1. Public finances: the long road ahead

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Summary

- The financial crisis and associated recession led to a significant deterioration in the outlook for the UK's public finances. We estimate, based on official forecasts, that this worsening amounts to 8.6% of national income.
- This picture was broadly unchanged by the Office for Budget Responsibility (OBR)'s December 2013 forecasts, despite upwards revisions to growth in the near term. Borrowing this year is forecast by the OBR to be £111 billion, which is still £51 billion higher than it forecast back in 2010.
- The package of tax increases and spending cuts announced since the March 2008 Budget is estimated to reduce public sector borrowing by 9.1% of national income by 2017–18. This would more than offset the estimated increase in borrowing from the crisis.
- Despite this, the Chancellor pencilled in a further 0.9% of national income cut to public spending in 2018–19 in the 2013 Autumn Statement. As a result, the OBR's forecast is for a budget surplus in 2018–19, which would be the UK's first since 2000–01.
- Public sector net debt in 2018–19 is projected to still stand at nearly £1.6 trillion, or 76% of national income. This will constrain government policy for many more years to come, since such a high level of debt (at least relative to recent decades) involves substantial annual debt interest payments and leaves the government more exposed to increases in interest rates.
- If the government's plans through to 2018–19 are delivered, and the resulting levels of non-interest spending and revenues are maintained going forwards, then we project that debt as a share of national income would decline through to the middle of this century before starting to increase again due to the effects of the ageing population.

1.1 Introduction

The recent financial crisis dealt a significant blow to the productive capacity of the UK economy, and consequently to the public finances. In the absence of any policy action in response, borrowing would have remained at unsustainably high levels. Instead, we are now four years through what is currently planned to be a nine-year fiscal consolidation. If the consolidation is implemented as planned, and if the current economic forecasts turn out to be correct, then by 2017–18 the government will have offset all of the permanent damage done to borrowing and by 2018–19 be running a budget surplus. The level of public debt, however, will still be substantial and is likely to constrain policy for at least the following decade.

In this chapter, we describe why some form of significant consolidation is necessary (Section 1.2), the consolidation that is currently planned (Section 1.3) and how the 2013

Autumn Statement changed the plan – in particular, the impact this had on the long-run outlook for the public finances (Section 1.4). Section 1.5 concludes. In Chapter 2, we discuss in more detail the risks and uncertainty surrounding the government's planned fiscal consolidation.

1.2 Why a fiscal consolidation is required

Prior to the financial crisis and recession, in the 2008 Budget the then Chancellor, Alistair Darling, forecast that public sector net borrowing would be 2.9% of national income in 2008–09, falling to 1.3% of national income by 2012–13. This level of borrowing would have been sustainable for the UK in the medium term, in the sense that it would have put debt on a declining path as a share of national income from a forecast peak of nearly 40% in 2010–11.

These forecasts turned out to be far too optimistic, as they did not (and could not) foresee the significant adverse effects on the public finances of the financial crisis and associated recession.[1] Panel A of Figure 1.1 shows spending and revenues as a share of national income between 1996–97 and 2007–08, and illustrates (dashed lines) how these would have looked up to the end of the current forecast horizon, excluding the estimated direct impact of fiscal policy measures announced since Budget 2008.[2] As GDP collapsed, a hole opened up in the public finances, representing a significant difference between revenues and spending.

Receipts fell more quickly than national income, and therefore fell from their 2007–08 share of national income. The reason for this is that the crisis had a disproportionately negative effect on relatively tax-rich activities such as the profits of the financial sector and the incomes of some of its employees. The biggest effect of the crisis and recession, however, was on spending as a share of national income, which increased markedly up to 2009–10. This was because the huge downward shock to the size of the economy in the crisis meant that the previously-set cash spending plans suddenly represented a much larger share of national income than had been anticipated.

Such an effect is not surprising – it is an automatic consequence of a recession. However, one might expect the loss of output experienced in a recession to be temporary, with economic growth being higher than normal in subsequent years so that the size of the economy catches up to its pre-recession 'trend' level. The increase in spending as a share of national income would therefore be expected to unwind over time, as the economy bounces back and grows more quickly than spending (without requiring policy changes). However, much of the decline in national income relative to forecasts made prior to the financial crisis is thought to represent a permanent rather than a temporary downgrade in the UK's economic prospects (a feature which is not exclusive to this recession: a revision of this type was also made after the recession of the early 1990s).

