IV - Outlook for the public finances

Introduction

After the public spending plans for the period to 2007/8 were announced earlier this year, the main interest in the forthcoming Pre-Budget Report (PBR), which is due later in November, is likely to focus on the Treasury's new public finance projections. The two main questions arising are, first, whether the Chancellor will meet his Golden Rule of borrowing only to invest on average over the current economic cycle, and, second, whether tax increases will eventually be needed to fund the spending plans announced earlier this year. It is therefore timely to examine in more detail the outlook for the public finances in order to provide an independent benchmark against which the Treasury's new PBR forecasts can be assessed.

This article uses the PricewaterhouseCoopers (PwC) model of the public finances to assess how recent and possible future economic and fiscal developments affect the Chancellor's options for the 2004 Budget and Spending Review. It is structured as follows:

Section IV.1 – presents the results of some new PwC analysis on underlying trends in UK tax revenues;

Section IV.2 – describes a number of alternative scenarios for the economy and the public finances;

Section IV.3 – summarises our public borrowing projections in alternative scenarios;

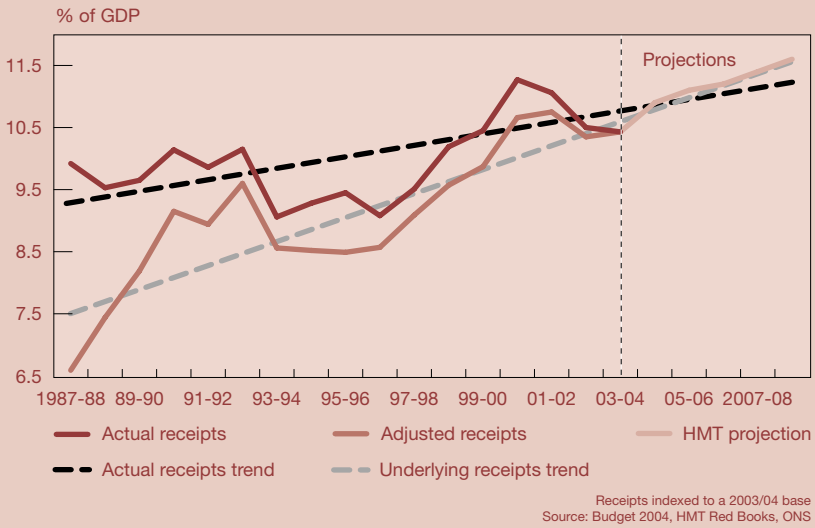
Section IV.4 – discusses implications for future tax and spending policy; and

Section IV.5 – summarises and draws conclusions from the analysis.

IV.1 Underlying trends in UK tax revenues

The Chancellor predicted in his 2004 Budget that total government receipts would increase from an estimated 37.8% of GDP in 2003/04 to 40.5% of GDP in 2008/09. Many independent analysts (including the IMF, OECD, IFS and NIESR) believe that the Treasury's medium term revenue forecasts are too optimistic, even if the economy performs as well as the Chancellor hopes. In this section, we contribute to this debate by analysing underlying historic trends in four major tax revenue streams, after adjustment for past policy changes. This analysis[1] then feeds into our own public finance modelling, the results of which are presented later in the article.

Figure 4.1 – Income tax revenue trends



Receipts indexed to a 2003/04 base
Source: Budget 2004, HMT Red Books, ONS

Adjustment for policy changes

We have adjusted tax revenues for discretionary policy changes in order to give a clearer picture of underlying trends in tax receipts. Movements in the underlying receipts series will be influenced over time by a number of factors, but mainly by real fiscal drag and the effects of the economic cycle.

The actual tax receipts data were adjusted for discretionary changes using the ex ante costings of tax measures published in successive Red Books since 1987. Costings relative to an indexed base (i.e. assuming that income tax allowances/thresholds and excise duties are indexed in line with RPI inflation) were used. After the first full year of the tax changes, the costings were generally assumed to grow in line with money GDP. The costings were summed to give the total adjustment for discretionary tax changes for each financial year and then subtracted from actual tax receipts data to give the adjusted series. This adjustment was carried out for four of the most important taxes: income tax, corporation tax, VAT and excise duties. (Analysis of national insurance contributions (NICs) was not included as costings of past NIC policy changes were not available on a consistent basis over a long enough period. As discussed below, however, our standard tax revenue model suggests that Treasury NIC projections are reasonable.) In each case the results were expressed relative to an indexed 2003/4 base (i.e. the adjusted figures for each year show estimated receipts if the 2003/4 tax regime had applied in that year).

In order to identify a trend in the adjusted underlying receipts series for each of the four tax categories, a simple linear regression was carried out for the period 1987/88 to 2002/03, and the resulting derived historic trend was projected forward to 2008/9 (see dashed lines in Figures 4.1-4.4).

[1] This analysis was originally carried out by Seema Shah prior to Budget 2004, but has now been updated to take account of the Treasury's Budget projections and latest estimates of actual tax revenues.

