3. Fiscal repair: painful but necessary

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Summary

- Our latest estimates – based on official forecasts – suggest that the financial crisis and associated recession have punched a permanent hole in the public finances of 7.5% of national income, or £114 billion in today's terms.
- Measures announced by the previous Labour government and the coalition government are estimated to have the direct effect of strengthening the public finances by 8.1% of national income, or £123 billion in today's terms, by 2016–17.
- Official figures now suggest that the structural deficit was 0.8% of national income, or £12 billion in today's terms, larger in 2007–08 than the March 2008 Budget suggested. Even had the Labour government known and dealt with this problem, the need for a large fiscal repair job would still have become apparent post-crisis.
- The latest forecasts suggest that borrowing in 2016–17 will be £24 billion, which is not much lower than the £26 billion forecast by Alistair Darling in his March 2010 Budget, despite the large additional fiscal consolidation announced by the new coalition government. However, in the absence of these new measures, borrowing would now be forecast to be much higher.
- The additional spending cuts announced by George Osborne in the Autumn Statement for 2015–16 and 2016–17 mean that he continues to comply with his fiscal mandate. But the latest official forecasts suggest that he only has a fifty–fifty chance of meeting his supplementary target to have debt falling as a share of national income in 2015–16.
- One risk to the public finances is that the government fails to deliver its planned fiscal consolidation. By the end of 2011–12, 73% of the planned tax increases will have been implemented. The spending cuts, however, are largely still to come – only 12% of the planned total cuts to public service spending, and just 6% of the cuts in *current* public service spending, will have been implemented by the end of this financial year.
- The impact of the remaining cuts to the services provided is difficult to predict; they are of a scale that has not been delivered in the UK since at least the Second World War. On the other hand, these cuts come after the largest sustained period of increases in public service spending since the Second World War. If implemented, the planned cuts would, by 2016–17, take public service spending back to its 2004–05 real-terms level and to its 2000–01 level as a proportion of national income.
- Perhaps the only relevant example of such deep cuts being delivered elsewhere in recent decades is Ireland in the late 1980s. The rarity with which such cuts have been delivered no doubt reflects the fact that they have seldom been deemed necessary and therefore not attempted. Should they not be possible, further tax rises or welfare cuts would be needed to reduce borrowing as currently planned.

3.1 Introduction

The latest official forecasts suggest that public sector net borrowing (PSNB) will be lower in 2011–12 than in the last two financial years but still significantly higher than in any other year since the end of the Second World War.

Government borrowing increased rapidly during 2008–09 and 2009–10, as real economic activity in the UK – and particularly the fortunes of the financial sector – fell sharply. The official forecasts for the public finances changed from one of apparent sustainability in early 2008 to a large, unsustainable, structural imbalance between revenues and spending. The substantial challenge facing the current coalition government is to reduce public borrowing to a sustainable level while taking into account trade-offs between the level of household incomes, the quality and quantity of public services provided and, potentially, any permanent damage to the UK economy from the consolidation.

The coalition government plans to cut public borrowing over a seven-year period through to 2016–17. Some tax increases and spending cuts have already been implemented, but many more are yet to come. In order to increase confidence that the government will stay the course with this ambitious deficit reduction programme, the Chancellor, George Osborne, has committed to two fiscal targets for borrowing and debt levels.

The UK economy was more adversely affected than many other countries by the financial crisis and global recession of 2008 and 2009. In part because of this, the UK government's fiscal consolidation task is relatively large by international standards. However, though the UK is certainly not alone in the scale of the fiscal imbalance it currently faces, some other countries with similarly large fiscal imbalances – such as the United States – have yet to set out how they will address this problem.

There are a number of risks and uncertainties facing the UK's public finances over the next few years, including the possibility that the scope for future economic growth might be weaker than the official forecasts suggest and the possibility that the government is unable or unwilling to deliver the planned large cut to public service spending. Even once the immediate problems with the UK's public finances have been addressed, the UK – like most other developed countries – faces pressure on its public finances from an ageing population. While measures to address these pressures do not have to come into force immediately – certainly the problems resulting from the financial crisis are more pressing – they will need to be addressed eventually.

Section 3.2 starts by setting out the latest official forecasts for the UK's public finances and how these compare with the outlook before the financial crisis began and what the likely path for public borrowing and debt might have been had no policy action been taken. Section 3.3 describes the magnitude of tax increases and spending cuts that have been announced to reduce public sector net borrowing to a sustainable level. Section 3.4 discusses the government's fiscal targets for borrowing and debt levels, while Section 3.5 compares the UK's fiscal position and plans with those of other industrialised countries.

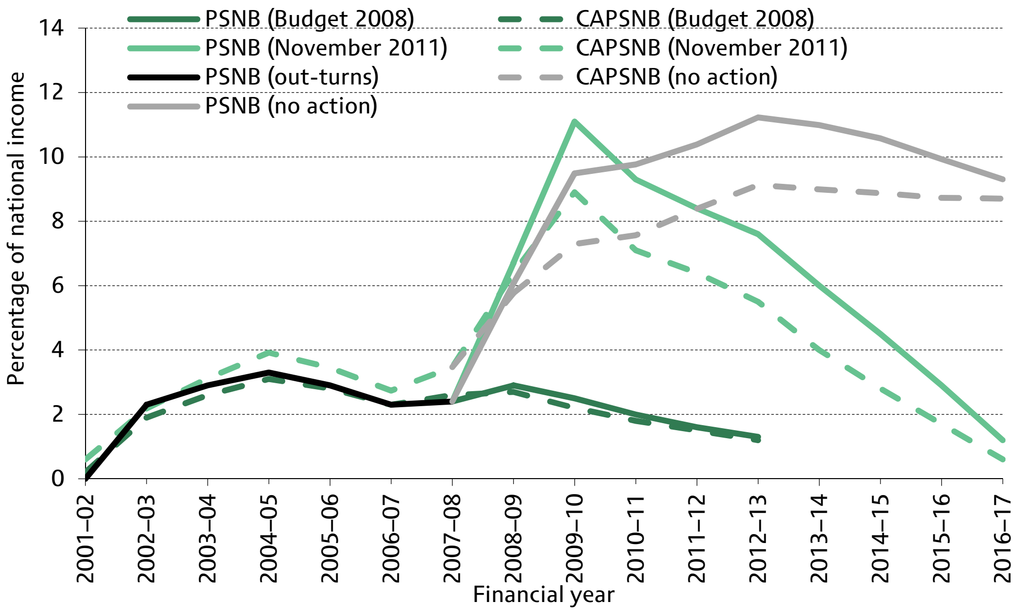
Section 3.6 discusses two of the risks associated with the UK's public finances over the next few years – the possibility that the scope for future economic growth might be weaker than the official forecasts suggest and the possibility that the government is unable or unwilling to deliver the planned large cut to public service spending. Section 3.7 discusses the longer-term pressures posed by an ageing population and Section 3.8 concludes.

3.2 The current state of the public finances and how we got here

The latest official forecasts suggest that PSNB will amount to 8.4% of national income this year (2011–12). The Office for Budget Responsibility (OBR) believes – and many independent forecasters concur – that the majority of this borrowing most likely reflects a permanent (rather than temporary) imbalance between the stance of public spending and tax policy in the UK. Figure 3.1 shows the OBR's latest estimates (November 2011) of and forecasts for PSNB – both the headline figure and the cyclically-adjusted figure, which strips out those elements of borrowing that are estimated to reflect temporary weakness in the UK economy. Largely as a result of the net tax increases and net spending cuts that have been announced by the current and previous government since late 2008, PSNB is expected to fall substantially over the next five years. Total PSNB is forecast to be 1.2% of national income in 2016–17, with cyclically-adjusted borrowing forecast to be 0.6%.

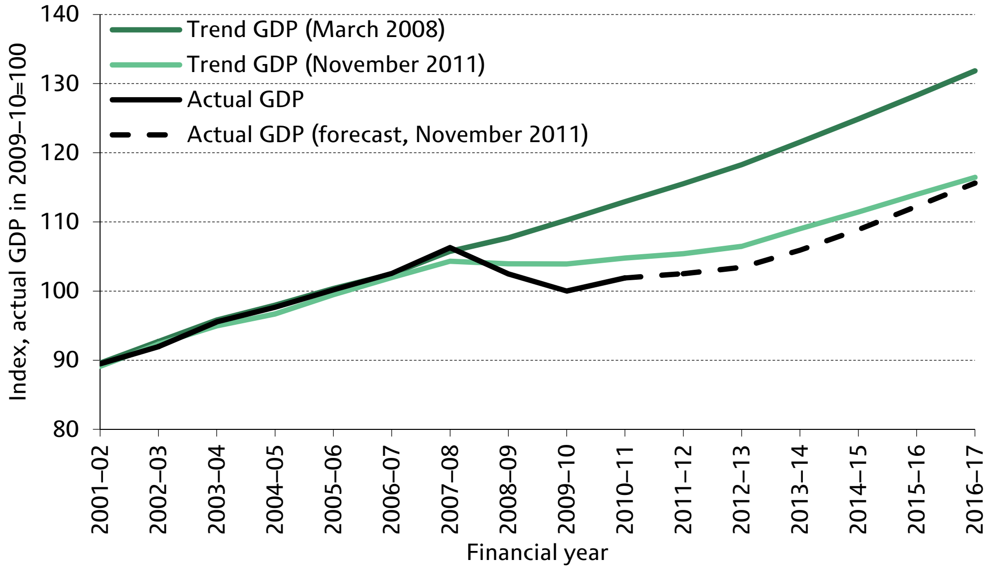
The current imbalance between tax and spending policy was not anticipated before 2008 either by the Treasury or by many independent forecasters; the recent financial crisis and associated recession radically altered the appearance of the strength of the UK's public finances. Before the crisis, in the March 2008 Budget, the then Chancellor Alistair Darling forecast that the UK's public finances were on a sustainable footing, with headline borrowing forecast to fall from its 2007–08 level of 2.4% of national income to just 1.3% of national income by 2012–13 (the end of what was then the forecast horizon).

Figure 3.1. Public sector net borrowing with and without cyclical adjustment



Notes: CAPSNB denotes cyclically-adjusted PSNB. Figures for cyclically-adjusted PSNB from November 2011 use the OBR's Principal Component methodology for estimating the output gap. 'No action' ignores the direct impact of all fiscal policy measures that have been implemented since Budget 2008.
Sources: Out-turn figures for PSNB from Office for National Statistics, series J511. Out-turn figures for CAPSNB from HM Treasury, Public Finances Databank, January 2012. Forecasts for PSNB from HM Treasury, *Budget 2008*, HC 388 and Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2011*. November 2011 CAPSNB are authors' calculations using data from T. Pybus, 'Estimating the UK's historical output gap', Office for Budget Responsibility, Working Paper 1, 2011.

Figure 3.2. Evolution of gross domestic product



Notes: Figures for trend GDP from November 2011 use the OBR's Principal Component methodology for estimating the output gap. Its alternative, Aggregate Composite, methodology produces very similar results.
Sources: Trend GDP figures from chart 3.7 of T. Pybus, 'Estimating the UK's historical output gap', Office for Budget Responsibility, Working Paper 1, 2011. Forecasts for actual GDP from Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2011*. Out-turn figures for real GDP from Office for National Statistics, series ABMI.

Cyclically-adjusted borrowing was forecast to fall from 2.6% of national income to 1.2% over the same period, as shown in Figure 3.1.

However, the economic outlook deteriorated rapidly after that and inflation turned out much lower than had been expected. The latter meant that the cash plans for spending on public services in 2008–09, 2009–10 and 2010–11 (that had been laid out, pre-crisis, in the October 2007 Comprehensive Spending Review) became more generous in real terms than had been intended. The last Labour government also intervened with a fiscal stimulus package in 2008 and 2009 to attempt to shore up aggregate demand in order to help limit the length and depth of the recession. We now know that borrowing rose substantially – reaching a post-Second World War high in 2009–10 – and now looks set to remain high for several years to come.

