A FISCAL FRAMEWORK FOR THE FUTURE

A NOTE FOR THE 2006 BUDGET

Ruth Lea

THE AUTHOR

Ruth Lea is Director of the Centre for Policy Studies. She is on the University of London Council, is a Governor of the London School of Economics and is a non-Executive Director of the Arbuthnot Banking Group. She has served on the Council of the Royal Economic Society, the National Consumer Council, the Nurses' Pay Review Body, the ONS Statistics Advisory Committee, the ESRC Research Priorities Board and the Retail Prices Advisory Committee. She was Head of the Policy Unit at the Institute of Directors (IoD) from 1995 to 2003 before which she was the Economics Editor at ITN, was Chief Economist at Mitsubishi Bank and Chief UK Economist at Lehman Brothers. She also spent 16 years in the Civil Service in the Treasury, the Department of Trade and Industry and the Central Statistical Office.

The aim of the Centre for Policy Studies is to develop and promote policies that provide freedom and encouragement for individuals to pursue the aspirations they have for themselves and their families, within the security and obligations of a stable and law-abiding nation. The views expressed in our publications are, however, the sole responsibility of the authors. Contributions are chosen for their value in informing public debate and should not be taken as representing a corporate view of the CPS or of its Directors. The CPS values its independence and does not carry on activities with the intention of affecting public support for any registered political party or for candidates at election, or to influence voters in a referendum.

© Centre for Policy Studies, March 2006

ISBN No: 1 905389 27 2

Centre for Policy Studies
57 Tufton Street, London SW1P 3QL
Tel: 020 7222 4488 Fax: 020 7222 4388
e-mail: mail@cps.org.uk   website: www.cps.org.uk

Printed by The Centre for Policy Studies, 57 Tufton Street, London SW1

CONTENTS

CHAPTER 1 INTRODUCTION AND SUMMARY 1

CHAPTER 2 THE ECONOMIC BACKGROUND 4

CHAPTER 3 THE FISCAL BACKGROUND 16

CHAPTER 4 A FISCAL FRAMEWORK FOR THE FUTURE 31

ANNEXES

CHAPTER ONE
INTRODUCTION AND SUMMARY

1.1 INTRODUCTION

The March 2006 Budget will be the Chancellor's tenth. There is a widespread feeling that politics will dominate the Budget with economics taking a secondary role. The Chancellor is in consolidation mode. There are few expectations he will change his economic forecasts significantly – the GDP forecast for 2006 looks quite plausible and is much in line with consensus thinking. It is also unlikely that he will alter the forecasts for the public sector balances either.

Crucially there is little expectation that there will be major tax announcements as the debate over the "black hole" in the current balance has receded over the last 12 months. It has receded because the Chancellor has, somewhat stealthily, taken decisions to mitigate it. He has increased the tax burden through fiscal drag and aggressive anti-avoidance measures; and, by pencilling in very tight illustrative spending figures for FY2008 to FY2010, he has taken the pressure of the public finances for that period. This effectively puts off the hard decisions to another day – specifically when the new spending plans are announced for FY2008 to FY2010 in the 2007 Spending Review.

1.2 THE ECONOMIC BACKGROUND

Chapter 2 looks at the economic prospects and concludes:

- The Treasury's growth forecast of 2 to 2½% GDP for 2006 looks plausible. But further out the forecasts look over-optimistic. (Section 2.2.)

- One reason for the possible over-optimism is that the Treasury has over-estimated the size of the (negative) output gap. (Section 2.3).
- A second reason is that slowing productivity growth is undermining trend (or potential) output growth. The economy, therefore, will not be able to grow as quickly as otherwise would be the case without triggering inflationary pressures. (Section 2.4.)
- The Treasury's analysis of the output gap has putatively been behind the two re-datings of the economic cycle. But the respecifications seem to have more to do with political opportunism and expediency than economic transparency. (Section 2.3.)
- There is evidence that the UK's economic performance and competitiveness is slipping down the international league tables. (Section 2.5.)

1.3 THE FISCAL BACKGROUND

Chapter 3 analyses the fiscal background to this year's Budget, concluding:

- The 2005 PBR forecast for the current deficit for FY2005 is unlikely to be revised significantly, reflecting bumper tax revenues in January. (Sections 3.2 and 3.4.)
- But further out, the projections look over-optimistic partly reflecting over-optimistic GDP growth projections. (Section 3.3.) The fiscal projections are also flattered by the very tight illustrative public spending projections pencilled in for the years FY2008 to FY2010. (Section 3.3.)
- The Chancellor's revenues have benefited from fiscal drag and aggressive anti-avoidance measures. He has also increased the tax burden on North Sea oil companies. These measures have undoubtedly acted to mitigate the "black hole" in the current balance. (Sections 3.3 and 3.6.)
- The Chancellor has amended the Golden Rule by:
  - firstly, replacing the analysis based on actual current budget balances by balances as a % of GDP and,
  - secondly, by re-dating the Rule's economic cycle – twice. The first re-dating (from the period FY1999 to FY2005 to the period FY1997 to FY2005) was probably motivated by the need to meet the Golden Rule. The second re-dating (from the period FY1997 to FY2005 to the period FY1997 to FY2008) looks as though it was motivated by a desire to defer any decisions about the next economic cycle. (Section 3.4.)
- Given the possibility that the public finances projections are over-optimistic, there is a risk that the Sustainable Investment Rule, even on current definitions, may be missed over the forecast period. (Section 3.4.)

- If the liabilities of Network Rail and the PFI were added to public sector debt the Sustainable Investment Rule would probably be breached as early as FY2005. (Section 3.5.)
- The very tight illustrative public spending projections pencilled in for the years FY2008 to FY2010 suggest an average annual increase of around 1.8% in real terms. If these "plans" are adhered to in the 2007 Spending Review, they will prove to be very painful indeed. The speculation is that they will not be adhered to. (Section 3.7.)
- There has been a dramatic increase in the ratio of public spending to GDP since 2000 in the UK, the largest of any major OECD country. Many countries are reducing the state's share of GDP (and the tax burden as a % of GDP). The UK is swimming against the tide. (Section 3.8.)

1.4 A FISCAL FRAMEWORK FOR THE FUTURE

Chapter 4 looks at a model fiscal framework for the future and recommends:

- The Chancellor's two fiscal rules, the Golden Rule and the Sustainable Investment Rule, along with the three-year Spending Reviews, have served the country quite well and should be retained. (Section 4.1.)
- But the current system has three main shortcomings (section 4.2):
  - The rules must be adhered to and there is a need for more independent scrutiny of the Treasury's assumptions, forecasts and assessments of the economic cycle. The NAO and the ONS could do this.
  - There is a need for a third rule, which ensures the reduction in the state's share of GDP; public spending growth should be slower than GDP growth.
  - The Treasury's analysis of tax changes should be dynamic and not static.
- There is a need for a tax system that bolsters competitiveness, encourages enterprise, encourages and enables families to be independent of the state, encourages savings and pensions and simplifies the tax system. (Section 4.3.)
- There is a need to stamp out public spending waste. The Government's Gershon Review of July 2004, looking for £21.5bn of efficiency savings, is a start but a very modest start. The Government's claimed progress to date, of £4.7bn, was questioned by the NAO. (Section 4.4.)

CHAPTER TWO
THE ECONOMIC BACKGROUND

2.1 Introduction

2.2 The economic forecasts

2.3 The output gap

2.4 Trend output growth and productivity growth

2.5 Some international comparisons

2.1 INTRODUCTION

The economic section of the Budget report is of key interest. The City, in particular, will be listening for the GDP growth forecasts – not least because they have implications for the public finances.

The Chancellor's economic forecasts (as opposed to his forecasts on the public finances) have been fairly accurate in the past. But even so, as annex 1, table 1 demonstrates, the mid-point forecasts (as opposed to the "bottom of the range" forecasts) were over-optimistic for 2001 to 2003 and 2005, even allowing for the ONS's upward revisions to the data. If the ONS's "first" estimates of GDP growth are used, then the degree of the Treasury's over-optimism is larger.

The Chancellor's 2005 Pre-Budget Report forecast for the economy, at least for 2006, looks plausible and major revisions to the economic data are not expected in this year's Budget. As with the public finances data, there is a widespread feeling that the Chancellor is currently in "consolidation" mode.

2.2 THE ECONOMIC FORECASTS

The main components of the Chancellor's 2005 Pre-Budget forecasts are set out in the table below.

THE CHANCELLOR'S PBR FORECASTS

	2004	2005	2006	2007	2008
GDP at constant market prices*	3¼	1¾	2 to 2½	2¾ to 3¼	2¾ to 3¼
Balance of payments (current account) (£bn)	-23¼	-26½	-30	-32¾	-35¾
CPI (Q4)*	1¼	2¼	1¾	2	2
Money GDP, £bn	1164	1212	1267 to 1273	1338 to 1350	1413 to 1433
Money GDP, % change*	5 ¼	4 ¼	4 ½ to 5	5 ½ to 6	5¾ to 6¼

* Percentage change year-on-year. The Consumer Price Index forecast refers to the year-on-year change for the 4th quarter average.

Source: HM Treasury, PBR 2005, *Britain meeting the global challenge: Enterprise, fairness and responsibility*, TSO, Cm 6701, December 2005.

The main points of interest in these forecasts were, firstly, the significant downgrading of the Budget forecast for 2005 GDP growth from 3% to 1¾%; and, secondly, the pick-up in growth in years 2007 and 2008. The GDP growth forecast for 2006 is well in line with the current Consensus forecast as show in the following table. The Treasury's GDP forecast for 2007 is, however, on the optimistic side compared with Consensus.

CONSENSUS FORECASTS FOR THE BRITISH ECONOMY

	2005 (ESTIMATE)	2006	2007
GDP*	1.8	2.1	2.4
CPI*	2.1	2.0**	2.0
Balance of payments (current account) (£bn)	-24.5	-27.9	-29.6
3month interbank rate (%)		4.4 (end May 2006)	4.4 (end Feb. 2007)

* Percentage change year-on-year. The CPI forecast refers to the year-on-year change for Q4.

** January's CPI inflation rate was 1.9% (YOY)

Source: Consensus Economics, *Consensus Forecasts*, February 2006.

The Chancellor's economic forecasts and projections are relevant to the public finances. The GDP growth projections are based on the "cautious" view of the Treasury's "neutral" estimate of trend output growth, which is 2¾% to end 2006, slowing to 2½% thereafter due to demographic effects. The "cautious" annual trend growth assumption is ¼% lower than the neutral view.

THE TREASURY'S ECONOMIC ASSUMPTIONS FOR THE PUBLIC FINANCE PROJECTIONS

	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
Output (GDP)	2¾	1¾	2¼	3	2¾	2¼	2¼
Prices:							
- CPI	1 ½	2 ¼	2	2	2	2	2
- GDP deflator	2 ¼	2 ½	2 ½	2 ¾	2 ¾	2 ¾	2 ¾
- Money GDP (£bn)	1176	1225	1283	1357	1431	1503	1577

Note: The status of the data: FY2004 was an outturn, FY2005 was an estimate, FY2006 to FY2008 were forecasts, and FY2009 to FY2010 were projections.

Source: HM Treasury, PBR 2005, *Britain meeting the global challenge: Enterprise, fairness and responsibility*, TSO, Cm 6701, December 2005. Table B3.

