5. Green Budget public finance forecasts

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Summary

- Public sector net borrowing and the current budget deficit are likely to be £2.5 billion bigger this year, and £4.8 billion bigger next year, than forecast in the October 2007 Pre-Budget Report.
- Assuming that the economy evolves largely as the Treasury expects, but with corporation tax receipts only bouncing back to their long-term average by 2012–13 and with weaker growth in stamp duty revenues from both property and share transactions, by 2012–13 we are around 0.5% of national income – or £8 billion in today's terms – less optimistic than the Treasury about the current budget balance.
- In today's terms, we expect the current budget to be in surplus by £8 billion in five years' time, roughly £18 billion stronger than now. Of this improvement, half reflects a rise in the tax burden and half cuts in public spending after 2007–08.
- Despite this, we believe that without a further tightening the golden rule would be more likely to be missed than met unless the economic cycle that the Treasury believes began in 2006–07 runs for 10 years or more.
- We also forecast higher public sector net debt than the Treasury, expecting it to rise by 3½% of national income by 2012–13. In the absence of new policy announcements, we believe that it is more likely than not that debt will breach the 40% of national income ceiling that Mr Brown chose to adhere to when he was Chancellor – even ignoring the potential impact of Northern Rock.
- If the Chancellor wants to keep net debt below 40% of national income and maintain the improvement in the current budget balance that he was looking for in the PBR, we believe that he would need to announce tax increases worth around £8 billion. This seems unlikely, given the government's political constraints and the outlook for the economy. But there is scope for the Bank of England to offset the impact of a modest fiscal tightening on growth and inflation, so taking some action to underpin the fiscal position now would be prudent.

5.1 Introduction

This chapter presents the IFS public finance forecasts and discusses them in the context of the fiscal rules. Section 5.2 presents the 2008 Green Budget forecasts for 2007–08 and 2008–09, using as a baseline the assumption that the economy evolves largely as the Treasury predicted in the October 2007 Pre-Budget Report (PBR), but where, as we shall see, revenues from both corporation tax and stamp duty are noticeably weaker. Section 5.3 looks at the medium-term prospects for the public finances (up to 2012–13), based on the same underlying economic assumptions. Section 5.4 compares our baseline forecasts with forecasts based on the alternative macroeconomic assumptions outlined by Morgan Stanley in Chapter 4. Finally, Section 5.5 examines whether or not the Chancellor would meet the fiscal rules under our forecasts and what this implies for tax and spending decisions in the next and future Budgets.

5.2 Short-term projections

In 2006–07, receipts came in just over £1 billion higher than the Treasury had forecast in its Pre-Budget Report in December 2006 and about £½ billion higher than we forecast in the January 2007 Green Budget, as shown in Table 5.1. The out-turn for the current budget was further strengthened relative to these earlier forecasts by current spending coming in £1.9 billion below the Treasury's forecast and £3.9 billion below our Green Budget forecast. This was the result of unexpectedly slow growth in current spending over the last five months of 2006–07. As a result, the current budget deficit was £3.2 billion smaller than the Treasury forecasted in its 2006 Pre-Budget Report and £4.5 billion smaller than we forecast in last year's Green Budget. On top of this, lower-than-forecast investment spending meant that public sector net borrowing in 2006–07 was £5.8 billion lower than the Treasury forecasted in December 2006 and £7.1 billion lower than we forecasted in January 2007. For more details on the components of these forecasts and out-turns, see Appendix A.

Table 5.1. Comparison of forecasts for 2006–07

£ billion	**HM Treasury PBR forecast, December 2006**	**IFS Green Budget forecast, January 2007**	**Estimate, PBR, October 2007**
Current receipts	517.9	518.5	519.1
Current expenditure[a]	525.7	527.7	523.8
Net investment	28.9	28.9	26.3
Public sector net borrowing	36.8	38.1	31.0
Surplus on current budget	–7.9	–9.2	–4.7

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

Sources: Out-turn figures for 2006–07 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). Forecasts from HM Treasury, *Pre-Budget Report 2006*, December 2006 (http://www.hm-treasury.gov.uk/pre_budget_report/prebud_pbr06/prebud_pbr06_index.cfm) and table 5.2 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/index.php).

Borrowing in 2007–08

Table 5.2 provides an overview of the Treasury's and the January 2008 Green Budget baseline projections for receipts, spending and borrowing in the current financial year. Though the October 2007 Pre-Budget Report did revise down the Treasury's previous, Budget 2007, forecast for receipts in 2007–08, the 2008 Green Budget baseline forecast for 2007–08 is that receipts will be a further £2.5 billion lower than PBR 2007 expected. Our baseline estimate for current spending and net investment in 2007–08 is that they will be the same as the Treasury's PBR forecast. Therefore, our baseline forecast for the current budget deficit in 2007–08 is that it will be £2.5 billion larger (at £10.8 billion) than the PBR 2007 forecast suggested. Similarly, we expect borrowing in 2007–08 to be £2.5 billion higher than the Treasury's forecast (at £40.5 billion).

Table 5.2. Comparison of forecasts for government borrowing, 2007–08

£ billion	Budget, Mar. 07	PBR, Oct. 07	Green Budget, Jan. 08	Differences in Green Budget forecast relative to: Budget	PBR
Current receipts	553	551.2	548.7	–4.3	–2.5
Current expenditure[a]	558	559.5	559.5	+1.5	0.0
Net investment	29	29.7	29.7	+0.7	0.0
Total managed expenditure	587	589.2	589.2	+2.2	0.0
Public sector net borrowing	34	38.0	40.5	+6.5	+2.5
Surplus on current budget	–4	–8.3	–10.8	–6.8	–2.5

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

Sources: Treasury forecasts 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 HM Treasury, *Budget 2007: Financial Statement and Budget Report*, March 2007 (http://www.hm-treasury.gov.uk/budget/budget_07/report/bud_budget07_repindex.cfm).

Receipts and spending in 2007–08

The 2008 Green Budget forecast for receipts in 2007–08 is £2.5 billion lower than the Treasury's 2007 PBR projection. Table 5.3 shows the forecast for receipts in 2007–08 (and also that for 2008–09) broken down into the constituent taxes. For most taxes, we expect revenues in 2007–08 to be in line with the Treasury's PBR forecast. There are two exceptions to this – corporation tax and stamp duty.

Over the first nine months of this financial year, corporation tax receipts are fractionally below those received over the same period last year (–0.3%). Therefore, in the light of this evidence, we forecast that corporation tax revenues will be the same in cash terms as in 2006–07, which was £44.3 billion. This is £2.0 billion below the Treasury's latest forecast of £46.3 billion. Figures for corporation tax receipts in January 2008 – set to be released by the Office for National Statistics on Thursday 21 February 2008 – will give a clear indication of the likely level of corporation tax receipts in 2007–08 and the extent to which the impact of the recent turmoil in certain financial markets on the public finances in this financial year is smaller or greater than we or the Treasury expect.

For stamp duty revenues, we assume that the yield from stamp duty land tax is the same in nominal terms over the remaining three months of this financial year as they were in the same period last year, which would be the case if house prices were the same in cash terms and if there were no change in the number of housing transactions. For stamp duty revenues from share transactions, our forecast attempts to take into account stock-market movements that have occurred in January 2008 by assuming that the revenues from this tax over the last three months of this financial year will be around 5% lower in cash terms than they were during the same period in 2006–07.

