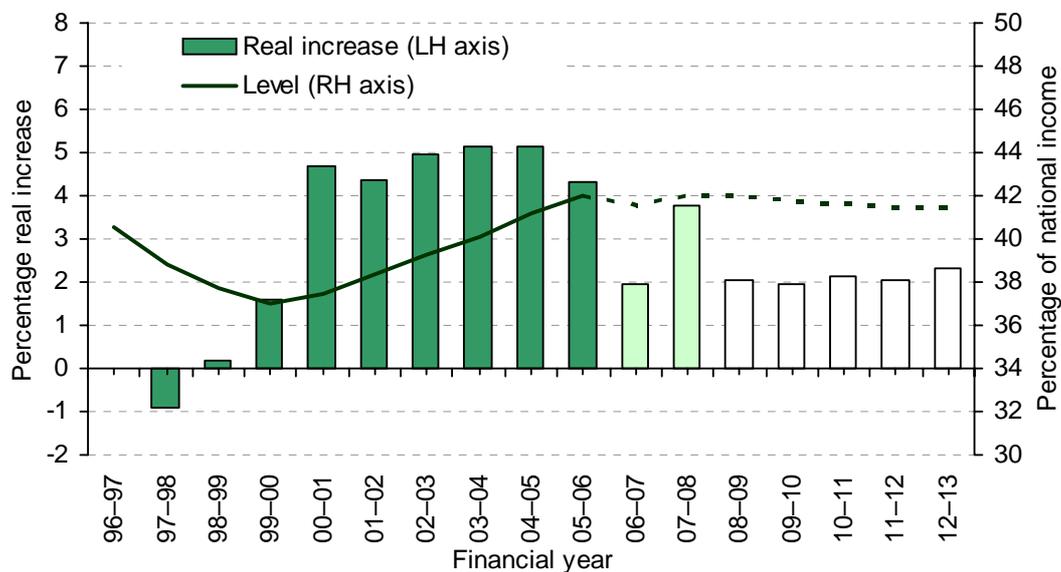
The Treasury now believes that economic activity is running only 0.2% above the level consistent with stable inflation (the ‘output gap’). So the structural improvement in the current budget balance forecast over the next five years is actually slightly larger than the forecast improvement in the headline measure (see Table 2.3).

Spending

The 2007 Comprehensive Spending Review (CSR) – published alongside October’s Pre-Budget Report – intensifies the squeeze on spending that began in Spending Review 2004. The Treasury plans to increase spending by 2.1% a year on average in 2008–09, 2009–10 and 2010–11. This is barely half the 4.0% increase seen on average over the previous nine years, covered by the 1998, 2000, 2002 and 2004 spending reviews. If these increases are delivered, spending will fall by 0.4% of national income, from 42.0% to 41.6% of national income.

In its Pre-Budget Report public finance forecasts, the Treasury also pencilled in two further years of modest spending growth, averaging 2.2% a year in real terms in 2011–12 and 2012–13, as shown in Figure 2.4. This would cut spending by a further 0.2% of national income to 41.5%. At 0.5% of national income, the total cut in spending projected over the next five years is worth £7.2 billion in today’s terms. This squeeze would be less dramatic than that