Figure 4.2 – Corporation tax revenue trends

Receipts indexed to a 2003/04 base
Source: Budget 2004, HMT Red Books, ONS

Income tax trends

Personal income tax currently accounts for just over a quarter of total revenues. We can see from the dotted trend line in Figure 4.1 that actual income tax receipts have been on a gradual upward trend relative to GDP. This ratio rose significantly above trend during the boom of the late 1990s, but then fell back to trend by 2002/3 as incomes in the City in particular declined. If we project this actual trend forward, then we get a continued steady rise, which might be attributed to fiscal drag, but nothing like as rapid an upward trend as suggested in the latest Treasury forecasts. This has led many commentators (including PwC in the analysis that we published this time last year) to conclude that the Treasury's income tax projections were too bullish.

If, however, we look instead at the adjusted income tax receipts line in Figure 4.1, the trend increase after stripping out policy changes is much more marked and, looking forward, broadly consistent with Treasury projections. The most dramatic past changes came with the income tax cuts in the 1987 and 1988 Budgets, which explains why the adjusted line (representing estimated income tax receipts in those years if the 2002/3 policy regime had applied at that time) is so far below the actual line before these large tax cuts came in, but then rises rapidly towards the actual receipts line as these cuts took effect. Thereafter, income tax changes have been more mixed, with the adjusted and actual receipts lines following a somewhat similar cyclical path around an upward trend that is the product of fiscal drag. During the 1997-2001 Parliament, the starting rate of income tax was cut from 20% to 10% and the basic rate was cut by 1p to 22%, but the revenue effect of these policy decisions was, to a significant extent, offset by the abolition of mortgage interest relief at source, and the replacement of the married couple's allowance with the children's tax credit.

Corporation tax trends

The corporate income tax system has been subject to two major reforms and many smaller changes during the last 25 years. In 1984 the main corporation tax rate was cut from 52% to 35% (although this occurred before our analysis begins in 1987 and so is not reflected in Figure 4.2 below), and in 1997-99 changes were introduced t o the way dividend income was taxed, to the timing of corporation tax payments (phased in over four years), and to the main corporation tax rate.

Figure 4.2 shows that both the actual and the adjusted corporation tax receipts series display highly cyclical patterns, with both series moving closely together, reflecting the offsetting policy changes that were introduced over the period since 1987. In 1991, the main corporation tax rate was reduced from 35% to 34%, and subsequently to 33%, introducing a gap between the adjusted and actual revenue series. In 1993, the value of tax credits attached to dividends was reduced from 25% to 20%, and the rate of ACT was also reduced. By 1995, the overall revenue gain of these policy decisions offset the revenue loss from the previous reduction in the main rate. The main corporation tax rate was cut again in 1997-98 to 30%, and ACT and dividend tax credits for pension funds were abolished, but these effects were eventually offset by the increase in yield from the introduction of quarterly payments for corporation tax.

Analysis of the underlying historic trend of corporation tax receipts suggests that the Treasury's medium-term forecasts may be overly reliant on the reversal of the weakness of tax revenues relating to financial company profits exhibited since 2000: the forecasts suggest that corporate tax revenues will rebound to above their historic policy-adjusted trend line over the next 4-5 years. Our analysis suggests that the Treasury may be right to project some rebound in the corporation tax/GDP ratio, but not by as much as is forecast.

It is also worth noting that there could be costs to the Exchequer from ongoing UK and EU legal cases relating to loss relief, ACT, thin capitalisation, controlled foreign companies and franked investment income. Depending on the outcome of these cases, the Inland Revenue could have to make repayments of corporation tax revenues running into several billions of pounds over the next few years[2]. Although the exact amounts involved are highly uncertain, these potential costs represent a further downside risk to the Treasury's current corporation tax revenue projections.

2 Any such repayments would be one-off costs, although the outcome of the cases could potentially also have an ongoing negative effect on corporation tax revenues.

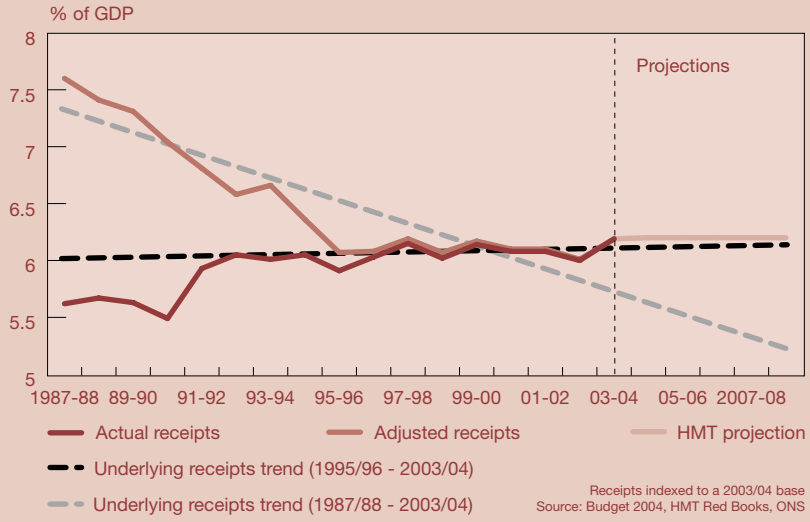
VAT trends

Over the last 25 years, VAT has approximately doubled its share of total tax revenues. The greater part of this change took place in 1979, when the standard VAT rate was raised from 8% to 15% (before the start of our analysis period), and in 1991 when rates were further increased to 17.5% (the effect of which is included in Figure 4.3).