The main reason why a hole has opened up is that the official forecasts (initially from the Treasury and now from the OBR) suggest that the amount of output that the UK economy is capable of producing on a sustained basis (that is, the level of output that is consistent with stable inflation) – and thus the level of public spending that a given tax system could finance – is now expected to be permanently lower than had been thought before the crisis. Figure 3.2 shows how actual and trend levels of growth in UK national income, from different vintages of official forecasts, compare with one another. The latest estimate of gross domestic product (GDP) in 2009–10 is indexed to 100. The gap between actual GDP and trend GDP indicates how large a 'boom' or 'bust' the UK economy was thought to be experiencing at any particular time. The different views on the size of the UK's potential output thus give different impressions of the size of 'boom' or 'bust'.

In March 2008, the Treasury was expecting that the trend output of the UK economy in 2016–17 would be 13% greater than the latest OBR forecasts suggest it is actually going to be. That is, rather than the potential size of the UK economy being about £1,960 billion in 2016–17, as the latest OBR forecast suggested, the pre-crisis expectation was that it would be around £2,220 billion (or roughly an extra £3,500 per person in the UK in today's terms). It is this 'loss' of productive capacity that has caused a hole to open up in the public finances and has similarly damaged the prospects for private consumption.

Our estimates, based on the OBR's latest official forecasts, suggest that the apparent 'hole' in the UK's public finances that has opened up since the March 2008 Budget – that is, the additional structural borrowing that is now forecast to persist in the medium term, over and above what was forecast in the March 2008 Budget – equates to 7.5% of national income (or £114 billion in today's terms).

A key issue – both of historic interest and also to help ensure that lessons are learned for the future planning of the public finances – is whether this is really a new problem that has been caused by the crisis or whether it was simply revealed when the crisis struck, and – if the latter – whether this is something that should also have been apparent back in 2008. In other words: was the Treasury (and many others) previously being unduly optimistic about the extent to which the performance of the UK economy before the crisis was permanent rather than temporary? Or was the crisis really a large (unpredictable) negative shock to our productive potential? This amounts to asking the questions: should it have been possible to predict, in 2007–08, how large the gap between the two green lines in Figure 3.2 was at that point, and how was it likely to evolve going forwards?

The OBR's revised estimates suggest that the potential output of the UK was slightly (1.4%) smaller in 2007–08 (prior to the crisis) than the Treasury previously thought. So the OBR now thinks that the economy was actually experiencing a larger (but still relatively small) boom in 2007–08 than the Treasury had thought at the time. This is shown by the fact that the pale green line lies below the dark green line in Figure 3.2. Thus the latest OBR figures suggest there was a positive output gap of 1.9% of national income in 2007–08, rather than the 0.5% the Treasury previously estimated.

In 2007–08, total PSNB stood at 2.4% of national income. Since, at the time, the Treasury thought that the UK economy was operating slightly above its productive potential, underlying structural borrowing was estimated to be a slightly higher 2.6% of national income. The larger output gap now estimated by the OBR implies that structural borrowing in 2007–08 in fact stood at around 3.5% of national income, as shown in Figure 3.1. In other words, 0.8% of national income of the current structural borrowing problem (or around £12 billion in today's terms) is, according to the OBR's figures, now apparent back in 2007–08. A structural deficit of 3.5% of national income in 2007–08 would have been the highest level since 1995–96 (when it stood at 3.8% of national income) but still far below its previous peak of 5.5% of national income in 1992–93.

So, with the benefit of hindsight, the OBR now thinks that the public finances were structurally weaker back in 2007–08 than the government believed (or at least admitted to) at the time. Had Mr Brown and Mr Darling based their policy on the OBR's latest estimate of the output gap in 2007, they would have needed to have tightened fiscal policy (i.e. increased taxes or cut spending) by around £12 billion in order to have forecast the fall in borrowing that they were projecting at the time.[1] While a fiscal tightening of this size is not insignificant in normal times, it is only a small fraction of the

[1] Whether an additional £12 billion fiscal tightening prior to the crisis would have been desirable would also depend in part on whether it would have induced a monetary policy response. Unless the Monetary Policy Committee of the Bank of England had also been convinced that the output gap was larger than it too thought at the time, the reduction in aggregate demand brought about by an additional pre-crisis tightening of fiscal policy might well have been offset through lower interest rates. This, in turn, could have boosted asset prices further and, potentially, worsened the subsequent financial crisis.

7.5% of national income (or £114 billion in today's terms) additional hole we estimate is implied by the November 2011 official forecast compared with the March 2008 one. So we would still have been left with a further £102 billion of fiscal austerity being required after 2008 to get the public finances back on track.

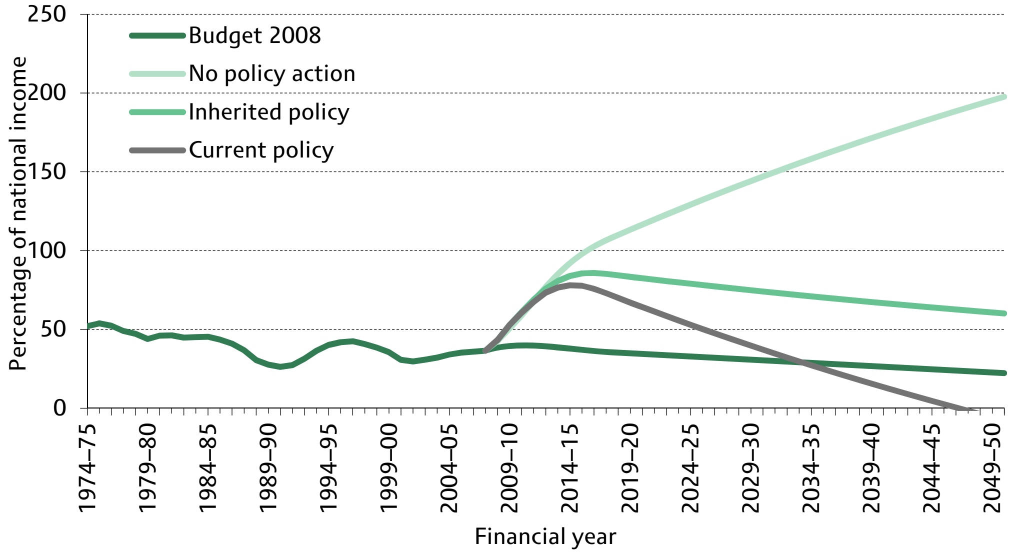
To assert that the Labour government should have done even more before 2008, while accepting the latest official estimates for the output gap up to 2007–08, one would have to believe that it should have been able to forecast more accurately the path of trend output growth beyond 2007–08. Over the period from 2007–08 to 2016–17, the OBR's latest figures imply that trend output will grow on average by just 1.2% a year. This compares with the 2½% a year that underpinned the official public finance forecasts produced prior to the crisis. While at the time Mr Darling's assessment of the path of trend growth was not seen as being particularly cautious, it also was not widely seen as being unduly optimistic either. For example, the estimates produced by Morgan Stanley in the January 2007 IFS Green Budget suggested that 2½% a year trend growth was not an unreasonable central forecast.[2]

Of course, in addition to the permanent hole in the public finances that has resulted from this revision to the trend level of UK output, there is some further additional borrowing expected over the next few years because the UK economy is expected to be operating somewhat below even this lower level of trend output. That is, the OBR expects there to be a negative output gap in each year until 2016–17. This is shown in Figure 3.2 by the fact that the latest official forecasts (November 2011) have actual GDP running below estimated potential GDP for each of the next five years.

The latest official forecasts, shown in Figure 3.1, suggest that borrowing will return to sustainable levels over the next few years. However, had the last Labour government and the current government not announced any permanent net tax increases or spending cuts over the last few years, public borrowing in the UK would have been left at an unsustainably high level (as shown by the grey lines in Figure 3.1). Figure 3.3 shows the estimated profile of public sector net debt both under current policies and assuming no fiscal action had been announced since March 2008 to reduce this level of borrowing. Under the scenario with no policy action, it is estimated that debt would have grown rapidly for the foreseeable future and passed 100% of national income in 2016–17, rather than peaking at around 80% of national income and then declining as it is forecast to do under current policy. In practice, the path for debt without any policy action would be even worse than suggested by Figure 3.3, as the interest rate that foreign investors charge the UK government for financing its borrowing would have risen and most likely risen so sharply that a fiscal tightening would in fact have been forced on the UK government.

[2] See D. Miles, M. Baker and V. Pillonca, 'The economic outlook', in R. Chote, C. Emmerson, A. Leicester and D. Miles (eds), *The IFS Green Budget: January 2007* (http://www.ifs.org.uk/budgets/gb2007/07chap4.pdf).

Figure 3.3. Debt forecasts – with and without policy action



Notes: Forecasts for debt levels assume that non-debt interest spending and revenues remain constant as a share of national income from 2018–19 onwards, while inflation is assumed to run at 2.7% a year and real growth in national income at 2.3% a year. Average nominal interest rates are assumed to remain at 3.7% (the level forecast in the November 2011 Economic and Fiscal Outlook for the end of the OBR's forecast horizon, 2016–17). 'No policy action' ignores the direct impact of all fiscal policy measures that have been implemented since Budget 2008. 'Inherited policy' takes policy as of the March 2010 Budget.
Sources: Authors' calculations using results set out in HM Treasury, *Public Finances and the Cycle*, Treasury Economic Working Paper 5, November 2008 (http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/prebud_pbr08_publicfinances.htm) (in particular tables 2.B, 2.C and 2.D) and the forecasts for borrowing, net investment and the output gap from Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2011* (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011/).

3.3 Fixing the UK's public finances

In order to prevent debt reaching an unsustainable level, the Labour government and the coalition government that succeeded it in May 2010 announced a series of net tax increases and net spending cuts. The combined direct effect of policies announced since March 2008 is expected to reduce PSNB by 8.1% of national income (or £123 billion a year in today's terms) by 2016–17. This is slightly larger than the £114 billion extra hole in the public finances that has become apparent since early 2008 (described in Box 3.1). By aiming to more than offset the size of the permanent gap that has opened up in the public finances since 2008, Mr Osborne is now aiming for a slightly tighter fiscal position in the medium term than Mr Darling was in March 2008 – while Mr Darling forecast in March 2008 that cyclically-adjusted PSNB would be 1.2% of national income in the medium term, the latest official forecasts suggest that medium-term cyclically-adjusted PSNB will instead be 0.6% of national income.

As shown in Figure 3.5, the policies announced over the last few years served to increase PSNB in 2008–09 and 2009–10 – in order to provide additional stimulus to the UK economy – but from 2010–11 onwards, the new policies are set to reduce public spending and increase tax revenues each year. A fifth of the reduction in borrowing that will be in place by 2016–17 is planned to come from tax increases, 12% is to come from cuts to investment spending, 14% from cuts to benefit spending, 7% from lower debt interest payments as a result of reduced borrowing in the short term, and the remaining 48%

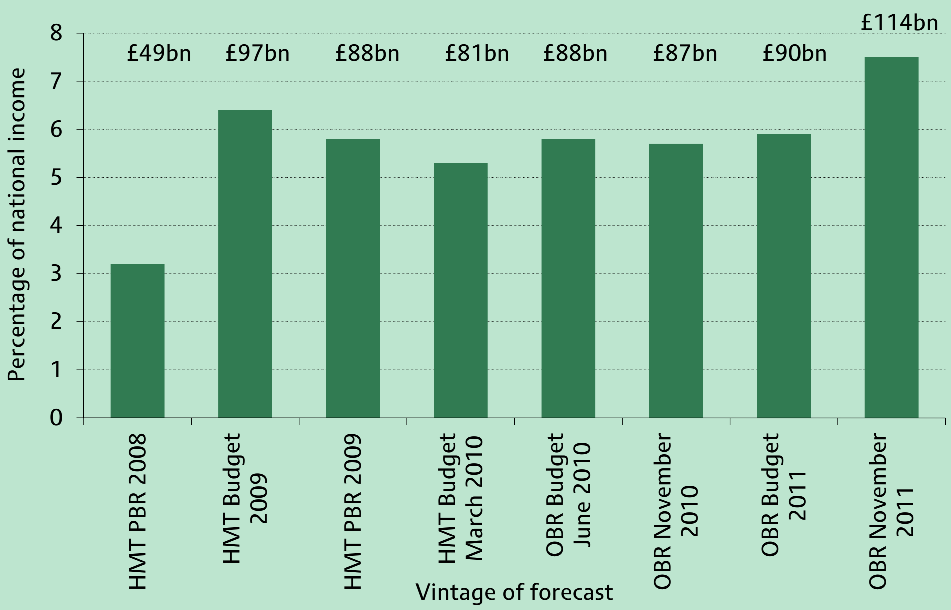
Box 3.1. The changing severity of the problem

Our estimates, based on the official forecasts, suggest that the apparent 'hole' in the UK's public finances that has opened up since the March 2008 Budget equates to 7.5% of national income (or £114 billion in today's terms).