Table 5.3. Comparison of Green Budget and HM Treasury forecasts for government borrowing, 2007–08 and 2008–09

£ billion	2007–08		2008–09	
	PBR Oct. 2007	*Green Budget Jan. 2008*	*PBR Oct. 2007*	*Green Budget Jan. 2008*
Income tax (net of tax credits)	149.6	149.6	156.9	156.9
National Insurance contributions	96.5	96.5	101.0	102.7
Value added tax (VAT)	81.4	81.4	85.8	84.8
Corporation tax (net of tax credits)	46.3	44.3	50.9	47.8
Petroleum revenue tax	1.5	1.5	1.5	1.5
Fuel duties	24.9	24.9	26.2	26.2
Capital gains tax	4.8	4.8	5.4	5.4
Inheritance tax	3.9	3.9	3.3	3.3
Stamp duties	15.1	14.6	15.8	13.6
Tobacco duties	8.1	8.1	7.8	7.8
Spirits duties	2.3	2.3	2.3	2.3
Wine duties	2.6	2.6	2.8	2.8
Beer and cider duties	3.3	3.3	3.4	3.4
Betting and gaming duties	1.4	1.4	1.4	1.4
Air passenger duty	2.0	2.0	2.1	2.1
Insurance premium tax	2.4	2.4	2.5	2.5
Landfill tax	0.9	0.9	1.1	1.1
Climate change levy	0.7	0.7	0.7	0.7
Aggregates levy	0.3	0.3	0.4	0.4
Customs duties and levies	2.4	2.4	2.3	2.3
Total HM Revenue and Customs	**450.4**	**447.9**	**473.7**	**469.0**
Vehicle excise duties	5.5	5.5	5.9	5.9
Business rates	21.9	21.9	24.1	24.1
Council tax[a]	23.7	23.7	24.9	24.9
Other taxes and royalties[b]	15.3	15.3	16.0	16.0
Net taxes and NI contributions[c]	**516.8**	**514.3**	**544.5**	**539.9**
Accruals adjustments on taxes	1.5	1.5	2.4	2.4
Less Own resources contribution to EU budget	–4.7	–4.7	–4.8	–4.8
Less PC corporation tax payments	–0.2	–0.2	–0.2	–0.2
Tax credits adjustment[d]	0.5	0.5	0.6	0.6
Interest and dividends	7.6	7.6	7.5	7.5
Other receipts[e]	29.7	29.7	31.0	31.0
Current receipts	**551.2**	**548.7**	**581.0**	**576.4**

[a] PBR figures are based on stylised assumptions rather than government forecasts, as council tax increases are determined annually by local authorities, not by the government.

[b] Includes VAT refunds and money paid into the National Lottery Distribution Fund.

[c] Includes VAT and the traditional 'own resources' contributions to the EU budget.

[d] Tax credits that are scored as negative tax in the calculation of 'Net taxes and NI contributions' but expenditure in the National Accounts.

[e] Includes gross operating surplus and rent; net of oil royalties and business rates payments by local authorities.

Sources: PBR forecasts from HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 (http://www.hm-treasury.gov.uk/pbr_csr/report/pbr_csr07_repindex.cfm); this table is similar to table B8 on page 168. Authors' calculations.

We assume that current spending will be in line with the Treasury's forecast from PBR 2007. This forecast that current spending in 2007–08 would be £559.5 billion – slightly above the Treasury's Budget 2007 forecast of £558 billion. Growth in current spending over the first nine months of this financial year has been below that forecast by the Treasury for the year as a whole. This is particularly true of current spending by central government departments on public services. Over the first nine months of 2007–08, this has been 5.3% higher than the same months of 2006–07, whereas the Treasury forecast implies that it will grow by 6.5% over the year as a whole. If this lower growth rate were to continue for the remaining three months, current spending by central government departments on public services would come in £3.9 billion below the Treasury's forecast. However, in 2006–07 only 24.9% of total spending for the year was carried out in the last three months, which was significantly below the 25.9% that occurred during the last three months of 2005–06. If it is the case that there was an unusual squeeze in spending during the last three months of 2006–07 and that in fact the pattern of spending over the year in 2005–06 is more typical, this would imply that spending for 2007–08 as a whole would actually come in £0.9 billion higher than the Treasury's forecast. We therefore assume that the Treasury's forecast for current spending (which lies somewhere between these two scenarios) is correct. However, these figures – and the relatively large errors in the forecasts for current spending in 2006–07 made by both the December 2006 Pre-Budget Report and the January 2007 IFS Green Budget (as shown in Table 5.1) – highlight the uncertainty around these forecasts.

Borrowing in 2008–09

The October 2007 Pre-Budget Report revised the forecast for the current budget balance in 2008–09 down by £7 billion – from a forecast surplus of £3 billion to a forecast deficit of £4 billion (see Table 5.4). Since policy measures introduced in the 2007 Pre-Budget Report had very little effect on the current budget in 2008–09 (they are set to result in only an estimated £400 million deterioration in the current budget) and the forecast for spending was only increased by £1 billion, this downward revision to the current budget balance mostly reflected downward revisions to the underlying strength of current receipts. The 2008 Green

Table 5.4. Comparison of forecasts for government borrowing, 2008–09

£ billion	**Budget, Mar. 07**	**PBR, Oct. 07**	**Green Budget, Jan. 08**	**Differences in Green Budget forecast relative to:**	
				Budget	**PBR**
Current receipts	586	581.0	576.4	–9.6	–4.6
Current expenditure[a]	584	585.1	585.2	+1.2	+0.2
Net investment	32	32.3	32.3	+0.3	+0.0
Total managed expenditure	616	617.4	617.5	+1.5	+0.2
Public sector net borrowing	28	36.4	41.2	+13.2	+4.8
Surplus on current budget	3	–4.1	–8.9	–11.9	–4.8

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

Sources: Treasury forecasts 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 HM Treasury, *Budget 2007: Financial Statement and Budget Report*, March 2007 (http://www.hm-treasury.gov.uk/budget/budget_07/report/bud_budget07_repindex.cfm).

Box 5.1. Company earnings and corporation tax revenues

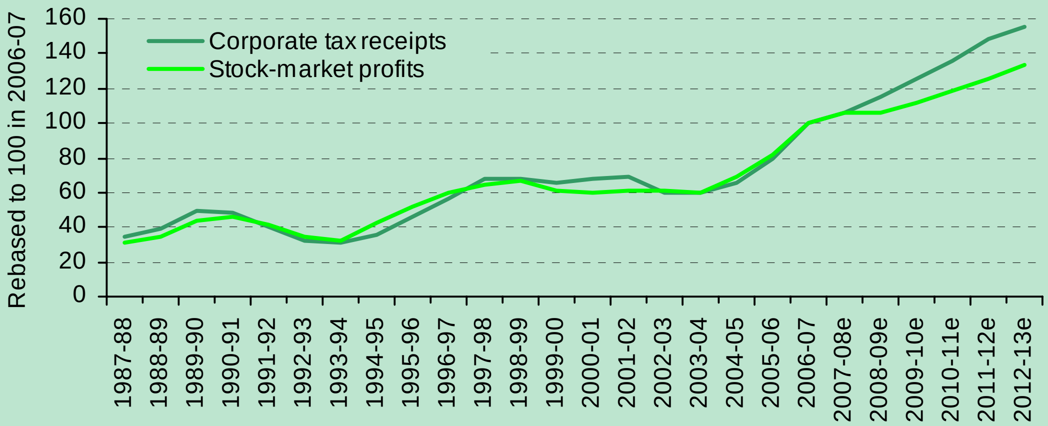
By Graham Secker (Morgan Stanley)

In recent years, we have highlighted the ambitious forecasts that the government has factored in for corporation tax receipts. The October 2007 Pre-Budget Report is the sixth consecutive PBR to see a downward revision to corporate tax receipt expectations from the previous Budget. In the latest PBR, the government reduced its corporation tax forecasts by £3.3 billion in 2007–08 and £3 billion in 2008–09. These represent the biggest downgrades seen since 2002. The government is now anticipating that corporate tax receipts will grow by just 4% in 2007–08 and by 10% in 2008–09. While this forecast growth is lower than in any of the last five PBRs, we believe the government is still too optimistic as we expect that growth in corporate profits will slow sharply over the next year.