Even though these economic forecasts and projections are "cautious" in Treasury parlance, they are arguably over-optimistic (with the exception of 2006) and, insofar as they are over-optimistic, then the public finances projections are likely to be over-optimistic as well. There are two, inter-related, main reasons for believing that the Treasury's forecasts are over-optimistic and they will be discussed below. They are:

- The Treasury has over-estimated the size of the (negative) output gap – in other words, spare capacity.
- The Treasury has over-estimated trend output growth, not least of all because it has failed to accommodate weakening productivity growth.

2.3 THE OUTPUT GAP

The "output gap" is defined as the difference between "potential GDP" (when the economy working at full capacity) and "actual GDP". It is calculated as "actual GDP" minus "potential GDP" so:

- When the output gap is negative, there is unused capacity (eg unemployment) and the economy can grow faster than "trend" without risking stoking up inflationary pressures. ("The porridge is too cold.")
- When the output gap is positive, the economy is running ahead of its non-inflationary capacity and is risking stoking up inflation. The policy response should be to tighten with fiscal and/or monetary policy. ("The porridge is too hot.")
- When the output gap is zero, the economy can run at trend (but no faster) without risking stoking up inflationary pressures. The economy is "at trend". ("The porridge is just right.")

In the 2005 PBR,[1] the Treasury estimated the output gap as equivalent to 1.4% of potential output in FY2005, falling to zero in FY2009. Many commentators believe that the Treasury's estimates are too generous and, therefore, there is not the spare capacity in the economy to support the forecast growth rates without triggering inflation. These commentators include:

- The OECD, which forecasts smaller output gaps than the Treasury.[2]

- Similarly, the NIESR forecasts are more modest than the Treasury.[3] NIESR estimates that, even though the economy "is currently operating below capacity", the output gap is relatively small at around ⅓ per cent of GDP – though this could be larger especially given the predilection of the ONS to revise data upwards.
- A study by the *Financial Times* in January 2006 concluded that "there is little or no spare capacity in the economy limiting the scope for above-average growth in the next few years, according to calculations based on the Treasury's methods for assessing the state of the economic cycle".[4]
- The IMF noted "the uncertainties surrounding the estimates of the output gap, and the associated risk of the authorities' fiscal projections being somewhat more optimistic than warranted".[5]
- The Monetary Policy Committee of the Bank of England, too, seems uncertain about the degree of spare capacity. Its January minutes contained the sentence: "there is probably some spare capacity in the economy following the period of below-trend growth. But the extent of spare capacity is uncertain, particularly if there has been some negative effects on potential supply from the recent weakness of business investment and productivity".[6] The inter-related issues of weak productivity growth and trend output growth will be discussed below.
- IFS/Morgan Stanley estimates the output gap is "more like 0.5% of GDP", with the gap closing by 2007.[7]

The table below shows three sets estimates of the output gap, which confirms the above analysis.

ESTIMATES OF OUTPUT GAPS (AS % OF POTENTIAL OUTPUT)

	OECD	NIESR	TREASURY: 2005 PBR
2004	0.5	0.5	Na
2005	-0.5	-0.1	-1.4 (FY2005)
2006	-0.7	-0.3	-1.5 (FY2006)
2007	-0.4	0	-0.7 (FY2007)
2008	Na	Na	-0.1 (FY2008)
2009	Na	Na	0 (FY2009)
2010	Na	Na	0 (FY2010)

Sources: OECD, *Economic Outlook*, Volume 2005/2, no 78, December 2005, OECD; NIESR, *National Institute Economic Review*, no 195, January 2006, Sage; and HM Treasury, PBR 2005, *Britain meeting the global challenge: Enterprise, fairness and responsibility*, TSO, Cm 6701, December 2005.

The Treasury's estimates for the output gap are economically significant for two main reasons. Firstly, the Treasury uses its estimates of the output gap to specify the current economic cycle. The Treasury identifies the start and end points of the cycle as when the economy was (or will be) "at trend" – in other words when the output gap was (or will be) zero. A full economic cycle encompasses the pattern of an upswing to a peak, followed by a downswing to a trough, which is then, in turn, followed by an upswing.

The economic cycle has assumed great significance under the current Chancellor because of the specification of the Golden Rule, the first of his fiscal rules. (This is discussed in chapter 3.) Suffice to say at this point, the Treasury has identified the current cycle, to date, in three ways:

- From FY1999 to FY2005: the original specification (at the start of the current Chancellor's tenure).
- From FY1997 to FY2005: as altered in July 2005, putatively following data revisions.[8] The NAO has, however, agreed, with qualification, that the start date of FY1997 is reasonable.[9]
- From FY1997 to FY2008: as altered in the 2005 PBR.

It is widely accepted that the estimation of economic cycles is as much art as science (especially as the ONS frequently revises the data). But the Treasury's serial re-dating of the economic cycle has raised eyebrows with many commentators on the grounds that it has been more to do with political expediency than impartial economic research.

For example:

- The NIESR has written: "using our estimate of the output gap to date the cycle would suggest that there are three economic cycles between the beginning of 1994 and the end of 1997. This is different from the PBR… unfortunately, the Treasury's redefinitions of the start and end dates of the economic cycle this year cannot help but look opportunistic, since both improve the public finances when measured against the golden rule, as too does their method of calculation in adding up proportions of GDP instead of borrowing and lending".[10] (See chapter 3 for more on these issues.)
- IFS/Morgan Stanley wrote, "re-dating the cycle at such a convenient moment risks undermining the credibility of the fiscal framework".[11]
- And the IMF voiced its "concerns about re-dating of the economic cycle" although, it added, "the [fiscal] framework continues to serve the UK well".[12]

Secondly, the estimates of the (negative) output gap are measures of the degree of spare capacity in the economy and, therefore, of how quickly the economy can grow above trend before triggering inflationary pressures. Clearly, if the output gap is large and spare capacity is substantial, then the economy can grow quicker than when it is small. Similarly, if the economy is performing at less than capacity then any public sector deficits can be expected to be mitigated (if not totally wiped out) by buoyant revenue rises if/when the economy grows above trend as it is able to do. It is reasonable to claim that any deficits in these economic circumstances are more connected with cyclical factors in the economy rather than structural factors. But if an economy has little spare capacity, and cannot therefore grow significantly above trend, then any sizeable public sector deficits are likely to be "structural" and require addressing either by raising taxes and/or shaving spending.

If it is, therefore, the case that the Treasury's forecasts of the output gap are over-optimistic then there are two consequences:

- Their GDP growth forecasts, after 2006, are over-optimistic.
- Their government revenue projections are over-optimistic and their estimate of the structural public sector deficit is too modest. As IFS/Morgan Stanley wrote "most independent forecasters believe that the output gap is less than forecast by the Treasury, in which case the structural deficit would be deeper than the Treasury thinks".[13]

2.4 TREND OUTPUT GROWTH & PRODUCTIVITY GROWTH

There are, to simplify, two drivers of trend output (or "potential") growth[14]:

- Productivity (or "labour productivity") growth which is, arguably, the key driver behind trend output growth and, therefore, the key determinant of increases in living standards. Very broadly, two factors drive productivity growth:
    - Growth in capital per worker ("capital deepening").
    - "Technical progress" (or innovation) or growth in "Total Factor Productivity" (TFP), a great catch-all.
- The growth in the "quantity" of labour inputs. This broadly covers:
    - Hours worked.
    - Employment rates (the proportion of the population of working age in employment).
    - The population of working age (frequently referred to as the "demographics", including net immigration).

The Treasury's forecasts of GDP and the public finances crucially depend on their estimates for trend output growth, which they "decompose" into the drivers ("contributions to trend growth") as shown in the table below.

TREASURY: CONTRIBUTIONS TO TREND GROWTH AND ESTIMATED TREND GROWTH RATES (ANNUALLY, %), 2005 PBR ESTIMATES

	CONTRIBUTIONS TO TREND GROWTH					
	Trend output per hour worked (hourly productivity)		Trend average hours worked	Trend employ-ment rate	Pop. of working age	Trend output growth
	Underlying	Actual				
1986Q2 to 1997H1	2.22	2.04	-0.11	0.36	0.24	2.55
1997H1 to 2001Q3	2.79	2.59	-0.44	0.42	0.58	3.15
2001Q4 to 2006Q4:						
- 2005 Budget	2.35	2.25	-0.1	0.2	0.5	2¾
- 2005 PBR	2.25	2.15	-0.2	0.2	0.6	2¾
2006Q4 onwards:						
- 2005 Budget	2.35	2.25	-0.1	0.2	0.3	2½
- 2005 PBR	2.25	2.15	-0.2	0.2	0.4	2½

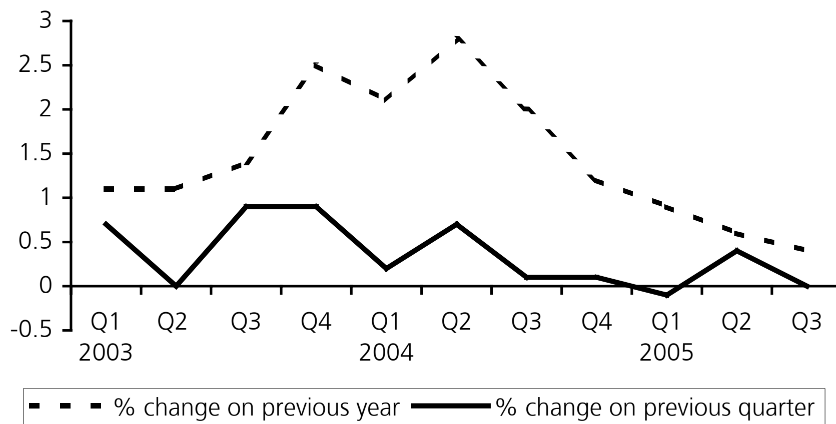
Source: HM Treasury, PBR 2005, *Britain meeting the global challenge: Enterprise, fairness and responsibility*, TSO, Cm 6701, December 2005.

The Treasury currently estimates that trend output growth is 2¾% a year (to the end of 2006), with the growth partly reflecting historically high net immigration comfortably offsetting a trend decline in the number of hours worked. But trend output growth is expected to slow to 2½% thereafter due to demographic effects.

As already discussed, the Treasury takes a "cautious" view of trend output growth when projecting the public finances taking, for example, 2¼% instead of 2½% for the years 2007 and beyond. But even so, if underlying productivity growth rates were to decelerate significantly, these trend output growth estimates would prove to be too optimistic. And the worry is that actual productivity growth rates have indeed slowed dramatically recently – they are exceptionally disappointing.

According to the latest ONS data, productivity growth slowed sharply in 2005, grinding to halt in the third quarter (the latest available), as can be seen from the chart below.

WHOLE ECONOMY PRODUCTIVITY CHANGE ON A YEAR EARLIER (%) AND CHANGE ON PREVIOUS QUARTER (%), SEASONALLY ADJUSTED, OUTPUT PER WORKER



Source: ONS, *Productivity 3rd quarter 2005*, First Release, 23 December 2005.

The recent poor productivity performance has, moreover, seen some reversal of the improvement in international rankings seen since the 1990s, as the following table for output per worker shows.