This 'hole' is equal to the total level of borrowing now forecast, less borrowing that was implied by the plans set out in the March 2008 Budget and borrowing that has arisen since then but is believed to be temporary rather than permanent. An assessment of how much of the currently high level of borrowing reflects a permanent structural imbalance in the UK's fiscal stance – as opposed to temporary weakness caused by currently weak economic activity – is central to understanding how much fiscal action is required by the government over the next few years to get the UK's public finances back on track.

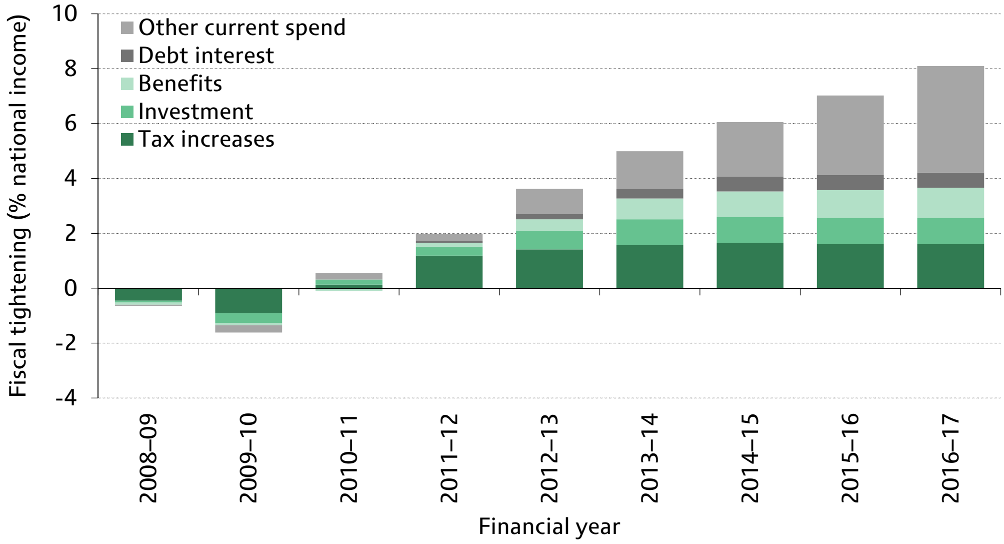
Early on in the financial crisis – at the time of the October 2008 Pre-Budget Report (which was in the immediate aftermath of the demise of Lehman Brothers) – our calculations suggested that Mr Darling thought that the hole amounted to 3.2% of national income (or £49 billion in today's terms), as shown in Figure 3.4. However, subsequent forecasts increased this to around £90 billion before most recently being increased further to £114 billion (in spite of the fact that forecasts for total borrowing have actually been revised down on a number of occasions over the last few years). The larger this structural imbalance is thought to be, the more action is required by the government to increase tax revenues or cut public spending in order to get the public finances back to a sustainable position. Revisions to the estimated size of this hole are one major reason why we saw significant announcements of new (either explicit or implicit) medium-term tax increases and spending cuts in the 2008 Pre-Budget Report, the 2009 Budget and the 2011 Autumn Statement.

Figure 3.4. Disease: the changing size of the problem



Sources: Authors' calculations using all HM Treasury Budgets and Pre-Budgets between November 2008 and March 2010 (all available at http://www.hm-treasury.gov.uk/budget_archive.htm) and all Office for Budget Responsibility Economic and Fiscal Outlooks between June 2010 and November 2011 (all available at http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011/).

Figure 3.5. Timing and composition of the fiscal remedy



Notes: Bars represent the planned fiscal tightening (reduction in government borrowing), decomposed into tax increases and spending cuts, with the spending cuts further subdivided into benefit cuts, other current spending cuts and investment spending cuts.
Sources: Authors' calculations using all HM Treasury Budgets and Pre-Budget Reports between March 2008 and March 2011 (up to the March 2010 Budget are available at http://www.hm-treasury.gov.uk/budget_archive.htm; June 2010 Budget onwards available at http://www.hm-treasury.gov.uk/budget.htm) and all OBR Economic and Fiscal Outlooks between June 2010 and November 2011 (all available at http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011/).

from cuts to other non-investment spending.[3] In other words, the fiscal contraction is to rely much more heavily on spending cuts than on tax increases.

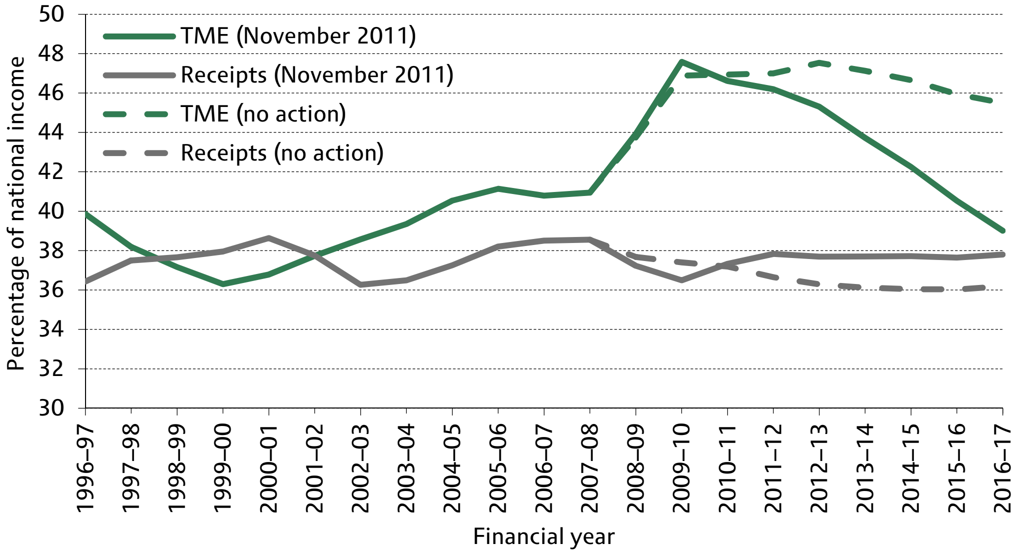
The composition of the planned tightening varies over time, with the tax rises being much more front-loaded than the spending cuts. By the end of 2011–12, the plans imply that we will have experienced 73% of the tax rises, 34% of the investment cuts, 12% of the benefit cuts, but just 6% of the cuts to non-investment spending on public services.

One potential justification for the chosen composition of the planned fiscal consolidation can be drawn from Figure 3.6. This shows figures for government revenues and spending as a share of national income over the period from 1996–97. The dotted lines show how tax revenues and spending would have evolved as shares of national income after 2007–08 if the direct impact of all policy action since the March 2008 Budget is ignored.

In the absence of policy action, spending would have increased from 40.9% of national income in 2007–08 to a peak of 47.5% in 2012–13, before falling slightly as the economy recovered from its temporary weakness. However, even after the economy returned to its trend level (forecast by the OBR to be in 2017–18), spending would still have been at around 45% of national income.

[3] Figures do not sum to 100% due to rounding.

Figure 3.6. Revenues and spending



Note: 'No action' ignores the direct impact of all fiscal policy measures that have been implemented since Budget 2008.
Sources: Out-turn figures for revenues and spending are from HM Treasury, Public Finances Databank, January 2012. Authors' calculations using all HM Treasury Budgets and Pre-Budget Reports between March 2008 and March 2011 (up to the March 2010 Budget are available at http://www.hm-treasury.gov.uk/budget_archive.htm; June 2010 Budget onwards available at http://www.hm-treasury.gov.uk/budget.htm) and all OBR Economic and Fiscal Outlooks between June 2010 and November 2011 (all available at http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011/).

The amount of revenue yielded by the UK tax system is generally related to the level of national income and so, while the crisis lowered the forecast productive potential of the economy, revenues as a share of national income were relatively unaffected. Tax revenues as a share of national income would have fallen permanently in the absence of policy action, but only from 38.6% of national income in 2007–08 to around 36% from 2012–13 onwards.[4]

Therefore, while a much greater proportion of the fiscal consolidation is coming from spending cuts than from tax rises, this is forecast to bring tax receipts and spending as shares of national income back to around the levels that they were at before the financial crisis.

Making the patient sicker?

One of the charges laid at the door of the current government is that its fiscal consolidation package is having an unduly detrimental effect on economic growth. This debate has been rather muddied by a failure to consider properly what the appropriate counterfactual might be.

[4] Tax revenues would not be forecast to regain their previous share of national income in the absence of policy changes largely for two main reasons: first, because the financial sector, which is relatively profitable and pays relatively more tax than other industries, is not expected to comprise as large a share of total output in future as it did before the crisis; and second, because property and equity prices are now forecast to be permanently lower than was expected pre-crisis, which reduces expected revenues from stamp duties, capital gains tax and inheritance tax.

Economic and fiscal forecasts have worsened since the coalition government took office. Specifically, the OBR's latest forecast for borrowing (made in November 2011), which takes into account actions by the new government and all other recent economic developments, was higher for many of the upcoming years than the forecast produced by the Treasury in March 2010, which was on the basis of the previous government's plans and other economic information available just before the 2010 general election. This is despite the additional tax increases and spending cuts announced since the general election. The Shadow Chancellor, Ed Balls, has made much of these upward revisions to borrowing, comparing the latest figures unfavourably with the 'balanced plan' set out by Alistair Darling before the last general election.[5]

Table 3.1. How borrowing forecasts changed between March 2010 and November 2011 (% of GDP unless otherwise stated)

	2010–11	2011–12	2012–13	2013–14	2014–15	2015–16	2016–17
PSNB, Budget March 2010							
£ billion	**£163**	**£131**	**£110**	**£89**	**£74**	**£51**	**£26**
% of GDP	**11.1**	**8.5**	**6.8**	**5.2**	**4.0**	**2.7**	**1.3**
Additional cyclical	–1.6	–1.2	–0.6	–0.1	0.2	0.3	0.4
Additional structural	0.3	1.9	2.7	2.6	2.4	2.2	2.2
November 2011 borrowing forecast, with no measures after 2010 general election							
£ billion	**£145**	**£141**	**£141**	**£128**	**£114**	**£96**	**£76**
% of GDP	**9.8**	**9.2**	**8.9**	**7.7**	**6.6**	**5.2**	**3.9**
Additional measures	–0.5	–0.8	–1.3	–1.7	–2.1	–2.3	–2.7
Of which:							
Tax	–0.2	–0.4	–0.4	–0.5	–0.5	–0.2	0.0
Spending	–0.4	–0.4	–0.9	–1.2	–1.6	–2.1	–2.7
PSNB, Autumn Forecast November 2011							
£ billion	**£137**	**£127**	**£120**	**£100**	**£79**	**£53**	**£24**
% of GDP	**9.3**	**8.4**	**7.6**	**6.0**	**4.5**	**2.9**	**1.2**

Notes: The March 2010 Budget assumed some extra 'unspecified' tightening in 2015–16 and 2016–17. In order to quantify how much of the specific spending cuts and tax increases announced by the coalition government were 'additional' to those implicitly assumed in the Labour government's forecasts, we need to make some assumption about how this additional unspecified tightening would have been split between tax increases and spending cuts: we assume that it would have had the same composition as the tightening introduced by the Labour government by 2014–15, i.e. 30% from higher taxes and 70% from spending cuts.
Sources: Authors' calculations using all HM Treasury Budgets and Pre-Budget Reports between March 2008 and March 2011 (up to the March 2010 Budget are available at http://www.hm-treasury.gov.uk/budget_archive.htm; June 2010 Budget onwards available at http://www.hm-treasury.gov.uk/budget.htm) and all OBR Economic and Fiscal Outlooks between June 2010 and November 2011 (all available at http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011/).