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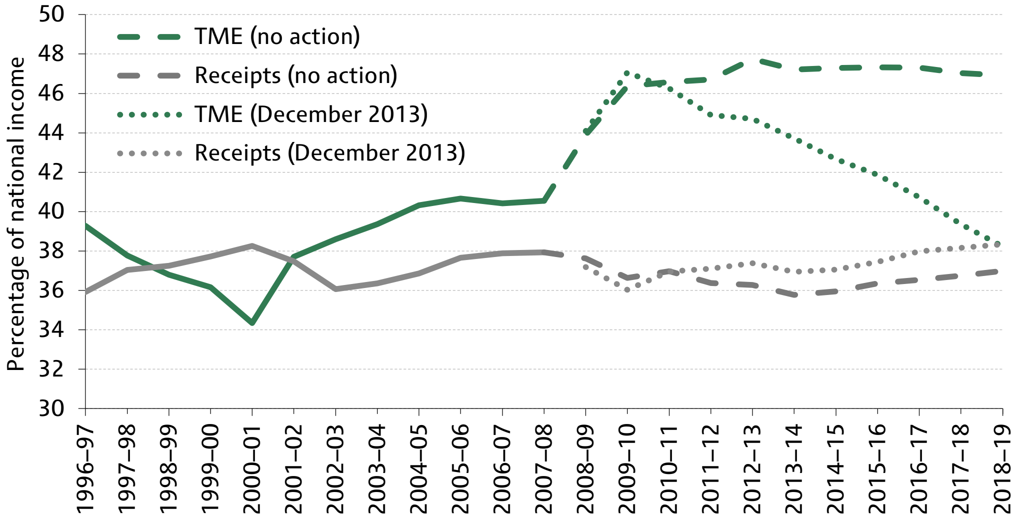
[1] This is discussed in more detail in Office for Budget Responsibility, 'Estimating the UK's historical output gap', Working Paper 1, 2011, http://budgetresponsibility.org.uk/wordpress/docs/WorkingPaperNo1-Estimating-the-UKs-historical-output-gap.pdf.

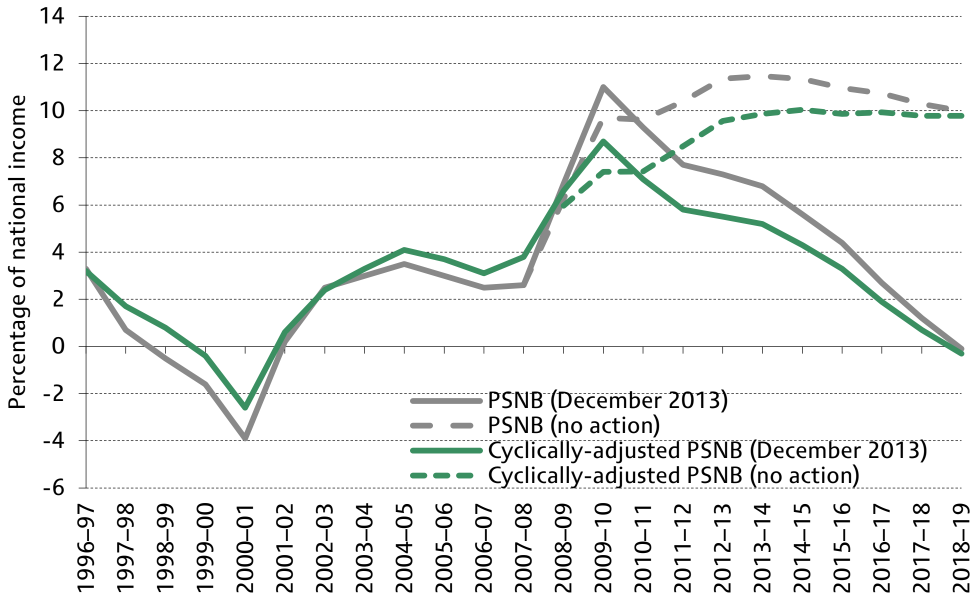
[2] The method used to calculate spending in the absence of policy changes is described in Box 1.1 in the next section.

Figure 1.1. UK public finances – with and without policy action

Panel A: Revenues and spending



Panel B: Borrowing



Note: PSNB is public sector net borrowing. Cyclically-adjusted PSNB shows structural borrowing (i.e. borrowing unrelated to the current strength or weakness of the economy relative to its trend level). Figures exclude transfers relating to the Asset Purchase Facility (APF) and the Royal Mail Pension Fund.
Source: Authors' calculations using all HM Treasury Budgets, Pre-Budget Reports and Autumn Statements between March 2008 and December 2013.

The latest official forecast for trend GDP suggests that by 2018–19 the sustainable level of UK output will have been permanently reduced by around 16.7% – a total of £281 billion in today's terms – compared with the Treasury's projections made in March 2008. Of this, 1.7 percentage points (£28 billion) reflects revisions to official forecasts for the sustainable level of output in 2007–08, while the remaining 15.0 percentage points (£253 billion) reflects downwards revisions to trend growth after the crisis began to bite. The permanent reduction in the size of the economy means that, in the absence of policy action, public spending would have remained at its new higher level as a share of national income (and would only have fallen gradually over time to the extent that economic growth exceeded spending growth). Tax receipts would still have been 1.0% of national income lower than their 2007–08 share by 2018–19.

Panel B of Figure 1.1 illustrates that, in the absence of any new policies announced since Budget 2008 that would increase taxes or cut spending, we estimate that public sector net borrowing would have been as much as 10.0% of national income by 2018–19. Of that, only 0.2 percentage points is forecast to be the result of the economy operating slightly below trend at that point ('cyclical borrowing'), leaving 'structural borrowing' (otherwise known as 'cyclically-adjusted borrowing') of 9.8% of national income – borrowing that would not be expected to disappear automatically as the economy returns to its trend level. This is 8.6% of national income greater than the medium-term level of structural borrowing implied by the pre-crisis (i.e. March 2008 Budget) forecasts.