Figure 2.4. Total managed expenditure

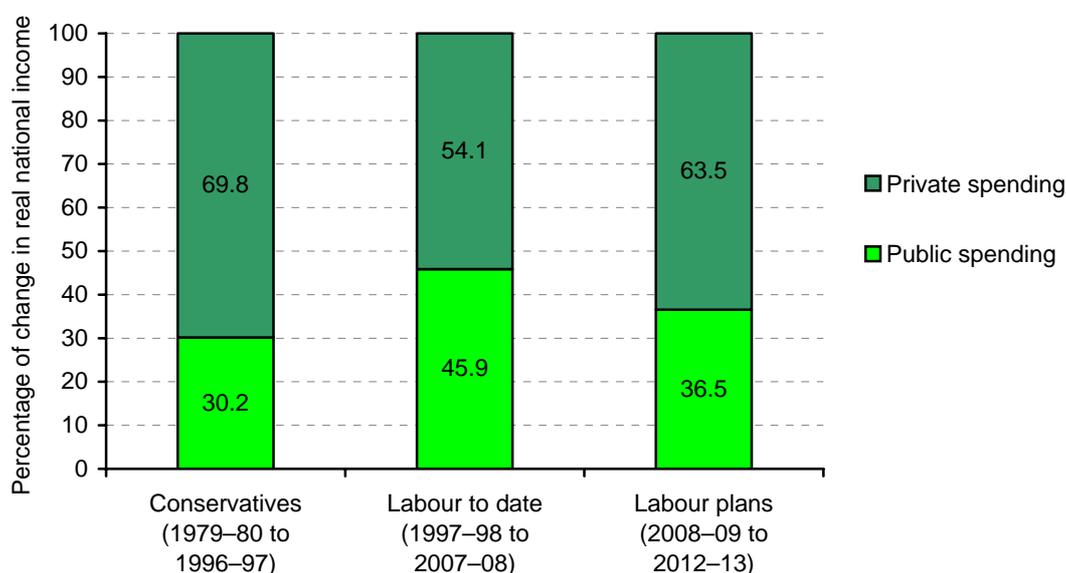


Sources: Total managed expenditure from table B1 of HM Treasury, *Public Sector Finances Databank*, December 2007 (http://www.hm-treasury.gov.uk/media/B/2/pfd_211207.xls) and table B5 of HM Treasury, 2007 *Pre-Budget Report and Comprehensive Spending Review*, October 2007 (http://www.hm-treasury.gov.uk/pbr_csr/report/pbr_csr07_repindex.cfm). GDP and GDP deflators up-to-date as of 20 December 2007 from HM Treasury website (http://www.hm-treasury.gov.uk/media/6/8/GDP_Deflators_20071220_NA_update_circ.xls).

seen during Labour’s first two years in office (when it was aiming to stick to the plans that it inherited from the Conservatives) and would still leave spending higher in 2012–13 than it was in 2004–05.

Another way to characterise the squeeze on spending is to ask how the ‘proceeds of growth’ are shared between public and private spending. In other words, what proportion of every extra pound of national output does the Treasury expect the public sector to spend and what proportion does it expect to leave to the private sector? This split is shown in Figure 2.5. Under the Conservatives from 1979 to 1997, the public sector spent around 30% of additional national output, leaving 70% to the private sector. Under Labour to date, the public sector has spent just over 45% of the additional national output, leaving the private sector a little under 55%. Over the next five years, the shares are expected to be somewhere between the two previous periods, with the public sector spending around 37% of the extra national output and the private sector around 63%.

Figure 2.5. Sharing the proceeds of growth



Source: As Figure 2.4.

As in every previous spending review under Labour, the real increases in spending during the CSR 2007 period and beyond have been, or are set to be, larger than those originally intended. Chapter 7 discusses potential pressures on the government’s latest spending plans.

Revenues

The Treasury is expecting revenues to increase by 1.0% of national income (£14 billion) over the next five years. The extra revenue is expected to come predominantly from taxes on incomes and profits, partially offset by a decline in revenue from taxes on spending, as can be seen in Table 2.4.

As usual, the forecast incorporates an ongoing structural increase in revenues arising from ‘fiscal drag’. The Treasury estimates that fiscal drag increases current receipts by 0.2% of

Table 2.4. Revenue changes projected in PBR 2007 (% of national income)

	2007–08	2012–13	Change
Income tax & NICs	17.5	18.3	0.8
Corporation tax	2.9	3.3	0.4
North Sea revenues	0.5	0.5	No change
VAT & excise duties	8.7	8.4	–0.3
Other taxes & royalties	7.1	7.1	No change
Net taxes & NICs	36.8	37.6	0.8
Other receipts etc.	2.5	2.6	0.1
Current receipts	39.2	40.2	1.0

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

Source: Table B9 of HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 (http://www.hm-treasury.gov.uk/pbr_csr/report/pbr_csr07_repindex.cfm).

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.⁸ 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.

As with spending, we can characterise changes in the tax burden as changes in how the ‘proceeds of growth’ are shared between the public and private sectors. Over the next five years, the Treasury expects to take 48% of every extra pound of real national income in tax, compared with 45% under Labour to date and 30% under the preceding Conservative government.