[5] See, for example, the response from Mr Balls to the Chancellor's Autumn Statement, 29 November 2011: 'Higher borrowing than he promised a year ago – £158 billion more borrowing. And can he [the Chancellor] also confirm – despite the pain of £40 billion of extra spending cuts and tax rises the Chancellor boasted about a year ago – can he confirm that compared to the plans he inherited at the last election because the recovery he choked off and because unemployment is higher he is now set to borrowing more at the end of this Parliament than the balanced plan inherited from Labour' (http://www.labour.org.uk/autumn-statement-shows-osbornes-plan-not-working,2011-11-29).

In this subsection, we try to clarify what we know about the differences between current forecasts and those set out by the last government and the extent to which those differences arise from different policy prescriptions and from more recent economic news.

A comparison between the current government's plans and those set out by the last government is provided in Table 3.1, which decomposes the difference between borrowing as forecast in the March 2010 Budget (Labour's last) and borrowing as forecast by the OBR in November 2011. The change in the borrowing forecast is split into revisions that reflect the estimate of the direct impact of new policy announcements and revisions that reflect new information on the economic outlook. The latter include both additional cyclical borrowing – as a result of temporarily weaker-than-expected economic performance – and additional structural borrowing as a result of permanent reductions in economic activity relative to what was previously expected.

The official estimates of the direct impact of policy measures announced since the coalition government came to power are that these will reduce borrowing by 2.7% of national income a year by 2016–17. Over the same period, the Treasury's and OBR's forecasts suggest that underlying borrowing has been revised up by 2.6% of national income in 2016–17. In other words, the fact that borrowing for 2016–17 is now forecast by the OBR to be roughly the same as forecast by the Treasury in March 2010 reflects two offsetting factors: (i) the underlying economic outlook has weakened significantly and thus borrowing would be expected to rise; and (ii) the current government has taken action to cut public spending and increase tax revenues by more than had been committed to by the previous government, which the OBR expects will reduce borrowing.

Of course, there are uncertainties around any estimates of the impact of policy changes on overall borrowing and it is possible that some of the weaker outlook for the economy has actually been caused by a detrimental impact of the additional fiscal consolidation announced by the coalition government that is not captured in the official estimates of the measures' impact on revenues and spending. However, the error in estimating the size of the policy impact would have to be implausibly large to lead one to conclude that borrowing would actually have been lower in the absence of the additional tax rises and spending cuts that have been announced since May 2010. In addition, the largest revisions to borrowing forecasts occurred between March 2011 and November 2011, with the OBR revising upwards its forecast for structural borrowing by nearly 2% of national income in each year between 2011−12 and 2014−15, even though overall the new discretionary policies announced in the November 2011 Autumn Statement are unlikely to have had a significant negative impact on the outlook for the economy over this period.

All things considered, it seems likely that, in the absence of the additional fiscal tightening announced since the general election, borrowing would have been on course to be closer to £76 billion in 2016–17 than to the £26 billion that was forecast in the March 2010 Budget. What tax and spending plans a new Labour government would have followed had it been elected in 2010 cannot be known. The size of the hole in the public finances is now thought to be bigger than was estimated when Labour were in power before the election. Just as the coalition government has implemented policies to reduce borrowing that were not in either the Conservative or Liberal Democrat Parties' manifestos, Labour too may have raised taxes or cut spending further in areas they had not mentioned in their manifesto, just as they did in the first year after the 1997, 2001 and 2005 general elections.[6]

That the scale of fiscal consolidation now planned by the government will have a significant negative effect on economic growth in the UK is, of course, a valid concern. Most economic models suggest that fiscal policy does have some effect on economic output in the short term – in particular, by temporarily affecting aggregate demand. When producing its forecasts for the UK economy, the OBR makes a judgement about the likely impact of any fiscal giveaway or takeaway. To help it do so, it makes use of fiscal multipliers, which are estimates of the direct short-run effect of fiscal measures on national income. These fiscal multipliers are different for different types of policies – for example, a change in the rate of VAT is assumed to have a multiplier of 0.35, while a change in investment spending is assumed to have a multiplier of 1. The OBR's figures suggest that the short-run impact of the package of additional tax increases and spending cuts announced by the coalition government for 2010–11 was to reduce economic output by 0.3% in that year.[7]

What is much harder to estimate is whether fiscal action has any effect on long-term economic output. On the one hand, there are good reasons to think that the impact of fiscal policy changes may diminish over time. For example, monetary policy may become looser to offset a tightening of fiscal policy and economic resources no longer employed in the public sector may eventually be absorbed productively into the private sector. On the other hand, cutting public spending could adversely affect the UK's supply-side potential, which could lead to a permanent loss of economic output. For example, cuts to public sector investment spending might lead to a permanent deterioration in the UK's infrastructure (for example, roads, railways, scientific research facilities); cuts to the education budget might reduce the productivity and wages of individuals in the future; or some individuals made unemployed in the short term could end up unable to find another job because their skills decline, thus increasing the level of long-term unemployment (and reducing the size of the productive workforce) in the UK.

The OBR believes that, over time, the fiscal multipliers fade, as monetary policy is able to respond to offset the impact on demand and as the economy moves to a new equilibrium. The OBR has assumed that the additional squeeze on public spending in 2015–16 and 2016–17 – announced in the November 2011 Autumn Statement – will have no impact on the path of national income as 'at this long time horizon, we would expect looser monetary policy to fully offset the effects of a pre-announced fiscal tightening of this size, leaving our forecast for overall GDP growth unchanged as a result of this measure'.[8]

3.4 The government's fiscal rules

Mr Osborne has chosen to adhere to two fiscal rules to constrain the government's behaviour. These were set out in the June 2010 Budget. The first, the forward-looking 'fiscal mandate', states that the structural current budget must be forecast to be in

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[6] See R. Chote and C. Emmerson, 'Taxes and elections: are they by any chance related?', IFS Observation, March 2010 (http://www.ifs.org.uk/publications/4793).

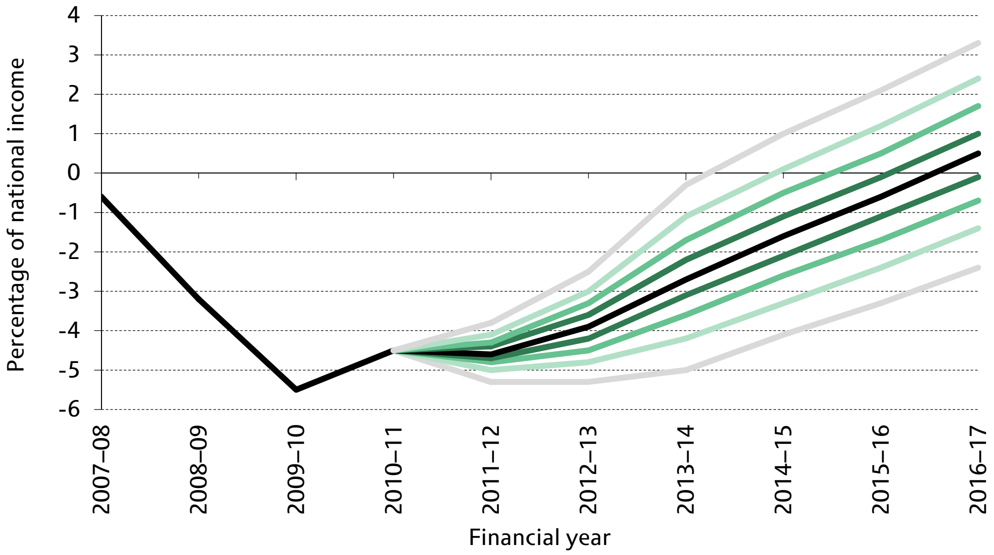
[7] This is calculated as the difference between the two OBR forecasts for economic growth in 2010–11 that were published in June 2010 before and after the June 2010 Budget.

[8] Source: Box 3.2 of Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2011* (http://cdn.budgetresponsibility.independent.gov.uk/Autumn2011EFO_web_version138469072346.pdf).

balance or in surplus by the end of the rolling, five-year forecast horizon. In other words, after taking into account the estimated impact of the ups-and-downs of the economic cycle, government receipts should be projected to be equal to or greater than government non-investment spending. The second, the 'supplementary target', states that public sector net debt as a share of national income should be falling at a fixed date of 2015−16.

Compliance with these rules is adjudicated by the independent OBR. The government has required the OBR to publish (biannually) a judgement on whether current policy is consistent with these two fiscal rules. The black line in Figure 3.7 shows the OBR's latest 'central' forecast for the cyclically-adjusted current budget under current policies. In 2016−17, the end of the current forecast horizon, the cyclically-adjusted current budget is forecast to be in surplus by 0.5% of national income. The government is therefore complying with its fiscal mandate.

Figure 3.7. Cyclically-adjusted current budget fan chart



Notes: The lines around the central forecast indicate the range of values within which there is a 10% chance of the true out-turn for borrowing falling – for example, there is a 20% chance of the current budget surplus being between the innermost pair of (dark green) lines and an 80% chance of the current budget balance lying within the outermost pair of (grey) lines.
Source: Chart 5.2 of Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2011* (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011).

However, forecasting borrowing several years hence is, even in the best of times, a difficult business and Figure 3.7 shows some indication of the degree of uncertainty around the OBR's latest central forecast. Based on past forecast accuracy, there is a 20% chance that the outcome will lie within the darkest green lines, a 40% chance the outcome will lie within the next-darkest bands and so on. There is, therefore, roughly a 40% chance that the cyclically-adjusted structural current budget will not in fact be in balance or surplus in 2016−17, assuming the OBR's latest forecast is as accurate as previous official forecasts have been over the last 30 years. (Of course, the current climate may be even more uncertain than normal – Section 3.6 discusses some specific risks facing the UK's public finances over the next few years, and Chapter 4 discusses the outlook for the public finances under some alternative scenarios for the macroeconomy.)

The pledge to meet this fiscal mandate explains why the government announced additional net spending cuts in its November 2011 Autumn Statement. At the time of the March 2011 Budget, the end of the forecast horizon was 2015−16, and the OBR forecast a surplus on the cyclically-adjusted current budget of 0.8% of national income in that year. However, by November 2011, despite the fact that the forecast horizon had rolled forward one year, the OBR's expectations of the strength of the UK economy had worsened so significantly that, if no policy action had been taken, the OBR would have forecast a cyclically-adjusted current budget deficit of 1.1% of national income for 2016–17. Without policy action, the government would not have been complying with its fiscal mandate. In fact, the government announced additional spending cuts amounting to £30 billion (or 1.5% of national income) in 2016–17 and so the OBR's latest forecast (as shown in Figure 3.7) is for a cyclically-adjusted current budget surplus of 0.5% of national income instead.[9]

The government therefore now has some small room for manoeuvre on its fiscal mandate. The same is not true, however, for the supplementary target. Figure 3.3 showed that public sector net debt is forecast by the OBR to peak at 78.0% of national income in 2014–15 before falling to 77.7% in 2015–16. In other words, while debt as a share of national income is currently forecast to fall in 2015–16, the forecast is for a fall of just 0.3% of national income (or £4½ billion in today's terms). This could easily go the other way if economic growth in future turns out to be lower than forecast or if borrowing in 2014–15 (or 2015–16) turns out to be slightly lower (higher) than currently forecast. For example, over just an eight-month period between March and November 2011, the OBR's estimate of how much UK government borrowing would be in 2011–12 increased by £5 billion. Since the OBR's central forecast is for debt to be *just* falling in 2015–16, the government only has a very slightly better than fifty–fifty chance of meeting its supplementary target.