Applying the 2002/03 tax regime to the period before 1991 (and a few years following 1991 as the revenue effects of the rate increase gradually emerged), tax revenues would have been considerably higher, resulting in the large gap between the actual and adjusted revenues series shown in Figure 4.3. After 1994, when VAT was extended to domestic fuel, this trend was reversed to some extent.

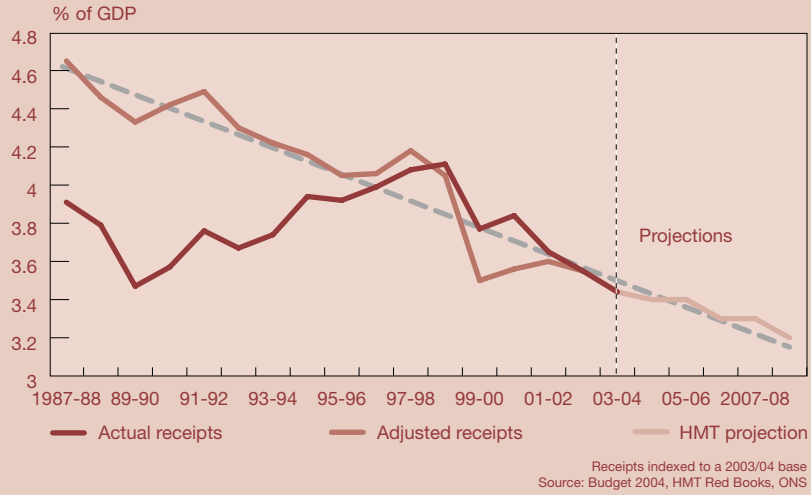
The adjusted tax receipts trend (for 1987/88-2002/3) diverges markedly from the Treasury forecast of VAT receipts in the medium term. This downward trend line relies, however, on including the early 1990s decline in underlying receipts relative to GDP, which changed after 1994/95. Using an adjusted tax receipts trend line only including data from 1995/96 onwards produces a substantial change, suggesting a broadly flat trend relative to GDP. When projected forward, this closely matches the latest Treasury forecasts shown in Figure 4.3.

Figure 4.3 – VAT revenue trends



Receipts indexed to a 2003/04 base
Source: Budget 2004, HMT Red Books, ONS

Figure 4.4 – Excise duties revenue trends



Receipts indexed to a 2003/04 base
Source: Budget 2004, HMT Red Books, ONS

Trends in excise duties

The ratio of actual excise duty receipts to GDP shows no clear trend, as illustrated in Figure 4.4. This might suggest that Treasury projections of a declining trend in this ratio in future years is somewhat conservative. Once we adjust for past policy changes, however, a large gap opens up between the actual and the adjusted revenue series and we can see that there is a clear downward trend in the policy-adjusted ratio (see Figure 4.4). The main reason for this is that, with health and environmental objectives in mind, 1993 saw the introduction of automatic annual increases – 'escalators' – in excise duties on both petrol (introduced at 3% above inflation and then increased to 5% above inflation later that year) and cigarettes (3% above inflation). In its July 1997 Budget, the new Labour government strengthened both commitments, announcing real annual increases of 6% for fuel and 5% for cigarettes. This policy only began to be reversed in 2000, amidst concerns of cross-border smuggling of tobacco products and political unrest about the price of petrol.

The trend decline in the (policy-adjusted) excise duty receipts/GDP ratio is expected to continue, in large part because the excise duty tax base is itself declining as a percentage of GDP. The underlying excise duty tax receipts trend suggests a broadly similar projection to the latest Treasury forecast.

Conclusions

Our analysis of policy-adjusted historic trends suggests that Treasury projections for corporation tax receipts are somewhat overly optimistic. In the case of income tax revenues and excise duties, however, our policy-adjusted trend projections suggest broadly similar figures to the Treasury projections. For VAT, the Treasury projections seem reasonable based on historic trends since 1995/96, assuming that the fall in the underlying ratio of VAT receipts to GDP in the first half of the 1990s will not recur. These findings have been taken into account in updating and recalibrating our tax revenue model, which we have used to produce the public finance projections discussed below in the remainder of this article.

IV.2 Alternative scenarios for the public finances

Throughout this analysis, we make the basic assumption that the tax regime and spending plans for the period from 2003/4 to 2005/6 will be as set out in the March 2004 Budget Red Book and the July 2004 Spending Review[3]. Given these baseline assumptions, the future evolution of the public finances will be driven primarily by economic growth rates and the responsiveness of tax revenues to this growth.

In developing alternative scenarios, we also take account of the Treasury view that purely cyclical variations in economic growth will have only temporary effects on the public finances and so should not be a major source of concern. This view is somewhat debatable, given that cyclical deficits have a tendency to turn into structural deficits in practice, but it is nonetheless helpful to distinguish as far as possible between cyclical and structural effects. The latter will depend on the assumptions made on:

- the initial cyclical position of the economy (as measured by the 'output gap' between actual and potential GDP in 2003/4);
- the trend growth rate of potential GDP after that date; and
- the responsiveness ('elasticity') of tax revenues to economic growth[4].