For an economy such as the UK, this level of borrowing would have been unsustainable on an ongoing basis. Public sector net debt would have increased markedly year-on-year, likely surpassing 100% of national income before the end of the current decade, and 200% within the next two decades.[3]

The extent of the permanent damage done to the public finances (and therefore the hole to be filled) depends on the extent of the permanent reduction in UK national income due to the financial crisis. This is discussed in more detail in Chapter 2, though it should be noted here that even those who are now more optimistic about the UK's growth prospects still expect the UK economy to have been significantly, and permanently, adversely affected by the crisis.

The conclusion that a significant fiscal tightening was required in the wake of the recent financial crisis and recession was not lost on either the last Labour government or the current coalition government, both of which announced policies to increase tax revenues and reduce public spending by significant amounts in order to return borrowing to a sustainable level. Disagreements between the major parties, such as they exist, focus on the precise timing and perhaps composition of the tightening rather than on the eventual need for one.

The composition of the fiscal tightening currently planned is discussed in more detail in the next section, but Figure 1.1 pre-empts this by illustrating in Panel A the latest forecasts for tax receipts and public spending as shares of national income (in other words, taking into account the net effect of all policies introduced by the Labour and coalition governments since Budget 2008). Tax receipts are forecast to increase to 38.3% of national income by 2018–19 (equal to their share in 2000–01), while spending is forecast to decline to 38.2% of national income (roughly the same share as in 2002–03). The net effect of this is shown in Panel B: the permanent increase in structural borrowing as a result of the financial crisis is forecast to be eliminated by 2017–18 and, in fact, the government is forecast to have an overall surplus of 0.1% of national income in 2018–19.

These estimates all take into account, as far as possible, the latest official forecasts and published official estimates of the impact of tax and spending changes on borrowing. Of course, these estimates may not be accurate, and they are certainly not without controversy. One possibility is that the tax increases, and spending cuts, implemented

[3] Of course, such an outcome is highly unlikely to occur since the financial markets would almost certainly force action on the government before such a point was reached.

since April 2010 have not reduced the deficit by as much as intended – for example, because they had a more detrimental effect on economic activity than the Office for Budget Responsibility (OBR) assumes. If this were the case, then Figure 1.1 would overstate both the level of borrowing without policy action, and the role of fiscal tightening in reducing the deficit. Further detail on the OBR's estimate of the impact of the fiscal consolidation on growth is provided in the next section.

1.3 The current consolidation plan

The current size and composition of the planned fiscal tightening – that is, the estimated net effect on borrowing of all policies announced since Budget 2008 – are shown in Figure 1.2. (The methodology for estimating the size of the fiscal tightening is described in Box 1.1.) In 2008–09 and 2009–10, the net effect of new policies was actually to increase borrowing, as tax cuts and spending increases were used to help households and to stimulate the economy during the recession.[4] From 2010–11, however, the net effect of new policies was to reduce borrowing, and these reductions in borrowing are projected to increase each year up to 2018–19. By 2017–18 the fiscal tightening is planned to reduce borrowing by an estimated 9.1% of national income – more than offsetting the estimated 8.6% of national income permanent increase in structural borrowing associated with the financial crisis – and by 2018–19 the fiscal tightening is forecast to amount to 10.1% of national income.

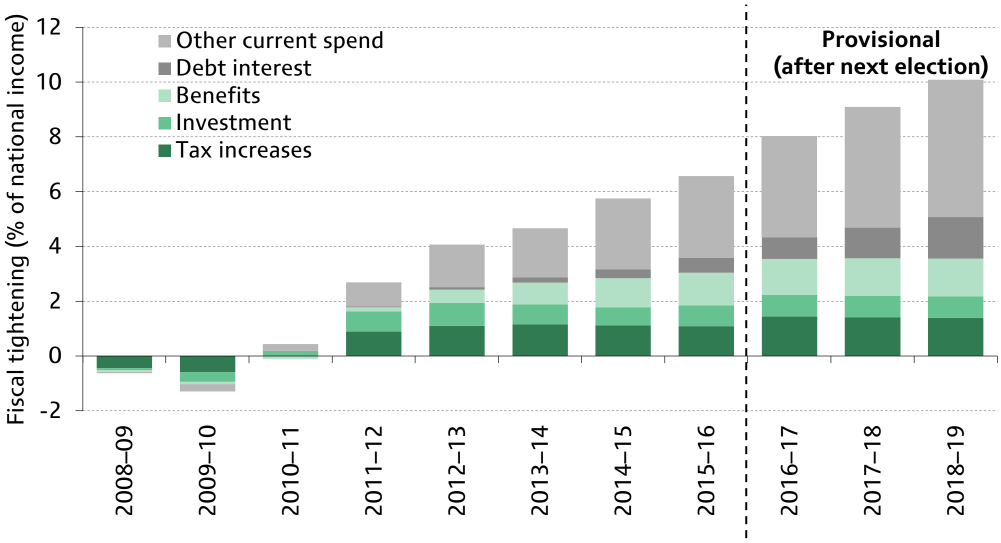
The composition of the planned tightening is currently heavily weighted towards spending cuts. Only 14% of the overall tightening (1.4% of national income) is planned to come from tax increases, while 71% of the overall tightening (7.2% of national income) is to come from lower than planned non-interest spending – 8% from investment spending, 14% from benefit spending and 50% from other current non-interest spending (0.8%, 1.4% and 5.0% of national income respectively).[5] The remaining 15% of the planned tightening comes from lower debt interest spending, which results from the fiscal tightening reducing borrowing and therefore debt compared with if no new policies were introduced since Budget 2008.