INTERNATIONAL COMPARISONS OF WHOLE ECONOMY PRODUCTIVITY, GDP PER WORKER, UK=100

	France	Germany	Japan	UK	US	G7	G7 exc. UK
1991	132	115	108	100	138	124	126
1997	121	107	94	100	128	115	116
2001	117	102	89	100	126	111	112
2002	112	99	86	100	122	108	109
2003	112	<u>100</u>	<u>88</u>	100	<u>124</u>	<u>110</u>	<u>110</u>
2004	<u>111</u>	<u>100</u>	<u>89</u>	100	<u>127</u>	<u>111</u>	<u>111</u>

Source ONS, *International comparisons of productivity*, *revised estimates for 2004*, 23 February 2006, selected years only. Choosing "output per hour worked", an alternative definition for productivity, flatters the French and German relative positions as they work shorter hours than in the UK and depresses the US and Japanese relative positions as they work longer hours than in the UK.

Note: The underlined data indicate the years of the reversal of the trend in the UK's improvement.

There has been much speculation as to the reasons for the recent spectacular deceleration in productivity growth.

The most comforting explanation is that it is "cyclical" and that cyclical shifts in the intensity of work have reflected a tendency for employers to hoard labour during a slowdown – which would suggest the presence of spare capacity in the event of an upturn. The MPC, for example, has written "some of the slowdown in productivity growth may primarily reflect normal cyclical considerations such as labour hoarding. [But] there remained a possibility that underlying Total Factor Productivity growth had slowed".[19] In other words, the MPC felt that cyclical hoarding was far from being the only explanation and there were more worrying, more fundamental, "structural" reasons.

These "structural" reasons include:

- Trends on capital per worker ("capital deepening"). Recent data on business investment have been disappointing.[15,16] Businesses, despite good profitability and low costs of capital, are reluctant to invest. The MPC has, for example, voiced its concerns that poor investment rates may undermine the economy's spare capacity.[17]
- The mix of public sector/private sector jobs and differences in measured productivity between them, which would undermine Total Factor Productivity (TFP). There has been a rapid rise in the number of public sector jobs since 2000, squeezing the private sector, and public sector productivity performance has been extraordinarily poor.[18] These trends inevitably undermine productivity performance. But the impact should be kept in perspective as the public sector share of total employment tends to shift quite slowly. There is also the associated issue of the increasing state share of GDP, which is briefly referred to below.
- Other, as yet, incompletely understood reasons for the slowdown in Total Factor Productivity (TFP). The Bank of England's Inflation Report was, however, a useful contribution to the debate. The Bank

> wrote "the extent of the slowing of the labour productivity growth is uncertain. But it seems likely that at least some of the slowing in productivity growth has been genuine. One possibility is that the greater use of migrant labour from the EU Accession countries has led to a fall in labour productivity growth. These migrant workers generally appear to occupy lower paid, lower productivity jobs. The recent energy price rises might also have lowered productivity growth. Higher energy prices will lower productivity growth temporarily if companies choose to scrap capital equipment that becomes unprofitable following a rise in energy prices. In addition, uncertainty over energy prices may lead firms to postpone investment decisions, which would also reduce temporarily the growth of the capital stock".[19]

The evidence does, therefore, seem to suggest a genuine slowdown in underlying productivity growth that, arguably, is not currently being taken on by the Treasury. And, of course, slower underlying productivity growth means lower trend output growth, less productive capacity, lower GDP growth and a slower increase in living standards. These are supply side effects, irrespective of the competence of demand management – in other words, whether the economy is "stable" or not.

The Chancellor rightly gave the Bank of England independence in terms of setting interest rates. The Bank of England has performed a magnificent job and can take much credit for the "stability", the absence of "booms and busts", of the economy. There is no reason to believe that the Bank will not continue to deliver stability. But stability in itself is not enough. There is the increasingly likely prospect of sluggishness and stagnation unless there are vigorous attempts to encourage business to invest and generally improve the falling competitiveness of the economy. (Competitiveness will be mentioned further below.) <u>It should be emphasised that there is no reason to believe that efforts to stimulate the economy through supply side measures, including tax cuts, are incompatible with stability</u>.

One analysis of decelerating underlying productivity growth is salutary. The IFS/Morgan Stanley[21] has undertaken a useful exercise in decomposing GDP per capita into its drivers of capital deepening, quantity of labour inputs and Total Factor Productivity (TFP). (For definitions see the beginning of this section.) Their results are shown in the following table.

DECOMPOSITION OF GDP PER CAPITA, CONTRIBUTIONS TO GROWTH (%)

	Capital deepening	Quantity of labour inputs	TFP growth trend	Cyclical component of TFP growth	GDP pc growth
1972-2004	0.70	-0.02	1.41	0.04	2.13
1972-1984	0.70	-0.34	1.36	0.03	1.76
1985-1995	0.48	0.11	1.59	0.10	2.29
1995-2004	0.98	0.25	1.28	0.02	2.52
2001	1.45	0.03	1.57	-1.22	1.82
2002	0.78	-0.26	1.42	-0.32	1.62
2003	0.38	-0.02	1.57	0.13	2.10
2004	0.20	0.15	1.34	1.07	2.75
2005Q3	0.42	0.43	1.08	-0.84	1.09

Source IFS/Morgan Stanley, *The IFS Green Budget*, January 2006, IFS; chapter 3 on the economic outlook by Morgan Stanley.

The IFS's main conclusions are:

- Technical progress (Total Factor Productivity, TFP) growth has slowed to around 1% in recent quarters.
- The decline of capital deepening's contribution is also a "concern".
- Rising employment rates and favourable "demographics" (reflecting immigration) have more than compensated for the trend decline in hours worked in recent years. But the expansionary effects of a rising labour supply are likely to be smaller in future, whilst TFP growth has slowed.
- Consequently, the Treasury's productivity and trend output growth estimates seem over-optimistic.
- Near-term trend output growth (GDP) was assessed at around 2.4% annually – with the balance of probability that it is lower than 2.4% rather than it is higher than 2.4%. (Indeed other commentators have speculated that trend output growth may currently be only 2% annually, so the economy can grow no more than 2% on average without triggering inflationary pressures.)
- The long-term sustainable growth in per capita income could "easily" fall below 2%, compared with a historical average of 2.1-2.2%.

And their central case projections for potential output growth are noticeably lower, though not catastrophically lower, than the Treasury's.

ESTIMATES OF POTENTIAL OUTPUT GROWTH (%)

	FY 2004	FY 2005	FY 2006	FY 2007	FY 2008	FY 2009	FY 2010
HMT, 2005 PBR	2.75	2.75	2.69	2.50	2.50	2.50	2.50
Morgan Stanley central case	2.35	2.30	2.30	2.30	2.29	2.37	2.42
HMT minus Morgan Stanley	0.40	0.45	0.39	0.20	0.21	0.13	0.08

Sources: IFS/Morgan Stanley, *The IFS Green Budget*, January 2006, IFS, discusses these drivers in detail. HM Treasury, Pre-Budget Report 2005, *Britain meeting the global challenge: Enterprise, fairness and responsibility*, Cm 6701, TSO, December 2005.

2.5 SOME INTERNATIONAL COMPARISONS

The Chancellor will no doubt take the opportunity of his budget to extol his handling of the economy. But there are clearly difficulties arising and the UK's position as one of the developed world's more dynamic economies can no longer be taken for granted.

Briefly, the following points should concern policy makers:

- The economy has performed less well since 1997 than in the five years from 1992 to 1997.[22]
- Even though the UK economy has performed better than the core eurozone economies in recent years, it has performed worse than the other Anglophone countries.[23] The table below shows UK growth in a wide international context.
- As pointed out above, the UK's international record on productivity is deteriorating.
- UK international competitiveness continues to slip. The World Economic Forum (WEF) calculated that the UK was the fourth most competitive economy in 1998. In 2004 it was eleventh in the league tables and in 2005 it had slipped further to thirteenth.[24] The International Institute of Management Development (IMD) rated the British economy as the ninth most competitive economy in 1997. In 2004 and 2005 it was rated as the 22nd most competitive economy.[25]
- The reasons for falling competitiveness include the rising regulatory burden,[26] the increasingly unattractive tax regime by international standards[27, 28] and the increasing size of the state which drags down growth. [29] Taxes will be further discussed in chapter 3.

UK GDP GROWTH IN AN INTERNATIONAL CONTEXT: KEY OECD ECONOMIES

COUNTRY	2000	2005 (2000=100)	RANK
Australia	100.0	117.3	4
Canada	100.0	113.5	=6
France	100.0	108.0	9
Germany	100.0	103.3	13
Ireland	100.0	129.2	1
Italy	100.0	103.5	12
Japan	100.0	106.5	10
Korea	100.0	124.5	2
Netherlands	100.0	103.8	11
New Zealand	100.0	119.0	3
Spain	100.0	116.7	5
UK	100.0	112.3	8
US	100.0	113.5	=6
Euro area	**100.0**	**106.9**	
Total OECD	**100.0**	**111.0**	

Source: OECD, *Economic Outlook*, number 78, December 2005, OECD.

REFERENCES

1. HM Treasury, *PBR 2005*, *Britain meeting the global challenge: Enterprise*, *fairness and responsibility*, TSO, Cm 6701, December 2005.
2. OECD, *Economic Outlook*, *Volume 2005/2*, *no 78*, December 2005, OECD.
3. National Institute of Economic and Social Research (NIESR), *National Institute Economic Review*, no 195, January 2006, Sage.
4. Chris Giles, "FT calculations reveal little or no spare capacity in the economy", *FT*, 16 January 2006.
5. IMF, *IMF Executive Board concludes 2005 Article IV consultation with UK*, Public Information Notice (PIN) no. 06/24, 3 March 2006.
6. BoE, Monetary Policy Committee Meeting, "Minutes, 11 and 12 January 2006", 25 January 2006.
7. Institute of Fiscal Studies (with Morgan Stanley), *The IFS Green Budget*, January 2006, IFS.
8. HMT, "Evidence on the UK economic cycle", 19 July 2005, from www.hm-treasury.gov.uk
9. HM Treasury, *PBR 2005*, *Britain meeting the global challenge: Enterprise*, *fairness and responsibility*, TSO, Cm 6701, December 2005.
10. National Institute of Economic and Social Research (NIESR), *National Institute Economic Review*, no 195, January 2006, Sage.
11. IFS, (with Morgan Stanley), *The IFS Green Budget*, January 2006, IFS.
12. IMF, *IMF Executive Board concludes 2005 Article IV consultation with UK*, Public Information Notice (PIN) no. 06/24, 3 March 2006.
13. IFS (with Morgan Stanley), *The IFS Green Budget*, January 2006, IFS.
14. IFS (with Morgan Stanley), *The IFS Green Budget*, January 2006, IFS, discusses these drivers in detail.
15. The ONS announced recently that business investment fell 1.0% in 2005Q4 to be only 0.3% higher than a year earlier. ONS, "Business Investment", First Release, 23 February 2006.
16. The ONS recently announced that it would be raising its estimates for software investment, which mitigated the appalling overall figures for business investment. ONS, "ONS improves measure of "new economy"", 13 February 2006.
17. BoE, Monetary Policy Committee Meeting, "Minutes, 11 and 12 January 2006", 25 January 2006.
18. See Ruth Lea, *The price of the profligate Chancellor*, CPS, March 2004.
19. BoE, Monetary Policy Committee Meeting, "Minutes, 11 and 12 January 2006", 25 January 2006.
20. BoE, *Inflation Report*, February 2006.
21. IFS (with Morgan Stanley), *The IFS Green Budget*, January 2006, IFS.
22. Ruth Lea, *Whatever happened to the Golden Legacy?*, CPS, March 2005.
23. Ruth Lea, *The UK: better than the eurozone but worse than other Anglophone economies*, CPS February 2005.
24. Available on www.weforum.org.
25. Available on www.imd.ch.
26. The BCC estimates that the cost to British business of major regulations introduced since 1998 has risen to over £50bn. See "Burdens on businesses now tops £50bn" press release, 9 March 2006. Available from www.chamberonline.co.uk.
27. See Charlie Elphicke and William Norton, *The case for reducing business taxes*, CPS, February 2006, with a foreword by Charlie McCreevy, EU Commissioner.
28. See Ruth Lea, *For the economy's sake, we cannot afford not to cut taxes*, CPS, November 2004.
29. See Ruth Lea, *Tax 'n' spend: no way to run an economy*, CPS, July 2004.