3.5 International comparison of the UK's fiscal position and future plans

The UK experienced a substantial deterioration in its fiscal position over recent years. Whilst many other countries also saw their fiscal positions weaken markedly, the UK saw one of the largest deteriorations. However, the UK has also set out plans to implement a relatively larger fiscal consolidation than most other countries (at least so far), and so – by 2016 – is currently forecast to rank more highly internationally in terms of its fiscal strength than it did before the crisis.

A summary of the UK's borrowing compared with that of other advanced economies, using data from the International Monetary Fund (IMF), is shown in Table 3.2. Prior to the crisis, the UK had the (joint) third-highest level of government borrowing among 28 advanced economies – only Portugal and Greece had higher levels of borrowing as a share of national income, while France and the US had the same level of borrowing. On a cyclically-adjusted basis, the UK had the fourth-highest level of borrowing – exceeded only by Portugal, Ireland and Greece. So compared with other advanced economies, the UK's fiscal position was relatively weak before the financial crisis struck.

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[9] The rolling nature of the forecast horizon could be interpreted as a weakness of the fiscal mandate – a government could keep promising to implement a tightening by the end of the forecast horizon but never actually deliver one without strictly violating the fiscal mandate. But such a rule does have advantages: for a fuller description of the pros and cons of the formulation of a fiscal rule in this way (and a fuller discussion of the supplementary target), see R. Crawford, C. Emmerson and G. Tetlow, 'The new fiscal framework: an assessment', in M. Brewer, C. Emmerson and H. Miller (eds), *The IFS Green Budget: February 2011* (http://www.ifs.org.uk/budgets/gb2011/11chap2.pdf).

Table 3.2. Borrowing as a share of national income in the UK compared with 28 advanced economies

	UK rank	Notes
Headline borrowing		
Level		
2007 (pre-crisis)	3rd highest	United States and France the same; Portugal and Greece higher
Peak	6th highest	Japan, Spain, United States, Greece and Ireland higher
2016	13th highest	
Change		
Increase, 2007 to peak	12th largest	
Reduction, peak to 2016	4th largest	Iceland, Greece and Ireland larger
Reduction, 2011 to 2012	9th largest	
Reduction, 2007 to 2016	4th largest	France, Portugal and Greece larger
Cyclically-adjusted borrowing		
Level		
2007 (pre-crisis)	4th highest	Portugal, Ireland and Greece higher
Peak	5th highest	Spain, Ireland, Iceland and Greece higher
2016	15th highest	
Change		
Increase, 2007 to peak	9th largest	
Reduction, peak to 2016	5th largest	Portugal, Ireland, Greece and Iceland larger
Reduction, 2011 to 2012	7th largest	
Reduction, 2007 to 2016	4th largest	Portugal, Ireland and Greece larger

Notes: Measures are general government balance as a percentage of GDP and general government cyclically-adjusted overall balance as a percentage of potential GDP. The 28 advanced economies on which comparable data to the UK are available are: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Finland, France, Germany, Greece, Hong Kong, Iceland, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Slovakia, Slovenia, South Korea, Spain, Sweden, Switzerland and the United States. Peak levels of borrowing were reached in 2009 or 2010 for almost all economies. There are a few exceptions: for example, in Ireland and Iceland cyclically-adjusted borrowing peaked in 2008.
Sources: Statistical tables 1 and 3 of International Monetary Fund, 'Addressing fiscal challenges to reduce economic risks', *Fiscal Monitor*, September 2011 (http://www.imf.org/external/pubs/ft/fm/2011/02/data/fmdata.xlsx).

During the financial crisis and recession, the UK experienced the twelfth-largest increase in total borrowing and ninth-largest increase in cyclically-adjusted borrowing. The economies that experienced even worse problems include a number whose difficulties are well known and have led them to seek bailouts from multilateral organisations – Iceland, Ireland and Greece.

However, over the next few years, the UK government has committed to a programme of fiscal consolidation that the IMF forecasts will be sufficient for the UK to see the fourth-largest reduction in total borrowing (fifth-largest reduction in cyclically-adjusted borrowing) amongst this set of economies. Only Iceland, Ireland, Greece and Portugal have so far committed to a larger consolidation of their public finances by 2016. A number of economies – such as the US, Spain and Japan – whose current levels of government borrowing are similar to those in the UK, have only so far set out limited plans for reducing their borrowing, and thus, unlike the UK, are currently forecast to continue to have relatively high levels of borrowing up to 2016.[10] The US, for example, is forecast to have cyclically-adjusted general government borrowing of 4.9% of national income in 2016, compared with the 1.1% forecast by the IMF for the UK.

Although the UK had a relatively high level of annual government borrowing before the crisis, the stock of accumulated government debt was middling by international standards. In 2007, the ratio of government debt to national income in the UK was lower than that seen in 10 out of 23 other advanced economies on which comparable data are available.[11] However, because the UK government's levels of borrowing have increased sharply and will be higher than those of many other economies over the next few years, the UK is set to climb up the international league table of indebtedness by 2016, experiencing the seventh-largest overall increase in debt as a share of GDP between 2007 and 2016, resulting in the eighth-highest level of debt among 24 economies. However, UK debt – forecast to be around 75% of national income at that stage – would still be substantially lower than that forecast for the US and Italy (around 90%) and for Ireland, Portugal and Japan (all 100% or more).

3.6 Risks to the public finances

The government has ambitious plans to reduce public sector borrowing (discussed in Section 3.3), but there is much uncertainty surrounding the outlook for borrowing over the next few years. This section considers two risks to the government's fiscal plans. The first is that the output gap turns out to be smaller than currently thought and therefore the structural deficit bigger. The second is that the government might not be able (or willing) to implement as large a cut to public service spending as is currently planned.

There are, of course, always risks to fiscal projections, even in more 'normal' times. Figure 3.8 shows the out-turns for borrowing since 1976–77 and how these compare with the forecasts that had previously been made. Past errors in borrowing reflect two broad factors: first, errors in forecasting the level of future macroeconomic activity; and second, errors in forecasting tax receipts and spending conditional on the macroeconomic position. Figure 3.8 suggests that, in general, past governments have tended to underestimate future borrowing levels when economic activity was weakening (for example, during the late 1980s and early 1990s) and overestimate it when economic activity was strengthening (for example, during the late 1990s).[12]

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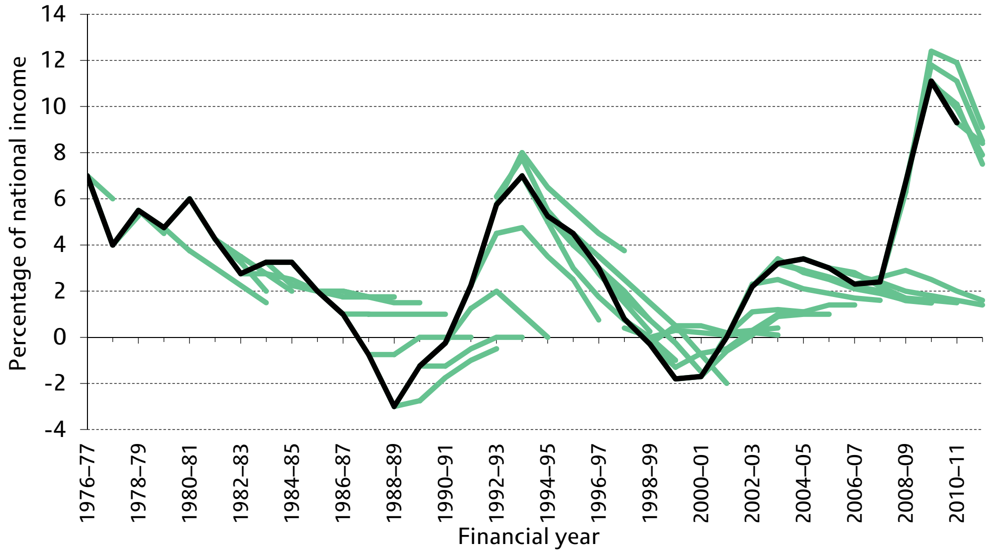
[10] For additional discussion of these borrowing forecasts, see R. Crawford, C. Emmerson and G. Tetlow, 'How does the UK's planned fiscal consolidation compare?', IFS Observation, September 2011 (http://www.ifs.org.uk/publications/5693).

[11] The 23 advanced economies on which comparable data to the UK are available are: Australia, Austria, Belgium, Canada, Denmark, Estonia, Finland, France, Germany, Iceland, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, South Korea, Spain, Sweden, Switzerland and the United States. Source: Statistical table 8 of International Monetary Fund, 'Addressing fiscal challenges to reduce economic risks', *Fiscal Monitor*, September 2011 (http://www.imf.org/external/pubs/ft/fm/2011/02/data/fmdata.xlsx).

[12] Another reason why borrowing out-turns may have deviated from previous forecasts is, of course, that active policy changes were subsequently made that increased/decreased borrowing. But such changes might be expected to have a tendency to bring borrowing back into line with forecasts as governments give away unexpected improvements and take away in the event of unexpected deteriorations.

Figure 3.8. Revisions to borrowing forecasts



Notes: The black line shows estimated out-turn a year after the fiscal year in question had ended. More recent out-turns differ but often due to definitional changes, which are less of a fair reflection of the aggregate that was being forecast at the time. The green lines show forecasts from all previous Budget statements.
Sources: Office for Budget Responsibility, using data from various HM Treasury forecasts.

Errors in estimating the output gap

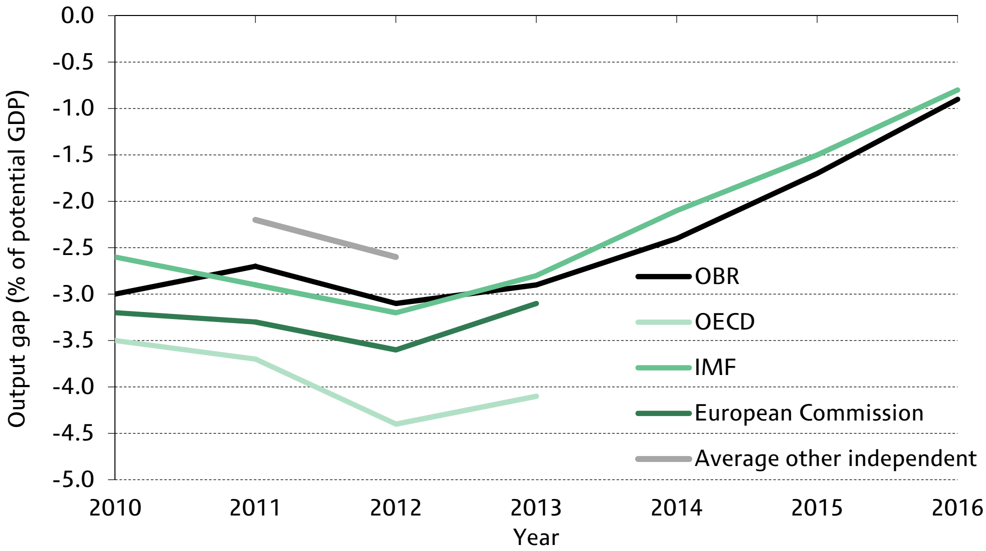
In November 2011, the OBR estimated that the output gap – that is, the gap between how much the UK economy is actually producing and the amount it is capable of producing while keeping inflation stable – would stand at –2.7% in 2011. It expects this gap to widen slightly next year before closing gradually over the following four years; this is shown in Figure 3.9.