The key macroeconomic characteristics of our three illustrative scenarios[5] are set out in Table 4.1.

There are many possible GDP profiles consistent with the assumptions in Table 4.1, all of which imply that the output gap returns to zero by 2007/8 (which is also the Treasury projection in the Red Book). The three specific growth scenarios we have used are as shown in Figure 4.5:

- main scenario: UK economic growth picks up to an average of 3.25% in 2004/5 before returning to its trend rate of 2.5% thereafter; this growth profile implies a zero output gap in 2007/8 based on the assumptions on the 2003/4 output gap (0.75%) and subsequent trend growth for this scenario shown in Table 4.1; as this table shows, this GDP growth profile, averaging around 2.7%, is only slightly lower than the 2.8% average growth rate assumed by the Treasury over the same five year period in its 2004 Red Book public finance projections;
- pessimistic scenario: the UK economy slows sharply from 3% in 2004/5 to 2% in 2005/6 and 1.75% in 2006/7 as the world economic recovery stalls and UK consumer spending slows markedly in response to a decline in house prices; due to the fact that we assume trend growth of only 2.25% in this scenario, and a zero initial output gap in 2003/4, this growth profile is still consistent with the level of GDP being in line with trend in 2007/8 (having initially moved above trend in 2004/5 before falling gradually back to trend thereafter); and
- optimistic scenario: which assumes continued rapid growth in the US and world economy over the next year, resulting in UK growth picking up to an average of 3.2% in the four years to 2007/8 (but with a gradual deceleration back to assumed trend growth by 2007/8); this relatively rapid growth profile (compared both to our own main scenario and the Treasury projections) does not create any significant inflationary pressures given the larger degree of initial spare capacity (1.5% of GDP in 2003/4) and higher trend growth rate (2.75%) assumed in this relatively optimistic scenario.

As noted above, all three of these GDP growth scenarios see the output gap return to zero by 2007/8, which is also the assumption underlying the Treasury's public finance projections. It follows that any budget deficit or surplus in 2007/8 in these scenarios can be interpreted as being structural rather than cyclical.

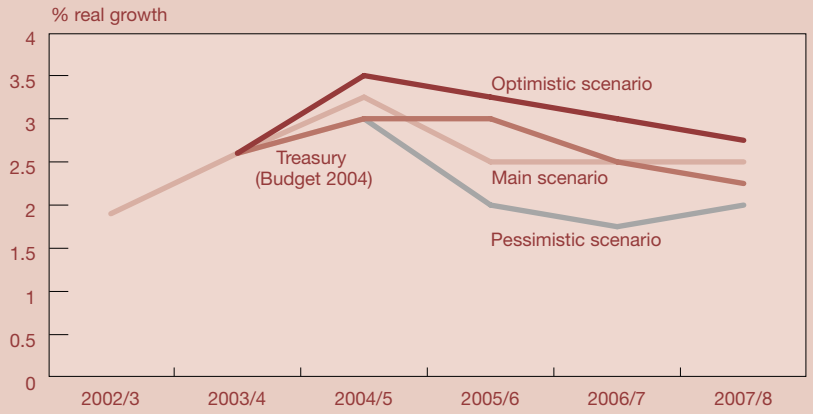
As regards tax revenue elasticities, our model contains a series of assumptions for each type of tax based on the analysis

Table 4.1 – Economic assumptions in alternative scenarios

Key parameters	Pessimistic scenario	Main scenario	HM Treasury assumptions	Optimistic scenario
Initial output gap (% of GDP in 2003/4)*	0%	-0.75%	-1.4%	-1.5%
Trend GDP growth after 2003/4	2.25%	2.5%	2.5%***	2.75%
Actual average GDP growth (2004/5 to 2007/8**)	2.2%	2.7%	2.8%	3.2%
Tax revenue elasticities	Base case – 0.1	Base case values	Not known	Base case + 0.1

*Negative figure indicates that GDP is assumed to be below trend in 2003/4 (and vice versa).
**Note that the output gap is zero (by construction) in 2007/8 in each of these three scenarios.
***Until 2006/7; from 2007/8, the Treasury assumes trend growth falls to 2.25% due to slower working age population growth
Source: PricewaterhouseCoopers assumptions, HM Treasury assumptions underlying public finance projections (from Budget 2004 Red Book, Tables C1 and C3).

Figure 4.5 – Alternative GDP growth scenarios



Source: ONS, alternative PwC scenarios and HM Treasury assumptions used in Budget 2004 public finance projections

[3] With a few minor exceptions on the spending side, as discussed further below.
[4] The full PwC public finance model breaks down tax revenues into around 15 sub-categories (e.g. income tax, corporation tax, VAT, national insurance, fuel duties, tobacco duties, alcohol duties, council tax, business rates etc), with varying economic drivers and elasticities. We then make further adjustments for tax policy changes.
[5] We adopt the Treasury's inflation forecasts in each case, essentially assuming that the MPC sets interest rates to keep inflation on target in all scenarios. This assumption is not entirely realistic, but it helps in comparing public borrowing projections across scenarios if we make a uniform inflation assumption.

