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Eliminating the deficit in this parliament?

Carl Emmerson

Presentation at David Hume Institute seminar,

King Khalid Building, Surgeon's Hall, Edinburgh, 12 May 2016

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Three fiscal targets

- Cap forecast welfare spending
  - introduced to help Chancellors make unpopular benefit cuts rather than allow spending to increase inappropriately
  - November 2015: breached in 2016–17, 2017–18, 2018–19; met in 2019–20, 2020–21
  - March 2016: breached in all five years

Three fiscal targets

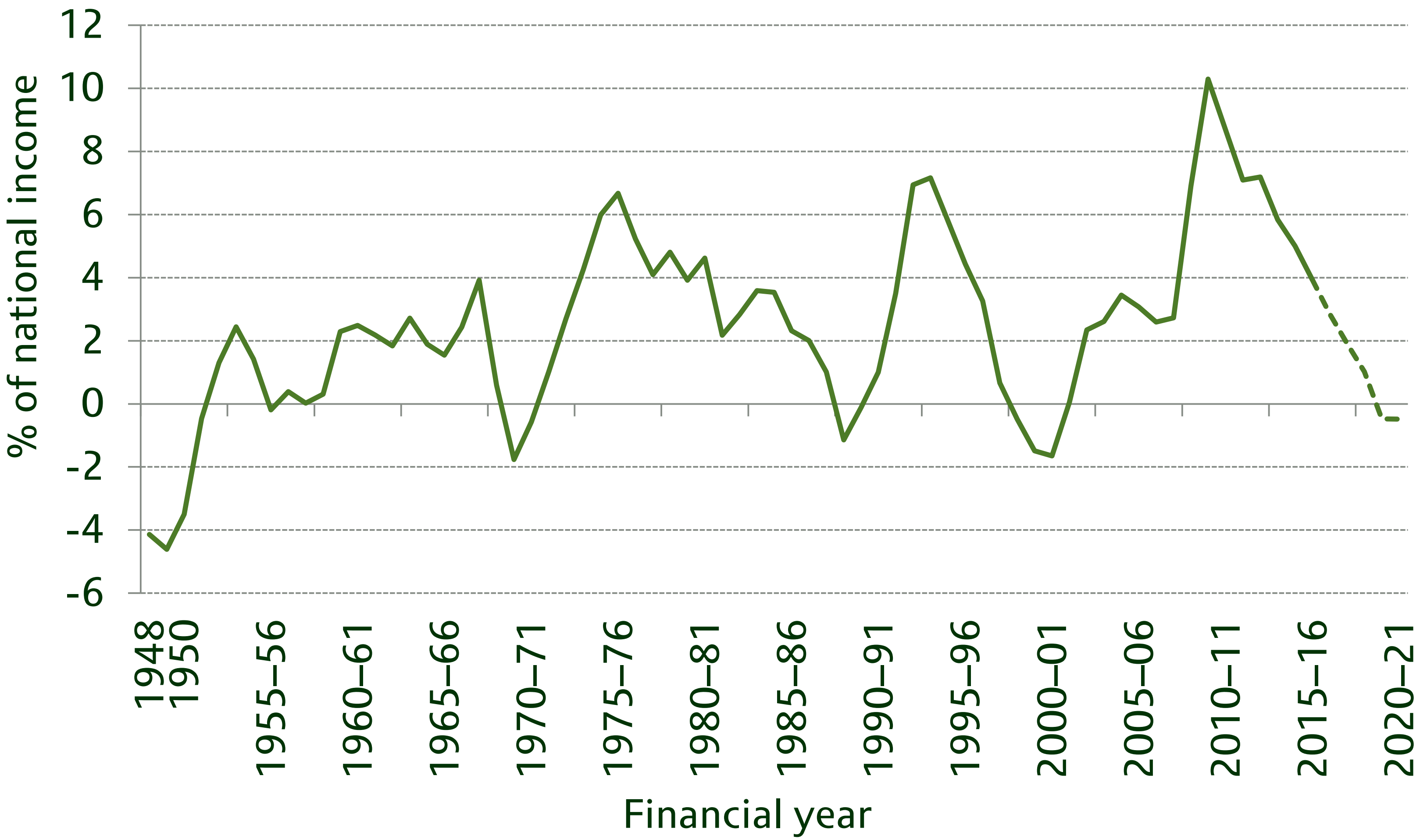
- Cap forecast welfare spending ✗

- Reduce public sector net debt as a share of national income every year until a surplus is achieved
  - good reasons to want to reduce indebtedness of the public sector
  - but as of November 2015 was only being achieved via asset sales
  - March 2016 Budget forecast on course to be missed
  - initial out-turn for 2015–16 suggests it has been missed