Because the OBR thinks that the UK economy is operating below its full potential level this year, it also thinks that some of the borrowing that the government is doing this year is simply a temporary, rather than a permanent, imbalance. This is because, if all of the economy's resources were being fully utilised, the OBR would expect tax revenues to be somewhat higher (for example, more people would be in work and thus earning income) and government spending to be somewhat lower (for example, fewer people would be claiming unemployment benefits).

The OBR's estimate of how much unused capacity there is in the UK economy (2.7% this year) is somewhat lower (i.e. more pessimistic) than the IMF, OECD and European Commission's latest estimates suggest but higher (more optimistic) than the average forecast among other independent forecasters. These are also shown in Figure 3.9. In other words, at the moment, the OBR's view on the output gap lies somewhere in the middle of the range of publicly-available, independent estimates for the UK.

If the OECD's estimate, rather than the OBR's, is correct then more of current government borrowing is a temporary, rather than permanent, problem and there is more scope for borrowing to fall over the next few years than the OBR has forecast. Table 3.3 shows how cyclically-adjusted public sector net borrowing might evolve over the next five years if the OECD's estimate of the output gap is correct, rather than the OBR's. These figures show cyclically-adjusted net borrowing falling to zero in 2016–17. This would be a much tighter fiscal stance than any previous UK government – at least in modern times – has achieved over any sustained period of time. Therefore, if the OECD is right about the size

Figure 3.9. Alternative estimates of the output gap



Sources: Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2011*; Organisation for Economic Cooperation and Development, *Economic Outlook No. 90*, December 2011; International Monetary Fund, *World Economic Outlook*, September 2011; European Commission, *European Economic Forecast – Autumn 2011*; 'Average other independent' from HM Treasury, *Forecasts for the UK Economy: A Comparison of Independent Forecasts*, No. 297, January 2012 (http://www.hm-treasury.gov.uk/d/201201forcomp.pdf).

Table 3.3. Implications of alternative estimates of the output gap for cyclically-adjusted public sector net borrowing

	2010–11	2011–12	2012–13	2013–14	2014–15	2015–16	2016–17
PSNB	9.3	8.4	7.6	6.0	4.5	2.9	1.2
CAPSNB:							
OBR output gap	7.1	6.4	5.5	4.0	2.8	1.7	0.6
OECD output gap	6.7	5.8	4.9	3.4	2.2	1.1	0.0
Output gap 0 in 2011–12	9.3	8.4	7.5	6.0	4.8	3.7	2.6

Notes: CAPSNB denotes cyclically-adjusted public sector net borrowing. The OECD output gap for fiscal years is authors' calculation using the weighted sum of OECD published output gap figures for calendar years.
Sources: Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2011*; Organisation for Economic Cooperation and Development, *Economic Outlook No. 90*, December 2011. Cyclical-adjustment methodology based on HM Treasury, *Public Finances and the Cycle*, Treasury Economic Working Paper 5, November 2008.

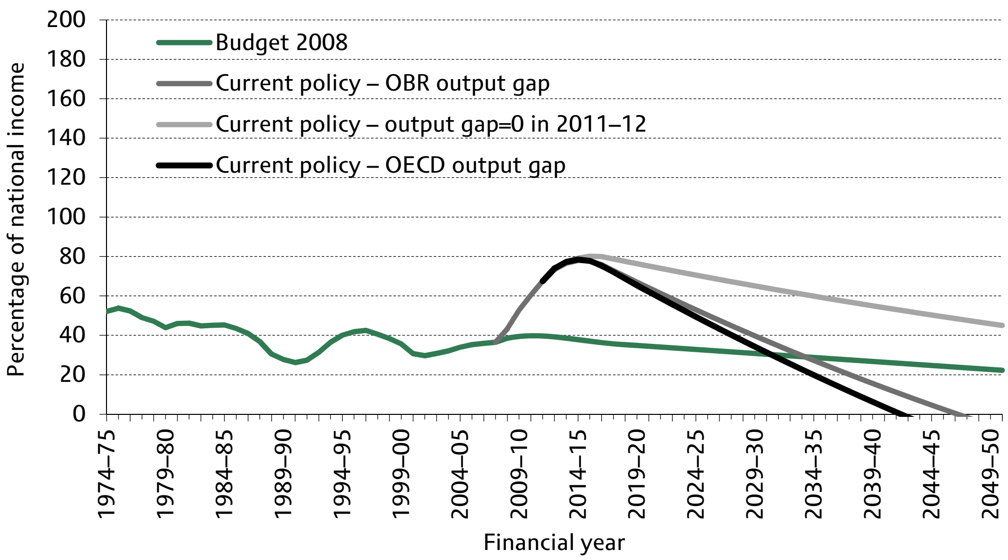
of the output gap (and no other adverse shocks to the UK's public finances materialise), there may be scope for future tax cuts or spending increases (or, at least, less need for net tax rises or spending cuts to deal with the public finance implications of an ageing population, as discussed in Section 3.7).

Conversely, if the output gap is actually smaller than the OBR thinks at the moment, there will be less scope for borrowing to fall over the next few years. If the output gap were in fact zero in 2011–12 and the economy grows according to the OBR's assumption for trend growth thereafter, then the only reduction in borrowing we would see over the next few years would be that resulting from discretionary tax increases and spending cuts. The bottom row of Table 3.3 shows that, if this were the case, cyclically-adjusted borrowing would be 2.6% of national income by 2016–17, which is the end of the currently-planned fiscal consolidation.

This level of borrowing would be consistent with gradually decreasing debt levels and certainly would not be historically unprecedented. Public sector net borrowing as a share of national income has been at least as high as this in 26 out of the last 63 years (the period for which comparable data are available). But it would leave debt as a share of national income on course to be at higher than pre-crisis levels even by 2050, as can be seen in Figure 3.10. It would also mean that this and future governments would be less well placed to accommodate any future shocks, and policy action would likely still need to follow to deal with the long-run pressures that are discussed in Section 3.7. Under this scenario, the Chancellor would also, in the absence of further fiscal tightening, fail to meet his fiscal mandate and supplementary target.

The figures presented in this subsection are merely intended to be indicative of the sensitivity of the public finance outlook to estimates of the current output gap. Chapter 4 explores in much more detail what our forecasts are for the public finances under the

Figure 3.10. Debt forecasts – under alternative assumptions about the size of the output gap



Notes: Forecasts for debt levels assume that non-debt interest spending and revenues remain constant as a share of national income from 2018–19 onwards, while inflation is assumed to run at 2.7% a year and real growth in national income at 2.3% a year. Average nominal interest rates are assumed to remain at 3.7% (the level forecast in the November 2011 Economic and Fiscal Outlook for the end of the OBR's forecast horizon, 2016–17). 'Output gap = 0' figures are calculated assuming that the output gap is currently zero (i.e. there is no scope for a reduction in cyclical borrowing over the next few years) but that the OBR's forecast for future growth in trend output (of 2.3% a year) does materialise. 'OECD output gap' figures are calculated assuming that the OECD is correct about the current size of the output gap but that the OBR's forecast for future growth in trend output (of 2.3% a year) does materialise; we assume that the output gap also closes in 2017–18 under this scenario.

Sources: Authors' calculations using results set out in HM Treasury, *Public Finances and the Cycle*, Treasury Economic Working Paper 5, November 2008 (http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/prebud_pbr08_publicfinances.htm) (in particular tables 2.B, 2.C and 2.D) and the forecasts for borrowing, net investment and the output gap from Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2011* (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011/). Organisation for Economic Co-operation and Development, *Economic Outlook No. 90*, December 2011.

OBR's forecast for the macroeconomy and under three alternative macroeconomic scenarios, which are described in Chapter 2.

Difficulty of delivering tight public spending plans

A second risk to the planned fiscal consolidation is if the government is unable, or unwilling, to deliver the large cuts to public service spending that have been announced, but which have yet to occur. To give some indication of the potential difficulties in implementing the planned public spending cuts, we compare the size of the planned cuts with those currently planned in other advanced economies, and with those seen in the past both in the UK and overseas.

Prior to the crisis occurring, the UK was 'mid-table' compared with other advanced economies in terms of its level of public spending as a share of national income, as shown in Table 3.4. Fifteen out of the 29 other advanced economies for which comparable data are available had higher levels of spending than the UK. Over the crisis, the UK experienced the ninth-largest increase in public spending as a share of national income.

Over the next few years, the UK currently has the fifth-largest planned reduction in public spending as a share of national income. Only Iceland, Greece, Estonia and Ireland are planning larger cuts. (However, some countries have yet to announce full details of their fiscal consolidations and so may ultimately require larger reductions in spending than currently announced. But even between 2011 and 2012 – a period for which most countries have announced their fiscal plans – the UK is expected to experience a relatively large reduction in spending as a share of national income, with only five other economies forecast by the IMF to see sharper falls.)

Table 3.4. Spending as a share of national income in the UK compared with 29 advanced economies

	UK rank	Notes
Spending		
Level		
2007 (pre-crisis)	16th highest	
Peak	16th highest	
2016	22nd highest	
Change		
Increase, 2007 to peak	9th largest	
Reduction, peak to 2016	5th largest	Iceland, Greece, Estonia and Ireland greater
Reduction, 2011 to 2012	6th largest	Sweden the same; Portugal, Slovenia, Iceland, Hong Kong and New Zealand greater
Reduction, 2007 to 2016	5th largest	South Korea, Iceland, Sweden and Greece greater

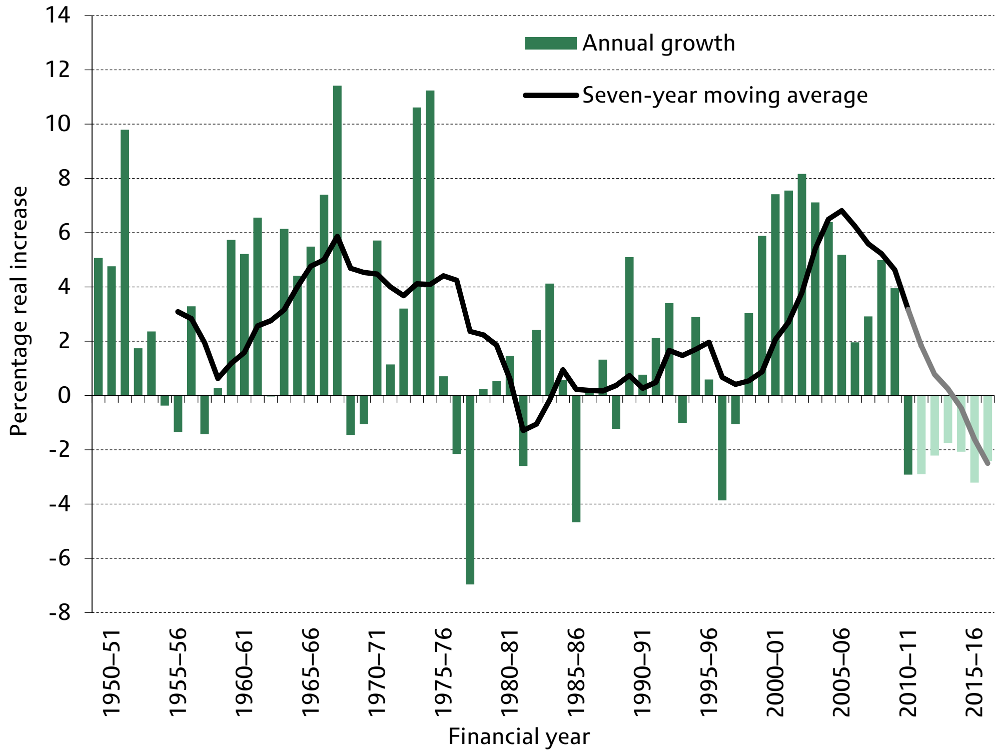
Notes: Measure is general government expenditure as a percentage of GDP. The 29 advanced economies on which comparable data to the UK are available are: Australia, Austria, Belgium, Canada, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hong Kong, Iceland, Ireland, Israel, Italy, Japan, Netherlands, New Zealand, Norway, Portugal, Singapore, Slovakia, Slovenia, South Korea, Spain, Sweden, Switzerland and the United States.