In fact, according to provisional data from the Office for National Statistics, corporate tax receipts have already started to slow significantly, with receipts in the four quarters to the end of Q3 2007 running 3% lower than the four-quarter period to the end of Q3 2006. While we believe that profits reported by companies listed on the UK stock market will show modest growth in 2007–08, we currently forecast zero growth for 2008–09. The reason for our pessimism on the outlook for stock-market profits is the prospect of a significant slowdown in the domestic and global economy, as highlighted by the fall in share prices seen both in the UK and elsewhere in January 2008.

In the last three Green Budgets, we have included a graph showing how much more optimistic the Treasury is about growth in corporate tax receipts than we are in corporate earnings growth. Figure 5.1 contains an update of this analysis; it shows a divergence between HMT's view on corporate tax receipts and Morgan Stanley's view on stock-market earnings. Over the next five years, HMT forecasts non-North-Sea corporate tax receipts to grow at an average of 8% per annum; this compares with our own forecast of 5% (this constitutes 0% in 2008–09 and 6% growth thereafter – the latter is the average nominal earnings growth of the UK stock market since 1960). Based on HMT's forecast of £40.7 billion of non-North-Sea corporation tax receipts in 2007–08, the difference between these two growth rates equates to £8 billion in 2012–13.

Figure 5.1. Treasury forecasts for corporation tax revenues and Morgan Stanley forecasts for UK stock-market growth



Note: Stock-market profits from 2007–08 onwards are based on Morgan Stanley forecasts.
Sources: ONS; MSCI; Morgan Stanley Research.

Budget forecasts a current budget deficit of £8.9 billion and net borrowing of £41.2 billion, which are both £4.8 billion worse than the Treasury's latest forecast.

Receipts and spending in 2008–09

The October 2007 Pre-Budget Report revised down current receipts by £5 billion relative to the forecast made in the March 2007 Budget. A small part of this revision (around £350 million) reflected new policy changes announced in PBR 2007. Most of the rest of the downward revision is due to the expected impact of the financial market disruption that occurred during Summer 2007, lower-than-expected oil and gas production which is expected to depress North Sea oil revenues and changes to the economic forecasts for earnings growth in 2008. This downward revision to the Treasury's receipts forecast was accompanied by a slight (£1 billion) upward revision to the forecast for current spending in 2008–09.

Relative to the Treasury's forecast from the 2007 Pre-Budget Report, the 2008 Green Budget forecast for 2008–09 is that receipts will be £4.6 billion lower and spending £0.2 billion higher. The latter reflects the debt interest payments that will be required to service the additional borrowing that we forecast will be necessary in 2007–08 (discussed above).

As shown in Table 5.3, the two biggest discrepancies between the January 2008 Green Budget forecast and the October 2007 Pre-Budget Report forecast for receipts in 2008–09 are for receipts of corporation tax and stamp duties. We forecast corporation tax receipts (which, due to the timing of tax payments, are dependent on both lagged and contemporaneous corporate profits) on the basis that corporate profits in 2007–08 and 2008–09 grow in line with Morgan Stanley's central forecast of 6% and 0% respectively (see Box 5.1 for more details). Since this growth rate is considerably below that implied by the Treasury's forecast for growth in underlying corporation tax receipts and because our forecast for corporation tax receipts in 2007–08 is £2 billion lower than the Treasury's, the 2008 Green Budget baseline forecast for corporation tax receipts in 2008–09 is £47.8 billion, £3.1 billion lower than the Treasury's 2007 Pre-Budget Report forecast.

We are also forecasting lower stamp duty revenues in 2008–09 than the Treasury. In part, this is due to us taking into account the impact of stock-market movements since the start of 2008 on revenues from stamp duty on share transactions. In addition, for receipts of stamp duty land tax, we use evidence from market expectations of the future path of the HBOS house price index. This suggests that house prices are expected to decline in nominal terms by 7½% in 2008, which if it were to occur might also be accompanied by a sharp decline in the volume of transactions. Therefore we assume that both of these factors will depress revenues from stamp duty land tax and so are forecasting receipts from stamp duty overall to be £2.2 billion lower than the Treasury expects.

5.3 Medium-term prospects

Over the medium term, we expect the near-term gap between the Green Budget and PBR current budget balance forecasts to widen until 2009–10 and decline slightly thereafter (Tables 5.5 and 5.6). The Green Budget forecasts a deficit £4.8 billion – or 0.3% of national income – bigger than the PBR in 2008–09, a gap that widens to £11 billion – or 0.7% of

Table 5.5. Medium-term public finance forecasts under Pre-Budget Report 2007 assumptions

£ billion	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13
Green Budget forecasts						
Current budget						
Current receipts	548.7	576.4	605	640	678	716
Current expenditure[a]	559.5	585.2	613	642	673	706
Surplus on current budget	**–10.8**	**–8.9**	**–8**	**–2**	**5**	**10**
Capital budget						
Net investment	29.7	32.3	34	37	39	42
Public sector net borrowing	**40.5**	**41.2**	**41**	**39**	**34**	**32**
HM Treasury forecasts						
Current budget						
Current receipts	551.2	581.0	616	651	686	724
Current expenditure[a]	559.5	585.1	613	642	672	705
Surplus on current budget	**–8.3**	**–4.1**	**3**	**9**	**14**	**20**
Capital budget						
Net investment	29.7	32.3	34	37	39	42
Public sector net borrowing	**38.0**	**36.4**	**31**	**28**	**25**	**23**

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

Sources: Authors' calculations. Treasury forecasts 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); this table is similar to table B5 on page 165.

national income – in 2009–10. By the end of the forecast period, the difference is £10 billion or 0.5% of national income. Given the uncertainties around both forecasts (judging from past forecasting performance), these are not very large differences.

Over the coming five years, we expect the current budget balance to move from a deficit of 0.8% of national income in 2007–08 to a surplus of 0.6% of national income in 2012–13. Of this 1.3% of national income forecast improvement (£19 billion in today's terms), half (0.7% of national income or £9 billion) comes from a forecast rise in the tax burden and the remaining half (0.7% of national income or £10 billion) from a forecast cut in current spending as a share of national income. Over the same period, the PBR has broadly the same reduction in current spending, but with a 0.2% of national income larger forecast increase in the tax burden.

For current spending, we assume that the Treasury keeps to the departmental spending plans set out in the Comprehensive Spending Review for 2008–09, 2009–10 and 2010–11. Our forecast is for slightly higher overall spending in these years due to slightly higher debt interest payments arising from higher borrowing in earlier years. For 2011–12 and 2012–13 – years for which departmental spending plans will presumably be set out in a spending review in 2009 – we assume that growth in nominal spending is the same as that implied by the figures contained in the October 2007 PBR. This would lead to spending continuing to fall as a share of national income and, as described in Chapter 7, could have implications for the government's aspirations to reduce poverty both in the UK and overseas while progressing towards the delivery of 'world-class' public services.