described in Section IV.1 above for income tax, corporation tax, VAT and excise duties, together with earlier research by PwC and others (notably the IFS) for other tax categories. But these assumptions are inevitably subject to significant margins of uncertainty, due both to normal statistical error and to structural changes in the tax base (e.g. more effort going into indirect tax planning as the VAT rate rises, or a loss of alcohol and tobacco duty revenue due to increased cross-border shopping and smuggling activity). This margin of error is captured by reducing all base case tax elasticity assumptions by 0.1 in our pessimistic scenario (so revenues grow less rapidly for a given economic growth profile) and by increasing all elasticities by 0.1 in our optimistic scenario. For example, the elasticity of VAT revenue with respect to consumer spending is 1 in our main scenario (i.e. a 1% rise in consumer spending translates to a 1% rise in VAT revenue), but this elasticity is reduced to 0.9 in our pessimistic scenario and increased to 1.1 in our optimistic scenario.

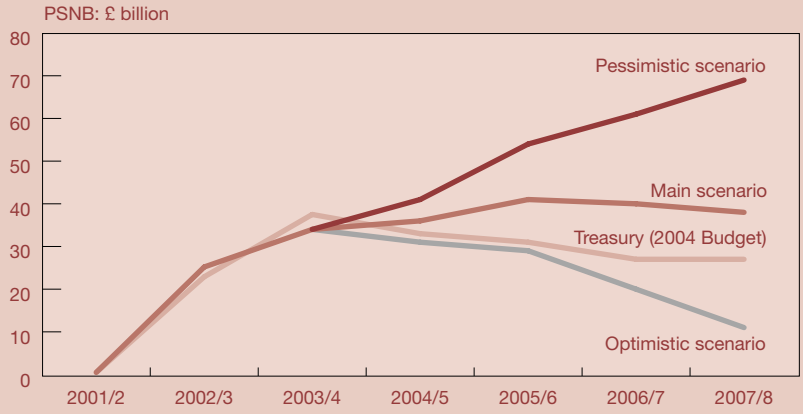
In broad terms, an increase of 0.1 in all the elasticities results in an increase of around 0.5% in total tax revenues in the first year, or around £2.25 billion at 2004/5 values. This effect accumulates over time, however, so that by the fourth year of the projections revenues would be around 2% higher than in the base case (which translates to an increase of around £11 billion in total tax revenues in 2007/8).

As noted above, public spending is assumed to be in line with plans announced in the July 2004 Spending Review with two minor exceptions:

- based on data for the current financial year to date, and reflecting similar undershoots in previous years, we assume a one-off shortfall relative to Treasury plans in net investment spending of £3 billion in 2004/5 (which still implies a significant increase relative to 2003/4); but we assume this is offset in part by higher than planned current spending, continuing trends in the first half of the year; and

- unemployment-related social security benefit payments and debt interest payments are allowed to vary across the different scenarios.

Figure 4.6 – Public sector borrowing scenarios



Source: ONS, alternative PwC scenarios and HM Treasury forecasts from 2004 Red Book

Table 4.2 – Comparisons of Treasury and PwC revenue projections for 2005/6

Revenue as % of GDP (unless stated)	Actual revenues (2003/4)	Projections for 2005/6		
		Treasury forecast	PwC main scenario	Difference
Income tax (gross of tax credits)	10.7	11.1	11.1	0
Tax credits	-0.4	-0.3	-0.3	0
Non-North Sea corporation tax	2.3	3.2	2.8	-0.4
North Sea revenues	0.4	0.3	0.3	0
VAT	6.2	6.2	6.2	0
National insurance contributions	6.5	6.6	6.6	0
Excise duties (fuel, tobacco and alcohol)	3.4	3.4	3.4	0
Other taxes and royalties	6.6	6.8	6.6	-0.2
Net taxes and social security contributions	**35.7**	**37.3**	**36.7**	**-0.6**
Other receipts and accounting adjustments	1.9	2.1	2.0	-0.1
Total current receipts	**37.6**	**39.4**	**38.7**	**-0.7**
Money GDP (£ billion)	1115	1243	1240	-0.2%
Current receipts (£ billion)	419	490	480	-2.0%

Source: ONS, HM Treasury (2004 Red Book and Public Finance Databank), PricewaterhouseCoopers main scenario for 2005/6

IV.3 Results of scenario analysis – public borrowing projections

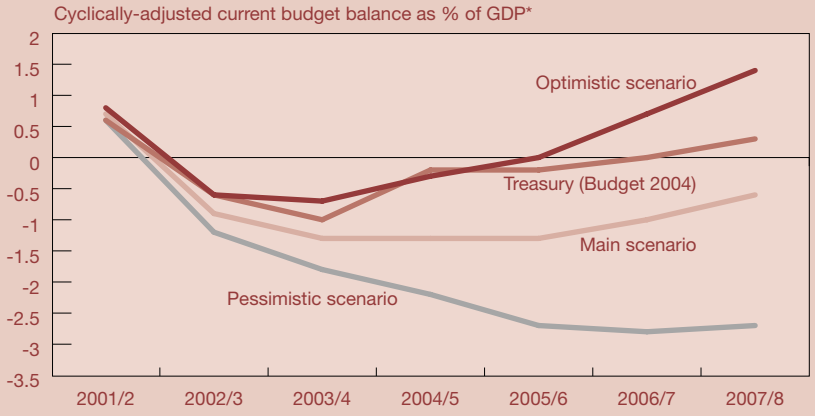
Figures 4.6 and 4.7 show our three alternative scenarios for public sector net borrowing (PSNB) and the cyclically adjusted current balance, together with Treasury forecasts from the last Red Book.