CHAPTER THREE
THE FISCAL BACKGROUND

3.1 Introduction

3.2 Public finances: recent data

3.3 Public finances: prospects

3.4 The fiscal rules

3.5 Classification issues

3.6 HMRC's drive against tax avoidance

3.7 Public spending: prospects

3.8 International comparisons of state share of GDP

3.1 INTRODUCTION

The forecasts for the public finances will undoubtedly be of interest to the economic and political commentators in the forthcoming Budget, though there is a wide feeling that the Chancellor is currently in "consolidation" mode. In particular there will be a focus on:

- Any revisions to the forecasts for the current budget and Public Sector Net Borrowing in the light of the recent data – the January data were exceptionally good. Announcements of major increases in tax rates are not expected.

- Discussion on the two fiscal rules, especially in the light of the Chancellor's second re-dating of the cycle for the "Golden Rule". It is expected that he will claim that they both will be met.
- Any discussion on public spending "plans" for the three years FY2008 to FY2010. The current three-year plans for FY2005 to FY2007 were laid out in the Spending Review of 2004[1] and the next set of plans is due in summer 2007. If the original two-year release cycle had been maintained, the next spending review would have been in July 2006. The figures currently pencilled in for this period are illustrative.
- On funding the Chancellor has been under pressure to shake up government debt management strategy to increase supply at the long end, where excess demand has depressed yields to ridiculous levels.[2]

3.2 PUBLIC FINANCES: RECENT DATA

The public finances for the first ten months were boosted by some especially buoyant January revenue data. As the following table shows, not only were receipts stronger than expected in the 2005 PBR, but sending was higher too. [3] Table 4 in annex 1, gives further details of the figures.

GROWTH IN PUBLIC SECTOR REVENUES AND SPENDING (%, YOY)

	PBR forecast, FY2005/06 over FY2004/05	10 months to Jan. 2006 over 10 months to Jan. 2005	Jan. 2006 over Jan. 2005
Central Government current receipts	6.9	7.8	14.4
Central Government current spending	4.8	5.8	7.4
Public sector net investment	26.9	46.7	-21.2

Source: IFS, *Public finance bulletin*, February 2006, 20 February 2006, www.ifs.org.uk. On current trends the IFS would expect a public sector current deficit of £10.1bn, compared with £10.6bn in the PBR and £5.7bn in Budget 2005. Substantial revisions to public sector net investment and PSNB for this year (and previous years), largely reflected the reclassification of London and Continental Railways (LCR) to the public sector.

As the following table shows, the buoyancy in revenues reflected the following:

- A dramatic 25% increase in "other" taxes on income and wealth, mainly Corporation Tax and Petroleum Revenue Tax. January is traditionally a strong month for company tax revenues. But this year the revenues were bolstered by HMRC's general, and aggressive, crackdown on tax avoidance (more below) and, more specifically, the planned shift in the timing of North Sea oil groups' tax payments from April to January, consequent on 2005 Budget's provisions to "modernise North Sea corporation tax". (But note that the higher revenues owed nothing to the increase in the supplementary rate to 20% on North Sea oil profits, announced in 2005 PBR, which does not take effect until FY2006, when it is expected to raise an additional £2bn a year.) Rising profits and higher oil prices were also factors behind company tax revenue

buoyancy. Last year's gains in equity prices and mergers and acquisitions activity contributed to robust profitability among companies in the financial sector.

- A buoyant 7.5% increase in income taxes and Capital Gains Tax. Fiscal drag, whereby taxpayers are pushed into higher rate tax bands through earnings inflation, is an ongoing factor for boosting revenues. Buoyant employee earnings in the financial sector (including big bonuses in the City) were another factor.
- A similarly buoyant increase in compulsory social contributions. (Increased NICs rates were announced in the 2002 budget and implemented in April 2003.)
- VAT revenue rises were relatively subdued reflecting the slowdown in consumer spending.

CENTRAL GOVERNMENT ACCOUNTS: SELECTED CURRENT RECEIPTS (NSA, £BN)

	January		April-January		Difference
	2006	2005	FY2005	FY2004	
Taxes on production (inc. VAT)	13.2	11.9	134.6	129.1	5.5 (4.3%)
Taxes on income & wealth, of which:	31.2	26.2	149.3	133.4	16.0 (11.9%)
- Income & CGT	20.2	18.9	107.4	99.9	7.5 (7.5%)
- Other (mainly CT & PRT)	11.0	7.3	41.9	33.4	8.5 (25.4%)
Compulsory social contributions	7.5	7.2	69.8	64.9	4.9 (7.6%)
Total current receipts	54.0	47.2	375.3	348.3	27.0

Source: ONS, *Public sector finances*, First Release, Jan 2006, 20 Feb 2006. For the complete set of central government accounts see table 5, annex 1.

3.3 PUBLIC FINANCES: PROSPECTS

The next table shows a fair estimate of the key public sector data for FY2005, bearing in mind the fact that government spending is "end-year loaded", the changes to the back data arising from the reclassification of London and Continental Railways (LCR) from the private to the public sector and the recent buoyancy in revenues.

PUBLIC SECTOR FINANCES (£BN)

	Public sector current budget balance	Public sector net borrowing
FY2004:		
- 2005 PBR	-19.9	38.8
- Latest ONS estimate*	-19.4	40.0
- 10 months: April - Jan	-15.0	30.0
FY 2005:		
- 2005 Budget	-6	32
- 2005 PBR	-10.6	37.0
- 10 months: April - Jan	-7.8	29.8
CPS estimate of outturn	**-11.0**	**39.0**

The current budget deficit for FY2005 is, therefore, expected to be £11bn, a little higher than the 2005 PBR forecast, and £5bn worse than the 2005 Budget forecast. Thus the general over-optimism in the Treasury's forecasts persists. (See annex 1, table 2 for the Treasury's record, which is heroically poor.) Given, the combination of aggressive anti-avoidance measures and fiscal drag, the figure for FY2005 is an improvement on FY2004's figure of £19.4bn. The PSNB figure is expected to be about £39bn, a tad up on the 2005 PBR forecast, well up on the 2005 Budget forecast but little changed from FY2004's £40bn.

Looking further ahead, there is widespread questioning of the Chancellor's forecasts of the public finance. The table below compares NIESR's and IFS's latest forecasts with the 2005 PBR forecasts.

PUBLIC SECTOR FINANCES (£BN)

	FY04+	FY05	FY06	FY07	FY08	FY09	FY10
PS Current Budget							
Budget 2005	-16.1	-6	1	4	9	12	Na
PBR 2005	-19.9	-10.6	-4	0	7	11	13
Current outturn	-19.4						
NIESR	-20.3	-13.5	-9.0	-7.2	-2.3	0.3	2.7
IFS Green Budget	Na	-10.5	-7.4	-5.6	-0.5	5.2	10.0
CPS expected outturn	Na	-11.0					
PS Net Borrowing							
Budget 2005	34.4	32	29	27	24	22	Na
PBR 2005	38.8	37.0	34	31	26	23	22
Current outturn	40.0						
NIESR	39.5	36.1	36.4	36.9	34.3	32.8	32.9
IFS Green Budget	Na	36.8	36.7	36.7	31.5	28.8	25.0
CPS expected outturn	Na	39.0					
PS net debt (as % of GDP)							
Budget 2005	34.4	35.5	36.2	36.8	37.1	37.1	Na
PBR 2005	34.7	36.5	37.4	37.9	38.2	38.2	38.2
Current outturn	35.1*						
NIESR	35.0	36.8	37.7	38.5	38.8	39.0	39.0
IFS Green Budget	Na	36.5	37.4	37.9	38.2	38.2	38.2

\+ Indicates outturns. The latest data on outturns are from the ONS (dated 20 February 2006).

* The increase reflects the reclassification of LCR to the public sector, which adds £5bn (0.4% of GDP) to PS Net Debt.

Sources: HM Treasury: *Budget 2005* and *Pre-Budget Report 2005*; NIESR: *National Institute Economic Review*, no. 195, NIESR, January 2006.; IFS (with Morgan Stanley), *The IFS Green Budget*, January 2006, forecasts under "cautious" assumptions.

NIESR's, and to a lesser extent the IFS's, forecasts are more pessimistic than the Treasury's, not all of which can be explained by the fact that they were prepared before the release of the January data. But it is notable that both independent forecasters do see a return to current budget surplus over the forecast period and are much less concerned about structural "black holes" in the current balance that need to be "filled" by either taxes and/or

slower spending growth than was the case last year. Indeed the IFS rather modestly suggests that there is a "reasonable case" for a £2.5bn increase in tax.[4] But there is no longer any sense of need or urgency. This is not so much a black hole as a fraying at the edges.

It is, however, worth emphasising the following points:

- The Chancellor has recently increased the tax burden significantly even though there has not been an eye-catching move such as the increase in NICs rates, which were announced in 2002 and implemented in 2003. As already discussed, fiscal drag and the aggressive moves against perfectly legal tax planning (avoidance) schemes, more below, have been revenue boosters.

- There have been explicit revenue raising announcements such as the increased supplementary rate on North Sea oil companies' profits, announced in the 2005 PBR, and which is expected to amount to £2bn each year from FY2006.

- Moreover, the 2005 PBR contains illustrative figures for Total Managed Expenditure (TME) that imply that it will grow by an average of 1.8% (real terms) between FY2008 and FY2010.[5] This is eye-wateringly tight. But they do have the effect of making the public sector projections look healthier. The hundred dollar question is whether the Chancellor, or his successor, would be prepared to stick to them. If these projections are replaced by more generous plans, then the need for tax increases unequivocally returns to the agenda. The public spending data are discussed further below.

- Under these circumstances, it could be very effectively argued that the Chancellor has, de facto, acted to fill the "black hole", without ever having to acknowledge there was one in the first place!

- If the economy, however, significantly underperforms the public finances could yet prove to be very difficult to stabilise. And the "black hole" will return.

Concerning the rest of the forecasts:

- Public Sector Net Borrowing is currently running at around 3% of GDP, and formally breached the Maastricht excessive deficit criterion (in which the deficit should be no more than 3% of GDP) in FY2003 and FY2004. It will probably do so in FY2005.

- Public Sector Net Debt as a % of money GDP, which touched a "local" low in FY2001 of 30.2%, is now rising quite rapidly reflecting the cumulative net borrowing data. Even though the above forecasts do not breach the Chancellor's second fiscal rule, the "sustainable investment rule" which asserts that public spending net debt should be below 40% of GDP over the cycle, they are moving perilously close to breaching it. And do note that the reclassification of LCR has added 0.4% of GDP to public sector net debt.