Three fiscal targets

- Cap forecast welfare spending ✗
- Reduce public sector net debt as a share of national income every year until a surplus is achieved ✗
- New fiscal mandate: achieve a headline surplus every year from 2019–20, unless growth drops below 1%
  - still standing, for now…

Achieving and maintaining a budget surplus would be a break from the past



Source: Office for Budget Responsibility.

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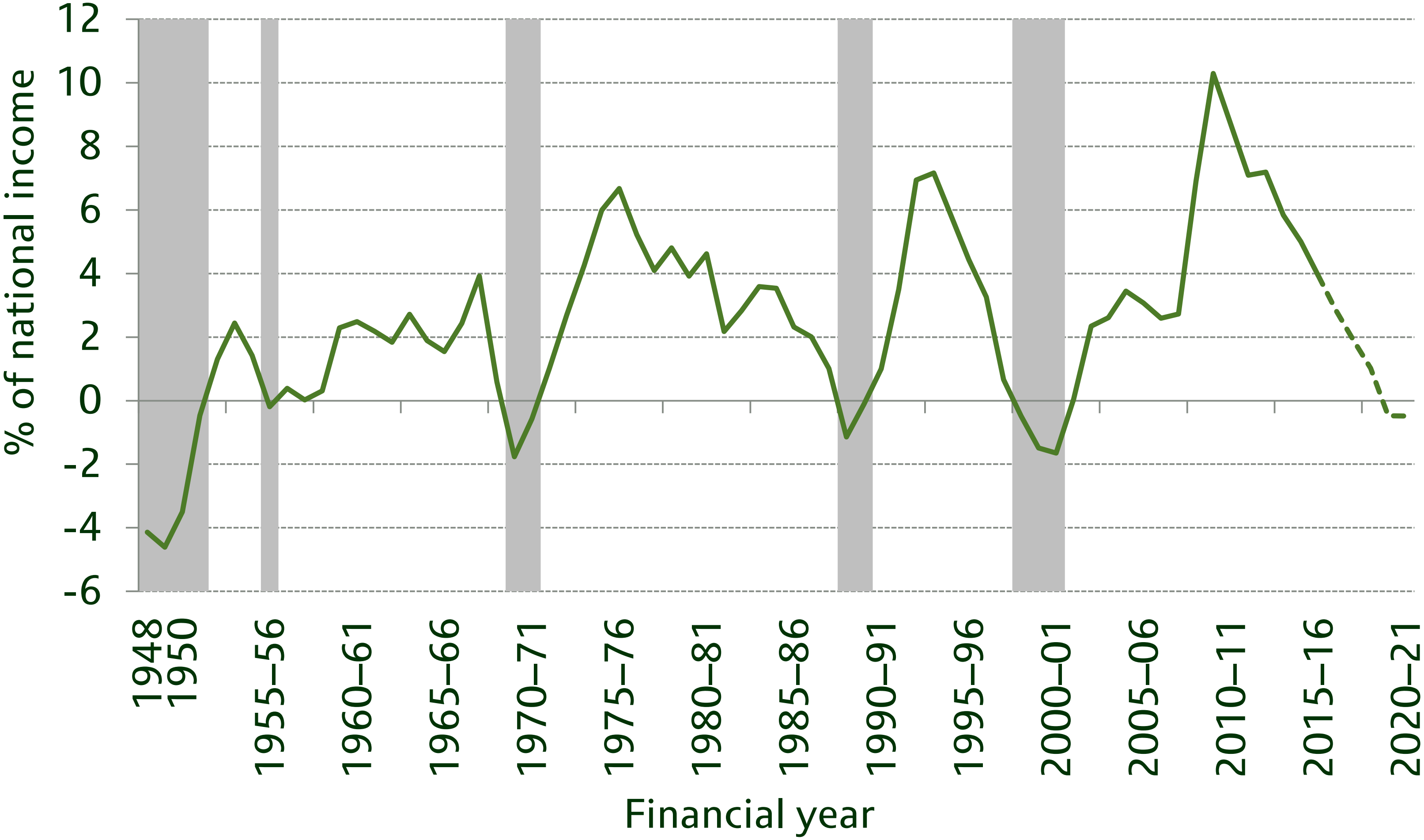

Source: Office for Budget Responsibility.

