The Institute for Fiscal Studies Green Budget 2024

Synopsis: The Institute for Fiscal Studies (IFS) detailed Green Budget, looking forwards to this month's Budget, which the IFS has once again joined with Citi to publish a detailed Green Budget, looking forwards to this month's Budget.

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The IFS launched its Green Budget 2024 on Thursday with some headline grabbing numbers about future revenue-raising requirements. This year's Green Budget has fewer chapter than the 2023 version, but nevertheless covers over 300 pages, including a detailed chapter on capital gains tax (CGT) reform which we covered in an earlier technical paper.

As usual, the economic analysis underlying the report has been provided by Citi. This makes the following points…

1. High debt levels, a reliance on overseas lenders (Mark Carney's 'kindness of strangers') and interest rate volatility represent a growing vulnerability for the UK economy.

2. While the UK economy has surprised to the upside since the start of 2024, the improvement is not yet indicative of a secure economic recovery. Real GDP growth is expected to be 1.0% in 2024 but ease to 0.7% next year (against the 0.8% and 1.9% projected by the Office for Budget Responsibility (OBR) in March). In part this reflects a cooling in global activity.

3. In the near term, the effects of higher interest rates may become more material as many parts of the UK economy are forced to borrow once more; around half of the cumulative effect of rate rises are still to be felt because of fixed term borrowing. The corollary is that growth is expected to accelerate markedly through 2026 and 2027 as monetary (and fiscal) constraints are eased.

4. The household 'cash' saving rate has climbed from 3.4% just before the pandemic to around 8% today. While that rate may come down modestly, Citi expects it to remain high. Consequently, Citi expects private consumption to increase by only 0.6% in 2025, against the Bank of England's baseline estimate of 1.5%.

5. The unemployment rate is expected to increase from the current 4.1% to 4.9% next year and 5.3% in 2026. That rise reflects slowing public sector employment growth and is likely to weigh on wage growth and consumer confidence.

6. In Citi's view, inflation in wages and services costs has been a catch-up response to earlier jumps in food and energy prices. This 'sticky' inflation is now beginning to fade (witness slowing wage growth) and Citi expects that through 2026 the CPI will below its target 2%.

7. Citi considers the Bank of England's 'inflation-averse state of mind' to be increasingly inappropriate given expectations for the economy. It sees the Old Lady moving to a more accommodative interest rate policy in 2025/26.

The main points from the Green Budget's second chapter, on the outlook for public finances in the new parliament are….

1. **The new Chancellor, Rachel Reeves, has inherited an unenviable public finance situation**. Taxes are at a historic high by UK standards and yet debt is high, rising and only barely forecast to decline in five years' time, while many public services are showing obvious signs of strain.

2. **Debt interest and benefit spending are both at high levels.** In the March 2024 Budget, annual debt interest spending was forecast to be around 1.4% of national income (£39bn in today's terms) higher over the next few years than the period running up to the pandemic. The same Budget forecast annual spending on state pensions and social security benefits to be 1.1% of national income (£32bn in today's terms) higher than in 2019/20. Meanwhile, NHS spending continues to rise and, for the first time in many decades, the defence budget seems more likely to be increased than cut.

3. **Public sector net debt cannot be allowed to rise indefinitely.** While the IFS says, 'There is likely scope for additional, well-directed, growth-enhancing public sector investment', it is wary of increasing debt significantly**.** In a timely reminder it notes **'**redefining targets does not change the fiscal reality.'

4. **Any new debt measure chosen matters less than making a coherent case for why the Government should be borrowing to pay for more investment.** However, the debt yardstick is tweaked, if the bottom line is more borrowing, the focus should be on ensuring that the increased investment budget is – and is seen to be – spent effectively. Even then, overseas lenders may be less enthusiastic – their perspective is more weighted to the debt side of the balance sheet.

5. **The Chancellor will still find herself constrained by her commendable commitment to aim to meet all day-to-day spending out of revenues.** The first fiscal rule in the Labour manifesto, to aim for current budget balance over the medium term, will still be a challenge and will be unaffected by any change in the second rule, which deals with total *debt* not the annual *deficit*.

6. **Based on Citi's central economic assumptions, the forecast current budget surplus in 2028/29 could be £17bn (0.5% of GDP) after accounting for the specific tax and spending measures in Labour's manifesto.** However, that potentially rosy picture comes with plentiful caveats. It incorporates inherited restrictive assumptions on spending that would still leave spending on some public services falling – even though

they already include a £14bn top-up to plans from the March Budget to fund public sector pay deals and deliver specific manifesto commitments.

As ever, there is considerable sensitivity to the assumptions used. Under Citi's optimistic scenario, the £17bn surplus turns into a £40bn surplus. Under Citi's pessimistic scenario, it turns into a deficit of £16bn.

7. **If the Government wishes to avoid real-terms cuts to day-to-day budgets for all public services, an additional top-up of £16bn in 2028/29 would be required (on top of the £14bn to pay for public sector pay deals and specific manifesto commitments).** Based on Citi's central economic scenario, this would eliminate the current budget surplus and leave debt on a rising path – with or without a top-up to investment budgets to allow them to escape cuts as well.

Such a 'stand-still' solution may well prove incompatible with ambitious targets for service performance in the IFS's view. If the Chancellor's aim were to ensure day-to-day budgets for all departments keep pace with national income, a further top-up of £17bn would be required. This would take the total top-up to £47bn relative to March spending plans. Combining this with a fresh £16bn tax rise would restore the forecast current budget to balance in 2028/29. This would come on top of the £9bn Labour's manifesto tax rises, so would be a tax rise of around £25bn in total. A net tax rise of this scale would be bigger than in the July 1997 (£14bn) and October 2010 (£13bn) Budgets, both of which took place early in the parliament of a new Government.

8. **A longer-term focus beyond the five-year forecast horizon might promote better policymaking.** As the OBR's recent Fiscal Risks and Sustainability Report underlined, there are serious long term issues facing UK government finances. The IFS notes that by the end of the parliament, the target year of the fiscal rules will have moved forwards to 2033/34, when the FRSR projection is for the current budget to be in deficit by 1.6%. Ideally this risk should start to be considered now.

9. **The OBR's model suggests that the growth-promoting effect of the average public investment project is neither huge nor swift to materialise.** The watchdog estimates that a sustained boost to public sector investment of 1% of national income would add less than 0.08% to the sustainable annual growth rate over the next five years and less than 0.05% over the next fifty. As a result, the average public investment project would take a long time to be self-financing. This helps explain why there is so much talk of tweaking the fiscal rules to capture asset values.

10. **Policymakers have often chosen to prioritise other objectives over growth.** The IFS sights Brexit as an obvious example, but notes that Labour's manifesto commitments point to an extensive list of objectives alongside growth, including lower-carbon production processes, reduced geographical inequality, and improved resilience in crises. The IFS accepts

11. that these are all entirely valid objectives but says the government should acknowledge the very real trade-offs involved.

Comment

The Green Budget highlights the difficulties facing the Chancellor and serves as a reminder that tweaking the debt definition is no panacea.

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