3.4 THE FISCAL RULES

The fiscal rules, which were put together in 1997, are:

- The golden rule: which states that, on average over the cycle, the government will borrow only to invest and not to fund current spending
- *The sustainable investment rule*: which states that public sector debt as a proportion of GDP will be held over the cycle at a stable and prudent level. The government believes that, other things being equal, it is desirable that public spending net debt should be below 40% of GDP over the cycle.

There were two features of the golden rule that have, notoriously, subsequently been altered which have undermined the credibility of the Chancellor's adherence to sound finances. The markets, so far, have been remarkably forgiving.

The first is that, when the Chancellor first announced his Golden Rule, it was assumed that the *actual balances* would be cumulated over the cycle, and that the net figure should be zero or positive for the Golden Rule to be met. However, in more recent announcements the emphasis has been on the balances as percentage shares of GDP. This has been criticised on the grounds that it gives greater weight to the earlier years of the cycle, when some of the surpluses were large, and smaller weight to the later years when some of the deficits were large.

The second relates to the actual specification of the cycle. As discussed in chapter 2, there have been three different specifications of the cycle.

(A) From FY1999 to FY2005: the original specification.

(B) From FY1997 to FY2005: as altered in July 2005.

(C) From FY1997 to FY2008: as altered in the 2005 PBR.

There is little doubt that, for all the Treasury's justifications of the re-datings, the changes were primarily made for reasons of political expediency rather than economic transparency.

Taking all these revisions into account there are, therefore, theoretically six combinations of the Golden Rule: three incorporating the actual balances and three incorporating the current balance as a % of GDP. The first table below, incorporating levels and using the, arguably optimistic, 2005 PBR projections, shows that the Golden Rule would have been missed on all three specifications of the cycle – albeit by the finest of margins when the cycle is taken as FY1997 to FY2008 and of no economic consequence whatsoever.

PUBLIC SECTOR CURRENT BUDGET BALANCES: LEVELS (£BN)

	Balances	Cumulative (A) FY1999-FY2005	Cumulative (B) FY1997-FY2005	Cumulative (C) FY1997-FY2008
Actual:				
FY1997	-1.2	Na	-1.2	-1.2
FY1998	10.4	Na	9.2	9.2
FY1999	20.2	20.2	29.4	29.4
FY2000	21.5	41.7	50.9	50.9
FY2001	10.3	52.0	61.2	61.2
FY2002	-13.1	38.9	48.1	48.1
FY2003	-21.3	17.6	26.8	26.8
FY2004	-19.4	-1.8	7.4	7.4
Projections:				
FY2005	-10.6	-12.4	-3.2	-3.2
FY2006	-4	Na	Na	-7.2
FY2007	0	Na	Na	-7.2
FY2008	7	Na	Na	-0.2
Golden Rule met?		Missed	Just missed	Missed by a whisker

Sources: Actual data: ONS, *Public sector finances*, First Release, Jan 2006, 20 Feb 2006.
Projections: HM Treasury, Pre-Budget Report 2005, *Britain meeting the global challenge: Enterprise, fairness and responsibility*, Cm 6701, TSO, December 2005.

Given the evidence on the actual balances, it is unsurprising that the Treasury's favoured yardstick is balances as a % of GDP. The next table is a more flattering picture of the public finances under the Golden Rule – which would have been missed for the years FY1999 to FY2005, but met otherwise.

PUBLIC SECTOR CURRENT BUDGET BALANCES: LEVELS (£BN)

Year (year of cycle from FY1997)	Balances	Cumulative (A) FY1999-FY2005	Cumulative (B) FY1997-FY2005	Cumulative (C) FY1997-FY2008*
Actual:				
FY1997 (1)	-0.15	Na	-0.15	-0.15 (-0.15)
FY1998 (2)	1.20	Na	1.05	1.05 (0.5)
FY1999 (3)	2.20	2.20	3.25	3.25 (1.1)
FY2000 (4)	2.23	4.43	5.48	5.48 (1.4)
FY2001 (5)	1.02	5.45	6.50	6.50 (1.3)
FY2002 (6)	-1.23	4.22	5.27	5.27 (0.9)
FY2003 (7)	-1.90	2.32	3.37	3.37 (0.5)
FY2004 (8)	-1.65	0.67	1.72	1.72 (0.2)
Projections:				
FY2005 (9)	-0.9	-0.23	0.82	0.82 (0.1)
FY2006 (10)	-0.3	Na	Na	0.52 (0.1)
FY2007 (11)	0	Na	Na	0.52 (0.0)
FY2008 (12)	0.5	Na	Na	1.02 (0.1)
Golden Rule met?		Missed	Hit	Hit

* Average annual surplus since FY1997 in brackets.

Sources: Actual data: ONS, *Public sector finances*, First Release, Jan 2006, 20 Feb 2006.
Projections: HM Treasury, Pre-Budget Report 2005, *Britain meeting the global challenge: Enterprise, fairness and responsibility*, Cm 6701, TSO, December 2005.

There are, of course, dangers to these forecasts. As pointed out already, commentators including the IFS and NIESR still regard the Treasury's forecasts as on the optimistic side and the "better" figures for FY2008 does assume that the Chancellor will stick to the hair shirt projection for spending, despite the pressures on the public services that this will entail. The IMF's most recent assessment of the public finances was also less optimistic than the Treasury's.[5]

It is worth noting that the continuation of the modest current deficit for FY2006 (£4bn, 0.3% of GDP), for example, into FY2007 and FY2008 would mean the Golden Rule would be missed (albeit by a fine margin). And this does lead to the thought that, whilst the first re-dating of the cycle was because as originally specified the Golden Rule would have been missed, the second re-dating was more about deferring decisions about the specification of the next cycle for the Golden Rule by a couple of years. If this is correct, then the decision was purely political. There is also the possibility that the cycle was extended to include a year (FY2008) in which the balance would be positive to give the next cycle a "better start".

Turning to the Sustainable Investment Rule, the Treasury remains confident that it will be met over its full projection period, as the following table shows.

PUBLIC SECTOR NET DEBT (END OF PERIOD)

	Actual (£bn)	As a % of GDP
Actual:		
FY1997	352.1	41.5
FY1998	350.0	39.2
FY1999	343.0	36.4
FY2000	309.8	31.4
FY2001	314.6	30.4
FY2002	346.3	31.8
FY2003	381.5	33.2
FY2004	421.0*	35.1*
Forecast:		
FY2005	456.6	36.5
FY2006	495	37.4
FY2007	529	37.9
FY2008	560	38.2
FY2009	589	38.2
FY2010	617	38.2
Sustainable Investment Rule met?		**Yes**

* Revised upwards since the 2005 PBR because of the reclassification of LCR to the public sector (about £5bn, or 0.4% of GDP)

Sources: Actual data: ONS, *Public sector finances*, First Release, Jan 2006, 20 Feb 2006.
Projections: HM Treasury, Pre-Budget Report 2005, *Britain meeting the global challenge: Enterprise, fairness and responsibility*, Cm 6701, TSO, December 2005.

There are, of course, dangers with this forecast as well, not least of all because of the ONS's reclassification of LCR to the public sector. The

IMF's latest projections suggest that the Sustainable Investment Rule will be breached by the end of the decade.[6] This does suggest that, at some point, taxes will have to be raised further and/or spending shaved further if this rule is to be regarded as binding – which may or may not be the case. But, either way, there is currently no sense of urgency.

3.5 CLASSIFICATION ISSUES

The controversies surrounding the classification of various spending programmes, guaranteed by the Treasury but not counted towards the national debt, continue.[7] They include:

- The costs of Network Rail, estimated at around £20bn. Network Rail's liabilities, although guaranteed by government, were agreed to be off-balance sheet because of the sham independence conferred on the organisation by the presence of a board.
- Public sector pensions liabilities are off-balance sheet.[8]
- Projects under the Private Finance Initiative (PFI), estimated at around £24bn. PFI deals have been judged to be to be "on balance sheet", though none of the related borrowing has been counted towards the national debt.

If the liabilities of Network Rail and the PFI were added to public sector debt the Sustainable Investment Rule would probably be breached as early as FY2005, especially after the LCR decision. Concerning the PFI, it is all too easy to regard PFI funded projects as a costless option. But they are not, as the data on future payments in the table below show.

ESTIMATED PAYMENTS UNDER PFI CONTRACTS – DECEMBER 2005 (SIGNED DEALS), PROJECTIONS

Year	£bn	Year	£bn
FY2005	6.4	FY2018	4.6
FY2006	6.5	FY2019	4.6
FY2007	6.7	FY2020	4.6
FY2008	6.8	FY2021	4.3
FY2009	7.0	FY2022	4.3
FY2010	7.2	FY2023	4.3
FY2011	7.3	FY2024	4.3
FY2012	7.3	FY2025	4.3
FY2013	7.4	FY2026	3.9
FY2014	7.4	FY2027	3.9
FY2015	7.5	FY2028	3.4
FY2016	7.5	FY2029	3.0
FY2017	6.7	FY2030	2.4

Source: HM Treasury, Pre-Budget Report 2005, *Britain meeting the global challenge: Enterprise, fairness and responsibility*, Cm 6701, TSO, December 2005.

Even though Network Rail, in particular, remains controversially classified in the private sector, the ONS has acted decisively on operations relating to the Channel Tunnel rail link. In August 2005 the ONS agreed that bonds

used to fund the Channel Tunnel rail link, valued at £1.25bn, would have to feature on the Chancellor's balance sheet. And, with the January public finance data, London and Continental Railways (LCR), operator of the Channel Tunnel rail link, were reclassified as part of the public sector. The ONS estimates that PS net debt is £5bn (0.4% of GDP) higher as a result of LCR reclassification.

3.6 HMRC'S DRIVE AGAINST TAX AVOIDANCE

As already discussed above, the Treasury (along with HM Revenue and Customs) has actively sought to raise revenue by a combination of fiscal drag and aggressive anti-avoidance measures. This section discusses the latter.

The Government now appears to take the view that much tax planning (or tax avoidance) is "unacceptable", even though it is within the law, and it is cracking down on schemes with unprecedented tenacity. The main reason for this is undoubtedly to raise revenue – HMRC estimates that it is losing £10bn a year because of tax avoidance. But such aggressive and hostile campaigns can backfire. A few artificial schemes may be stopped but big companies will consider moving to more hospitable regimes.[9]

Behind the tax authorities' attack on business's tax policies is the unspoken suggestion that business is not paying its "fair share" of tax. Such is the degree of business's concern that the "Hundred Group" of finance directors has sought to address the "lack of understanding about what business taxes are, and how much tax companies actually pay". It has released information showing that the Hundred Group's 108 members, broadly equating to the FTSE 100 companies, paid £18.2bn in business taxes in FY2004, which amounted to 4.3% of all Government receipts.[10]

The main developments in the anti-avoidance strategy are as follows:

- The Government's efforts to tackle tax avoidance have become more high-profile in recent years. Measures to "protect revenues" announced since the 2002 budget alone are estimated to be raising about £4½ bn this year.[11]
- The Finance Act (2004) introduced the "Tax Avoidance Disclosure" (TAD) rules to tackle tax avoidance. The TAD rules provide a framework for early disclosure by "promoters" of tax planning schemes that fall under certain categories to the tax authorities. The TAD regime came fully effective in the latter part of 2004. It has led to a considerable volume of disclosures and, subsequently, a raft of blocking measures, outlined, to date, in the 2004 PBR, the 2005 Budget and the 2005 PBR. It should be noted that disclosure is not restricted to marketed schemes. There is also a requirement to disclose planning that arises from bespoke everyday advice under certain circumstances.[12]
- The 2005 Finance Act specifically closed several tax planning schemes including involving the exploitation of arbitrage, employee securities, VAT avoidance and financial avoidance.[13]

- In Autumn 2005, HMRC officials initiated the "Tax in the Boardroom" initiative. They wrote directly to the chairmen of the UK's largest 500 companies, seeking to establish a dialogue over the management of tax issues and tax risk.[14] Arguably, this is an unwarranted intrusion into British business and hints at even more aggressive approach to tax raising from British business.