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Should we run budget surpluses?

- Debt as a share of national income will fall if debt grows less quickly than the economy
  - little economic difference between a small budget surplus and a small budget deficit
  - as long as does not harm growth, smaller deficit / greater surplus would lead to debt falling more quickly

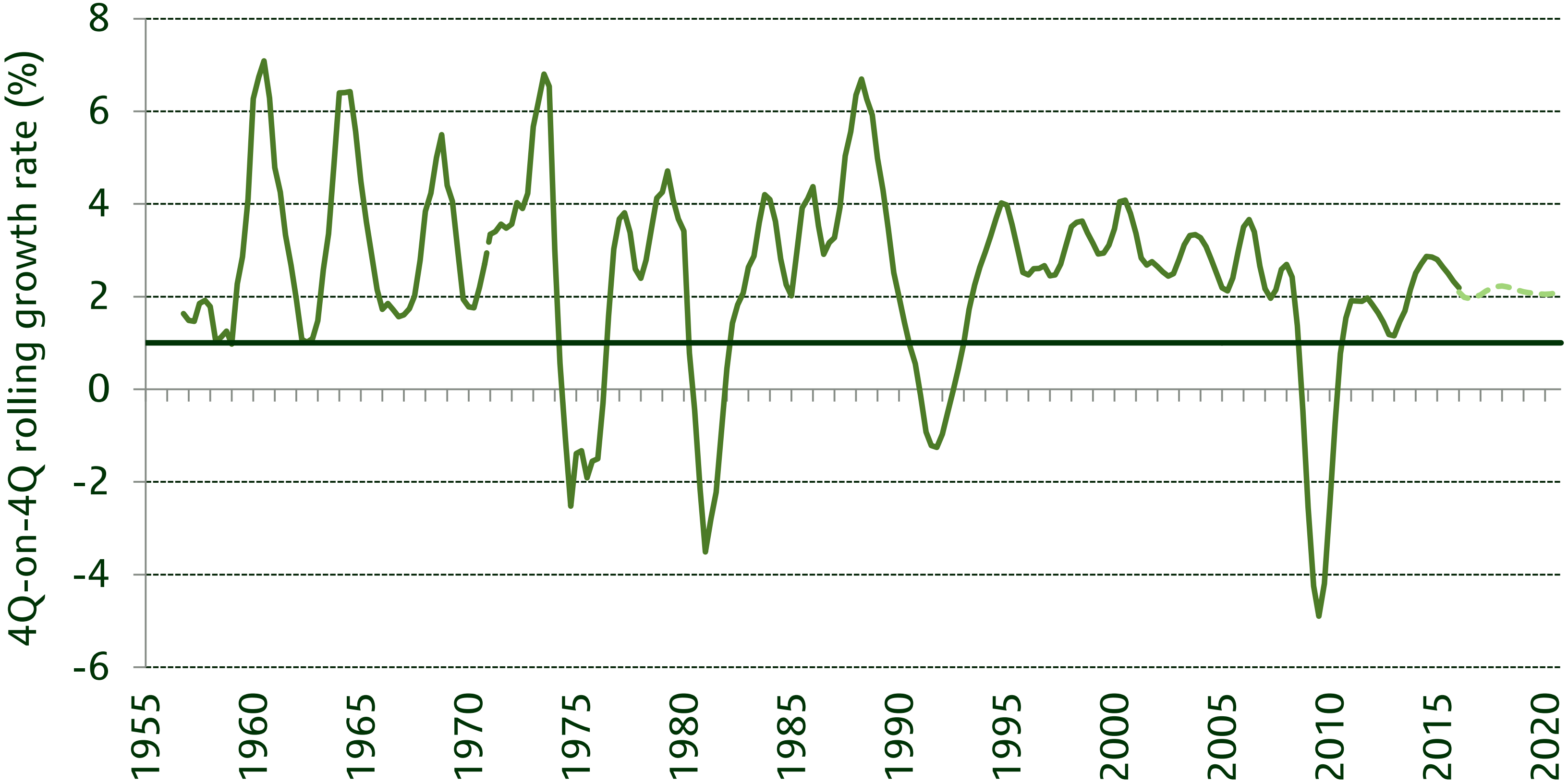
- Several potentially good reasons to borrow
  - investment spending
  - output stabilisation
  - adjust gradually to shocks
  - forecast errors
  - tax rate smoothing