But it is important to remember that even when the tax burden is rising, the income left to spend in the hands of the private sector can also be rising. (In addition, some tax revenue is simply redistributed within the population in the form of social security benefits and tax credits.) Under Labour to date, between 1996–97 and 2007–08, the Treasury estimates that real national income has risen by £374 billion or £11,800 per family. Of this total, families are paying £5,400 more in tax, leaving them with £6,500 more income after tax. Over the next five years, the Treasury expects real national income to rise by £173 billion or £5,500 per family. Of this, £2,600 will be taken in tax, leaving an increase in after-tax income of £2,900. (These figures take into account all government revenue and not just taxes that are formally paid by specific households. This reflects the fact that all taxes – even those formally paid by businesses – are ultimately paid by individuals.)

2.6 Uncertainty and the Treasury’s fiscal forecasts

As almost all Chancellors discover 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

⁸ Paragraph A24 of HM Treasury, *End of Year Fiscal Report*, December 2003 ([http://www.hm-treasury.gov.uk/media/9/B/end_of_year_352\[1\].pdf](http://www.hm-treasury.gov.uk/media/9/B/end_of_year_352[1].pdf)).

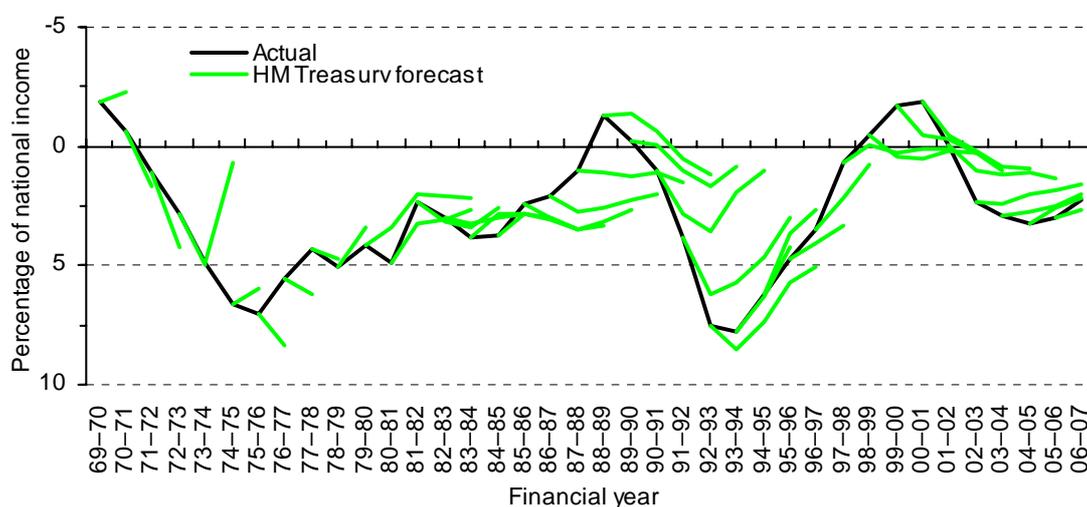
strengthened by 1.7% of national income (and public sector net borrowing by 1.4%) over the next five years, how confident should we be that this will actually be the outcome?

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 latest predictions. If we 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 2.6 shows how Treasury forecasts of changes in public sector net borrowing since the early 1970s compare with what actually happened. We can see that the errors are relatively large and serially correlated: in other words, an optimistic forecast tends to be followed by another optimistic one and a pessimistic forecast by another pessimistic one.

Figure 2.6. Treasury public sector net borrowing forecasts



Source: Authors' calculations, from data contained in HM Treasury, *End of Year Fiscal Report*, October 2007 (http://www.hm-treasury.gov.uk/pbr_csr/documents/pbr_csr07_fiscal.cfm).

The apparent forecast errors shown in Figure 2.6 are likely to understate the true error that would have occurred had policies been unchanged. This is because previous Chancellors might well have responded to forecast errors by taking action to bring borrowing back on track. For example, in the late 1980s, when previous forecasts for borrowing were proving to have been too pessimistic, Nigel Lawson announced significant tax-cutting Budgets. Conversely, in the early 1990s, when previous forecasts for borrowing were proving too optimistic, Norman Lamont and Kenneth Clarke announced significant tax-increasing Budgets. A similar response also occurred under Mr Brown: Budget 2000 announced increases in public spending as a share of national income at a time when borrowing was better than previously forecast. Conversely, Budget 2004 and Budget 2007 announced future cuts in public spending as a share of national income at a time when the outlook for borrowing appeared worse than previously forecast.