Table 5.6. Medium-term public finance forecasts under Pre-Budget Report 2007 assumptions

% of national income	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13
Green Budget forecasts						
Current budget						
Current receipts	39.1	39.2	39.1	39.3	39.6	39.7
Current expenditure[a]	39.9	39.8	39.6	39.4	39.3	39.2
Surplus on current budget	**–0.8**	**–0.6**	**–0.5**	**–0.1**	**0.3**	**0.6**
Capital budget						
Net investment	2.1	2.2	2.2	2.3	2.3	2.3
Public sector net borrowing	**2.9**	**2.8**	**2.7**	**2.4**	**2.0**	**1.8**
Public sector net debt	**37.8**	**38.9**	**40.0**	**40.7**	**41.0**	**41.2**
HM Treasury forecasts						
Current budget						
Current receipts	39.3	39.5	39.7	39.9	40.0	40.2
Current expenditure[a]	39.9	39.8	39.5	39.4	39.2	39.1
Surplus on current budget	**–0.6**	**–0.3**	**0.2**	**0.6**	**0.8**	**1.1**
Capital budget						
Net investment	2.1	2.2	2.2	2.3	2.3	2.3
Public sector net borrowing	**2.7**	**2.5**	**2.0**	**1.7**	**1.5**	**1.3**
Public sector net debt	**37.6**	**38.4**	**38.8**	**38.9**	**38.8**	**38.6**

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

Sources: Authors' calculations. Treasury forecasts 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); this table is similar to table B6 on page 165.

On the receipts side, the main difference between the Green Budget forecast and the October 2007 PBR forecast is the projected growth in receipts between 2008–09 and 2009–10. The Green Budget projection is for receipts to grow by 5.0% in nominal terms (which is slightly below expected growth in the economy), whereas the October 2007 PBR forecast is for them to grow by 6.0% – a full percentage point faster than our projection. The underlying cause of this is the different view we take over corporation tax receipts. Our projected growth in corporation tax receipts in 2009–10 is depressed by the lagged effect of us taking Morgan Stanley's forecast of no growth in corporate profits in 2008–09. Over the three years from 2010–11 to 2012–13, we assume that corporation tax receipts grow strongly and return to their long-run average. The next section discusses the composition of receipts in more detail.

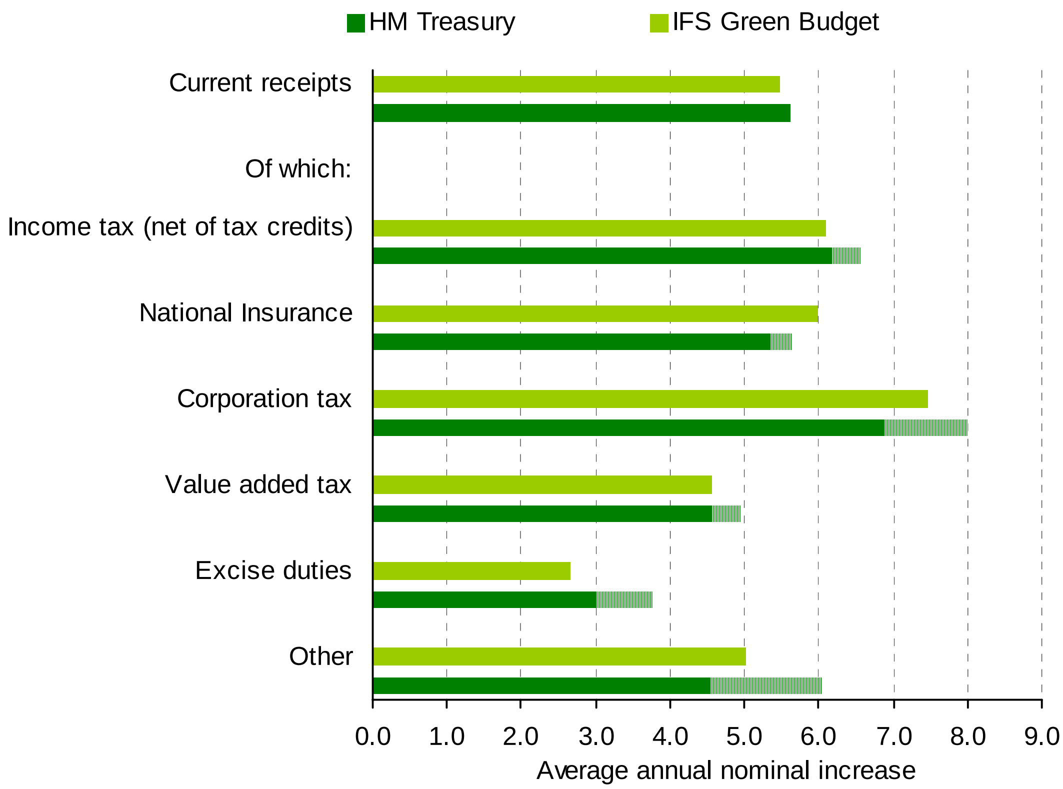
The Green Budget forecasts for net investment are in line with the PBR ones throughout the forecast period. Consequently, the profile for public sector net borrowing over the medium term tracks that of the current budget, with borrowing in every year being higher under the Green Budget forecasts than under the PBR forecasts.

The higher borrowing forecasts mean that we have higher forecasts than the Treasury for public sector net debt right through to 2012–13. As discussed in Section 3.3, the sustainable investment rule required that public sector net debt be kept below 40% for all the years of the economic cycle that the Treasury believes covered the financial years from 1997–98 to 2006–07. Despite the fact that it believes a new cycle has begun, the Treasury has not yet announced how it will assess compliance with the rule over this new cycle. The Green Budget forecast is that net debt will be at 40% of national income in 2009–10 and then continue to climb further – albeit by a relatively small amount – for the rest of the forecast period.

Breakdown of medium-term revenue projections

Figure 5.2 shows the average annual nominal growth rate for each major component of tax revenues under the Green Budget projection over the period from 2007–08 to 2012–13. These are compared with the Treasury's October 2007 projections. Comparing the two medium-term projections is hampered by a lack of availability of detailed forecasts from the Treasury, since the PBR only shows limited information on the composition of its medium-term revenue projections and rounds revenues from each of the categories to the nearest 0.1% of national income. As a result, a lower and upper bound on the Treasury's projection are shown in the graph (the range between these bounds being shown by the striped region).

Figure 5.2. PBR and IFS forecasts for revenue growth, 2007–08 to 2012–13

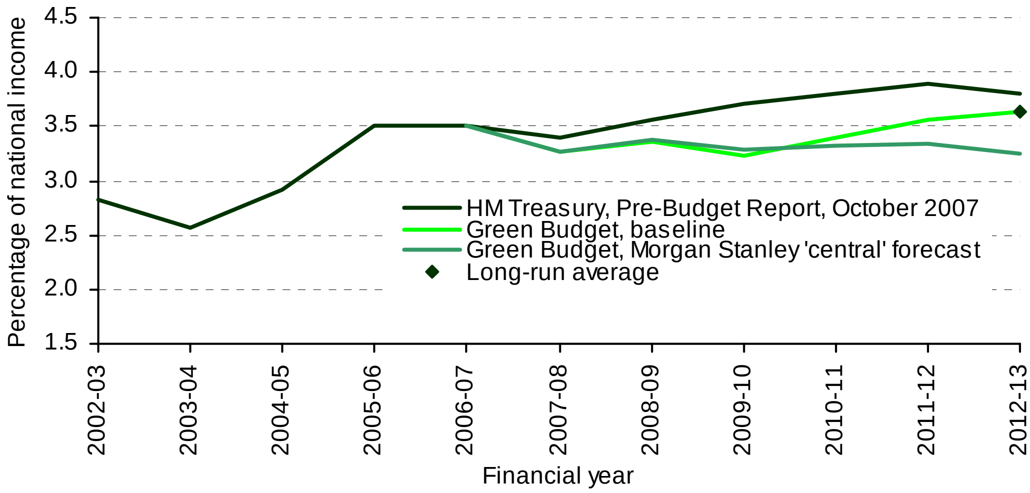


Note: Corporation tax includes petroleum revenue tax.
Sources: Authors' calculations. Treasury forecasts from HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 (http://www.hm-treasury.gov.uk/pbr_csr/report/pbr_csr07_repindex.cfm).