3.7 PUBLIC SPENDING: PROSPECTS

As already suggested this Budget will be probably one of consolidation. There is currently no sense of urgency about increasing major tax rates and the economic forecasts are likely to be broadly unchanged. The difficult economic decision concerning the public spending plans for FY2008 to FY2010, moreover, will be deferred until the summer of 2007.

The Chancellor has, however, pencilled in some illustrative projections for spending and they look extraordinarily tight, if not unrealistically tight. The 2005 PBR contained average annual nominal increases of just over 4½% for Total Managed Expenditure (TME) for FY2008 to FY2010. In real terms, after deflating using the GDP deflator assumed to rise by 2¾% annually, the average annual increase in TME is around 1.8%. This barely looks credible. Such plans, therefore, look very painful but they represent, arguably, the only way out of increasing major tax rates.

If they are put into place they would effectively become the Chancellor's "Phase Three" of spending patterns. The three phases would be:

- Phase 1: FY1997 to FY1999, during which the Chancellor stuck to the tough Conservative spending plans. **Famine**.
- Phase 2: FY2000 to FY2007, during which the "Profligate Chancellor" [15] turned on the spending taps - though it should be noted that spending growth in FY2005 to FY2007 showed some deceleration. **Feast**.
- Phase 3: FY2008 to FY2010, for which eye-wateringly tight data are pencilled in. **Famine**.

So it would be a case of from famine to feast to famine. The following table puts the spending projections into context. Annex 1, table 3 shows the spending data for the four spending reviews to date (1998, 2000, 2002 and 2004).

As can be seen from the table, TME has increased from around £320bn in FY1997 to nearly £520bn in FY2005 and, despite some truly bizarre claims that spending over the next two years will be "tight", expenditure is planned to rise to £580bn by financial year 2007/08 – some £260bn higher than a decade earlier.[16]

TOTAL MANAGED EXPENDITURE (TME) £BN, CURRENT PRICES, & AS A % OF GDP

	TME (£bn)*	% of GDP
FY1997	322.1	38.9
FY1998	332.7 (3.3%)	37.9
FY1999	340.9 (2.5%)	37.0
FY2000	364.1 (6.8%)	37.7
FY2001	387.6 (6.5%)	38.5
FY2002	418.0 (7.8%)	39.3
FY2003	455.2 (8.9%)	40.5
FY2004	487.3 (7.1%)	41.4
FY2005 (estimate)	519.9 (6.7%)	42½ (approx)
Planned projections:		
FY2006	550.1 (5.8%)	43 (approx)
FY2007	580.7 (5.6%)	43 (just under)
Illustrative projections:**		
FY2008	606 (4.4%)	
FY2009	636 (5.0%)	
FY2010	664 (4.4%)	

* Percentage increases in brackets.

** Taken from 2005 PBR, table B9 and calculated as current expenditure + (gross investment – asset sales).

Sources: TME data: HM Treasury, 1998 *PBR*, for FY1997; HMT & ONS, *Public Expenditure Statistical Analyses 2004* (PESA 2004) for FY1998; HMT & ONS, *PESA* 2005, for FY1999 to FY2003; 2005 PBR, for FY2004 to FY2007 and FY2008 to FY2010. TME/GDP (%) data: HM Treasury, 2005 *PBR*, table B31 for FY1997 to FY2004 and chart B4 for FY2005 to FY2007.

Yet, despite these heroic increases in public spending, the evidence is that some services have nevertheless been poorly funded, [17] and much funding has been wasted – not least of all in the NHS.[18] The hundred dollar question will be how the public services will cope if or when spending growth is curtailed during the period FY2008 to FY2010 – especially in the NHS.

Already there are some voices of concern:

- The IMF has already warned that the government has under-estimated the future growth in NHS costs. [19]
- The IFS has pointed out that health spending has grown by an annual average of 7.6% (in real terms) from FY1999 to FY2005 (inclusive) and education spending by just under 7%. If health and education spending were to rise at annual average rates of 4.4% and 2.4% respectively (in real terms) for the forthcoming period FY2008 to FY2010, and if ODA spending were in line with Labour's Manifesto commitment, then spending on all other programmes would have to be grow by only 0.8% a year.[20]

Given that the IFS's projections on health and education seem plausible then the consequences for other programmes is grim. Indeed it may be suggested that these plans would never be implemented for political reasons. But the alternative to plans along these lines would almost inevitably be major hikes in tax rates.

3.8 INTERNATIONAL COMPARISONS OF STATE SHARE OF GDP

Given the huge increases in spending in recent years, it is unsurprising that the British state's share of GDP has significantly risen in recent years. On the Treasury's own figures, total public spending (Total Managed Expenditure) as a percentage of GDP will be over 42% for FY2005 compared with 37% in FY2000. [21]

One of the "orthodoxies" of the 20th century was the notion that big states were beneficial – that somehow governments knew how to spend the fruits of people's labours better than they did. But there is now a wealth of economic research which shows that countries with large public sectors perform economically less well than countries with smaller public sectors.[22] This is all the more relevant in the emerging 21st century when the BRICs (Brazil, Russia, China and India) nations are rapidly challenging the 20th century complacencies of the rich Western countries.

Many countries have heeded the need to cut back the size of the state in recent years, cut back their state sectors and benefited accordingly. These countries included Canada, Ireland, New Zealand, Spain and Sweden. But the UK, almost uniquely, had not. Other exceptions are Japan (compared with 1990) and Portugal, where growth has been weak in recent years. The UK has had no such excuse.

GENERAL GOVERNMENT TOTAL OUTLAYS, % OF NOMINAL GDP, SELECTED OECD COUNTRIES

	1990	2000	2007*	Change between 2000 & 2007
Australia	36.2	35.7	35.5	-0.2
Austria	51.5	51.4	48.2	-3.2
Canada	48.8	41.1	40.0	-1.1
Denmark	55.9	53.9	52.1	-1.8
Finland	48.3	48.8	50.6	+1.8
France	49.3	51.6	53.0	+1.4
Germany	44.5	45.1	45.0	+0.1
Ireland	42.9	31.5	35.2	+3.7
Italy	54.4	46.9	49.0	+2.1
Japan	31.8	38.3	37.8	-0.5
New Zealand	53.3	39.3	39.0	-0.3
Portugal	40.6	43.7	47.1	+3.4
Spain	42.5	38.9	38.7	-0.2
Sweden	61.9	57.4	56.3	-1.1
Switzerland	30.0	33.9	36.1	+2.2
UK	42.2	37.5	45.7	+8.2
US	37.1	34.2	36.6	+2.4
Euro area	48.0	46.4	46.9	+0.5
OECD	**40.2**	**39.1**	**40.7**	**+1.6**

* Forecast

Source: OECD, *Economic outlook*, Number 78, December 2005, OECD. General Government comprises Central Government and Local Government.

The table above shows that the UK, by pursuing big state, big spending policies, is swimming against the 21st century tide. It is locked in the comfortable complacencies of the 20th century Social Democratic "European" mindset and the consequence will be relative economic decline. The table shows that the general government spending as a % of GDP is expected to rise by over 8% between 2000 and 2007 in the UK – a quite staggering increase which will well outstrip developments in other countries. Moreover, the UK's government spending as a share of GDP is expected to be greater than Germany's by 2007.

As the UK's public spending as a % of GDP rises, so does taxation's share of GDP. The following table shows how the tax burden in the UK is expected to outstrip that in Germany by 2007. It also shows how trends in the UK are against the current tide of developments in other countries.

GENERAL GOVERNMENT TOTAL TAX & NON-TAX RECEIPTS, % OF NOMINAL GDP, SELECTED OECD COUNTRIES

	1990	2000	2007*	Change between 2000 & 2007
Australia	34.5	36.7	36.4	-0.3
Austria	49.0	49.8	46.6	-3.2
Canada	43.0	44.1	40.6	-3.5
Denmark	54.6	56.2	54.1	-2.1
Finland	53.7	55.9	52.1	-3.8
France	47.4	50.1	50.0	-0.1
Germany	42.5	46.4	42.4	-4.0
Ireland	40.1	35.9	34.6	-0.5
Italy	42.6	46.2	44.2	-2.0
Japan	33.9	30.8	31.7	+0.9
New Zealand	48.9	40.5	43.3	+2.8
Portugal	34.2	40.8	42.5	+1.7
Spain	38.6	38.1	38.8	+0.7
Sweden	65.3	62.4	57.6	-4.8
Switzerland	30.6	36.3	35.3	-1.0
UK*8	40.7	41.3	42.5	+1.2
US	32.9	35.8	32.7	-3.l
Euro area	43.5	46.4	44.4	-2.0
OECD	**37.3**	**39.4**	**37.6**	**-1.8**

* Forecast

** The rise of just 1.2% in tax receipts as a share of GDP between 2000 and 2007 is distorted by the fact that the UK was running a large current balance surplus in 2000 and is expected to run a large current balance deficit in 2007.

Source: OECD, *Economic outlook*, Number 78, December 2005, OECD.

REFERENCES

1. HM Treasury, *2004 Spending Review*, TSO, Cm 6237, July 2004.
2. FT leader, "Politics not economics to define this Budget", *FT*, 6 March 2006.
3. HM Treasury, *Pre-Budget Report 2005*, *Britain meeting the global challenge: Enterprise, fairness and responsibility*, Cm 6701, TSO, December 2005
4. IFS (with Morgan Stanley), *The IFS Green Budget*, January 2006, IFS.
5. Gabriel Rozenberg, "'Golden Rule' at risk, IMF warns Chancellor", *Times*, 4 March 2006.
6. Scheherazade Daneshkhu, "IMF warns Brown will break his rules", *FT*, 4 March 2006.
7. See also (1) Ruth Lea, *Whatever happened to the Golden Rule?*, CPS, December 2005, and (2) Ruth Lea, *Whatever happened to the Golden Legacy?*, CPS, March 2005.
8. IFS (with Morgan Stanley), *The IFS Green Budget*, January 2006, IFS.
9. Times business section, "Tax loss", *Times*, 3 March 2006
10. Vanessa Houlder, "Top companies submit figures to counter charge of tax underpayment", *FT*, 9 March 2006.
11. IFS (with Morgan Stanley), *The IFS Green Budget*, January 2006, IFS.
12. IFS (with Morgan Stanley), *The IFS Green Budget*, January 2006, IFS.
13. House of Commons Hansard Debates for 6 July 2005, Finance Bill, Rt Hon Dawn Primarolo, Paymaster General.
14. IFS (with Morgan Stanley), *The IFS Green Budget*, January 2006, IFS.
15. Ruth Lea, *The price of the profligate Chancellor*, CPS, March 2004.
16. Ruth Lea, *Whatever happened to the Golden Rule?*, CPS, December 2005.
17. Ruth Lea, *Public spending trends: winners & losers*, CPS Perspective, April 2005.
18. Ruth Lea, *The NHS since 1997: modest improvements at immoderate cost*, CPS, May 2005.
19. Ed Conway, "IMF warns of looming £50bn gap in NHS finances", *Daily Telegraph*, 4 March 2006
20. IFS (with Morgan Stanley), *The IFS Green Budget*, January 2006, IFS.
21. HM Treasury, *Pre-Budget Report 2005*, *Britain meeting the global challenge: Enterprise, fairness and responsibility*, Cm 6701, TSO, December 2005.
22. Ruth Lea, *Tax 'n' spend: no way to run an economy*, CPS, July 2004.