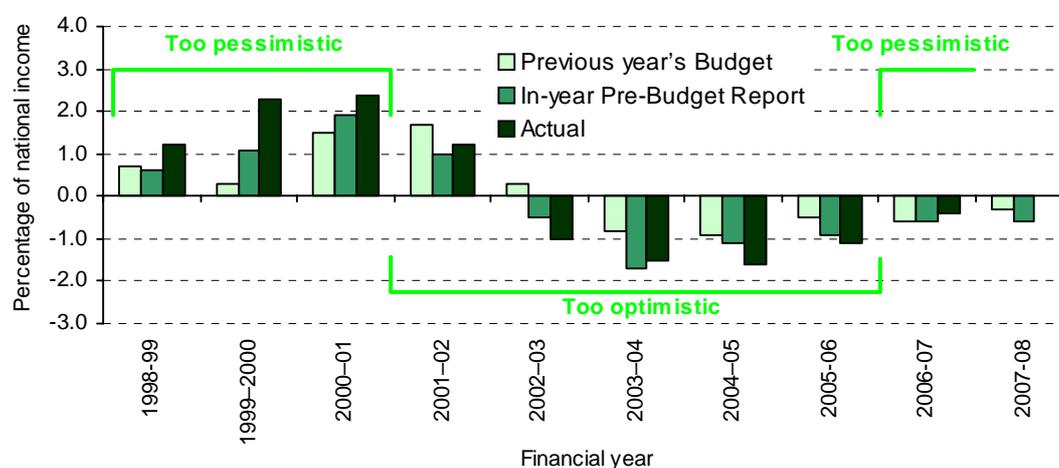
Table 2.5. Treasury errors in forecasting public sector net borrowing

Time period	Average absolute error (% of national income)	Average absolute error (£ billion)
One year ahead	1.0	13
Two years ahead	1.5	21
Three years ahead	1.9	27
Four years ahead	2.4	33

Notes: Figures in £ billion are calculated assuming HM Treasury forecast for national income in 2007–08 of £1,404 billion. Average absolute error is given over the period 1977–78 to 2006–07 for one year ahead, 1981–82 to 2006–07 for two years ahead, 1982–83 to 2006–07 (excluding 1996–97 to 1999–2000) for three years ahead, and 1983–84 to 2006–07 (excluding 1984–85 to 1986–87 and 1997–98 to 2000–01) for four years ahead.

Sources: HM Treasury, *End of Year Fiscal Report*, October 2007 (http://www.hm-treasury.gov.uk/pbr_csr/documents/pbr_csr07_fiscal.cfm); authors' calculations.

Figure 2.7. Treasury current budget balance forecasts



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

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 2006–07 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.⁹

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. (Labour claims that its forecasts are deliberately cautious, by assuming that economic growth will be a quarter of a percentage point lower each year than its true expectation; for a discussion, see Chapter 4.) Only a minority of the Treasury's previous errors in forecasting budget balances can be explained by errors in forecasting economic growth; the more significant factor in explaining

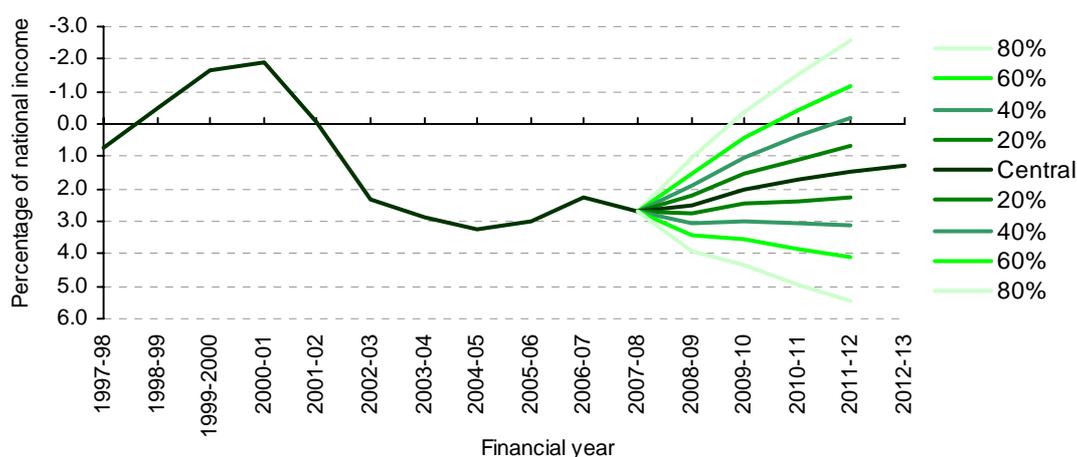
⁹ IFS forecasts show errors of similar magnitude. See C. Giles and J. Hall, 'Forecasting the PSBR outside government: the IFS perspective', *Fiscal Studies*, 1998, 19(1): 83–100 (http://www.ifs.org.uk/publications.php?publication_id=2250).