The key points to note from Figure 4.6, which shows public sector net borrowing (PSNB, not cyclically adjusted), are that:

- in our main economic scenario, the budget deficit is projected to be around £36 billion (3.0% of GDP) this year; this compares to a Treasury Budget forecast of a £33 billion deficit in 2004/5), with the difference being due primarily to an expected undershoot in tax revenues, which is consistent with trends in the first half of the current financial year;

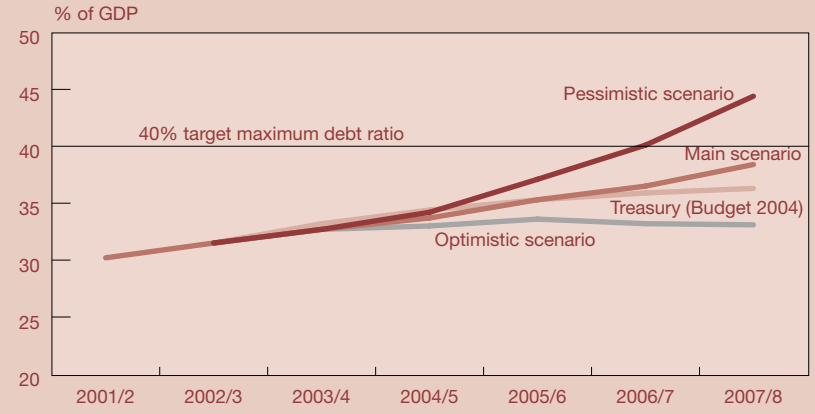
- the budget deficit is then projected to rise further to £41 billion (3.2% of GDP) in 2005/6 in our main scenario as tax revenue growth slows with the economy, while public spending continues to rise more rapidly in line with Treasury plans; thereafter, spending growth moderates and the budget deficit is assumed to decline gradually to around £38 billion (2.8% of GDP) in 2007/8, reflecting in particular the effects of fiscal drag in boosting income tax receipts; as illustrated in Table 4.2, the primary reason for the difference between our

Figure 4.7 – Current budget balance scenarios



*Cyclically adjusted using output gap estimates
Source: ONS, PwC scenarios, HM Treasury

Figure 4.8 – Public sector net debt scenarios



Source: ONS, PwC scenarios, HM Treasury forecasts

main scenario revenue projections and those of the Treasury is our more cautious view on the likely scale of the rebound in corporation tax revenues over the next few years, in line with the analysis in Section IV.1 above; we also assume slower growth in 'other taxes and royalties', where it is not entirely clear why the Treasury projections assume that these revenues grow faster than GDP over the next two years; and

- our two alternative scenarios suggest out-turns for the budget deficit ranging from around £30 billion to just over £40 billion in the current financial year, but with widely divergent paths in subsequent years; by 2007/8, our optimistic scenario projects a budget deficit of only around £10 billion (0.8% of GDP), while our pessimistic scenario projects a budget deficit of around £70 billion (5.2% of GDP, although note that this would still be well below the recent historic peak of 7.8% of GDP in 1993/4); in practice, of course, the government would probably not allow the budget deficit to rise so high in such a pessimistic economic scenario without taking corrective action at some point, but this 'no fiscal policy change' case has some illustrative value.

It should be stressed that both alternative economic scenarios, 'pessimistic' and 'optimistic', are individually relatively unlikely, but the assumptions underlying each of them are not entirely implausible and they illustrate how uncertain public borrowing levels can be when looking three or four years ahead. The analysis in Figure 4.6 suggests that the Treasury forecasts are within the plausible range of outcomes, but certainly tend towards 'optimism' rather than 'pessimism' (particularly in relation to 2004/5 and 2005/6). This is at odds with the fact that global macroeconomic and geopolitical uncertainties are still particularly significant at present, which suggests the need for a relatively cautious approach to determining the appropriate fiscal policy stance.

Figure 4.7 shows our projections in different scenarios for the cyclically-adjusted current budget balance, which is of particular relevance in assessing whether the Golden Rule is being met from year to year[6], alongside the Treasury Red Book projections. In our main scenario, the cyclically adjusted current budget deficit is projected to remain relatively stable at around 1.3% of GDP in both 2004/5 and 2005/6, but to fall to 0.6% by 2007/8. This contrasts with Treasury projections that a small cyclically adjusted current budget surplus 0.3% of GDP will be restored by 2007/8. The potential implications of this divergence for future tax and spending decisions are discussed further below.

As with the PSNB projections, our alternative scenarios show a wide range of outcomes, varying in 2007/8 from a current budget deficit of 2.8% in our pessimistic scenario to a current budget surplus of 1.4% of GDP in our optimistic scenario. The Treasury forecasts are within this plausible range, but towards the optimistic end of the spectrum.