Of the total planned tightening, nearly half (46%) is planned to have been achieved by the end of 2013–14. Virtually all of the tightening from tax increases has already been implemented: up to and including 2013–14, tax increases forecast to amount to 1.2% of national income have been put in place. (The largest remaining tax increase will come from the abolition of contracting-out for defined benefit pension schemes in April 2016.) By contrast, a large proportion of the cuts to planned spending is still to come: only 36% of the cuts to planned 'other current spending' (i.e. current spending excluding social security and debt interest payments, which therefore comprises mainly spending on public services) will be in place by the end of 2013–14. Of the cuts to benefits announced by the government, 58% of the forecast spending reduction will be delivered by the end of 2013–14. However, the largest cut arises from indexing most benefits with the

[4] Examples of the stimulus policies used include the temporary reduction in the main rate of VAT from 17.5% to 15% and some one-off boosts to certain social security benefits.

[5] It is important to note that these represent spending cuts relative to the level of spending that would have prevailed in 2018–19 in the absence of any new policies since March 2008, rather than cuts relative to current or previous levels. We assume that spending would have increased in real terms in the absence of policy action. Therefore, cuts that we show relative to the hypothetical 2018–19 level are significantly greater than the cuts relative to actual spending levels in, say, 2010–11.

Figure 1.2. Timing and composition of the fiscal tightening



	Percentage of total planned tightening in place by:								
	2010–11	2011–12	2012–13	2013–14	2014–15	2015–16	2016–17	2017–18	2018–19
							(after next election)		
Total	**3**	**27**	**40**	**46**	**57**	**65**	**80**	**90**	**100**
Tax increases	**0**	**64**	**79**	**84**	**80**	**79**	**104**	**102**	**100**
Spending	**4**	**21**	**34**	**40**	**53**	**63**	**76**	**88**	**100**
Investment	23	94	107	90	83	96	99	100	100
Current spend	2	13	27	35	50	60	73	87	100
Benefits	*–8*	*11*	*35*	*58*	*77*	*87*	*95*	*99*	*100*
Debt interest	*0*	*2*	*6*	*12*	*22*	*35*	*52*	*74*	*100*
Other current spend	*5*	*18*	*31*	*36*	*51*	*60*	*74*	*88*	*100*

Note: 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. The high proportion of the planned investment tightening achieved in 2011–12 and 2012–13 is due to departments not spending all of their allocated investment budgets. The high proportion of the tax increases done in 2016–17 and 2017–18 is due to the fact that most tax takeaways are fully in place by this point, while some tax giveaways are estimated to cost the exchequer slightly greater amounts in later years.
Source: Authors' calculations using all HM Treasury Budgets, Pre-Budget Reports and Autumn Statements between March 2008 and December 2013.

consumer price index (CPI) rather than the retail price index (RPI), which delivers an increasing saving over time (as long as the CPI is running below the RPI). By 2013–14, only one-third of the spending cut estimated to be delivered by 2018–19 from this change of indexation will have happened. But of the rest of the announced benefit cuts, 75% will be delivered by the end of 2013–14.

Given that, by the end of 2013–14, we are only forecast to be halfway through the pain of the planned fiscal tightening, there is still significant uncertainty about whether this plan can be delivered. This is particularly true of the cuts to 'other current spending'; while all the required specific tax increases and benefit spending cuts have been announced, spending settlements between departments have not been made beyond 2015–16, and therefore it is not yet clear which public services will bear the brunt of the extra spending cuts planned between 2016–17 and 2018–19. The risks to spending forecasts (and therefore the planned fiscal consolidation) are considered in more detail in Chapter 2.

The final three years of the currently planned fiscal consolidation (2016–17, 2017–18 and 2018–19) start after the next election, and therefore the size and the composition of the fiscal tightening for those years are only provisional; the next government might have different preferences over the size and source of reductions in borrowing. The Conservative Chancellor, George Osborne, has, for example, expressed a desire for further

Box 1.1. Measuring the size, composition and timing of the fiscal consolidation

The size of the fiscal consolidation arising from tax and benefit changes is taken to be the sum of the official estimates of the impact of tax and benefit policy changes (respectively). These costings are published alongside the policy announcements in Budgets and Pre-Budget Reports / Autumn Statements, and start from existing government policy – including the assumption that tax and benefit thresholds are uprated each year as set out in legislation.

Measuring the size of the fiscal consolidation arising from changes to public service spending is more difficult, and requires us to define a *counterfactual* – what would have happened to levels of spending in the absence of policy change. The fiscal consolidation can then be calculated as the difference between actual (or the latest forecast for) spending and this counterfactual.