previous forecast errors has been errors in predicting tax revenues and spending for any given level and composition of national income.¹⁰

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 2.7. The Treasury was serially over-pessimistic in its first three years of forecasts under Labour and serially over-optimistic in the following five. Budget 2006 saw the Treasury return to undue pessimism in its current budget forecast for 2006–07. But this may not persist as the impact of recent financial sector turbulence has already forced the Treasury to revise down its Budget 2007 forecast for the current budget in 2007–08.

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 2.8, 2.9 and 2.10 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. This seems reasonable: looking at the Treasury’s one-year- and two-year-ahead forecasts back to 1970 and 1980 respectively, the positive and negative errors roughly offset each other.¹¹

Figure 2.8. Probabilities for net borrowing outcomes



Sources: Historic figures come from HM Treasury, *Public Sector Finances Databank*, December 2007 (http://www.hm-treasury.gov.uk/media/B/2/pfd_211207.xls). Central projections are taken from HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 (http://www.hm-treasury.gov.uk/pbr_csr/report/pbr_csr07_repindex.cfm) and assume that the forecast for 2007–08 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).

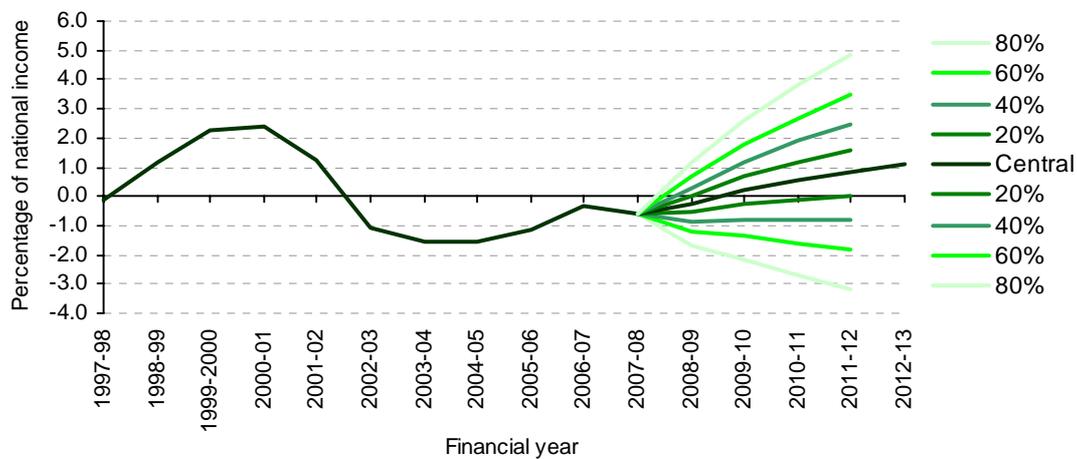
Figure 2.8 shows the probabilities of different outcomes for public sector net borrowing, based purely on the Treasury’s latest forecasts and its past forecasting performance. We assume that the Treasury’s projection for 2007–08 is correct but that there is uncertainty

¹⁰ See table B13 of HM Treasury, *Pre-Budget Report 1998*, November 1998 (<http://archive.treasury.gov.uk/pub/html/prebudgetNov98/index.html>).

¹¹ Table 2.2 of HM Treasury, *End of Year Fiscal Report*, October 2007 (http://www.hm-treasury.gov.uk/pbr_csr/documents/pbr_csr07_fiscal.cfm).