Overall, the Green Budget projection is for very slightly lower growth in tax (and non-tax) revenues from a slightly lower base. Between 2007–08 and 2012–13, the Green Budget forecasts show slightly weaker growth in income tax (net of tax credits) and stronger growth in National Insurance contributions. Growth in corporation tax receipts over the entire period is forecast to be the about the same as the Treasury expects. However, there are two key differences. First, by assuming that corporate profits follow Morgan Stanley's forecast in 2008–09 and 2009–10, we are assuming lower growth in receipts in the early part of the forecast horizon than in the later part. Second, we forecast that corporation tax revenues will be £2.0 billion lower in 2007–08 and therefore, although we have a similar growth rate over the following five years, it is from a lower base. These two factors are shown in Figure 5.3, which presents the Treasury's forecast for corporation tax receipts (including petroleum revenue tax) over the next five years and the Green Budget baseline forecasts, as well as the forecast using Morgan Stanley's central macroeconomic forecast (which assumes that corporate profits grow at 6% a year in the medium term; see Box 5.1).

There is little difference in forecast growth in VAT revenues. The Green Budget forecast is for excise duties to grow less quickly than the Treasury expects, which reflects the assumed elasticity of these tax receipts for any given increase in the tax base.

Figure 5.3. Forecasts for corporation tax receipts under HM Treasury and Green Budget assumptions



Note: Corporation tax includes petroleum revenue tax. Morgan Stanley central forecast is for lower nominal national income in all years from 2007–08 onwards than HM Treasury Pre-Budget Report forecasts suggest.
Sources: Authors' calculations. Treasury forecasts 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).

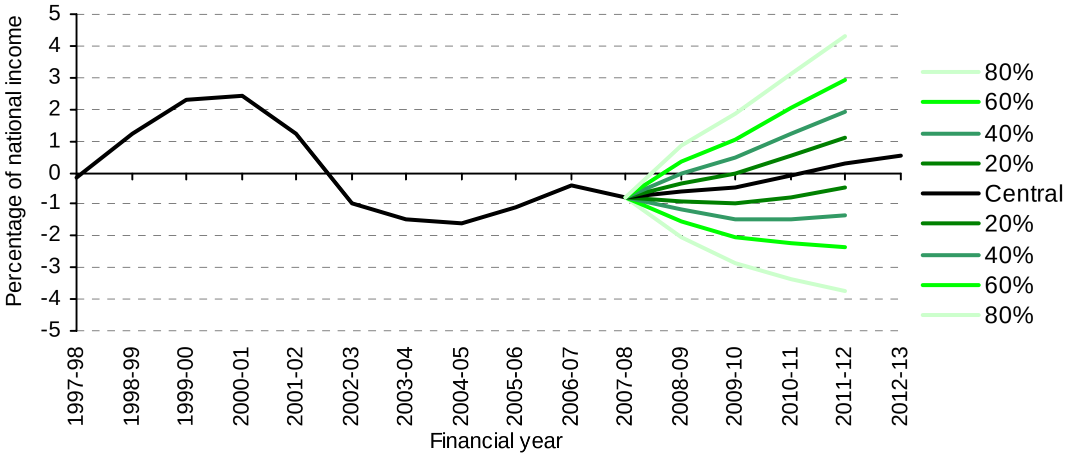
Uncertainties around the baseline Green Budget forecast

Public finance forecasts are by their nature uncertain and it is important to acknowledge this uncertainty when presenting them, in particular when interpreting point estimates for future deficits and debt. The further ahead forecasts are made, the larger the degree of uncertainty. Figures 5.4 and 5.5 present probabilistic fan charts for the Green Budget forecasts for the next four years, with the forecast for 2007–08 taken as given. The fan charts assume that the Green Budget forecasts will be right on average (and so are the best forecasts available) and that they are as accurate as the Treasury's forecasts have been in the past. If the Green Budget forecasts were more inaccurate than the Treasury's then the fan charts would be wider, while if they were more accurate then the fan charts would be narrower.

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

The central forecast for 2008–09 is for a current budget deficit of 0.6% of national income and Figure 5.4 indicates that there is a 20% probability that the actual outcome will be a deficit of between 0.9% and 0.3% of national income. In 2011–12, the central forecast is for a surplus of 0.3% of national income – but the greater uncertainties in forecasting four years in advance mean that we can only be 20% certain that the outcome will lie within the much larger range of –0.5% to 1.1% of national income. The 40%, 60% and 80% lines bound the ranges within which there is a 40%, 60% or 80% probability that the outcome will eventually lie. Therefore there is a 10% probability that the outcome will lie above the upper 80% line and a 10% probability that it will lie below the lower one. Under the Green Budget baseline forecast, there is an estimated 46% probability that, on unchanged policies, the current budget would still not be in surplus in 2011–12.

Figure 5.4. Probabilities of current budget balance outcomes (Green Budget baseline)

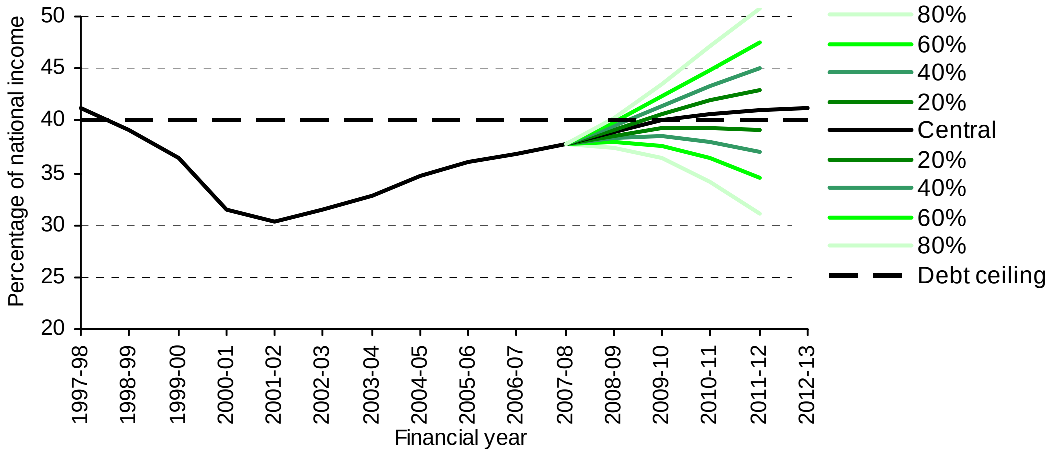


Notes: Central projections are taken from Table 5.6 and assume that the Green Budget projection for 2007–08 is correct. Methodology for computing fan charts taken from C. Emmerson, C. Frayne and S. Love, 'Updating the UK's Code for Fiscal Stability', IFS Working Paper W04/29, 2004 (http://www.ifs.org.uk/publications.php?publication_id=3163).

