THE PBR AND THE PUBLIC FINANCES: A PRELIMINARY REACTION

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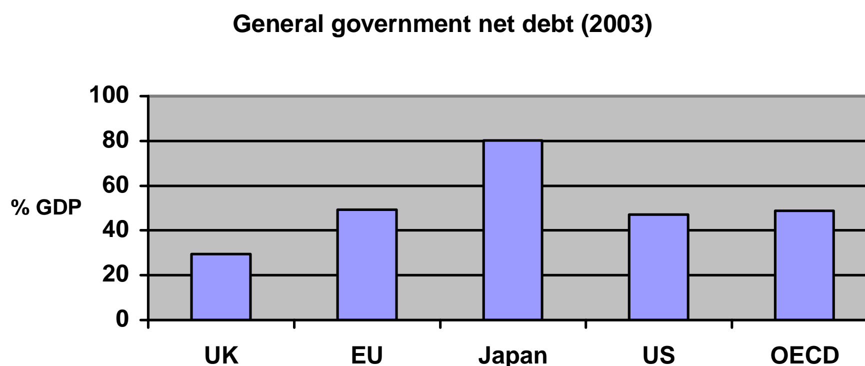
Gordon Brown conceded in his Pre-Budget Report that government borrowing would be around £10bn higher this year than he predicted in April's Budget, even though economic growth is roughly in line with the forecasts he made then. Adjusting public sector net borrowing for the state of the economy, the underlying fiscal position in 2003-04 looks weaker than at any time since Mr Brown became chancellor.

But even without explicit tax raising measures or reductions in spending plans, the Treasury expects the structural position to improve significantly over the next five years. It argues therefore that Mr Brown's fiscal rules are met over the current economic cycle and that he is on course to meet them over the following cycle. It is reasonable to ask if this is a prudent judgement to make.

It is worth stating at the outset that in no fundamental sense is there a crisis in the public finances. By international and historical standards, public sector net debt is modest and not increasing explosively. Financial markets are not concerned by the prospect of default or of resort to inflation to reduce the burden of the debt.



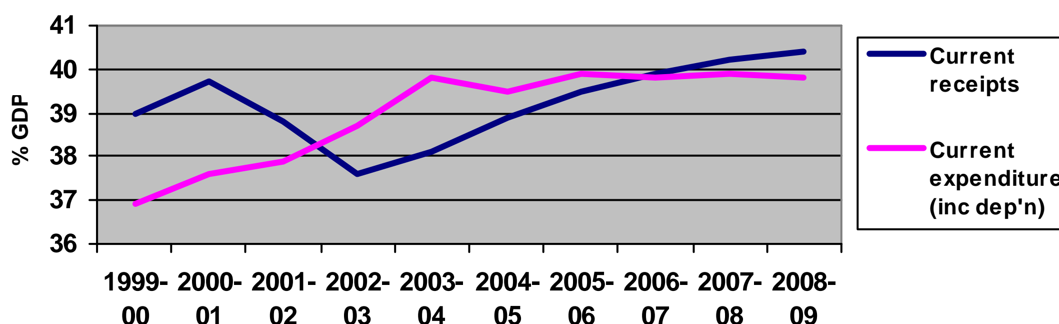
But we also have to assess the public finances against the more stringent benchmark of the rules that Mr Brown set himself under the Code for Fiscal Stability in 1998:

- The **golden rule** states that the government should only borrow to invest. This implies that tax revenues should equal or exceed current (or non-investment) spending. Sensibly, the rule does not have to be met every year, only on average over the ups and downs of the economic cycle.

- The **sustainable investment rule** states that public sector net debt should be kept at a "stable and prudent" level, currently defined (pretty arbitrarily) as no more than 40 percent of national income. This constrains the debt-financed investment the government can undertake, although it can also sponsor investment through the Private Finance Initiative without adding to net debt.