CHAPTER FOUR
A FISCAL FRAMEWORK FOR THE FUTURE

4.1 Introduction

4.2 A basic framework

4.3 Tax reform

4.4 Public spending: waste

4.1 INTRODUCTION

A model fiscal framework is one that:

- Ensures that the public finances are managed well so that the financial markets have confidence in the fiscal propriety of the Government. The Chancellor's two rules provide a reasonable framework – but they need to be adhered to - and the system of three-year Spending Reviews has worked well. Despite the Chancellor's appalling forecasting record and gerrymandering of the cycle, his standing in the financial markets has not been punished. This partly reflects the resilience of the strong economy he inherited in 1997.[1]

- Encourages economic growth and competitiveness by ensuring the state's share of GDP is controlled. This concept has been a noticeable absentee in the Chancellor's policy thinking. But controlling the size of the state should be an intrinsic part of Treasury thinking.

- Recognises the dynamic nature of tax changes; in other words, the impact on individuals and businesses of tax changes. The Treasury's analysis of tax changes is currently static.

In addition, any the government should be vigilant and committed in cracking down on government waste.

4.2 A BASIC FRAMEWORK

The current fiscal framework comprising the Chancellor's two rules, along with the Spending Review structure, is a good place to start the discussion of a model fiscal framework. The broad framework should be retained. The IMF, for example, is on the record saying that the framework has served the UK well. [2]

But there are three main shortcomings of the current framework:

- The Chancellor has undoubtedly played fast and loose with his own rules, as discussed in chapter 3. This calls for more independent audit and scrutiny of, for example, the Treasury's assumptions, forecasts and the specification of the cycle.
- There is a pressing need to introduce a third rule, which restricts the size of the state.
- The Treasury's analysis of tax changes, so vital to the successful operation of the Golden Rule, is static – not dynamic.

Starting with the need for more independent audit, this could be implemented by either setting up a new independent Commission or by using the current apparatus more extensively. There are, doubtless, advantages for either of these approaches but, on balance, there is much to be said for using the current apparatus more extensively. Several of the IMF's Directors expressed merit in further broadening the scope of NAO audit. [3]

The National Audit Office (NAO) is a highly reputable body and already audits some of the Treasury's work. There is a strong case, for example, for the NAO and the ONS together independently auditing the Treasury's specification of the economic cycle. Indeed the following table shows the extent to which the NAO is already involved.

KEY ASSUMPTIONS AUDITED BY THE NAO

The Treasury's key assumptions	NAO assessment of the Treasury's key assumptions
- Dating of the cycle	The end date of the previous economic cycle was in the first half of 1997*
- Privatisation proceeds	Credit is taken only for proceeds that have been announced
- Trend GDP growth	2½% a year to FY2006 & 2¼% in subsequent years
- UK claimant count	Rising slowly to 0.97m in FY2007, from recent levels of 0.87m
- Interest rates	3-month market rates change in line with market expectations (as at 24 Nov 2005)
- Equity prices	FTSE All-share index rises from 2776 (as at 24 Nov 2005) in line with money GDP
- VAT	The VAT gap will rise by 0.5 percentage points a year from a level that is at least as high as the estimated outturn for the current year
- Consistency of price indices	Projections of price indices used to project the public finances are consistent with CPI
- Composition of GDP	Shares of labour income & profits in national income are broadly constant in the medium term
- Funding	Funding assumptions used to project debt interest are consistent with the forecast level of government borrowing & with financing policy
- Oil prices	$56pb in 2006, the average of independent forecasts, & then constant in real terms
- Tobacco	The underlying market share of smuggled cigarettes will be set at least at the latest published outturn. For the 2005 PBR, a share of 16% is used for FY2003 onwards

* Though not unqualified. The NAO recommended that the Treasury should present "a formal assessment of the views of external organisations in terms of how they have influenced the Treasury's judgement of the dating of economic cycles".

Source: HM Treasury, Pre-Budget Report 2005, *Britain meeting the global challenge: Enterprise, fairness and responsibility*, Cm 6701, TSO, December 2005.

The need for a "third rule" to control the state's share of GDP is vital. As mentioned in chapter 3, there is now a wealth of economic research which shows that countries with large public sectors perform economically less well than countries with smaller public sectors.[4] In order to ensure the reduction in the state's share of GDP, public spending growth should be systematically slower than the GDP growth.[5] It is economically quite straightforward.

The third major shortcoming of the Treasury's rules relates to its analysis of tax changes and the impact on the economy and revenues. The Treasury's analysis is currently static rather than dynamic.[6] No allowance is made for changes in behaviour following tax changes and there is an urgent need for the Treasury to incorporate the dynamic effects of tax changes in their forecasts of tax revenue.[7] Whilst no allowance is made for the dynamic effects, the operation of the Golden Rule will continue to be flawed mainly because the forecasting will continue to be flawed.

Tax changes have significant "dynamic" impacts on individual and business behaviour and, hence, on revenues. They can crucially influence investment decisions, how much people work and save or whether businesses move their operations overseas to avoid confiscatory tax rates. All these decisions will have major knock-on effects for the overall ability of the economy to grow – and thus generate tax revenue.[8] There is a extensive library on the dynamic effects of tax cuts including the so-called "Laffer" curve effects.[9]

The Bush administration has recently decided to provide specific funding for a plan to create a Dynamic Analysis Division within the US Treasury's Office of Tax Analysis. This will advise the President on how proposed changes to US tax policy would affect economic; it is known in the US as "dynamic scoring". Even though the budget is a mere $513,000, this is a very significant step forward and one that should be followed by the UK Treasury.[10]

Other proposed reforms of the fiscal rules include:[11]

- It is not obvious why the Golden Rule should be asymmetric. The rule could be adapted so the goal is for a balanced budget rather than a surplus.
- The distinction between current and capital spending in the Golden Rule, as currently specified, may be inappropriate. For example, £1 of "current" spending on teacher training might be of greater benefit to future taxpayers than £1 of "capital" spending on, say, an Olympic venue of uncertain long-term use.
- Given the ageing population, there is a case for lowering the Sustainable Investment Rule's 40% ceiling of public sector debt to GDP.
- Also relevant to the Sustainable Investment Rule, off balance sheet liabilities, including PFI and Network Rail, should be included in public sector debt.

4.3 TAX REFORM

Much has been written on the need to reduce the tax burden and reform the tax system. Suffice to say in this paper there are very basic principles that should inform tax reform. They are:

- The need to maintain economic competitiveness and stimulate economic growth.[12]
- As discussed above, there is an urgent need to recognise, and therefore act on, the fact that tax changes have significant "dynamic" incentive effects on individual and business behaviour.[13,14]
- The need to encourage and enable families to be independent of state benefits. More specifically, there is an urgent need to take low-paid families out of paying (direct) taxes altogether. Norman Blackwell [15] recommends transferable personal tax allowances of £7,500 each. This would cost the Exchequer only £10.7bn a year in lost revenue – part of which would be offset by a reduction in some benefits.

- The need to encourage savings and pensions. Specifically, the Chancellor's abolition of tax credits on dividend payments paid to pension schemes and UK companies (July 1997 budget) has had a catastrophic effect on occupational pension schemes. There should be a reversal of this policy as and when possible.[16]
- The need to simplify the tax system, which has been made ever-more impenetrable by the current Chancellor. A simpler tax system would not only be easier to understand but less costly to administer, but a flat tax regime has problems as well as advantages.[17]

4.4 PUBLIC SPENDING: WASTE

As discussed in chapter 3, the public sector has expanded greatly since 2000. This is especially true of public sector employment. [18] And there is increasing evidence of waste. The TaxPayers' Alliance, for example, estimates that waste amounts to some £82bn.[19] This amounts to around 16% of the total spending for FY2005.

The Government announced the "Gershon Review" for making efficiency gains of some £21.5bn by end FY2007/08 in July 2004, at the time of the 2004 Spending Review. The Gershon Review also involved the "axing" of 104,000 public servants: 84,000 civil servants and 20,000 from English councils and the devolved administrations of Scotland, Wales and Northern Ireland. Even though the Government claims that the Gershon plans are well on track, and have already resulted in savings of £4.7bn, a recent report by the NAO is rather more sceptical. [20] It is expected that the Chancellor will discuss the efficiency savings further in the Budget.

Specifically the NAO concluded that "progress has been made but the reported efficiencies of £4.7bn should be regarded as provisional and subject to further verification". They also concluded that "the potential for reform goes well beyond the £21.5bn target". The NAO recommended that departments should improve their measurement of efficiency gains and wrote that reported efficiency gains would only be fully credible if departments could clearly demonstrate that:

- Baselines were in place and these baselines represent the situation before efficiency-related reforms began.
- Methodologies capture all elements of efficiency.
- Data assurance was based on clear audit trails and independent validation.

Clearly there is much to do.

REFERENCES

1. Ruth Lea, *Whatever happened to the Golden Legacy?*, CPS, March 2005.
2. IMF, *IMF Executive Board concludes 2005 Article IV consultation with UK*, Public Information Notice (PIN) no. 06/24, 3 March 2006.
3. IMF, *IMF Executive Board concludes 2005 Article IV consultation with UK*, Public Information Notice (PIN) no. 06/24, 3 March 2006.
4. Ruth Lea, *Tax 'n' spend: no way to run an economy*, CPS, July 2004.
5. Lord Blackwell, *Freedom and Responsibility: A manifesto for a smaller state, a bolder nation*, CPS, September 2003.
6. HM Treasury, *Tax Ready Reckoner and Tax Reliefs*, December 2005.
7. The TaxPayers' Alliance is planning a campaign for lower taxes, which emphasizes the dynamic rather than the static response of tax systems. See The TaxPayers' Alliance, *An attack plan strategy for a low-tax campaign*, January 2006, www.taxpayersalliance.com/lowtaxstrategy/pdf
8. Ruth Lea, "It's time to break the Government's web of tax fallacies", *Daily Telegraph*, 20 February 2006.
9. Patrick Minford, *An agenda for tax reform*, CPS, February 2006.
10. Allister Heath, "Six economists and $513,000 could change the way the world thinks about flat tax", *The Business*, 19 February 2006.
11. IFS, (with Morgan Stanley), *The IFS Green Budget*, January 2006, IFS.
12. Ruth Lea, *For the economy's sake, we cannot afford not to cut taxes*, CPS Perspective, November 2004.
13. Lord Blackwell, *Why Britain can't afford not to cut taxes*, CPS, October 2004.
14. Charlie Elphicke and William Norton, *The case for reducing business taxes*, CPS Perspective, February 2006.
15. Lord Blackwell, *Take poor families out of tax*, CPS Perspective, October 2005.
16. Lord Blackwell, *Why Britain can't afford not to cut taxes*, CPS, October 2004.
17. David Martin, *An overview of the flat tax*, CPS Perspective, September 2005.
18. Ruth Lea, *The price of the profligate Chancellor*, CPS, March 2004.
19. Matthew Elliott and Lee Rotherham, *The Bumper Book of Government Waste*, Harriman House, 2006 (TaxPayers' Alliance.)
20. NAO, *Progress in improving government efficiency*, Report by the comptroller and Auditor General, HC 802-I, session 2005-06, 17 February 2006, TSO.