Similarly, Figure 5.5 presents the probabilistic fan chart for the Green Budget net debt forecasts over the next four years, again assuming that the central forecast is the best available estimate and that the forecasts are as accurate as the Treasury has been on average in the past. This suggests that there is a 16% chance in 2008–09 of net debt exceeding the 40% ceiling imposed by Gordon Brown during the economic cycle that the Treasury estimates spanned the financial years from 1997–98 to 2006–07. With the central forecast for net debt exceeding 40% of national income in all the years from 2009–10 onwards, this chance rises to 55% by 2011–12. The implication of this for compliance with the sustainable investment rule and the appropriate response for policy in light of this are discussed in more detail in Section 5.5.

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

Figure 5.5. Probabilities of public sector net debt outcomes (Green Budget baseline)



Notes: Central projections are taken from Table 5.6 and assume that the Green Budget projection for 2007–08 is correct and that any cumulative variation in public sector net borrowing from that forecast in the Green Budget projection directly adds to public sector net debt. The second-order impact of changes in debt interest is ignored. Methodology for computing fan charts taken from C. Emmerson, C. Frayne and S. Love, 'Updating the UK's Code for Fiscal Stability', IFS Working Paper W04/29, 2004 (http://www.ifs.org.uk/publications.php?publication_id=3163).

5.4 Alternative macroeconomic assumptions

This section presents alternative forecasts under two different sets of macroeconomic assumptions from Morgan Stanley – a central scenario and a more pessimistic scenario.

Table 5.7 presents both the underlying economic growth and the trend level assumptions used by the Treasury and those presented by Morgan Stanley as well as the four sets of public finance forecasts: the Treasury's PBR forecasts, the Green Budget baseline forecasts, the Green Budget forecasts under the Morgan Stanley central macro forecasts and the Green Budget forecasts under the Morgan Stanley 'pessimistic case' forecast.

The Treasury forecasts that national income will grow by 3% in 2007–08, followed by 2% in 2008–09, 2¾% in 2009–10 and 2½% thereafter (which, for the period from 2008–09 onwards, is a ¼ percentage point below the Treasury's central estimate of trend growth).

Under the first alternative Green Budget scenario (the Morgan Stanley central case), growth in national income is expected to be ¼ percentage point below the Treasury's forecast this year and next year, ½ percentage point below in 2009–10 and ¼ percentage point above thereafter. The second alternative Green Budget scenario (the Morgan Stanley 'pessimistic case') assumes that the growth rate of national income is ¼ percentage point lower in 2007–08 and is also lower than the Treasury's forecast in 2008–09 and 2009–10. From 2010–11 onwards, growth in national income under the Morgan Stanley 'pessimistic case' is the same as under the Treasury's assumptions.

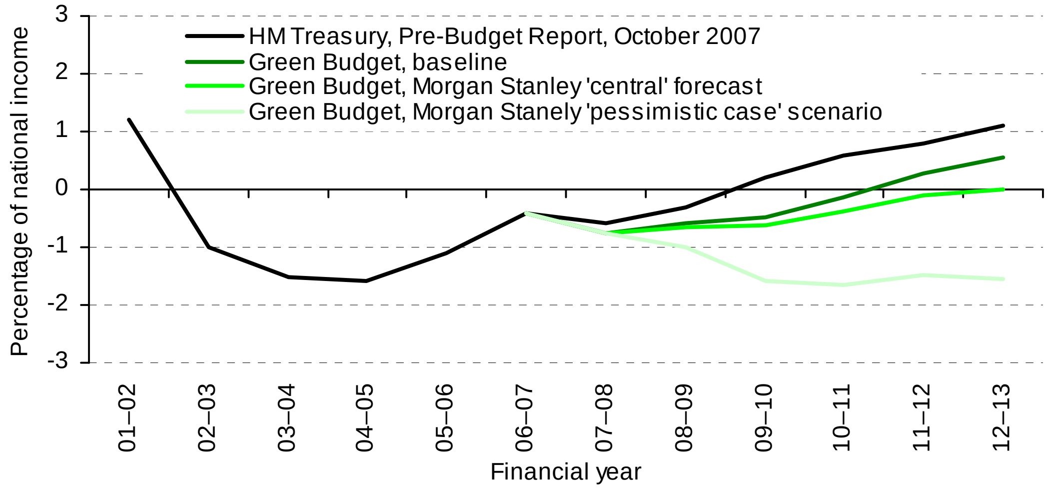
The Green Budget public finance forecasts using the Morgan Stanley central scenario show a slightly larger current budget deficit in 2008–09 and 2009–10 than under the Green Budget baseline scenario. For later years, the current budget remains further below the Green Budget baseline and does not return to surplus until the last year of the forecast horizon. Under the Morgan Stanley 'pessimistic case' scenario, there is a slightly larger current budget deficit in 2008–09 than under the Morgan Stanley central scenario, and a much larger deficit in later years. These forecasts for the current budget surplus are also compared in Figure 5.6. The equivalent figures for forecasts of the cyclically adjusted current budget surplus are shown in Figure 5.7.

Table 5.7. Public finance forecasts under various macroeconomic scenarios

	2007–08	2008–09	2009–10	2010–11	2011–12	2012–13
Treasury Pre-Budget Report forecasts						
GDP growth	3	2	2¾	2½	2½	2½
Output gap (% of potential GDP)	0.2	–0.3	0.0	0.0	0.0	0.0
Public finance forecasts (% of GDP)						
Current budget surplus	–0.6	–0.3	0.2	0.6	0.8	1.1
Cyclically adjusted current budget surplus	–0.7	–0.2	0.3	0.6	0.8	1.1
Net borrowing	2.7	2.5	2.0	1.7	1.5	1.3
Net debt	37.6	38.4	38.8	38.9	38.8	38.6
Green Budget baseline						
GDP growth	3	2	2¾	2½	2½	2½
Output gap (% of potential GDP)	0.2	–0.3	0.0	0.0	0.0	0.0
Public finance forecasts (% of GDP)						
Current budget surplus	–0.8	–0.6	–0.5	–0.1	0.3	0.6
Cyclically adjusted current budget surplus	–0.8	–0.5	–0.4	–0.1	0.3	0.6
Net borrowing	2.9	2.8	2.7	2.4	2.0	1.8
Net debt	37.8	38.9	40.0	40.7	41.0	41.2
Morgan Stanley central case						
GDP growth	2¾	1¾	2¼	2¾	2¾	2¾
Output gap (% of potential GDP)	0.4	–0.1	–0.2	0.1	0.4	0.6
Public finance forecasts (% of GDP)						
Current budget surplus	–0.8	–0.7	–0.6	–0.4	–0.1	0.0
Cyclically adjusted current budget surplus	–0.9	–0.9	–0.7	–0.2	–0.1	–0.2
Net borrowing	2.9	2.9	2.9	2.7	2.4	2.4
Net debt	38.0	39.7	41.6	42.6	43.4	44.2
Morgan Stanley 'pessimistic case'						
GDP growth	2¾	½	1¾	2½	2½	2½
Output gap (% of potential GDP)	1.0	–0.5	–0.5	0.0	0.3	0.5
Public finance forecasts (% of GDP)						
Current budget surplus	–0.8	–1.0	–1.6	–1.7	–1.5	–1.5
Cyclically adjusted current budget surplus	–0.9	–1.5	–1.5	–1.3	–1.5	–1.7
Net borrowing	2.9	3.3	3.9	4.0	4.0	4.0
Net debt	38.1	41.8	45.5	48.1	50.4	52.8