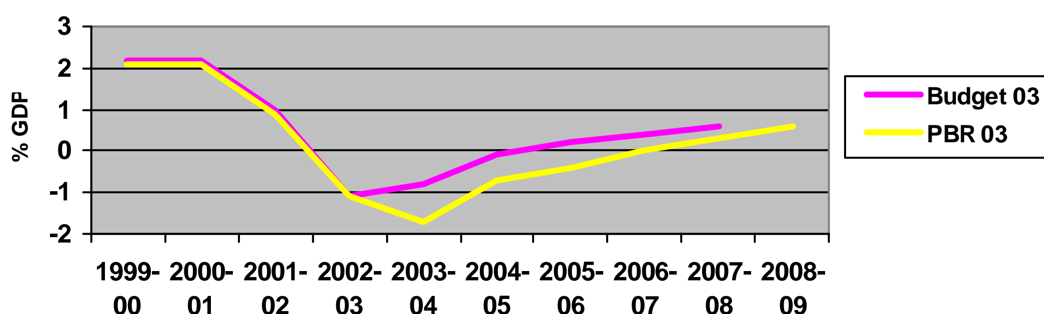
With public sector net debt currently below 33 percent of national income and public sector net investment planned to only to rise to 2.2 percent of national income in the medium term, the golden rule currently appears the more binding.

Current expenditure and receipts



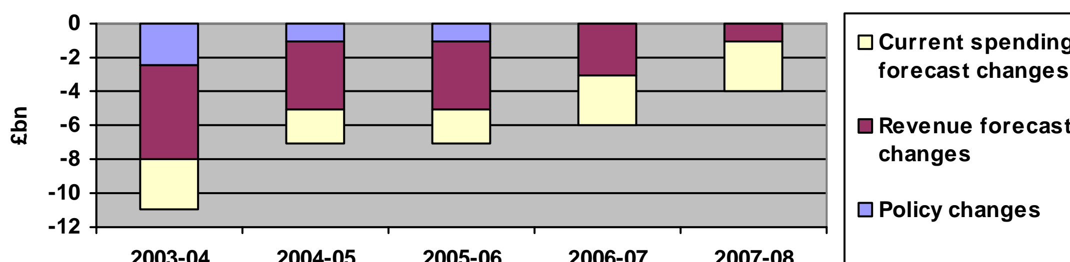
We calculate the current budget balance by deducting current expenditure and depreciation from current receipts. In the Budget the chancellor predicted that the current budget deficit would be at its deepest in 2002-03 at £11.7bn, recovering steadily thereafter. But rather than shrinking by 30 percent to £8.4bn this year as he predicted in April, over the first seven months of the current financial year the current budget deficit has been running at double last year's levels. The Treasury expects the deterioration to be less severe during the remaining five months, but it still expects the deficit for the year as a whole to be almost 65 percent up on last year at £19.3bn.

Current budget balance



The predicted deterioration in the current budget balance this year and over the remainder of the forecast period reflects a combination of deliberate policy changes announced in the PBR and other changes in forecasts of revenues and spending.

Changes in current budget balance forecasts since Budget 2003



During the current financial year the main policy change is £2.5bn in extra spending on Britain's commitments in Iraq (£2bn carried forward from the previous financial year plus £500m of extra resources announced in the PBR). In later financial years the main changes are extra spending on the child tax credit (putting the government within reach of hitting its 2004-05 child poverty target) and measures to boost productivity, offset by extra revenues from tackling tax evasion and avoidance.

Net impact of discretionary policy measures announced in the PBR

£ million	**2003-04**	**2004-05**	**2005-06**
Iraq etc	-£2,500	-£300	0
Child tax credit increase	0	-£885	-£925
Anti tax evasion	0	+£370	+£560
Other	-£20	-£155	-£290
Total	**-£2,520**	**-£970**	**-£655**

In addition to the impact of deliberate policy measures, forecasts for current spending have been raised by £2-3bn a year over the forecast period. The main contributing factors are higher-than-expected take-up of the child and working tax credits, higher expected debt interest payments, higher social security benefit spending (reflecting higher RPI inflation following the move to the new inflation target, partially offset by a lower assumption for future unemployment) and accounting adjustments.

Again excluding the impact of deliberate policy measures, the main changes to the Treasury's forecasts for current revenue over the next few years are:

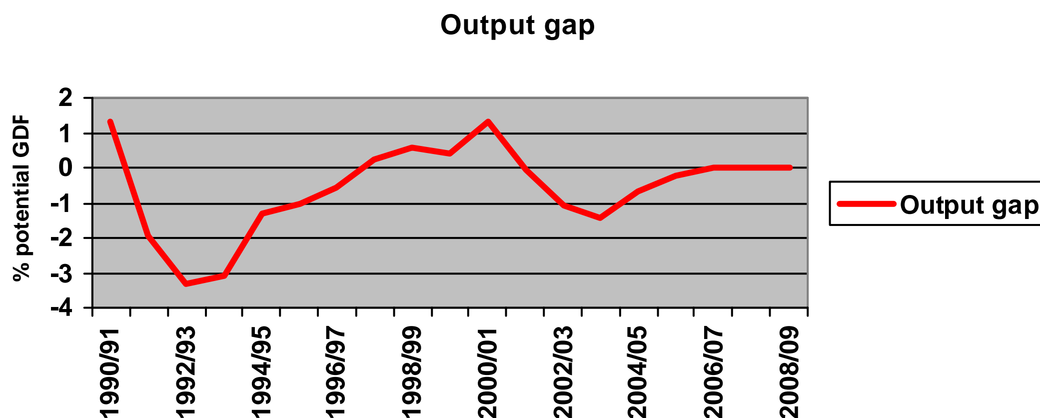
- an upward revision reflecting the fact that equity prices have risen by 20 percent since the Budget, not merely in line with money GDP as assumed. (This boosts expected future receipts from stamp duty and capital taxes);
- a downward revision reflecting the fact that wages and salaries have grown less quickly than the Treasury expected, reducing current and future expected receipts from income tax and national insurance;
- a downward revision reflecting the fact that consumer spending has grown less quickly than expected, reducing VAT and excise duty receipts (although VAT receipts per pound of consumer spending have been coming in unexpectedly strongly this year after a number of years of unexpected weakness).
- A downward revision from other factors, including lower housing transactions (affecting stamp duty) and lower-than expected oil production.

Non-policy related changes in current revenue forecasts

£billion	**2003-04**	**2004-05**	**2005-06**	**2006-07**	**2007-08**
Stock market	+£0.5	+£1	+£1.5	+£1.5	+£1.5
Low wage growth	-£3.5	-£4	-£4	-£3.5	-£3
Weak consumer spending	-£0.5	-£0.5	-£1	-£1	-£0.5
Other	-£2	-£0.5	-£1	0	+£1
Total	**-£5.5**	**-£4**	**-£4**	**-£3**	**-£1**

So what do the revisions imply for the Treasury's chances of meeting the golden rule? The Treasury focuses on performance over what it thinks of as the current economic cycle. As at the time of the Budget, it believes that this began when the economy was running at its sustainable level in 1999-2000. Output then moved above trend briefly and returned to its sustainable level in 2002-03. In the current financial year the economy is thought to be running 1.4 percent below capacity (a negative 'output gap'). The gap is expected to shrink over the next three years until the economy is back at its trend level in 2006-07. We can therefore think of the current cycle as the seven financial years running from 1999-2000 to 2005-06.

The pattern of the output gap is virtually the same as published in the Budget, despite significant upward revisions to estimates of GDP over the summer. This has been accomplished by raising the estimated trend rate of growth in the economy in the period 1997H1 to 2001Q3 from 2.61 percent a year to 2.94 percent a year. But the Treasury has left its projection of trend growth between 2001Q3 to 2006Q4 at 2.75 percent – and continues to assume 2.5 percent for projecting the public finances.



NB: Financial year averages, so mini-cycle prior to 1999-2000 not visible

The golden rule implies that the aggregate current budget balance over the seven years of the economic cycle should be in balance or in surplus. In recent Budget and Pre-Budget Report speeches, Mr Brown has quantified the government's room for manoeuvre by aggregating the past and forecast cash values of the current budget over the cycle. So in his 2003 Budget speech, for example, he noted that:

"We meet our golden rule over the cycle — not just achieving a balance but with an estimated surplus at £32 billions."

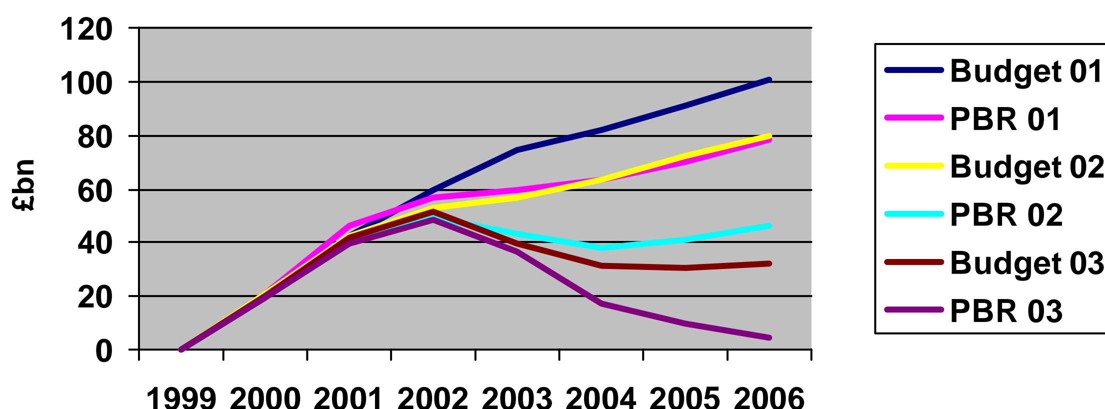
As a result of the increased borrowing forecast for this and the next two financial years, the predicted aggregate surplus has since declined. As the Pre-Budget Report noted:

"By 2005-06, when the current cycle ends under the assumptions used in these projections, the accumulated total surplus over the economic cycle will be £4½ billion." (Para B37)

The forecast over-achievement of the golden rule in the current cycle has declined even more over the past two-and-a-half years. In Budget 2001 - two years into the seven year cycle - the Treasury projected a cumulative surplus of £100bn between 1999-2000 and 2005-06.

Projecting over-achievement by such a large amount early in the cycle could be regarded as prudent, given the considerable uncertainty in forecasting the path of the public finances over the following five-year period. But there is no reason for the Treasury to seek to have over-achieved the golden rule *ex post* by a significant amount, unless public debt were at or near the 40 percent of national income ceiling and the government wished to create room for more investment. It is therefore reasonable that the forecast over-achievement of the golden rule should decline as the end of the cycle draws nearer and as the uncertainties surrounding the outturn over the remainder of the cycle diminish. However, with the forecast cumulative surplus having been reduced from £100bn in Budget 2001 to £4.5bn in PBR 2003, it is reasonable to ask whether it is prudent to have exhausted almost all the room for manoeuvre with two-and-a-half years of the cycle still to run.

Cumulative current budget surplus



Note: Figures show cumulative surplus at the end of financial year in March

In this context it is also worth bearing in mind that the "AME margin" - the contingency reserve within Annually Managed Expenditure - has now been reduced to £0.3bn in 2003-04 and to zero in the two following years. In the Budget, the AME margin is typically restored to £1bn, £2bn and £3bn over the following three years to provide scope for unexpected spending needs. To do the same in the forthcoming Budget would require the chancellor to find a net £2.7bn to restore the AME margin over the remainder of the current cycle (£1bn in 2004-05 plus £2bn in 2005-06 less the £0.3bn remaining in 2003-04). Unless this was offset by savings or tax increases elsewhere, this would further eat into the remaining £4.5bn cushion.

Assessing the rule on this basis was complicated in the PBR speech this year because the chancellor changed the basis on which he calculates the forecast cumulative surplus without explaining clearly at the time that he was doing it. This method involves adding up the annual current surpluses and deficits as percentages of GDP in the relevant years and then expressing the total in cash terms in 2005-06. This is a

more sensible way of assessing the rule, because a pound at the beginning of the cycle is worth more than a pound at the end of it.

Conveniently, it also happens to give a larger number. As the chancellor said in the PBR speech: *"...we have an average annual surplus over the whole cycle of around 0.2 percent of GDP - meeting our first rule in this cycle by a margin of £14 billion"*. The degree of overachievement forecast in earlier Budget and PBR speeches would also have been larger if the calculations had been carried out on this basis.

Whichever way you calculate the likely over-achievement, the figure is relatively modest when you consider that the average error in forecasting public sector net borrowing (the current budget balance plus public sector net investment) one year ahead has in recent years been 1 percent of GDP or £10 billion in today's prices.

Perhaps worryingly for the Treasury, the direction of its one-year ahead forecast errors has moved in a negative direction since the beginning of this economic cycle. The forecast was around 2 percent of GDP too pessimistic for 1999-2000, 1 percent of GDP too pessimistic in 2000-01, 0.5 percent of GDP too optimistic in 2001-02 and 1 percent of GDP too optimistic in 2002-03. If the PBR forecast is correct, the one-year ahead forecast for this financial year will again have been around 1 percent of GDP too optimistic.

