- The government has introduced a new independent Office for Budget Responsibility (OBR) to help enhance the credibility of official forecasts. The transparency and presentation of official forecasts have already been improved since the OBR was established; the OBR, the Treasury and other departments should continue to build on this. There is a case for extending the remit of the OBR so that it is able to consider the impact of alternative policy options, at least in some limited circumstances such as the run-up to a general election.
- The government has set itself a new forward-looking fiscal mandate, that policy is consistent with achieving at least a cyclically-adjusted current budget balance by the end of the forecast horizon, and a supplementary target to reduce debt as a share of national income between 2014–15 and 2015–16. The OBR judges that current policy is consistent with the fiscal mandate, and forecasts that the supplementary target is more likely than not to be met. But if the OBR’s forecasts are as accurate as past Treasury forecasts, there would still be a three-in-ten chance that further tax rises or spending cuts would be required to avoid a cyclically-adjusted current budget deficit in 2015–16.
- Compliance with the two fiscal targets does not ensure fiscal sustainability. The government’s fiscal mandate will require careful monitoring to ensure that it is not being achieved only through policies that are always promised but never implemented. The supplementary target – to reduce debt – applies only to 2015–16; the government should consider what profile of debt it wishes to target beyond that date, taking into account likely pressures on the public finances such as those arising from an ageing population. There are merits in a ‘sustainable commitments rule’

which would place a ceiling on the flow
of future debt interest and other pre-
committed payments, rather than on the st
ock of accumulated public sector debt.

Chapter 3

Fiscal vulnerability: a stocktake

- In opting for an aggressive pace and size of fiscal consolidation, the government hopes to have insulated the UK from the types of funding crises that have beset other European nations.

- The UK government bond market has not show
n any material signs of stress over the
past year, implying that investors believ
ed the UK deficit problem would be dealt
with effectively. Investor demand for UK
government debt remained healthy even
after the Bank of England halted its bond purchases under its policy of quantitative easing.

- In financial markets, past calm is no guarantee of future stability, however, and so we attempt to gauge how secure the UK's fiscal position is. Using 16 indicators of fiscal vulnerability, we find that the UK ranks close to the middle of our sample of 57 countries.

- The UK benefits from the long average maturity of its debt and the fact that the vast majority of government borrowing is in sterling. The strength of regulation and the rule of law also lower the likelihood of
a funding crisis. However, the large
government deficit and high reliance on ex
ternal debt are sources of vulnerability.

Summary

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- Achieving a sustainable reduction in the st
ructural budget deficit stands out as a
policy priority. Effective oversight of banks'
external exposures is also important if
risks are to be contained.

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The front-loading of tax increases and capital spending cuts should ensure that the deficit reduction plan stays on track in the near term, although the risk of political turbulence remains high. Fiscal adjustment may also be hampered by further adverse macroeconomic shocks, which monetary policy is, arguably, not well placed to counter.

Chapter 4

The economic outlook

- Fiscal tightening is likely to be a major drag on growth over the next few years. The Office for Budget Responsibility’s estimates of the effects of government cuts on national income are not unreasonable. However, we see a clear risk that the impact is larger than assumed.
- The consumer is key. Most households enter 2011 with their rates of pay failing to keep up with the cost of living. In addition, credit remains tight, house prices are falling and unemployment is starting to rise again. As a result, household consumption is likely to grow only marginally in real terms this year and accelerate only slowly in 2012 and 2013.
- The corporate sector is in much better shape than the household sector, enjoying strong profits growth and with healthy margins. Firms’ balance sheets are in good shape too – leaving many cash-rich. Availability of finance is unlikely to constrain firms’ investment plans. But we do not expect a strong investment-led recovery as many firms remain cautious about the demand outlook.
- Recent revisions to previous estimates have left the National Accounts looking as if there has been little in the way of rebalancing of the UK economy, with exports particularly disappointing, given the level of sterling and the strength of overseas

demand. Models have over-predicted export growth in recent years. Although our forecast for exports is similar to that of the OBR – on the presumption that the models get back on track – the risks appear skewed to the downside.

- The labour market remains a puzzle, with productivity remaining very low relative to its pre-recession trend. We expect near-flat employment, subdued wage growth and unemployment to rise a little further this year. But the increase could be much larger if firms were to seek to regain the pre-recession productivity path. This is a major source of downside risk to household incomes and to consumption.

- All told, our single most likely forecast for GDP growth is very similar to the OBR's for 2011, but with the risks around this forecast skewed to the downside. We assess the chances of a double dip this year at about 20%. Much more likely is a year of sluggish growth. Further out, we judge the OBR projections to be optimistic, both in terms of the speed at which spare resources get used up and as regards the economy's potential growth rate. The cumulative gaps between our own and the OBR's five-year-out projections amount to some 1½% of GDP.