The Chancellor’s fiscal mandate

- Achieve a headline surplus from 2019–20, unless at any point growth over four quarters …
  - … appears to have been below 1% in the last year
  - … or is forecast to be below 1%

- Fiscal mandate is easy to understand and transparent

The 1% escape clause

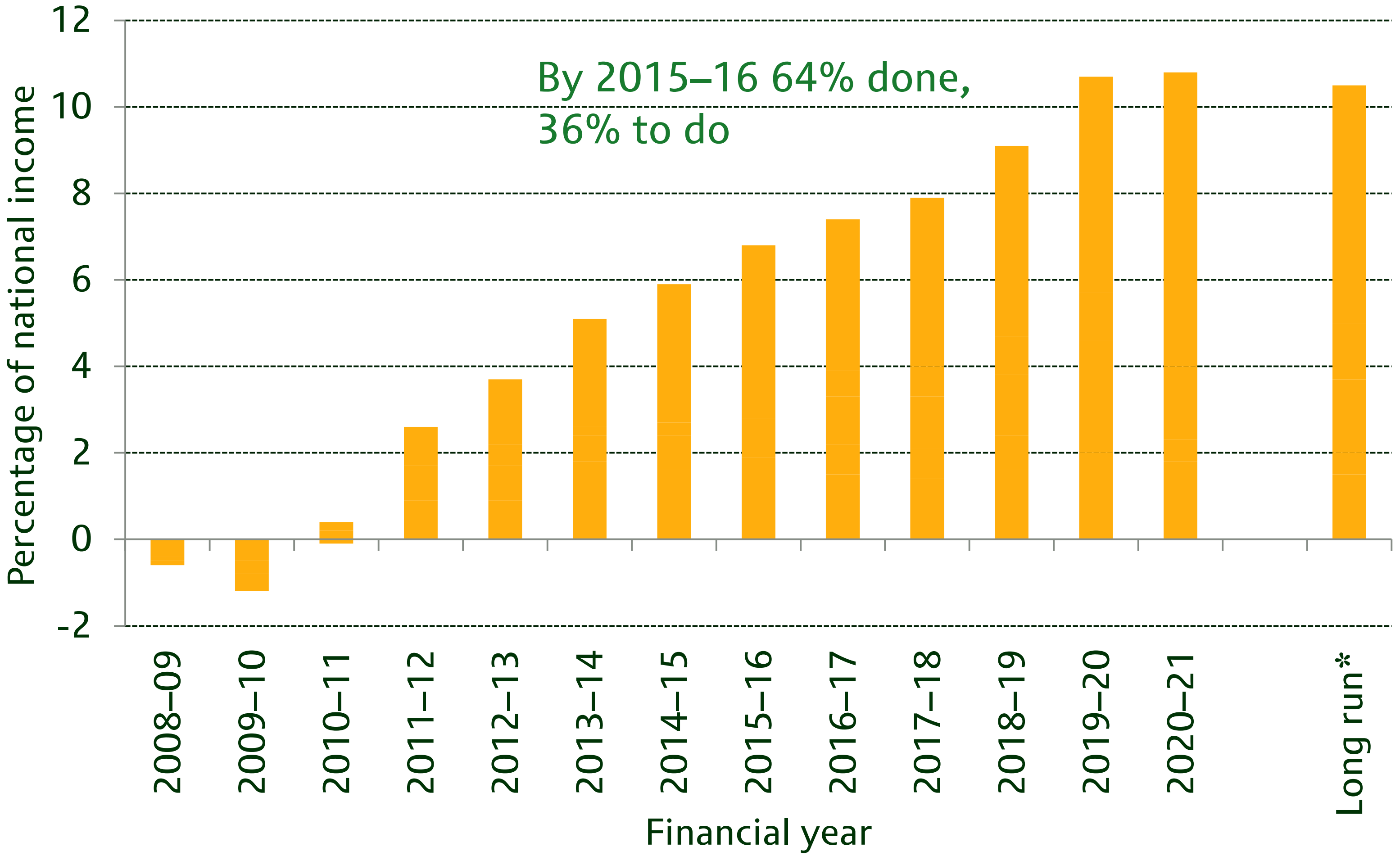


Source: Office for National Statistics; Office for Budget Responsibility.