In past Budgets and Pre-Budget Reports the Treasury has also underlined its room for manoeuvre in meeting the golden rule by asserting that it would be met if the level of trend output were one percent lower than is assumed in the central case. (This would reduce the structural current budget balance by around 0.7 percent of GDP each year and also affect the timing of the cycle.) The PBR indicates that the golden rule is no longer met on this basis (and the sharp-eyed will note that in Chart B2 it has started shading the area beneath the central case rather than beneath the cautious one).

But, as the PBR points out, in principle it is reasonable to reduce the caution you seek as you get closer to the end of the cycle, if you believe it is less likely that you will have to revise your assessment of trend output. Whether recent GDP revisions mean we are in fact more confident about the size of the output gap is open to debate. The current Treasury estimate appears relatively large by the standards of other forecasters.

Deciding how much caution you want to build into your forecasts for the public finances at different points in the economic cycle is a complicated and opaque question of judgement. It depends in part on how confident you want to be at any given point that existing policies will be consistent with meeting the golden rule when the cycle ends. The Treasury is not explicit about this. It could say, for example, that bearing in mind the size of forecast errors in the past it wished to be 80 percent certain of meeting the target on unchanged policies at any given time.

As the end of the cycle approaches, judgements of this sort could have important policy implications. Imagine that in Budget 2004 the Treasury expected to meet the golden rule exactly but that in PBR 2004 it unveiled forecast revisions of a similar magnitude to those announced last week - reducing the current budget balance by 0.9 percent of GDP in 2004-05 and 0.6 percent of GDP in 2005-06. This would imply that

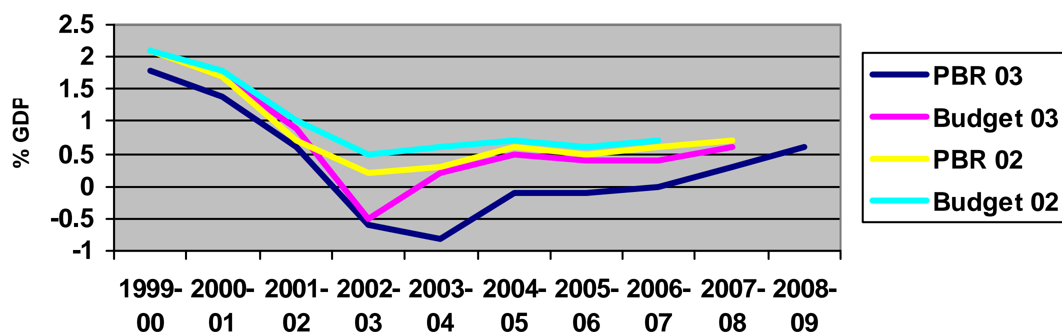
the government expected to miss the golden rule by an average of around 0.2 percent of GDP over the cycle. Do we really believe the government would tighten policy by an extra 1.5 percent of GDP - around 5p on the basic rate of income tax - for one year simply so it could once again expect to meet the golden rule on its central forecast?

Questions of this sort underline the problem in focusing on the achievement of the golden rule between two essentially arbitrary dates. It would be better to pose the following question: are current tax rates and spending plans consistent with expecting to meet the golden rule in the future over some appropriate medium term time horizon? There is an analogy here with monetary policy. We do not ask the Bank of England to try to get CPI inflation to average 2 percent over a defined economic cycle, but rather to set interest rates now at a level that will be consistent with hitting the inflation target approximately two years ahead - effectively a rolling target.

It is possible to get a snapshot of whether policy is consistent with the golden rule on this basis by looking at a cyclically adjusted measure of the current budget balance - in other words asking what the deficit or surplus would be if the output gap were zero.

A year ago, the Treasury expected the cyclically adjusted budget to be in surplus through to the end of the end of the then forecasting period in 2007-08. In this year's Budget, it was assumed that this structural balance would dip into deficit by 0.5 percent of GDP in 2002-03 (in part reflecting the one-off costs of the Iraq war) before rebounding to a surplus of 0.2 percent of GDP this year.

But higher forecast government borrowing - together with little change in estimates of the output gap - mean the structural balance is now thought to have been in deficit by 0.6 percent of GDP last year. It is expected to widen to 0.8 percent of GDP this year and to remain in modest deficit for the following two years. Balance should be restored in 2006-07, with surpluses thereafter of 0.3 percent of GDP in 2007-08 and 0.6 percent of GDP in 2008-09. In other words, although the underlying fiscal position looks worse over the next few years, the underlying budget balance is expected to move back into surplus on unchanged policies and therefore to be consistent with meeting the golden rule on a forward-looking basis.