- We do not expect the Bank of England to respond to high inflation with near-term interest rate hikes. However, persistent above-target inflation is likely to constrain

the Bank's ability to provide additional support for the economy. It may therefore make sense for the government to consider ways of reducing the pace of fiscal consolidation should demand conditions deteriorate significantly – enabling it to 'trim the sails' again in the same manner that it did so last November.

Chapter 5
Green Budget public finance forecasts

- We expect both public sector net borrowing and the current budget deficit in 2010–11 to be £2.9 billion, or 0.2% of national income, smaller than the Office for Budget Responsibility (OBR) forecast in November 2010.
- Assuming that the economy evolves largely as the OBR expects, in the medium term we are around 0.2% of national income more optimistic than the OBR about the current budget balance, the cyclically-adjusted current budget balance and public sector net borrowing. We forecast that the current budget balance will improve from a deficit of 7.0% of national income in 2010–11 to a surplus of 0.5% of national income in 2015–16. Of this 7.5% of national income forecast reduction in the current budget deficit, 6.2% of national income is forecast to come from a fall in current spending as a share of national income and 1.3% of national income from an increase in the tax burden.
- We forecast that the cyclically-adjusted current budget balance will improve from a deficit of 4.5% of national income in 2010–11 to a surplus of 1.1% of national income in 2015–16. Our forecast therefore implies that current policy is consistent with the Chancellor's fiscal mandate. We also forecast that, under this scenario, net debt would peak at 69.3% of national income in 2013–14, before falling in 2014

–15 and 2015–16, suggesting that the Chancellor's supplementary target would be on course to be met.

- Despite our slightly more optimistic outlook for the public finances than that of the OBR, there are large downside risks. If the economy were to evolve along the Barclays central scenario, we forecast that the cyclically-adjusted current budget would still be in deficit in 2015–16, albeit by only 0.4% of national income. Under this scenario, current policy would not be consistent with the Chancellor's fiscal mandate. Even under the Barclays 'optimistic' scenario for the economy, our fiscal forecasts are only just in line with the OBR's fiscal forecasts. This is because the composition of growth in this scenario is more skewed towards components that are taxed less heavily than in the OBR macroeconomic forecast. Under the Barclays 'pessimistic' scenario, the cyclically-adjusted current budget in 2015–16 is forecast to be in deficit by 2.2% of national income and public sector debt is forecast to be at 90.5% of national income and still rising.
- The case seems strong for the March 2011 Budget to contain no significant permanent net giveaways or takeaways. Any improvements in the public finances relative to the OBR's forecasts, such as those implied by our Green Budget baseline forecast, might best be banked to give the government additional headroom against a future worse outlook for the economy or the public finances or a need to top up its challenging plans for cuts to spending on public services. Although there may be no need to implement an alternative plan at this stage, with such large downside risks to the public finances, having alternativ

e plans to hand could prove useful.
Summary
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Chapter 6

Public spending cuts: pain shared?

- The government's six-year plan to redu
ce borrowing will see public spending
brought down from its peak of 47.4% of national income in 2009–10 to 39.3% by 2015–16. The period from April 2011 is set to be the tightest five-year period for public spending since at least the Second
World War. Out of 29 leading industrial
countries, the IMF forecasts that only Icelan
d and Ireland will deliver sharper falls in
spending as a share of national income than the UK between 2010 and 2015.
- The 2010 Spending Review set out broadly where the cuts will fall over the four years starting in April 2011. The big winners were the Department for International Development and the investment budget of the Department of Energy and Climate Change: both are to receive large spending increases by 2014–15. The areas that will see the largest cuts are housing, higher education and the Department for Environment, Food and Rural Affairs. There
will also be deep cuts to local authority
grants, the Home Office and the Ministry of Justice.
- The government has committed to real increases in the NHS budget each year between 2010–11 and 2014–15. If achieved, these will result in a continuation of the long-term trend for the NHS to take up an increasing proportion of public service spending.
- Within the nations, the Scottish parliament
appears to have made
similar decisions to
those made for England; the Welsh Assembly government has chosen not to protect NHS spending from spending cuts, thereby reducing the scale of the cuts required elsewhere; and the Northern Ireland Executive appears to have chosen to cut spending on schools by more than spen
ding on further and higher education.
- The last time the UK government attempted

to implement real public spending cuts (in the 1990s), it was successful at sticking to its cash plans, but lower-than-expected inflation meant that the planned real cuts were not delivered as quickly as intended. The current government's planned cuts to public spending are far greater than those attempted at that time, and achieving these more ambitious plans will be more difficult.

- Delivering such tight spending plans will, as identified by the government, require 'a robust framework to control spending'. There are improvements that can be made to the current system – in particular, Spending Reviews should routinely consider as wide a set of spending areas as possible and not only departmental programme expenditure.
- The government should be prepared to review its 2010 Spending Review settlements in a couple of years' time in the light of any changes to the economic and fiscal outlook or of particular difficulties faced by departments in delivering spending cuts that are palatable to the government and the wider public.