Figure 4.8 shows corresponding projections for public sector net debt as a proportion of GDP in our three economic scenarios. The Treasury projections show the net debt ratio rising gradually to 36.3% of GDP by 2007/8, but remaining well within the Chancellor's rule that this should be no more than 40% of GDP. In contrast, our main scenario sees net debt rising steadily to over 38% of GDP by 2007/8, not far below the 40% of GDP ceiling. As before, alternative scenarios range from a debt ratio of only 33% in the optimistic case to around 44% of GDP in the pessimistic case in 2007/8. In general, however, this debt rule is likely to pose much less of a constraint on fiscal policy over this period than the need to meet the Golden Rule, which poses a more immediate challenge to the Chancellor, as shown in Figure 4.7.

IV.4 Implications for tax and spending policy

There are two key questions to consider here:

- Does the Chancellor need to raise taxes in the short term in order to meet the Golden Rule over the current economic cycle?

[6] As discussed further below, the Treasury prefers to assess the Golden Rule as the average of unadjusted current budget balances (as a % of GDP) across the economic cycle. But it also pays attention to the cyclically-adjusted current balance in judging progress against this Golden Rule objective over time.

- Will the Government's spending plans prove affordable in the longer run without eventual tax increases?

Meeting the Golden Rule over the current economic cycle

The first issue here is how the Golden Rule should be interpreted. There are two main possibilities:

- the current budget balances in cash terms should be added up over the estimated period of the economic cycle with the Golden Rule being met only if the cumulative cash total is non-negative; or

- the average ratio of the current balance to GDP over the cycle should be non-negative.

Some commentators (e.g. the NIESR) have favoured the first interpretation but the Treasury favours the second, which in the current cycle makes the Golden Rule slightly easier to meet since it gives more weight to the large surpluses in the first two years of the current cycle as opposed to the deficits arising later in the cycle. Our own view is that the Treasury interpretation makes more sense because the economic significance of a given cash level of budget imbalance will depend on its size relative to GDP (and so relative to the tax base, which will tend to rise more or less in line with GDP) and we have therefore concentrated on this measure in our analysis here.

The second key issue, which is illustrated in Table 4.3, relates to the dating of the current economic cycle. The Treasury dates the current cycle as beginning in 1999/00, on the basis that GDP was 'on trend' in the first half of 1999 for the first time since the current fiscal framework was set out in 1998. But this is somewhat arbitrary and one could equally make the case for dating the current cycle from a peak or trough date, or indeed from a more recent 'on-trend' point, such as 2001Q4 (which the Treasury estimates to have been the last such 'on-trend' point). To the extent that such an alternative start date would rule out, in whole or in part, counting the large current budget surpluses of 2.1% of GDP in both 1999/2000 and 2000/01, this would make the Golden Rule much more difficult to meet in the current cycle.

Table 4.3 – Assesment of the Golden Rule over the current economic cycle (as defined by HM Treasury)

Current budget balance (% of GDP)	PwC optimistic scenario	Treasury forecast	PwC main scenario	PwC pessimistic scenario
1999/2000	2.1	2.1	2.1	2.1
2000/01	2.1	2.1	2.1	2.1
2001/02	0.9	0.9	0.9	0.9
2002/03	-1.3	-1.3	-1.3	-1.3
2003/04	-1.8	-1.8	-1.8	-1.8
2004/05	-1.1	-0.9	-1.5	-1.9
2005/06	-0.3	-0.4	-1.3	-2.4
Average to 2005/6	**0.1**	**0.1**	**-0.1**	**-0.3**
Average to 2004/5	*0.1*	*0.2*	*0.1*	*0.0*

Source: Actual ONS data up to 2003/4, HM Treasury forecast (2004 Red Book) and alternative PwC scenarios for 2004/5 and 2005/6

The end date of the cycle also matters, as illustrated by comparing the last two rows of Table 4.3. The latest Treasury estimates from Budget 2004 put this end date in early 2006 when, according to their forecasts, the economy is next projected to be on trend. On this basis, the Golden Rule would still be met using Treasury forecasts (or our own optimistic scenario), although only with a tiny average comfort margin of 0.1% of GDP per annum. In contrast, on our own main scenario, the Golden Rule would be very narrowly missed, although again by a tiny margin of just 0.1% of GDP per annum on average across the cycle. Basically, given the significant margins of error involved in any such projections, it is 'too close to call' whether the Chancellor will meet or just miss his Golden Rule for a cycle ending in 2005/6.

In contrast, if the end date of the cycle is put at 2004/5, which is more in line with independent estimates (and our own main scenario) that suggest that GDP has already moved back close to trend with the strong growth seen in 2004, then the Golden Rule would be narrowly met in our main scenario (and probably even in our pessimistic scenario where the average current budget balance would be around zero). This is because the projected current budget deficit in 2005/6 would be excluded from the calculation, although this would mean that the starting point for the next economic cycle was less favourable.

Whatever the precise statistical outcome, however, the policy question of interest is whether the Chancellor should take short-term action through raising taxes or cutting back on spending in 2005/6 to ensure that the Golden Rule is met. From an economic perspective, the answer is clear: missing the Golden Rule by a tiny margin might be something of a political embarrassment for the Chancellor given the emphasis he has put on meeting his fiscal rules in the past, but it would be of no real economic significance[7]. As such, it would seem inappropriate to take artificial short-term policy measures to avoid narrowly missing the target, unless these measures were justified on other grounds.