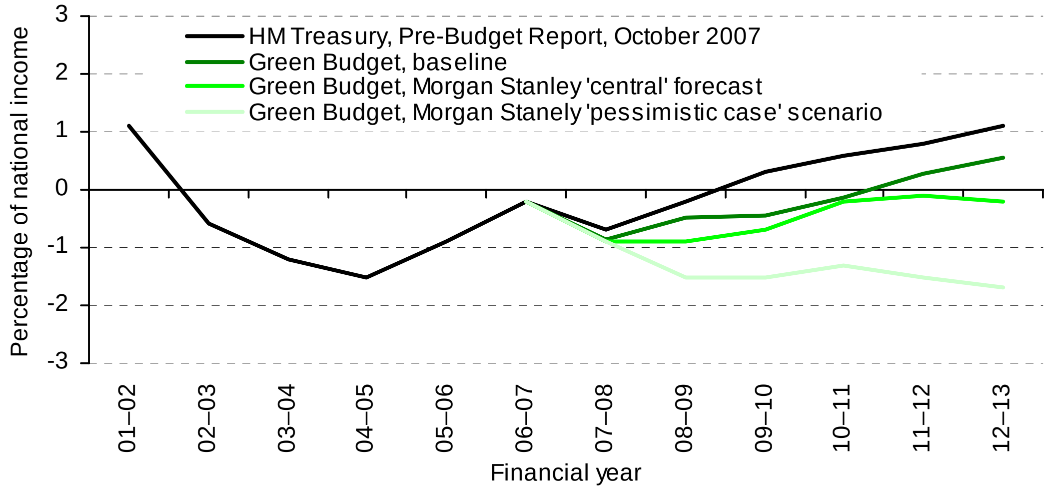
Sources: Morgan Stanley; Treasury forecasts from HM Treasury, *2007 Pre-Budget Report and Comprehensive Spending Review*, October 2007 (http://www.hm-treasury.gov.uk/pbr_csr/report/pbr_csr07_repindex.cfm).

Figure 5.6. Current budget balance forecasts



Sources: Authors' calculations; Treasury forecasts 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).

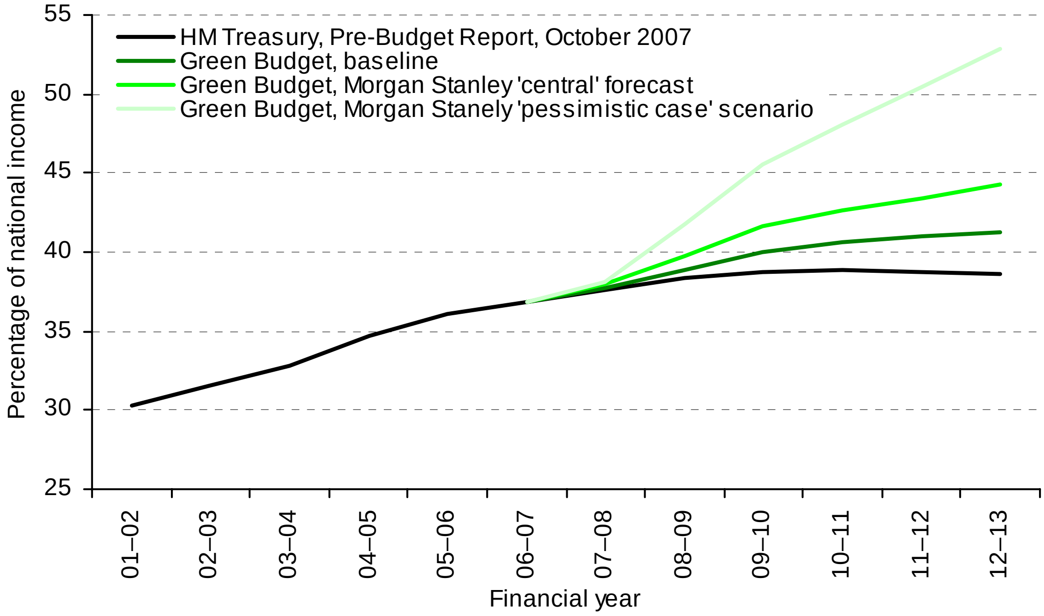
Figure 5.7. Cyclically adjusted current budget balance forecasts



Sources: Authors' calculations; Treasury forecasts 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).

Net debt is slightly higher as a share of national income in 2007–08 (reflecting a lower assumed level of national income in this year) under the Morgan Stanley central scenario than under the Green Budget baseline scenario and then moves further above the Green Budget baseline scenario for the rest of the forecast period. Net debt is higher under the 'pessimistic case' than under the central scenario in all years and by the end of the forecast period would be projected to exceed 50% of national income. These forecasts are compared in Figure 5.8.

Figure 5.8. Public sector net debt forecasts



Sources: Authors' calculations; Treasury forecasts 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).

5.5 The fiscal rules and the budget judgement

The Treasury argued in the 2007 Pre-Budget Report that it had met the golden rule over the last economic cycle (which it provisionally claims ended in 2006–07) and said that it was on course to meet it over the next. The Treasury also predicted that public sector net debt would peak at 38.9% of national income in 2010–11, below the 40% ceiling that it had set itself for the last economic cycle – thus continuing to satisfy the sustainable investment rule if the Treasury were to apply it in the same way over the next cycle.

Under each of the scenarios described in the last section, borrowing and net debt are expected to be higher over the next five years than forecast in the PBR. We are thus less confident than the PBR that the Treasury will continue to meet its rules without a further fiscal tightening.

The golden rule

If the Treasury's PBR forecast turns out to be correct, the golden rule will be met as long as the new economic cycle ends no earlier than 2011–12. This would provide enough time for the current budget deficits that the Treasury expects to record through to 2008–09 to be offset by surpluses in subsequent years. This would be true whether the Treasury counts 2006–07 both as the last year of the old cycle and as the first year of the new (as it did with the previous transition between cycles) or whether it starts the new cycle in 2007–08.

Under the Green Budget baseline scenario, the current budget would remain in deficit for an extra two years (to 2010–11). The deficits early in the cycle would not, assuming the current budget surplus remains at the same level we forecast it to be in 2012–13 beyond this point, be offset by subsequent surpluses until 2015–16 unless a further improvement in the current budget occurred beyond the forecast horizon (for example, through fiscal drag or further cuts in public spending as a share of national income). In other words, the Treasury could find itself needing a 10-year cycle (assuming the current cycle begins in 2006–07) rather than a six-year cycle in order to expect to meet the rule. Under neither of the economic scenarios outlined by Morgan Stanley in Chapter 4, nor under those defined by the statistical filters described in the same chapter, is the cycle expected to last that long. In addition, under the two Morgan Stanley scenarios, we expect borrowing to be even higher and would thus require an even longer cycle to give enough time for the early deficits to be offset by later surpluses.

This picture is, of course, in stark contrast to the pattern over the first 10 years of Labour's time in office. That began with a lengthy (albeit modest and uneven) upswing in the economy, which contributed to big current budget surpluses on average over the early years of the cycle that in effect paid for later deficits. This time, it looks as though the economy will barely have moved above potential before the downswing begins. There will be no cyclical budget surpluses to provide a cushion in the early years, and meeting the golden rule will therefore require the sort of sustained structural improvement in the current budget balance over the next few years that the Treasury has consistently predicted but so far failed to deliver.

The Treasury may come to argue that the last cycle did not end in 2006–07 and that we are still in the sustained downswing of the cycle that it assumes began in 1997–98. By pushing the end date further out, it would reduce the margin by which it estimates that the rule was met over the last cycle and make it easier to meet the rule over the next. This might be an appropriate judgement. However, such a re-dating would risk further undermining what remaining credibility the golden rule has as a guide to the health of the public finances and as a source of discipline on fiscal policy.