For years up to 2014–15, we take as the counterfactual the plans set out in the March 2008 Budget. At that point, the then government had set out plans for overall spending beyond 2010–11 (the end of the then current spending review period) alongside some small medium-term tax increases. The spending plans were for a real-terms increase in current spending, with investment held constant as a share of national income; this implied that overall spending would fall as a share of national income. Extending this same growth assumption up to 2014–15 – the last year for which the last Labour government published official forecasts – provides a counterfactual for these years. To the extent that real spending is less than this baseline, this is part of the consolidation.

Beyond 2014–15, we have no spending plans from the previous government. There are perhaps two obvious counterfactuals we could take. One would involve an assumption that, had the crisis not happened, real-terms spending would have stayed constant. This seems to us an entirely unrealistic scenario; it would have implied the size of the state shrinking and the deficit falling (and, ultimately, a surplus growing) indefinitely. Much more plausible is an assumption that spending would have risen in line with national income; certainly no period since the Second World War has seen a sustained cut to public spending as a share of national income. So, from 2014–15, we take as our counterfactual that total spending grows in line with GDP.

Using this methodology, counterfactual non-investment public service spending is assumed to grow more quickly beyond 2014–15 than before. Therefore the same real-terms cut to this spending between 2014–15 and 2015–16 as between 2013–14 and 2014–15, say, would imply a greater cut relative to the counterfactual and therefore a greater contribution to fiscal consolidation. That is one reason why, on this methodology, we find that a large proportion of cuts to non-investment spending are still to come.

benefit cuts after the next election in order to reduce the proportion of the tightening that would have to come from spending on public services.[6]

The damage done to the UK's public finances by the financial crisis and associated recession clearly required a fiscal tightening to bring public sector borrowing back to a sustainable level. The timing and speed of the appropriate fiscal repair job depend, however, on the extent to which it might affect economic activity. The OBR estimated the impact of the current fiscal consolidation plan on the level of national income in its July 2013 *Forecast Evaluation Report*.[7] In its estimation, the OBR assumed that the economy would respond to fiscal policy in the short run, but that fiscal policy action would have no permanent effect on the potential of the economy. Both assumptions are far from uncontentious; there is no clear consensus either on the size of the short-term 'fiscal multiplier' or on whether fiscal policy in the short run has an impact on the size of the economy in the long run.

Critics of the second assumption have argued that short-term fiscal tightening and the corresponding contraction of the economy have a long-lasting, negative effect on potential output. They argue, therefore, that stimulating demand to restore the economy in the short run may have dynamic supply-side effects.[8] Others argue the opposite, asserting that fiscal contractions actually boost the economy in the long run, as a wider berth is given to the private sector to grow, or that the increased confidence from lower borrowing stimulates activity.[9] In the absence of conclusive evidence, the OBR has decided to use an assumption of zero effect in the long run, but it is important not to forget that this debate exists.

The OBR estimated that the net effect of the fiscal stimulus policies in 2008–09 and 2009–10 was to boost national income temporarily by 0.6% (relative to its path assuming no policy action). In subsequent years, as the fiscal stimulus measures expired and net tax rises and spending cuts were implemented, the OBR estimated that the effect of policies was to reduce the level of national income temporarily, at most by 1.5% (in 2012–13). Because the fiscal consolidation plan is thought by the OBR to have reduced economic output by more in 2012–13 than in 2013–14, the OBR's forecast is for the consolidation to have actually *increased* growth in 2013–14.

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[6] For example: '£12 billion of further welfare cuts are needed in the first two years of next Parliament. That's how to reduce the deficit without even faster cuts to government departments, or big tax rises on people' (https://www.gov.uk/government/speeches/new-year-economy-speech-by-the-chancellor-of-the-exchequer).

[7] The report was published before the 2013 Autumn Statement, and so did not account for the extra tightening announced in December 2013. See chart 2.26 (page 54) and the discussion on pages 50 to 58 of http://budgetresponsibility.org.uk/pubs/FER2013.pdf.

[8] See, for example, J.B. DeLong and L.H. Summers, 'Fiscal policy in a depressed economy', *Brookings Papers on Economic Activity*, Spring 2012, 233–74, http://www.brookings.edu/~/media/Projects/BPEA/Spring%202012/2012a_DeLong.pdf, and a recent conference paper from the IMF: D. Reifschneider, W.L. Wascher and D. Wilcox, 'Aggregate supply in the United States: recent developments and implications for the conduct of monetary policy', http://www.imf.org/external/np/res/seminars/2013/arc/pdf/wilcox.pdf.