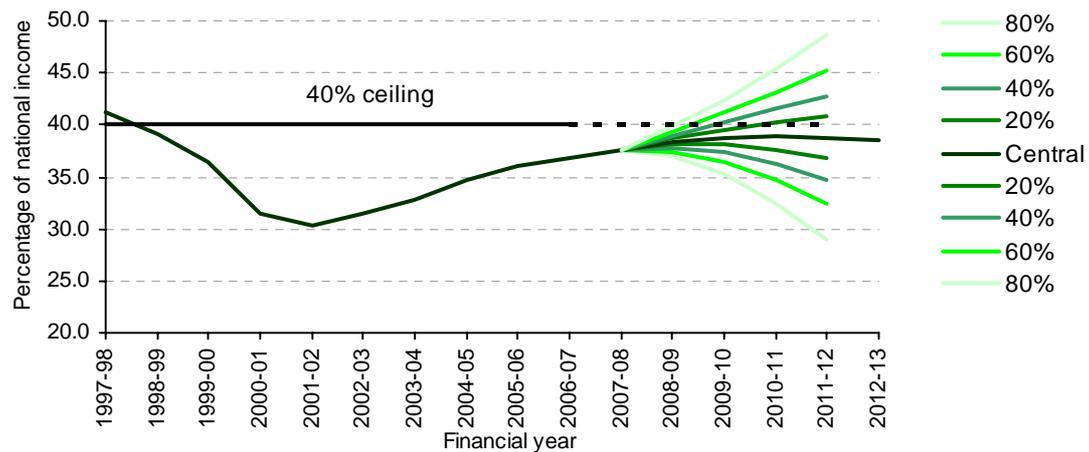
thereafter. The presentation is analogous to the Bank of England’s inflation and growth forecasts in its quarterly *Inflation Report*.¹² The ‘central’ estimate is the Pre-Budget Report forecast shown in Figure 2.1. Figure 2.8 shows that there is a 20% probability that the outcome will lie within the 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 that in 2011–12 there is around a one-in-three chance on past performance that the deficit will have been eliminated. This assumes that the Chancellor does not announce any new policy measures – of course, were net borrowing to turn out to be worse than the current forecasts suggest, the Chancellor may, as his predecessors typically did, choose to implement new measures to bring borrowing back towards previous forecasts.

Figure 2.9. Probabilities for current budget balance outcomes



Sources: As Figure 2.8.

Figure 2.10. 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 2.8.

¹² <http://www.bankofengland.co.uk/publications/inflationreport/index.htm>.

Figure 2.9 shows the probability distribution around the Treasury's central Pre-Budget Report forecast for the current budget balance. It suggests there is a 40% chance that the current budget will still be in deficit in four years' time rather than recording the surplus of 0.8% of national income predicted in the Pre-Budget Report, assuming that no further policy changes are implemented. There is a more than 30% chance that the current budget balance will be no better in four years' time than the Treasury expects it to be this year.

Figure 2.10 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 Figures 2.6 and 2.7. As we shall discuss in the next chapter, Figure 2.10 shows that the probability of public sector net debt breaching the 40% of national income ceiling established by the sustainable investment rule rises from about a third in 2009–10 to around 40% in 2010–11, again based purely on the Treasury's past forecasting performance and assuming no new policy announcements.

2.7 Conclusion

When Labour came to power in 1997, the public finances were strengthening but from a weak base. During Labour's first term, the budget moved into surplus and public sector debt fell sharply, encouraging the government to increase spending significantly in the belief that this would be easily affordable. Unfortunately, tax revenues weakened unexpectedly as the stock market fell, pushing the budget back into deficit and setting debt back on an upward path.

Looking back over Labour's 11 years in office, the pattern of sharp improvement and then steady deterioration is eerily familiar from the experience of the Conservatives after 1979, though in part this reflects a conscious determination to increase public sector net investment and a willingness to borrow to finance it. The net result is that the structural budget deficit and the level of public sector debt are both lower now than the levels inherited from the Conservatives, although most industrial countries have recorded bigger improvements over the same period.

Looking ahead, the government plans to reduce its borrowing and arrest the increase in debt by cutting spending and increasing tax revenues as a share of national income. If delivered, this would constrain the government's ability to achieve its goals for public services and poverty reduction (as we discuss in Chapter 7) and requires the Treasury to take almost half the extra national income that the economy is expected to generate over the next five years in tax.