The sustainable investment rule

The Treasury's reluctance to say whether it intends to apply the sustainable investment rule in the same way over the new economic cycle as over the last conveys the unfortunate impression that the government is hedging its bets while it assesses how likely it is that debt will exceed 40% of national income in the next few years.

The Treasury's PBR forecasts imply that, at its worst, public sector net debt will still be 1.1% of national income below the 40% of national income ceiling that Mr Brown chose to apply over the last cycle. However, the Green Budget base case shows net debt at 40% of national income in 2009–10 and continuing to rise to 41.2% at the end of the five-year forecasting horizon. Under Morgan Stanley's central scenario, we estimate that net debt would rise to 44.2% of national income and under their pessimistic scenario to 52.8%. Even under the pessimistic scenario, this does not imply a rise in indebtedness to crisis levels (although this level of debt has not been surpassed in the UK since 1975–76). But under each scenario, it would breach the sustainable investment rule (as it has been applied to date) and put the UK further at odds with the trend towards lower debt levels in most industrial countries. As shown in Table 5.8, taking into account previous forecasting errors, in 2010–11 there is a 41% chance that, in the absence of any further policy announcements, net debt would exceed 40% of national income under the Treasury's own forecast. Under the Green Budget baseline, this probability rises to 55%, and under the Morgan Stanley central scenario, it is 70%.

Table 5.8. The sustainable investment rule under the alternative forecasts: percentage chance of net debt exceeding 40% of national income

% chance	**HMT PBR forecast**	**Green Budget baseline**	**Morgan Stanley central**	**Morgan Stanley pessimistic**
2008–09	7.8	16.3	41.0	94.6
2009–10	33.4	49.3	71.7	97.5
2010–11	41.4	55.2	70.0	94.5
2011–12	43.8	55.1	67.2	91.3

Notes: As Figure 5.5.
Sources: As Table 5.7.

The government could argue that a larger-than-expected increase in the current budget deficit over the next couple of years would be a temporary result of the credit crunch and the particular difficulties of the financial sector and that the golden rule sensibly allows it to borrow more in bad times as long as it runs offsetting surpluses in good times. But the sustainable investment rule, at least as Mr Brown chose to apply it over the last cycle, offers no such get-out: it is a ceiling to be kept below every year, in good times or bad times.

This relative inflexibility did not seem much of a constraint five or six years ago, when the Treasury expected net debt to remain much closer to 30% than to 40%. But since then, its forecasts for borrowing – and thus for debt – have almost always proved optimistic. As a result, the headroom beneath the debt ceiling has been steadily eroded and the government now has little room for manoeuvre left if the credit crunch and economic slowdown are more severe than was expected at the time of the PBR.

The Budget judgement

Given our assessment that the outlook for the public finances is weaker over the next five years than the Treasury thinks, and that we are not as confident as the Treasury that the fiscal rules will be adhered to, what should Alistair Darling do in his first Budget?

One response is to argue that he should announce Budget measures sufficient:

- to make it more likely than not that net debt will remain below 40% of national income over the next five years;
- to ensure that the current budget balance is more likely than not to return to the black in 2009–10, as the Treasury thought appropriate at the time of the Pre-Budget Report; and
- to ensure that the overall budget deficit is forecast to be no larger (and the current budget surplus no smaller) at the end of the five-year forecasting horizon in 2012–13 than the Treasury thought appropriate in the PBR.

If the public finances are set to evolve as in the Green Budget base case, these goals argue for a tightening in the Budget of around 0.5% of national income or £8 billion to be implemented by the 2009–10 financial year. As the Treasury has just announced ‘firm and fixed’ spending plans for the next three years, such an adjustment would presumably take the form of tax increases rather than further cuts in spending.

Three objections might be put forward to such a course:

- *The outlook for the public finances is uncertain*: This is true today as it has always been. As the probability distributions in Figures 5.4 and 5.5 illustrate, there are big uncertainties around our central projections for the budget balance and public sector net debt (as there are around those of the Treasury, although it is reluctant to quantify them). But the Morgan Stanley central and pessimistic scenarios suggest that the risks to the Green Budget base case may well be more on the downside than the upside. A prudent and far-sighted government might think it better to tighten policy today and give itself scope to loosen in the future, if it turns out to have been unnecessary, than to do nothing today and face the possible need for a bigger and more abrupt adjustment at an even more inconvenient moment in the future.

- *The deterioration in the public finances the Green Budget expects relative to the Treasury's forecast is only temporary*: It is certainly true that we are more pessimistic about the outlook for the public finances in part because of the unexpected impact of the financial market disruption and credit crunch that got under way last year. The fortunes of the financial sector might well rebound swiftly, but the fiscal lesson of Labour's second term is that problems in the financial sector can have a bigger and more persistent impact on the public finances than first appears likely. Indeed, it may demonstrate that what looked like normal conditions beforehand were actually unsustainable. A tightening in policy now would help insure against these risks and help bolster the credibility of the government's claims to be a prudent manager of the public finances.

- *It would be a mistake to tighten fiscal policy when the downside risks to the economy are so great*: On the face of it, it does not seem desirable to take spending power out of the economy just as people become increasingly pessimistic about the outlook for growth. The golden rule is explicitly designed to allow the automatic stabilisers to work – in other words, to allow the government to borrow more when the economy is weak. The sustainable investment rule does not offer similar latitude, especially now that the government has almost entirely exhausted its margin for error. But if it comes to a choice between the needs of the economy and an arbitrary ceiling on public sector debt, the needs of the economy should clearly come first. However, Mervyn King, the Governor of the Bank of England, said on 22 January 2008[1] that, with base rates at 5.5%, monetary policy was probably still 'bearing down on demand' rather than stimulating it. This implies that the Bank has interest rate ammunition in reserve to stimulate activity if and when it needs to – and that we do not yet need fiscal policy to do the job. (The Bank may, of course, feel constrained in cutting interest rates because it expects inflation to be uncomfortably high this year, even while growth is weak. But that constraint would be much the same either with the current policy mix or with a slightly tighter fiscal policy offset in its impact on growth and inflation by a slightly looser monetary policy.) In his speech, Mr King added that 'As part of a longer-run rebalancing of the UK economy, an increase in our national saving rate, both private *and public* [our italics], is necessary'. This implies that the uncertain economic outlook should not deter the government from doing what looks necessary to get fiscal policy onto a sound medium-term footing.

[1] Speech by Mervyn King at a dinner in Bristol hosted by the IoD South West and the CBI, 22 January 2008 (http://www.bankofengland.co.uk/publications/speeches/2008/speech333.pdf).

Furthermore, underpinning the fiscal position now would leave greater scope for a loosening in the future if monetary policy proved overstretched or ineffective.

In terms of the political practicalities alone, it seems unlikely that Mr Darling (and his illustrious predecessor) would contemplate much of a fiscal tightening in this year's Budget. We might expect them to argue that any further near-term deterioration in the public finances will be temporary and that it is important in these uncertain times for fiscal policy to support monetary policy. The implications of the weak outlook for the economy merit serious consideration in making the Budget judgement. But, having already undermined people's faith in the letter of the fiscal rules, they risk undermining people's faith in the spirit if they do nothing to address a further worsening in the outlook for the public finances. Budget after Budget, Treasury Ministers have had to admit that the outlook for the public finances is weaker than they thought and that a return to their desired position is one year further away. That the prospect of having to say the same in this year's Budget largely reflects the domestic consequences of unhelpful global events is doubtless frustrating. But there is a danger in being seen always to pray, like Saint Augustine and Robbie Williams, 'Oh Lord, make me pure, but not yet'. The day of judgement cannot be postponed forever.