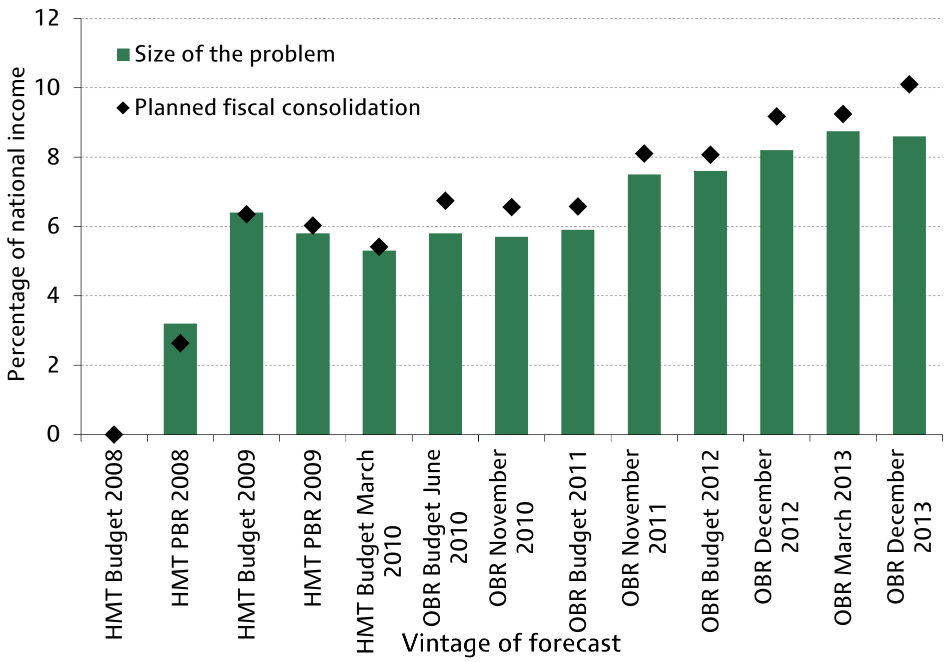
[9] See F. Giavazzi and M. Pagano (1990), 'Can severe fiscal contractions be expansionary? Tales of two small European countries', in O. Blanchard and S. Fischer (eds), *NBER Macroeconomics Annual 1990*, Volume 5, http://www.nber.org/chapters/c10973.

1.4 How the 2013 Autumn Statement changed the picture

The 2013 Autumn Statement contained some good news, in the form of the OBR's widely anticipated upward revisions to its forecasts for economic growth. The OBR increased its forecast for growth in 2013 from 0.6% to 1.4%, and in 2014 from 1.8% to 2.4%. However, while the economic growth is welcome, virtually all of this extra growth is expected by the OBR to be cyclical – in other words, reducing the amount of spare capacity in the economy rather than increasing the underlying potential size of the economy. As it is the latter that is relevant for the underlying state of the public finances, the estimated size of the permanent hole in the public finances is largely unchanged since the 2013 Budget, as is (therefore) the size of the fiscal consolidation required to deal with it. This is illustrated in Figure 1.3, which shows how the estimated size of the permanent fiscal problem has changed at each fiscal event since the problem first became apparent in mid-2008.

Figure 1.3 also illustrates how the size of the planned fiscal consolidation has changed since the 2008 Budget, with the bar furthest to the right showing the latest estimate of the size of the problem and the response planned under current policies. Despite the estimated size of the fiscal problem being largely unchanged between the 2013 Budget and the Autumn Statement, the government announced an increase in the total planned fiscal consolidation in the Autumn Statement of 0.9% of national income. This was achieved largely by announcing a real-terms freeze in total public spending in 2018–19

Figure 1.3. The changing size of the problem and cure: estimated increase in medium-term cyclically-adjusted borrowing (excluding policy response) and the size of the policy response since March 2008



Source: Authors' calculations using all HM Treasury Budgets and Pre-Budget Reports (PBRs) between November 2008 and March 2010 (available at http://webarchive.nationalarchives.gov.uk/20100407010852/http://www.hm-treasury.gov.uk/home.htm) and all OBR Economic and Fiscal Outlooks between June 2010 and December 2013 (available at http://budgetresponsibility.org.uk/economic-fiscal-outlook-december-2013/).

Table 1.1. How borrowing forecasts changed between November 2010 and December 2013 (£ billion)

	2010–11	2011–12	2012–13	2013–14	2014–15	2015–16	2016–17	2017–18	2018–19
PSNB, Autumn Statement, November 2010									
£ billion	**148.5**	**117.0**	**91.0**	**60.0**	**35.0**	**18.0**	n/a	n/a	n/a
Underlying change	–9.1	16.1	32.7	48.8	58.6	65.1	n/a	n/a	n/a
Borrowing forecast, with no measures after 2010 Autumn Statement									
£ billion	**139.4**	**133.1**	**123.7**	**108.8**	**93.6**	**83.1**	**83.6**	**78.1**	**74.9**
Extra policies*	0.0	–15.1	–8.7	2.4	2.4	–4.4	–32.5	–54.7	–77.1
PSNB, Autumn Statement, December 2013									
£ billion	**139.4**	**118.0**	**115.0**	**111.2**	**96.0**	**78.7**	**51.1**	**23.4**	**–2.2**

*'Extra policies' includes departments underspending against their allocated budgets.
Note: PSNB excludes Royal Mail and Asset Purchase Facility (APF) transfers.
Source: November 2010 and December 2013 OBR Economic and Fiscal Outlooks. Measures based on authors' calculations using all HM Treasury Budgets and Autumn Statements between November 2010 and December 2013. Latest out-turns for PSNB from ONS series J5II.

(as described in Box 1.1, this counts as a reduction in public spending against a counterfactual in which total spending grows in line with national income). This extra consolidation is of a similar size to the increases in the planned fiscal consolidation announced in the 2011 and 2012 Autumn Statements (1.5% and 1.1% of national income respectively). But on each of these previous two occasions, the increase in the planned consolidation could be justified as offsetting an increase in the estimated size of the problem that occurred at the same time.