Source: Statistical table 5 of International Monetary Fund, 'Addressing fiscal challenges to reduce economic risks', *Fiscal Monitor*, September 2011 (http://www.imf.org/external/pubs/ft/fm/2011/02/data/fmdata.xlsx).

So far, the government remains on course, broadly, to keep in aggregate to the spending plans that it set out in its October 2010 Spending Review: in 2010–11, there was even an overall underspend by central government departments. But, by the end of 2011–12, only 12% of the planned cuts to welfare spending and only 12% of the planned cuts to spending on public services (comprising 34% of the cuts to investment spending and just 6% of the cuts to non-investment spending) are forecast to have been implemented, as we saw in Section 3.3. Future implementation challenges therefore remain considerable.

The planned cuts to spending on public services are large by historical standards. The bars on Figure 3.11 show the increase in spending on public services (defined here as total public spending less spending on welfare benefits and spending on debt interest payments) after taking into account economy-wide inflation for each year since 1948–49. If the current plans are delivered, spending on public services will (in real terms) be cut for seven years in a row. The UK has never previously cut this measure of spending for more than two years in a row.

Figure 3.11. Planned cuts to spending on public services: has it been done before in the UK? (Total spending on public services)

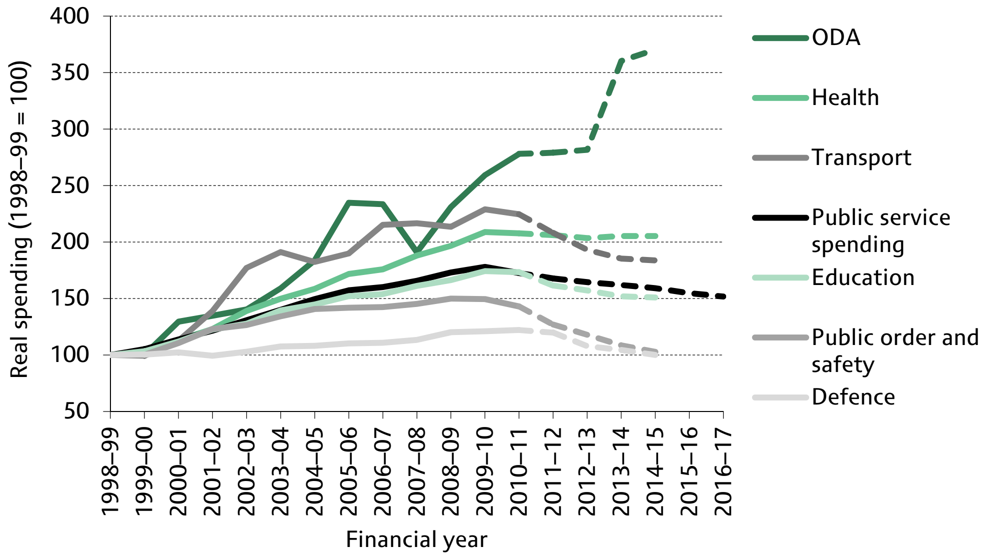


Note: Spending on public services defined as total public spending less both gross interest payments and net social benefits spending.
Source: http://www.ifs.org.uk/ff/lr_spending.xls.

Of course, it is likely to be the depth, rather than the length, of the cuts to spending on public services that matters more. The line on Figure 3.11 shows the average annual real increase in public service spending over the seven-year period up to that point. This shows that, if delivered, the government's plans would be the tightest seven-year period for spending on public services since the Second World War: over the seven years from April 2010 to March 2017, there would be a cumulative real-terms cut of 16.2%, which is considerably greater than the previous largest cut (8.7%), which was achieved over the period from April 1975 to March 1982. However, the currently planned cut does follow the largest cumulative seven-year increase in public service spending since the Second World War: between April 1999 and March 2006, the Labour government oversaw an increase in public service spending of 58.6% after economy-wide inflation. The result is that the cuts would, if implemented, still involve public service spending being the same as a proportion of national income in 2016–17 as it was in 2000–01 (a third higher in real terms), and the same in real terms as in 2004–05.

The fact that the planned cuts in the UK follow a period of big spending increases might make them somewhat easier to achieve. However, the areas where the biggest cuts are planned are not, on the whole, the areas where the biggest spending increases occurred. Figure 3.12 shows the evolution of public service spending (as defined in Figure 3.11) and of spending in selected areas of government activity, in real terms, since 1998–99. Spending on official development assistance (ODA) is set to continue seeing its budget increase sharply (for a discussion, see Chapter 7), and health spending – which also benefited from large increases in spending under Labour – is not projected to be cut over the next few years. Spending on education and transport are both projected to be cut back to 2004–05 levels in real terms (i.e. in line with the average cuts to public service spending, although within the education budget much of the spending cut is focused on higher education, which did not see a sharp increase in spending under Labour, rather

Figure 3.12. Government spending in real terms in selected areas



Notes: Forecasts for health and defence spending are HM Treasury forecasts for central government spending on health and defence. Forecasts for transport and for public order and safety are based on the HM Treasury forecasts for central government spending on them, assuming that this continues to account for half of public sector spending on transport and on public order and safety. Forecasts for ODA spending assume that the government maintains ODA spending at 0.56% of gross national income (GNI) until 2013–14, when it is increased to 0.7% of GNI, as planned in Spending Review 2010.

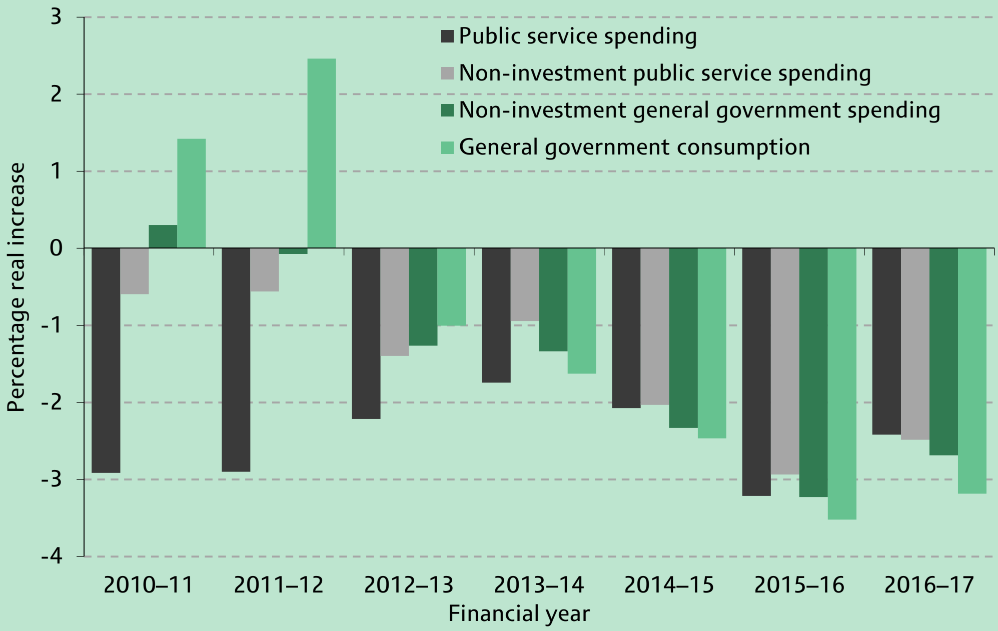
Sources: Forecasts for central government spending by function, apart from on education, are from table 6.4 of HM Treasury, *Public Expenditure Statistical Analyses 2011*, July 2011 (http://www.hm-treasury.gov.uk/pespub_pesa11.htm). Forecasts for education spending are from H. Chowdry and L. Sibieta, 'Trends in education and schools spending', IFS Briefing Note 121, 2011 (http://www.ifs.org.uk/publications/5732). Historical figures from http://www.ifs.org.uk/ff/lr_spending.xls and authors' calculations using table 7 of Department for International Development, *Statistics on International Development*, October 2011 (http://www.dfid.gov.uk/documents/publications1/sid2011/SID-2011.pdf).

Box 3.2. Internationally comparable spending data

Internationally comparable data on government spending on public services use a different definition of spending from that presented in Figure 3.11. The international data are for non-investment spending on public services rather than total spending, and the data are only for general government rather than the public sector (i.e. they include spending by central and local government but exclude spending by public corporations). The internationally comparable spending series are also deflated by a price index that is specific to the inflation rate of goods purchased by the government rather than using an economy-wide price index (which is what is done in Figure 3.11).

Figure 3.13 provides a decomposition of the differences between the change in our preferred series for public service spending for the UK and the measure that is available on a cross-country basis. The first series in Figure 3.13 is the same as that presented in Figure 3.11. The second series shows that the cuts to non-investment spending on public services are typically less deep than cuts to the overall spending. The third series shows that, in addition, excluding spending by public corporations makes relatively little difference to the overall picture. The final series shows the OBR's forecast path for real-terms growth in general government consumption, using a price index specific to goods and services purchased by the government rather than using an economy-wide deflator. This shows relatively strong growth in spending in 2010–11 and 2011–12; in part, this will reflect the fact that the changing VAT rates over this period have raised economy-wide inflation but do not affect this government-specific price index. However, over the remaining five years (from 2012–13 to 2016–17), the use of a specific price index makes relatively little difference to estimated real-terms growth in government spending.

Figure 3.13. Planned changes in public spending, different definitions



Source: 'Public service spending' is as Figure 3.11. 'Non-investment public service spending' is public service spending less spending on public sector net investment from http://www.ifs.org.uk/ff/lr_spending.xls. 'Non-investment general government spending' is government consumption spending in current prices taken from table 1.2 of the Office for Budget Responsibility, *Economic and Fiscal Outlook Supplementary Economy Tables – November 2011* (http://budgetresponsibility.independent.gov.uk/pubs/Economy-Supplementary-Tables-AS11.xls) deflated by the GDP deflator. 'General government consumption' is taken from table 1.1 of the same OBR spreadsheet.

Table 3.5. Planned cuts to spending on public services: has it been done before elsewhere? (General government consumption)

Country	Years covered	Biggest cut %	When	Other cuts ≥1% %	When
Czech Republic	1990–2010	18.2%	1991 & 1992	5.0%	1995 & 1996
				2.5%	2004
				1.6%	2008
Slovakia	1992–2010	13.3%	1993 & 1994	7.3%	1999
				2.9%	2004
Ireland	1970–2010	10.7%	1987–1989	6.8%*	2009 & 2010
				1.1%	1983 & 1984
Finland	1970–2010	7.2%	1992 & 1993	None	n/a
Greece	1961–2010	7.2%*	2010	5.5%	1988
				4.5%	1991 & 1992
				2.1%	2008
				2.1%	1982
				1.1%	1994
				1.1%	1986
Italy	1970–2010	6.3%	1993–1995	None	n/a
Singapore	1975–2010	6.3%	1988	1.6%	1994
Iceland	1970–2010	5.1%*	2009 & 2010	None	n/a
Israel	1995–2010	4.6%	2003 & 2004	None	n/a
United States	1961–2010	4.0%	1970–1973	None	n/a
Canada	1970–2010	3.9%	1994–1997	None	n/a
Hong Kong	1965–2010	3.2%	2005	None	n/a
Germany	1970–2010	2.1%	1989	1.5%	1982 & 1983
New Zealand	1970–2010	2.1%	2000	1.3%	1979
Slovenia	1990–2010	2.1%	1991 & 1992	None	n/a
United Kingdom	1961–2010	1.9%	1969	1.2%	1977
Denmark	1966–2010	1.6%	1989 & 1990	1.6%	1984
Sweden	1961–2010	1.4%	1994 & 1995	1.2%	2000
Switzerland	1970–2010	1.2%	1993	1.1%	1998
Portugal	1970–2010	1.2%	1992 & 1993	None	n/a
South Korea	1961–2010	0.9%	1964	None	n/a
Netherlands	1970–2010	0.7%	1996	None	n/a
Belgium	1970–2010	0.7%	1988	None	n/a
Spain	1970–2010	0.7%*	2010	None	n/a
France	1961–2010	0.7%	1998	None	n/a
Austria	1970–2010	0.4%	2000 & 2001	None	n/a
Japan	1970–2010	0.4%	1974	None	n/a
Australia	1965–2008	None	n/a	None	n/a
Norway	1970–2010	None	n/a	None	n/a

Notes: * indicates where cuts include 2010 and therefore a deeper cumulative cut will occur if the cuts persist into 2011.