Three problems with the fiscal mandate

- Unless we aim consistently for large budget surpluses, significant chance sharp adjustments will be necessary
  - greater than one-in-four chance that deficit in coming year more than 0.5% of national income greater than expected
- Rule might not allow government to respond to lower interest rates with more investment spending
  - optimal level of borrowing will almost certainly depend, at least in part, on the interest rate
- 1% threshold arbitrary, and could increase politicisation of the OBR's growth forecasts
  - history suggests growth not often around 1%, but the future might not look like the past

Size and timing of the fiscal response



Source: Institute for Fiscal Studies.

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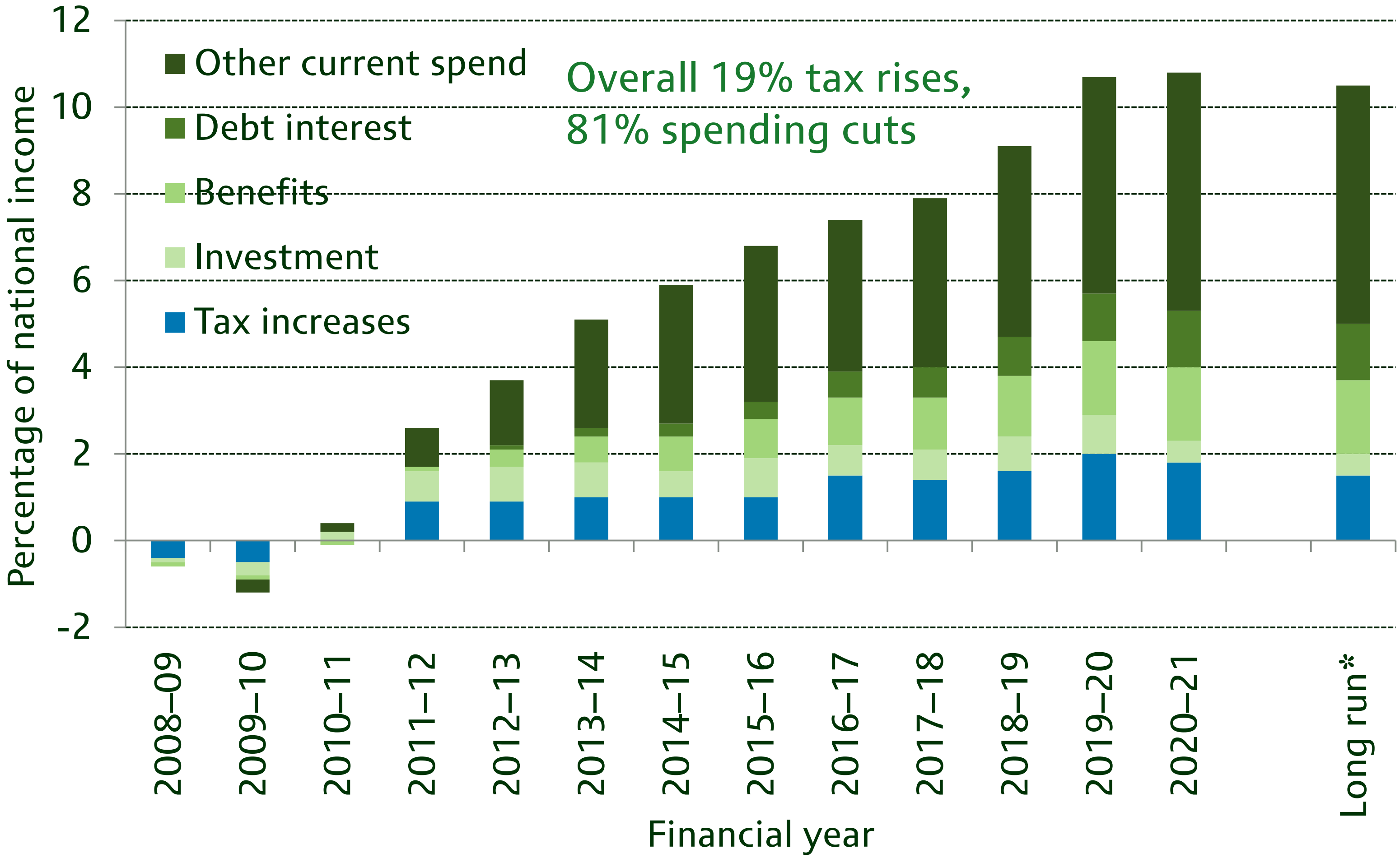
Size, timing and composition of the fiscal response



Source: Institute for Fiscal Studies.