Longer term implications

If the outcome turns out to be closer to our main scenario than the Treasury's Budget forecasts, then the government is likely to enter the next economic cycle with a significant current budget deficit. At some future point, higher taxes and/or current spending growth below the trend growth rate of GDP would therefore appear to be implied by our main scenario projections. Up to 2007/8, the Chancellor has already announced that current spending growth will moderate, but will still remain broadly in line with trend GDP growth, so this suggests that tax increases are the most likely future option if a fiscal correction is deemed necessary in the medium term. Of course, adjusting spending downwards would also remain an option in practice, particularly for the years beyond 2007/8 that would still be likely to fall within the next economic cycle, but for simplicity we focus on the tax side of the equation in the remainder of this article.

[7] Particularly as subsequent statistical revisions could easily reverse any initial estimates that the Golden Rule had just been met or just been missed in the current cycle.

Table 4.4 – Tax increases (or spending cuts) required to achieve alternative fiscal targets for 2007/8 in different PwC scenarios

Tax increases (or spending cuts) required to meet targets	Pessimistic scenario	Main scenario	Optimistic scenario**
Projected current budget balance in 2007/8 (% of GDP)	-2.9	-0.6	1.4
To achieve current budget balance in 2007/8*:			
- tax change in % of GDP	2.9	0.6	-1.4
- change in £bn at 2004/5 GDP values	34	7	-16
To achieve Treasury forecast for current budget surplus of 0.3% of GDP in 2007/8:			
- tax change in % of GDP	3.2	0.9	-1.1
- change in £bn at 2004/5 GDP values	38	11	-13

*Since the output gap is zero by construction in all three scenarios in 2007/8, this is equivalent to achieving structural budget balance on a cyclically adjusted basis
** Negative numbers in this column imply scope for tax cuts
Source: PricewaterhouseCoopers estimates in alternative scenarios

An illustration of the order of magnitude of possible tax increases in our main scenario is provided in Table 4.4. In this scenario, our projections suggest a current budget deficit of 0.6% of GDP (this is a structural deficit since, by construction, the output gap is zero in 2007/8 in all three PwC scenarios, as well as the Treasury Budget projections). This would suggest the need for:

- a tax increase of around 0.6% of GDP (equivalent to around £7 billion at 2004/5 GDP values) in order to achieve structural current budget balance; or
- a tax increase of around 0.9% of GDP (equivalent to around £11 billion at 2004/5 GDP values) if the aim was to restore the same current budget surplus as projected by the Treasury in the 2004 Red Book.

It should, however, be emphasised that any such estimates of tax increases are subject to great uncertainty since, as Table 4.4 shows, the projected current budget balance in 2007/8 could vary in alternative scenarios from a structural deficit of almost 3% of GDP, implying the eventual need for very large tax increases or spending cuts to restore fiscal sustainability, to a structural surplus of just under 1.5% of GDP, implying some scope for tax cuts or further spending increases. Although these are relatively extreme and unlikely scenarios, they are not impossible based on past experience. For the moment, the most we can conclude, therefore, is that there might well be a need for reasonably significant tax increases in the medium term, but this s too uncertain at present to justify immediate action.

It is possible, of course, to argue for tax increases on more general macroeconomic grounds, namely that this would help to keep interest rates down and so would tend to rebalance the economy in a desirable way (particularly if this led to the exchange rate being lower than would otherwise be the case, although it is highly uncertain whether this would in fact be the result of such an adjustment in the monetary-fiscal policy mix). But, in practice, this seems unlikely to be an option until 2006 at the earliest, by which time the macroeconomic arguments may not appear so favourable.

IV.5 Summary and conclusions

Our analysis suggests that the budget deficit is likely to rise in our main economic scenario from around £36 billion in the current financial year (3.0% of GDP) to around £40 billion (3.2% of GDP) in 2005/6, compared to a Treasury Budget forecast of around £31 billion (2.5% of GDP) in that year. The difference reflects:

- somewhat lower expected GDP growth in 2005/6 in particular, which in turn reflects a view that the economy is currently less far below its trend level than the Treasury estimated at the time of the Budget; and
- a significantly smaller rise in the ratio of corporation tax receipts relative to GDP than projected by the Treasury, which is backed up by our detailed analysis of historic trends (for other major tax categories, however, our analysis provides broad support for the Treasury projections).

If our tax revenue projections prove to be accurate, the Golden Rule may be narrowly missed over the current economic cycle (defined here as 1999/2000 to 2005/6), but only by a tiny margin. Given the uncertainties involved in any such projections, this does not provide a good reason for immediate tax increases. In the longer term, however, our analysis does suggest that a persistent structural current budget deficit could well remain, which would eventually imply the need either for tax increases in the medium term (of the order of £7-11 billion in our main scenario) or for a further deceleration in public spending growth in the period beyond 2007/8. There is no immediate crisis in the public finances, however, and decisions on future tax and spending levels can be deferred until 2006 at the earliest.