Sources: Authors' calculations using data on general government final consumption at constant prices from the World Bank national accounts data and OECD national accounts data accessed from http://data.worldbank.org/indicator/NE.CON.GOVT.KN?cid=DEC_SS_WBGDataEmail_EXT.

than on non-investment schools spending, which did).[13] In contrast, spending on public order and safety and on defence are projected to see their budgets cut back in real terms to the levels they were at in 1999–2000.

Given the lack of experience of delivering this scale of cuts in the UK, it is natural to ask whether such cuts have been delivered in any other countries. Box 3.2 describes how the available comparable cross-country data relate to the data we have been using for UK-level analysis.

On the internationally comparable measure, UK public service spending is set to fall by 11.3% over the five years from 2012–13 to 2016–17. This is large compared with the size of cuts to public spending experienced by other industrialised countries over the last forty years. Table 3.5 uses data from the World Bank to examine the deepest cuts seen in each of 29 advanced economies (including the UK) on this same measure of spending in the past; data for many of the countries cover the period from 1970 (and sometimes earlier) through to 2010. None of these countries has, for the periods for which we have data, cut this measure of public service spending for five consecutive years. In two instances, cuts have run for four years in a row: in the United States from 1970 to 1973 (cumulative cut of 4.0%) and more recently in Canada from 1994 to 1997 (cumulative cut of 3.9%).

Whilst the Czech Republic and Slovakia appear to have made cuts on a larger scale than that currently planned by the UK, these only occurred around the time of the end of Communism in, and the dissolution of, Czechoslovakia. The only more comparable example in the World Bank data of cuts being delivered on a similar (albeit still slightly smaller) scale to those currently planned by the UK government is in Ireland: general government consumption in Ireland was cut by 10.7% over a three-year period from 1987 to 1989. Of course, one cannot conclude from this that it is impossible to deliver such cuts: in most countries, in most periods such cuts will not have been delivered because they will not have been deemed appropriate and therefore will not have been attempted. In addition, some economies have seen relatively large cuts in general government consumption in the most recent year or so (for example, Greece, Iceland and Ireland); if these have persisted in 2011 (and potentially persist beyond that), they may end up being deeper than those planned by the UK government. Greece cut general government consumption by 7.2% in 2010, Ireland has cut it by 6.8% over 2009 and 2010, and Iceland has cut it by 5.1% over the same two years.

3.7 Longer-term pressures

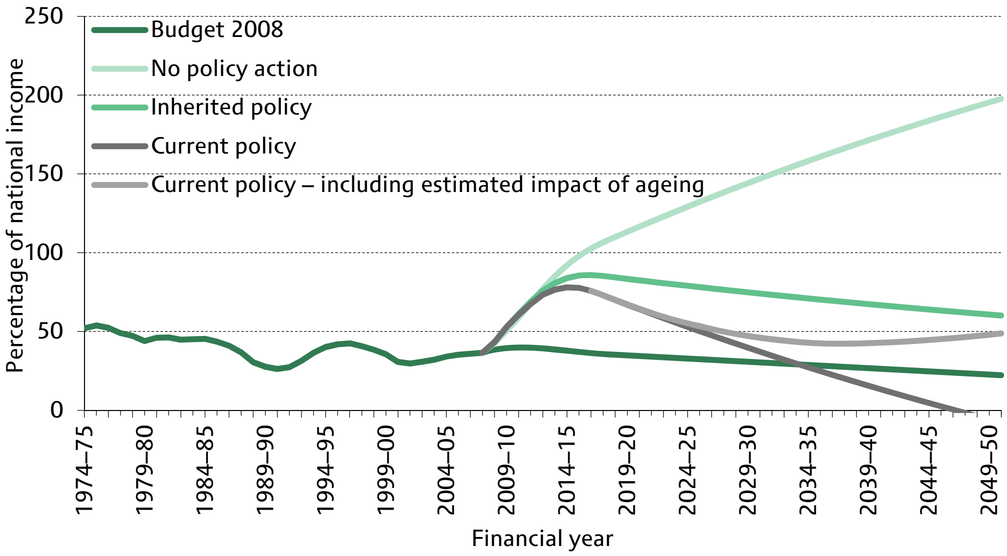
The government is intending to implement a large fiscal consolidation over the next few years, but the pain may not end with the end of the currently planned spending cuts and tax increases. The path for government debt shown by the dark grey line in Figure 3.14, which is typically presented as the forecast profile for debt under current policy, assumes that the government is able to maintain, in the longer term, its primary balance – that is, that it is able to maintain the difference between government revenues and non-debt interest spending at the level implied for 2018–19 by the latest official forecasts under current policy. However, demographic changes – specifically the ageing of the population

[13] For a discussion of the pattern of cuts across different areas of education spending, see H. Chowdry and L. Sibieta, 'Trends in education and schools spending', IFS Briefing Note 121, 2011 (http://www.ifs.org.uk/publications/5732).

– will tend to increase public spending, particularly on health, long-term care and state pensions. In its first Fiscal Sustainability Report, the OBR's central projection was that spending on health, long-term care, state and public service pensions and other pensioner benefits would increase from 17.1% of national income in 2015–16 to 22.3% by 2060–61.[14] Of this 5.2% of national income increase in age-related spending, increases in spending on health and state pensions would each account for 2.4 percentage points.

If the government does not offset this higher spending by raising tax revenues or reducing spending elsewhere, then government borrowing will be higher. An estimate of the impact of these ageing pressures (assuming they are not offset) on debt is shown by the light grey line in Figure 3.14. From the 2020s, the increase in age-related expenditure would be sufficient to start a noticeable slowdown in the reduction of debt as a share of national income. From the start of the late 2030s, debt is likely to plateau and then start increasing again.

Figure 3.14. Debt forecasts – with and without policy action and the estimated impact of an ageing population



Notes: Forecasts for debt levels assume that non-debt interest spending and revenues remain constant as a share of national income from 2018–19 onwards, while inflation is assumed to run at 2.7% a year and real growth in national income at 2.3% a year. Average nominal interest rates are assumed to remain at 3.7% (the level forecast in the November 2011 Economic and Fiscal Outlook for the end of the OBR's forecast horizon, 2016–17). 'No policy action' ignores the direct impact of all fiscal policy measures that have been implemented since Budget 2008. 'Inherited policy' takes policy as of the March 2010 Budget. 'Including estimated impact of ageing' uses the OBR's latest forecasts for changes in age-related spending between 2015–16 and 2060–61; we have adjusted these figures to take account of the lower age-related spending now expected between 2026–27 and 2035–36 as a result of the acceleration in the increase in the state pension age announced in the November 2011 Autumn Statement.

Sources: Authors' calculations using results set out in HM Treasury, *Public Finances and the Cycle*, Treasury Economic Working Paper 5, November 2008 (http://webarchive.nationalarchives.gov.uk/+/http://www.hm-treasury.gov.uk/prebud_pbr08_publicfinances.htm) (in particular tables 2.B, 2.C and 2.D) and the forecasts for borrowing, net investment and the output gap from Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2011* (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-november-2011/). Estimates of future age-related spending from OBR, *Fiscal Sustainability Report*, July 2011 (http://budgetresponsibility.independent.gov.uk/fiscal-sustainability-report-july-2011/).

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[14] Table 3.4 of Office for Budget Responsibility, *Fiscal Sustainability Report*, July 2011 (http://budgetresponsibility.independent.gov.uk/pubs/FSR2011.pdf). For a more detailed discussion of these future spending pressures, see also R. Crawford and P. Johnson, 'The changing composition of public spending', IFS Briefing Note 119, 2011 (http://www.ifs.org.uk/publications/5650).

A combination of further net tax rises and/or spending cuts would be necessary if future governments wished to maintain a lower level of public sector net debt. While such measures do not need to come into force yet – certainly the problems resulting from the financial crisis are more pressing – they will need to be addressed eventually and there are clear advantages to announcing early when, and how, fiscal policy is intended to adjust to meet this challenge.

A welcome example of this is the policy of the planned increases in the state pension age for men and women from 65 to 68, which were initially legislated by the previous government in 2007 to be implemented between 2024 and 2046 and which have now been partially brought forward by the new government. The earlier policies such as these are announced the better, as individuals should then be more able to plan and adjust their behaviour in advance – for example, by saving more privately for retirement.

3.8 Conclusions

Official estimates suggest that the potential level of output of the UK economy in 2016–17 was forecast to be 13% larger before the crisis than it is now forecast to be. This has led to the structural budget deficit increasing by 7.5% of national income, or £114 billion in today's terms. The substantial challenge facing the current coalition government is to reduce public borrowing back down to a sustainable level while taking into account trade-offs between the impact that the fiscal consolidation will have on household incomes, the quality and quantity of public services provided and, potentially, any permanent damage to the UK economy.

The direct effect of policies announced by both the previous Labour government and the current coalition government is estimated to be sufficient to reduce borrowing by 8.1% of national income in 2016–17, or £123 billion in today's terms. Of this, 20% is to come from tax increases and 80% is to come from cuts to public spending. But this composition varies over time: by the end of 2011–12, most (73%) of the tax rises will already have been implemented, but only 12% of the cuts to welfare spending and spending on public services will have been delivered.

Much focus has been on the risk to the public finances posed by the possibility that the economy does not recover as the official forecasts suggest, or that the economy does recover but that tax revenues do not respond as strongly as the OBR expects. These risks are not insignificant.

There are also implementation risks. While the impact of the planned cuts to welfare spending on household incomes is relatively easy to model, there is considerable uncertainty about the impact of the planned deep cuts to spending on public services. The magnitude of cuts that the government is planning have not been implemented in the UK since at least the end of the Second World War, and data from the World Bank suggest that there are relatively few examples of such deep cuts to spending on public services being delivered in other advanced economies in recent decades. Perhaps the only relevant example of such large cuts being delivered is in Ireland in the late 1980s.

That is not to say that such cuts are impossible. They come after the largest sustained period of increases in public service spending since the Second World War and the rarity with which such cuts have been delivered more likely reflects the fact that such cuts have seldom been deemed necessary, and have therefore not been attempted, rather than that they have been attempted and failed. But, should the planned cuts to public services not prove possible on the scale and timescale that are currently planned, a further squeeze on household incomes through a combination of tax rises and welfare cuts would be needed to keep to the planned path of deficit reduction.

The need to eliminate the increase in structural borrowing that has become apparent as a result of the financial crisis and associated recession, and to bring borrowing back to sustainable levels, is clear. But, even once these immediate issues have been addressed, a further fiscal tightening, albeit on a less stringent timetable, is likely to follow as the UK will need to decide how best to deal with the public finance implications of an ageing population. While the measures to tackle this do not need to come into force any time soon, announcing them early would allow individuals to plan and to respond appropriately in advance. A welcome example of this is the increases in the state pension age for men and women from 65 to 68, which were initially legislated by the previous government in 2007 to be implemented between 2024 and 2046 and which have now been partially brought forward by the new government. Giving individuals as much notice of this as possible will, for example, give them more time to adjust their retirement saving plans.