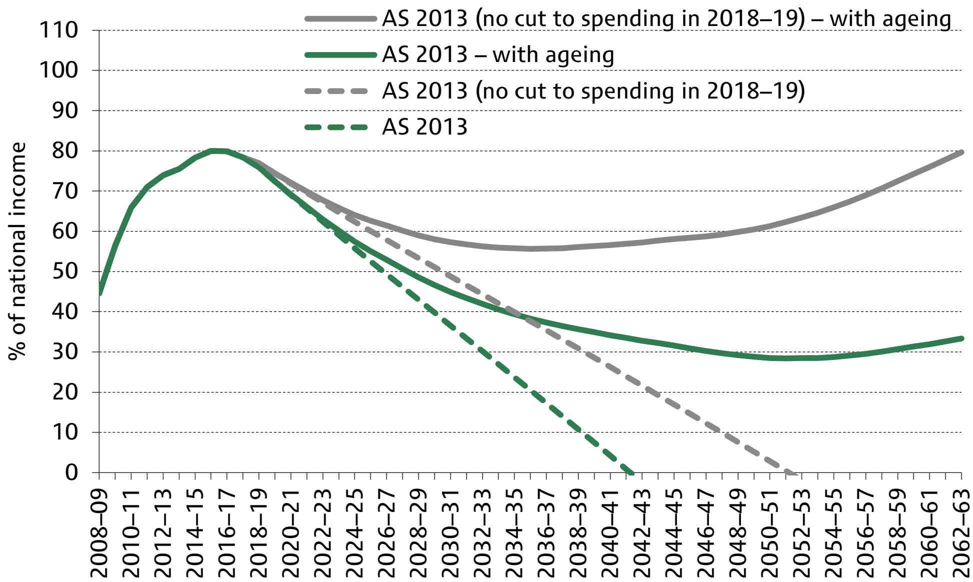
Table 1.1 compares the forecasts for borrowing in the 2010 Autumn Statement (before the large upwards revisions to the estimated size of the problem) with the latest forecasts from the 2013 Autumn Statement. At the time of the November 2010 Autumn Statement, the OBR forecast that borrowing would fall from £148.5 billion in 2010–11 to £18.0 billion in 2015–16. However, the deterioration in forecasts for the economy since then resulted in forecast borrowing being revised up. Since only an additional £4.4 billion of policy measures have been announced for 2015–16 in response to this worse outlook, borrowing is now forecast to only fall to £78.7 billion in 2015–16. However, the sizeable additional tightening to come in following years would, if implemented, more than offset all of the increase in forecast borrowing since November 2010, and is projected to leave the government running a surplus in 2018–19.

The Chancellor's objective in announcing additional fiscal tightening in the 2013 Autumn Statement, when there was no increase in the estimated size of the permanent problem that needed dealing with, was apparently to increase the rate at which public sector net debt as a share of national income would decline. The Chancellor has indicated that he would like all of the additional tightening to come from reduced spending rather than increased taxes confirming that he aims not just to deal with the deficit but also to reduce spending further. As he said in a speech at the start of the year, 'Our long term economic plan has five key parts to it. The first is to go on reducing the deficit so we deal with our debts' and 'Britain should never return to the levels of spending of the last government'.[10] The Chancellor's plan implies public spending in 2018–19 of 38.2% of national income, which would be broadly the same as the share last seen in 2001–02 (37.7%), as shown in Figure 1.1.

The Chancellor's desire to reduce public sector net debt more rapidly reflects the fact that in 2017–18 public sector net debt is still projected to be over £1.5 trillion, or 78.4% of national income. Such a high level of public debt, at least relative to the decades leading up to the financial crisis, requires a high annual servicing cost (for example, 3.8% of national income in 2018–19 – which is more than is currently spent on schools) and leaves the government more exposed to movements in interest rates. It also means the government is less well placed to absorb higher borrowing in future – for example, from the ageing of the population or if the UK were to be faced with another adverse shock to the public finances.

Under a simple extrapolation (in which revenues and non-interest spending are assumed to grow in line with national income), without the additional fiscal tightening announced for 2018–19, debt would not be expected to fall below the previous Labour government's ceiling of 40% of national income until the mid-2030s – illustrated by the dashed grey line in Figure 1.4. However, with the additional fiscal tightening in 2018–19 announced in the 2013 Autumn Statement, this is projected to occur at the end of the 2020s (illustrated

Figure 1.4. Public sector net debt – with and without ageing



Note: All lines use OBR forecasts for debt up to 2017–18 from the 2013 Autumn Statement. For 2018–19, the green lines use the OBR forecasts from the 2013 Autumn Statement, while the grey lines adjust those forecasts to remove the effect of the additional spending cuts announced for 2018–19. Projections for debt levels from 2019–20 onwards assume that cyclically-adjusted non-debt interest spending and revenues remain constant as a share of national income from 2018–19 onwards, while inflation, real growth in national income and interest rates are taken from the OBR's 2013 *Fiscal Sustainability Report* (roughly 2.2%, 2.4% and 5% per year respectively). The solid 'with ageing' lines use the OBR's latest 'central' projections for changes in age-related spending and revenues between 2020–21 and 2062–63 (which pre-date the 2013 Autumn Statement).
Source: Authors' calculations using Office for Budget Responsibility, *Economic and Fiscal Outlook December 2013* and *Fiscal Sustainability Report July 2013*.