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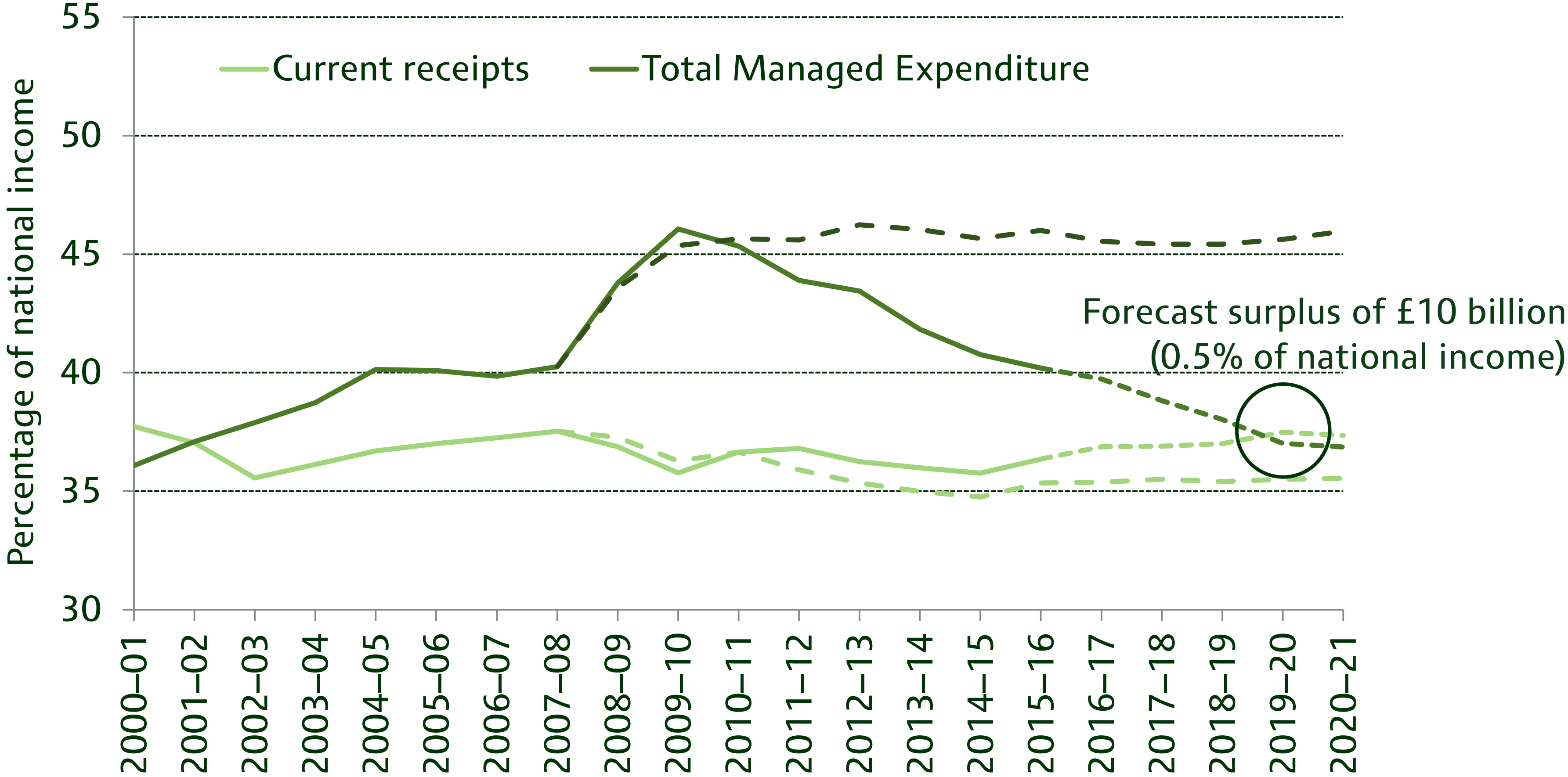
Eliminating the deficit?