Chapter 7
Public sector pay and pensions

- The public sector pay bill totalled £182 billion in 2009. It rose steadily as a share of national income from 2000 to 2005 and, after a pause, increased again in 2009.

Spending plans set out in the October 2010 Spending Review imply a significant public pay freeze and large employment cuts.

- Before the financial crisis, public sector employees were, on average, paid at levels roughly in line with their private sector counterparts once observed differences in skill composition were taken into account. Since 2008, a significant public pay premium has appeared. We do not therefore believe that the planned two-year pay freeze will lead to widespread recruitment problems in the public sector in the near future. However, the average pay differential hides large variations in relative pay between different areas of the country. Consequently, some public sector vacancies, especially in London and the South-East, will remain hard to fill.

- In certain parts of the public sector, such as education and health, the downsizing of the workforce implied by the Spending Review could be achieved using 'natural exits' and a freeze in recruitment, but this does not appear to be true of areas where exit rates are low and the spending cuts are deeper, such as the police. Given that redundancies and early retirement schemes are costly ways of reducing the size of the workforce, achieving spending targets within the timing set by the Spending Review will be difficult in these areas.
- The government has already made changes to public sector pensions, including a change in the way they are indexed which will affect existing workers as well as new entrants. Further reforms are likely as a result of the review by Lord Hutton. Public sector pensions continue to be more generous than their private equivalents for most workers. Reforms should consider not simply issues of generosity and long-term affordability, but also what incentive structures would help promote flexibility in the labour market.

Chapter 8
Measuring the distributional impact of public service cuts

- The fiscal tightening currently under way will rely on cuts to spending on public services to a greater extent than on cuts to social security spending or increases in taxation.

- Distributional analyses of changes to spending on public services are not common. This is because, unlike with changes to taxation and cash benefits (which directly affect the income of taxpayers and recipients), there is no readily calculable quantitative measure for valuing the benefit the public get from services that are provided in kind rather than in cash (such as hospitals, schools, the army and government administration).

- In spite of the unavoidable difficulties associated with carrying out this type of analysis, the imminent deep cuts in public service spending have provoked a good deal of interest in evaluating the distributional impact that they will have.

- The studies that have aimed to evaluate these distributional impacts (including that published by the Treasury alongside the Spending Review) typically assume that the value of a public service is equal to the cost of providing it. But the problems implicit in this approach (problems that are typically noted by those carrying out the studies) mean that the results should be interpreted extremely cautiously.

- It is certainly to be welcomed that the Treasury has considered the distributional impact of changes to spending on public services. However, we make a number of recommendations for any future analyses. In particular, given the absence of an established methodology for carrying out this type of analysis, it is crucial that details are published of how distributional impacts are estimated. Without such details, the robustness of the analysis cannot be assessed. It is also important that the Treasury take a more consistent approach to determining which measures are included in a distributional analysis.

Chapter 9
Defining a tax strategy

- Much tax policymaking over the past 20 years has lacked a coherent long-term strategy. It has often been harder to describe government tax strategy than the strategy for the major public services such as health and education and, indeed, the strategy for welfare benefits. Partly as a result, tax changes have tended to be piecemeal, have often lacked transparency and have not formed part of a long-term direction.
- As the Mirrlees Review has pointed out, it is extremely important that the tax system (and the benefit system as well) is seen as ju st that – a system. It is the overall effect of the system on outcomes such as efficiency, progressivity and the environment that matters. It is perfectly reasonable to have particular taxes that are regressive, or which don't help the environmen t, so long as the system as a whole meets objectives in these areas.
- The economic and welfare costs associated with a poorly designed tax system may not be obvious, but they are very large. As the tax system does more work as part of the current fiscal tightening, the costs of poor design will only grow.
- Lack of clear objectives and strategy can al so contribute to unnecessary complexity in the tax system.
- Still near the start of a parliament, now is a good time for the government to set out its strategy. It should make clear where it sees the shape of the system in the medium term and the purpose and direction of each of the major taxes.
- This government has made an encouraging start in setting out its ambition for an improved tax system and tax policymaking process. But there is further to go in ensuring robust and accounta ble policymaking, and further review of the ways in which HM Treasury and HMRC work together and of the extent of parliamentary scrutiny may be in order.