ANNEX 1
TABLES

TABLE 1/A THE CHANCELLOR'S GDP GROWTH FORECASTS FOR 2000 TO 2008: MID-POINTS

	2000	2001	2002	2003	2004	2005	2006	2007	2008
Nov 97	(2½)								
Mar 98	(2½)								
Nov 98	(2½)	(3)							
Mar 99	(2½)	(3)							
Nov 99	**(2¾)**	(2½)	(2½)						
Mar 00	(3)	(2½)	(2½)						
Nov 00	3	**(2½)**	(2½)	(2½)					
Mar 01	3	(2½)	(2½)	(2½)					
Nov 01	3	2¼	**(2¼)**	(3)	(2½)				
Apr 02		2¼	(2¼)	(3¼)	(2¾)				
Nov 02		2	1½	**(2¾)**	(3¼)	(3)			
Apr 03			1¾	(2¼)	(3¼)	(3¼)			
Dec 03			1¾	2	**(3¼)**	(3¼)	(2¾)		
Mar 04				2¼	(3¼)	(3¼)	(2¾)		
Dec 04				2¼	3¼	**(3¼)**	(2¾)	(2½)	
Mar 05					3	(3¼)	(2¾)	(2½)	
Dec 05					3¼	1¾	**(2¼)**	(3)	(3)
Current out-turn	4.0	2.2	2.0	2.5	3.2	1.8			

Note: The data are taken from successive Budget Statements and Pre-Budget Reports and relate to the mid-point of the forecasts. The forecasts taken from the PBR prior to the beginning of the forecast year are shown in bold in the above table. Thus the 1999 PBR's forecast for 2000 and the 2004 PBR's forecast for 2005 are in bold. Underlined data are out-turns. The current outturn data are from the ONS.

TABLE 1/B: LATEST OUTTURNS AND COMPARISON WITH MID-POINT FORECASTS (PBR) FOR GDP GROWTH

	2000	2001	2002	2003	2004	2005
Current out-turn	4.0	2.2	2.0	2.5	3.2	1.8
PBR, mid-point	**2.75 ('99)**	**2.5 ('00)**	**2.25 ('01)**	**2.75 ('02)**	**3.25 ('03)**	**3.25 ('04)**
Outturn minus PBR mid-point	1.25	-0.3	-0.25	-0.25	-0.05	-1.45
PBR, bottom of range	2.5 ('99)	2.25 ('00)	2.0 ('01)	2.5 ('02)	3.0 ('03)	3.0 ('04)
Outturn minus PBR, bottom of range	+1.5	-0.05	0	0	+0.2	-1.2

TABLE 2/A: TREASURY FORECASTS FOR THE PUBLIC SECTOR CURRENT BUDGET BALANCE (£BN), FROM FINANCIAL YEAR 2000/01.

Date of forecast	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Nov 98	3	8	10	11							
Mar 99	4	8	9	11							
Nov 99	11	13	13	12	11						
Mar 00	14	16	13	8	8						
Nov 00	16.6	16	14	8	8	8					
Mar 01	23.1	17	15	8	9	9					
Nov 01	25.1	10.3	3	4	7	8	9				
Apr 02	21.6	10.6	3	7	9	7	9				
Nov 02		7.7	-5.7	-5	3	5	8	10			
Apr 03		9.9	-11.7	-8	-1	2	6	9			
Dec 03			-11.8	-19.3	-8	-5	0	4	8		
Mar 04			-12.3	-21.3	-11	-5	0	4	9		
Dec 04				-21.1	-12.5	-7	1	4	9	12	
Mar 05				-20.4	-16.1	-6	1	4	9	12	
Dec 05					-19.9	-10.6	-4	0	7	11	13
Current outturn	21.5	10.3	-13.1	-21.3	-19.4						

TABLE 2/B: TREASURY FORECASTS FOR THE PUBLIC SECTOR NET BORROWING (£BN), FROM FINANCIAL YEAR 2000/01.

Date of forecast	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Nov 98	5	2	2	1							
Mar 99	3	1	3	4							
Nov 99	-3	-3	1	4	6						
Mar 00	-6	-5	3	11	13						
Nov 00	-10.1	-6	1	10	12	13					
Mar 01	-16.4	-6	1	10	11	12					
Nov 01	-18.8	2.5	12	15	13	13	13				
Apr 02	-15.9	1.3	11	13	13	17	18				
Nov 02		1.2	20.1	24	19	19	19	20			
Apr 03		-0.4	24	27	24	23	22	22			
Dec 03			22.5	37.4	31	30	27	27	24		
Mar 04			22.9	37.5	33	31	27	27	23		
Dec 04				34.8	34.2	33	29	28	24	22	
Mar 05				35.4	34.4	32	29	27	24	22	
Dec 05					38.8	37.0	34	31	26	23	22
Current outturn	-15.8	0	25.2	35.8	40.0						

Sources: For both tables, Pre-Budget reports and Budget Statements. The underlined figures are outturns. The current outturn data are from the ONS.

TABLE 3: SPENDING REVIEWS: TME PLANS (£BN)

Date	Component	FY'98	FY'99	FY'00	FY'01	FY'02	FY'03	FY'04	FY'05	FY'06	FY'07
July 98	DEL	168.8	179.2	190.1	200.2						
	AME	164.8	172.4	179.9	189.5						
	TME	333.6	351.6	370.0	389.7						
July 00	DEL		176.8	195.2	212.1	229.3	245.7				
	AME		163.9	176.4	180.8	186.2	193.9				
	TME		340.7	371.6	392.9	415.4	439.6				
July 02	DEL					239.7	263.5	279.8	301.0		
	AME					178.7	191.2	201.7	210.4		
	TME					418.4	454.6	481.5	511.4		
July 04	DEL							279.3	301.9	321.4	340.5
	AME							208.3	218.9	227.8	239.5
	TME							487.6	520.8	549.2	580.0

Note: DEL = Departmental Expenditure Limit (net of depreciation).
AME = Annually Managed Expenditure.
TME = Total Managed Expenditure.
The underlined data show the new spending plans for each Spending Review.

Sources: Latest data from HM Treasury, *2004 Spending Review*, TSO, Cm 6237, July 2004.

TABLE 4: PUBLIC SECTOR, COMPARISON OF FY1004 AND FY2005 DATA (NSA, £BN)

	January		April-January		Difference
	2006	2005	FY2005	FY2004	
Current budget	15.3	12.3	-7.8	-15.0	7.2
Net borrowing	-12.6	-8.8	29.8	30.0	-0.2
Net debt	442.7	406.8			35.9
Net debt (% annual GDP)	35.6	34.1			1.5
PS net investment minus:	2.7	3.5	21.9	15.0	7.0
- PS current budget	15.3	12.3	-7.8	-15.0	7.2
- PSNB	-12.6	-8.8	29.8	30.0	-0.2
Central government	-13.9	-10.1	27.3	28.0	-0.7
Local government	1.1	1.0	3.0	1.4	1.6
Public corporations	0.2	0.3	-0.5	0.6	-1.1
Public Sector total	-12.6	-8.8	29.8*	30.0*	-0.2

Source ONS, *Public sector finances*, First Release, Jan 2006, 20 Feb 2006. For the full year FY2004, the total is now estimated at £40bn (reflecting the inclusion of LCR in the public sector).

TABLE 5: CENTRAL GOVERNMENT ACCOUNTS (NSA, £BN)

	January		April-January		Difference
	2006	2005	FY2005	FY2004	
Current receipts					
Taxes on production (inc. VAT)	13.2	11.9	134.6	129.1	5.5
Taxes on income & wealth	31.2	26.2	149.3	133.4	16.0
Of which:					
- Income & CGT	20.2	18.9	107.4	99.9	7.5
- Other (mainly CT & PRT)	11.0	7.3	41.9	33.4	8.5
Other taxes	0.9	0.9	9.4	8.9	0.5
Compulsory social contributions	7.5	7.2	69.8	64.9	4.9
Interest & dividends	0.5	0.5	5.7	5.5	0.2
Other receipts	0.6	0.7	6.4	64	0
(A) Total current receipts	54.0	47.2	375.3	348.3	27.0
Current expenditure:					
Interest	2.6	2.6	22.0	20.3	1.7
Net social benefits	10.8	9.9	108.0	103.2	4.8
Other	23.8	22.1	246.7	232.7	14.0
(B) Total current expenditure	37.2	34.7	376.7	356.1	20.6
(C) Depreciation	-0.5	-0.5	-4.9	-4.7	-0.2
(D) Current budget = A-B+C	16.3	12.1	-6.3	-12.6	6.2
(E) Net investment	2.4	2.0	21.0	15.4	5.6
(F) Net borrowing = minus [D-E]	-13.9	-10.1	27.3	28.0	-0.7

Source: ONS, *Public sector finances*, First Release, Jan 2006, 20 Feb 2006.

ANNEX 2
DEFINITIONS USED IN THE PUBLIC FINANCES

Fiscal rules: these are:

- The golden rule: which states that, on average over the cycle, the government will borrow only to invest and not to fund current spending
- The sustainable investment rule: which states that public sector debt as a proportion of GDP will be held over the cycle at a stable and prudent level. The Government believes that, other things being equal, it is desirable that public spending net debt should be below 40% of GDP over the cycle.

Public finances – accounts: the key terms and relationships are shown in the table below on public sector transactions by sub-sector and economic category:

	Comprising:
1 Total current receipts	Taxes on income & wealth + taxes on production (including VAT) + other current taxes + taxes on capital + compulsory social security contributions + gross operating surplus + interest & dividends from private sector & RoW (rest of world) + interest & dividends (net) from public sector + rent & other current transfers
2 Total current expenditure	Current expenditure on goods & services + subsidies + net social benefits + net current grants abroad + current grants (net) within general government + other current grants + interest & dividends paid to the private sector & RoW
3 = 1-2 Saving, gross plus capital taxes	
4 Less depreciation (conventionally shown as negative in the accounts)	
5 = 3+4 Surplus on the current budget (current balance)*	
6 Total net investment	Gross fixed capital formation (GFCF) less depreciation + increase in inventories & valuables + capital grants (net) within public sector + capital grants to private sector + capital grants from private sector
7 = 6-5 Net borrowing (NB)**	
8 Financial transactions determining the net cash requirement (NCR)	Net lending to private sector & RoW + net acquisition of company securities + accounts receivable/payable + adjustment for interest on gilts + other financial transactions
9 = 7+8 Net cash requirement (NCR)***	

* The surplus on the current budget can also be defined as: current resources minus current uses (= net saving) plus receipts of capital taxes.

** Public Sector Net Borrowing (PSNB) is the net borrowing for the total public sector. It is the balance between income and expenditure in the consolidated current and capital accounts and is measured on an accruals basis.

*** The Public Sector Net Cash Requirement (PSNCR) is the net cash requirement for the total public sector. It is measured on a receipts basis. The PSNCR can also be defined as public sector cash receipts minus public sector cash outlays. It was previously known as the Public Sector Borrowing Requirement (PSBR).