To assess whether the chancellor can credibly claim that policy is consistent with the golden rule on this basis we need to ask whether he is correct about the relative extent

to which past and expected changes in the budget balance reflect cyclical and structural components, and - if he is - whether it is realistic to expect the structural budget position to move from a deficit of 0.8 percent of GDP to a surplus of 0.6 percent of GDP over five years on unchanged policies.

The IFS has been concerned in the past that the chancellor may be over-optimistic about the extent to which tax revenues will recover as the economy moves back towards trend. In particular, we wondered whether it was sensible to assume that corporation tax revenues would rise to 3.4 percent of GDP in 2007-08, a level achieved in the past (on a comparable basis) only when the economy was running well above potential or when the stock market boom was boosting the profits of the financial sector. We argued that assuming a return to the long-run average of 2.9 per cent of GDP might be more prudent. In the PBR, the Treasury has reduced its medium term forecast for corporation tax revenues to 3.2 percent of GDP in 2007-08 and 2008-09. We will revisit this question in next month's Green Budget.

The PBR also underlines the uncertainty currently surrounding trends in the yield of VAT as a proportion of consumer spending. The Treasury assumes that the ratio of VAT to consumer spending falls by 0.05 percentage points a year. In the first three years of the current cycle the decline was in fact 0.11 percentage points a year, resulting in overly optimistic VAT forecasts. But recent data suggest that the ratio this year may be increasing by 0.3 percentage points to 9.6 percent. Customs and Excise is not sure why and is therefore reviewing the assumption. It will have a new estimate to be audited by the National Audit Office before the Budget.

One notable feature of the Treasury's fiscal projections is the apparently spontaneous tightening in policy by 0.3 percent of GDP a year in 2007-08 and 2008-09 - the basis upon which one can argue that the fiscal position will be strengthening into the next economic cycle.

One explanation is "fiscal drag", which forces us to look more closely at what we mean by "unchanged" tax policies. Projections for the public finances are based on the assumption that tax allowances and thresholds are indexed in line with inflation. But earnings typically rise by more than inflation, which means that over time a higher proportion of people's earnings fall into the higher tax brackets.

In consequence, we see the share of GDP taken in income tax rising from 11.3 percent in 2006-07 to 11.6 percent in 2008-09, at a time when the output gap is constant. The longer fiscal drag continues, the greater the impact each year as the higher rate threshold moves down into the more densely populated parts of the income distribution.

Thanks to fiscal drag and the freezing of the personal allowance this year, the effective higher rate threshold (i.e. the basic rate limit plus the personal allowance) has fallen from 161 percent of average earnings in 1996-97 to 143 percent in 2003-04, which has seen the number of higher rate taxpayers rise from 2.1 million to 3.3 million. The Treasury deliberately does not publish its assumptions about earnings growth looking forward, for fear of being seen to define a "going rate". But if we were to assume that earnings rose by 2 percent a year on top of inflation (slightly less than the trend rate of increase in productivity), then the effective higher rate threshold

would drop to 129 percent of average earnings over the next five years. This would increase the number of people paying higher rate income tax to more than 4 million by 2008-09. The increase would be larger still if the dispersion of pre-tax incomes in the population continues to widen as it has in the past.

The tightening into the next economic cycle is larger than predicted in the Budget in part because higher forecast inflation in the medium term reduces the indicative cash spending plans for departments in the Budget as a share of GDP. Current spending is now expected to fall from 38.6 percent of GDP in 2007-08 to 38.5 percent in 2008-09.

Public spending: Average annual real % increase until 07-08		
	Budget 03	PBR 03
Total managed expenditure	3.3	3.1
PSNI	10.4	11.6
Current DEL	3.5	3.1
Current AME	2.2	2.2
Current UK NHS DEL	3.9	3.8
Current UK non-NHS DEL	3.3	2.8

In our Green Budget next month we will examine the PBR forecasts in more detail and assess them against the benchmark of the chancellor's fiscal rules. At this stage a number of questions (not all of which we will try to answer) suggest themselves:

- Are the Treasury's public finance projections based on a sensible assessment of the size of the output gap and of the trend growth rate of the economy?

- Is it realistic to expect the structural budget position to improve by 1.4 percent of GDP over the next five years on "unchanged" tax and spending policies?

- Is it politically realistic to assume a further significant rise in the number of people paying higher rate income tax over the next five years?