Chapter 10
Corporate taxes and intellectual property

- The statutory corporate tax rate is due to fall gradually from 28% in 2010–11 to 24% in 2014–15, a rate lower than currently in most EU15 countries. Increases in the tax base will partially offset this reduction in firms' tax burden.
- The tax rate on small business will be reduced to 20% from April 2011. This is the latest in a series of changes over the last decade that has seen the rate cut, then increased and now cut again. There is little justification for taxing firms that earn low

profits differently from those that earn high profits or from unincorporated businesses.
- A Patent Box that reduces the corporate tax rate on the income derived from patents to 10% is to be introduced from April 2013. The policy is poorly targeted at promoting research and will add unnecessary complexity to the tax system. In addition, the government's own estimates predict that the policy will lead to a large reduction in UK tax receipts.
- Consultation on reforms to the Controlled Foreign Companies regime continues with a view to legislating in Finance Bill 2012. The extent to which the government attempts to tax the intellectual property UK firms hold offshore in order to address tax avoidance will be an important aspect of the debate.
- The government intends to consult on reforms to research and development (R&D) tax credits with an aim to make them more narrowly targeted at research activity. It seems likely that reforms will result in a narrowing of the costs eligible for R&D tax credits, and not an increase in the generosity of the small companies' element.
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If all these reforms are enacted, the UK will have a corporation tax rate lower than most European countries currently have, but a system with significant additional complexity and which provides an expensive and distortionary tax break to a handful of firms, largely for activity that would have occurred in the absence of the policy.

Chapter 11

Environmental policy

- The government inherited targets to reduce emissions of greenhouse gases and increase the share of renewable energy. A number of initiatives have been proposed to help meet these objectives. Emissions fell markedly during the recession but it is not clear how much of the fall is permanent.
- The government is on track to meet its pledge to increase the share of green taxes in total receipts: green taxes are forecast to rise from 7.9% of receipts in 2009–10 to 8.3% in 2014–15. It is not certain that this is a good measure of a government's environmental credentials.
- Revenues from the Carbon Reduction Commitment will be kept by the Treasury rather than redistributed back to participating firms. This may be a more efficient way to raise revenue than increasing other taxes. Although the change may reduce incentives for firms to abate their emissions, this effect should be modest.
- Proposed reforms to the climate change levy would introduce an additional tax based on the carbon content of fuels. Taxing on the basis of carbon is desirable and may help improve certainty about the future carbon price. However, the proposal will add another layer of complexity to carbon pricing and, despite this change, the range of carbon prices for different users of different fuels is likely to widen rather than narrow in the years ahead.
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A new 'Green Deal' will offer households and businesses investment in energy efficiency measures at no up-front cost, paid for by higher energy bills over a number of years. It will better target energy-inefficient properties than the Warm Front scheme which it replaces, but will be of less benefit to poorer households.

- The government is likely to revisit the idea of a per-plane tax to replace air passenger duty, consulted on but rejected by the prev ious government. This would be desirable since the relevant externalities of aviation are not directly related to passenger numbers.
- There is continued debate about a 'fair fuel stabiliser' for fuel prices that would see duty rates cut when the pre-tax price rose and vice versa. This would help stabilise household finances, but official estimates suggest that it would make the public finances more uncertain. It would also be very difficult to implement in practice.

Chapter 12
The impact of tax and benefit changes to be implemented in April 2011

- Tax and benefit changes to be introduced in April 2011 involve a net 'takeaway' of £5.4 billion from households in 2011–12; th is is equivalent to £200 per household and comes on top of the £12.8 billion increase in indirect taxes introduced in January 2011, which is equivalent to £480 per household on average.
- Within this net 'takeaway', there is an £18.8 billion gross 'takeaway' and a

£13.4 billion gross ‘giveaway’. Many of these takeaways and giveaways have offsetting effects. This creates a complex pattern of gains and losses from the overall package of reforms.

- The biggest losers are the very richest households, who are particularly affected by the restriction on the amount that can be contributed to a private pension. This comes in addition to the introduction of the 50p income tax rate applying above £150,000 and the withdrawal of the income tax personal allowance above £100,000 that were introduced in April 2010. Working couples with children also lose significantly from cuts to tax credits.

- The main winners from these reforms are non-working lone parents and low- to middle-income households without children. The main factors offsetting the other reforms for these two groups are the increases in the child element of the Child Tax Credit and in the income tax personal allowance respectively.

- The reforms introduced in January 2011 and those to be introduced in April 2011 will slightly weaken the incentive to work at all, on average. However, those on low to middle earnings without children will see their work incentives strengthen because of the increase in the income tax personal allowance.

- On average, the incentive for the vast majority of workers to earn a little more will be slightly weakened as a result of these reforms. Some workers will see their marginal effective tax rates increase more substantially as a result of these changes – the number of individuals paying the higher 40% rate of income tax will increase by 750,000. However, some workers will face a lower marginal effective tax rate as a result of these reforms, in particular those brought out of the income tax and National Insurance systems by increases in the thresholds at which these taxes start to be paid.

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If the government were to meet its aspiration of having a £10,000 income tax personal allowance in 2015–16, this would increase the number of higher-rate taxpayers by a further 850,000 and take another million people out of income tax altogether.