[10] https://www.gov.uk/government/speeches/new-year-economy-speech-by-the-chancellor-of-the-exchequer.

by the green dashed line) because the starting point for spending would be lower. (In both cases, this assumes that revenues and spending turn out as currently forecast up to 2018–19. There is still significant risk around this, which is discussed in more detail in Chapter 2.)

In the longer run, however, keeping revenues and non-interest spending constant as a share of national income would require some tough policy decisions in response to two important long-run trends:

- First, some revenue streams are in long-run decline. The depletion of North Sea oil and gas reserves will lead to a fall in revenues from taxes on North Sea activity, while the trend towards electric motor vehicles will lead to a decline in revenues from vehicle excise duty and fuel duties in future. Revenues from these sources accounted for 6.6% of revenues in 2012–13, and are forecast to account for 5.0% by 2018–19 (assuming the government implements the currently planned increases in fuel duties in line with inflation from September 2015). Adjustments will need to be made in future to offset the decline in these revenues.
- Second, the average age of the UK population is increasing. This tends to put pressure on the public finances because older people are disproportionately heavy users of many public services (including the NHS and long-term care) and tend to receive a higher level of income from the state on average (in the form of state pensions) than children and younger adults do. These factors outweigh the lower demands that older people place on, for example, education provision.

The effect of the ageing population on the public finances is illustrated in Figure 1.4. The solid lines show projections for public sector net debt taking into account the OBR's estimated impact of demographics on total non-interest spending and total revenues from 2020–21 onwards from its 2013 *Fiscal Sustainability Report*.[11] The grey line illustrates that, without the additional spending cuts announced in the Autumn Statement for 2018–19, public sector net debt would have levelled off at over 50% before starting to increase again from the mid-2030s. The green line, however, indicates the significant difference made to the long-run picture by the additional 2018–19 spending cuts: debt would continue to fall until the 2050s, reaching below 30% of national income, before starting to increase again.[12] This dramatic difference is caused by both the direct effect of spending (and thus borrowing) being 1% of national income lower every year, and the faster rate of decline in the stock of debt, which will result in lower debt interest payments (and therefore even lower spending and borrowing) each year.

Therefore the additional spending cuts announced in the Autumn Statement for 2018–19 will (assuming they are implemented and maintained) put the public finances on a more sustainable footing. However, it is worth noting that while, under this simple projection, debt is projected to fall through to the 2050s, the level of debt is still projected to be relatively high by historical standards for at least another decade. The desire to run

[11] Note that these estimated effects of demographics do not take into account the policy changes announced in the 2013 Autumn Statement.

[12] Using the November 2013 IFS estimates of the impact of ageing on the public finances (which also do not take into account policies announced in the 2013 Autumn Statement) produces a slightly more optimistic projection for the path of public sector net debt, but the profile and conclusions are qualitatively the same (for more information on the IFS estimates of the impact of ageing, see M. Amior, R. Crawford and G. Tetlow, 'The UK's public finances in the long run: the IFS model', IFS Working Paper W13/29, 2013, http://www.ifs.org.uk/wps/wp201329.pdf).

budget surpluses in order to reduce debt is likely to be a strong influence on future Chancellors even after the current period of fiscal consolidation is over.

1.5 Conclusion

The recent financial crisis dealt a significant blow to the productive capacity of the UK economy, and consequently to the public finances. In the absence of any policy action in response, the permanent loss of national income (relative to what was previously forecast) would have resulted in public spending remaining permanently in excess of tax revenues to the tune of an estimated 9.8% of national income – a situation that would have been unsustainable.

We are now four years through what is currently planned to be a nine-year fiscal consolidation. Under the most recent OBR projections, the government is forecast to have offset the permanent hit to the public finances caused by the financial crisis by 2017–18, and to have more than offset it, resulting in a budget surplus, in 2018–19. If achieved, this would be the first surplus in the public finances since 2000–01.

However, this picture presupposes that there are no further revisions to the size of the blow that the financial crisis is estimated to have dealt to the economy and the public finances, that revenues recover as currently forecast, and that the government successfully implements the fiscal consolidation package that it is currently planning. There is clearly significant risk and uncertainty around all of these assumptions, which we discuss in more detail in Chapter 2.

Even if the forecasts do prove correct, that would still leave public sector net debt standing at nearly £1.6 trillion, or 76% of national income in 2018–19. This will constrain government policy for many more years to come, since such a high level of debt (at least relative to recent decades) involves substantial annual debt interest payments and leaves the government highly exposed to increases in interest rates.

That said, if the levels of non-interest spending and revenues planned for 2018–19 are implemented and maintained going forwards, then the long-run position of the public finances looks more sustainable than it did before the 2013 Autumn Statement. We project that debt as a share of national income would decline through to the middle of this century before the effects of the ageing population cause it to start increasing again.