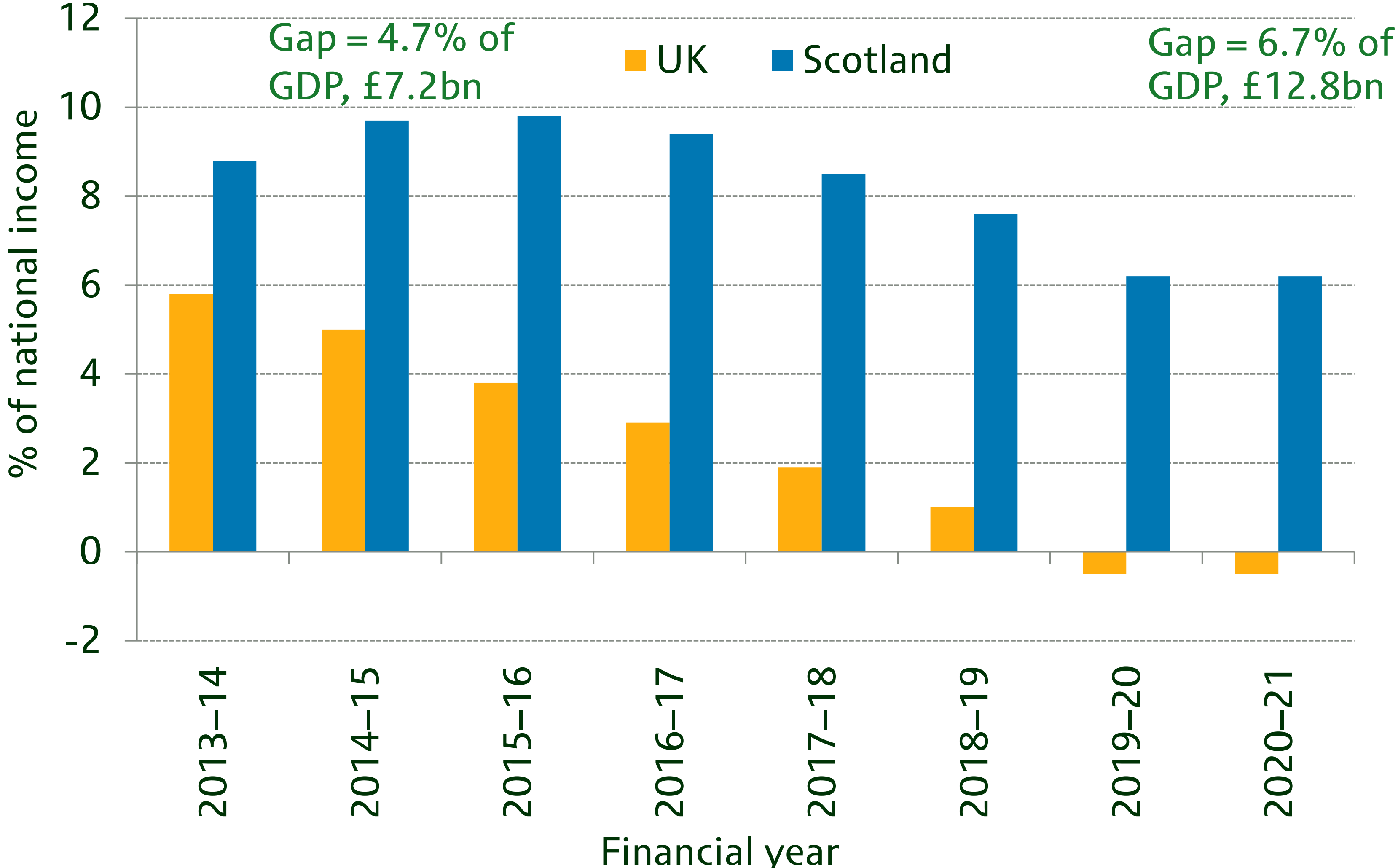


Source: Office for Budget Responsibility.

Eliminating the deficit in the UK, but not in Scotland

- UK deficit forecast to be eliminated by 2019–20, largely as the result of further tax rises and spending cuts (rather than strong growth)
- What about the gap between receipts and spending in Scotland?
- GERS suggests that in 2014–15 the "Scottish deficit" was a larger share of the economy than that of the UK
- IFS projections, using the latest OBR forecasts, suggest the gap will widen
  - driven by weak outlook for North Sea revenues

Gap between UK and Scotland deficit projected to widen



Source: Office for Budget Responsibility; GERS 2014–15; Phillips (2016).

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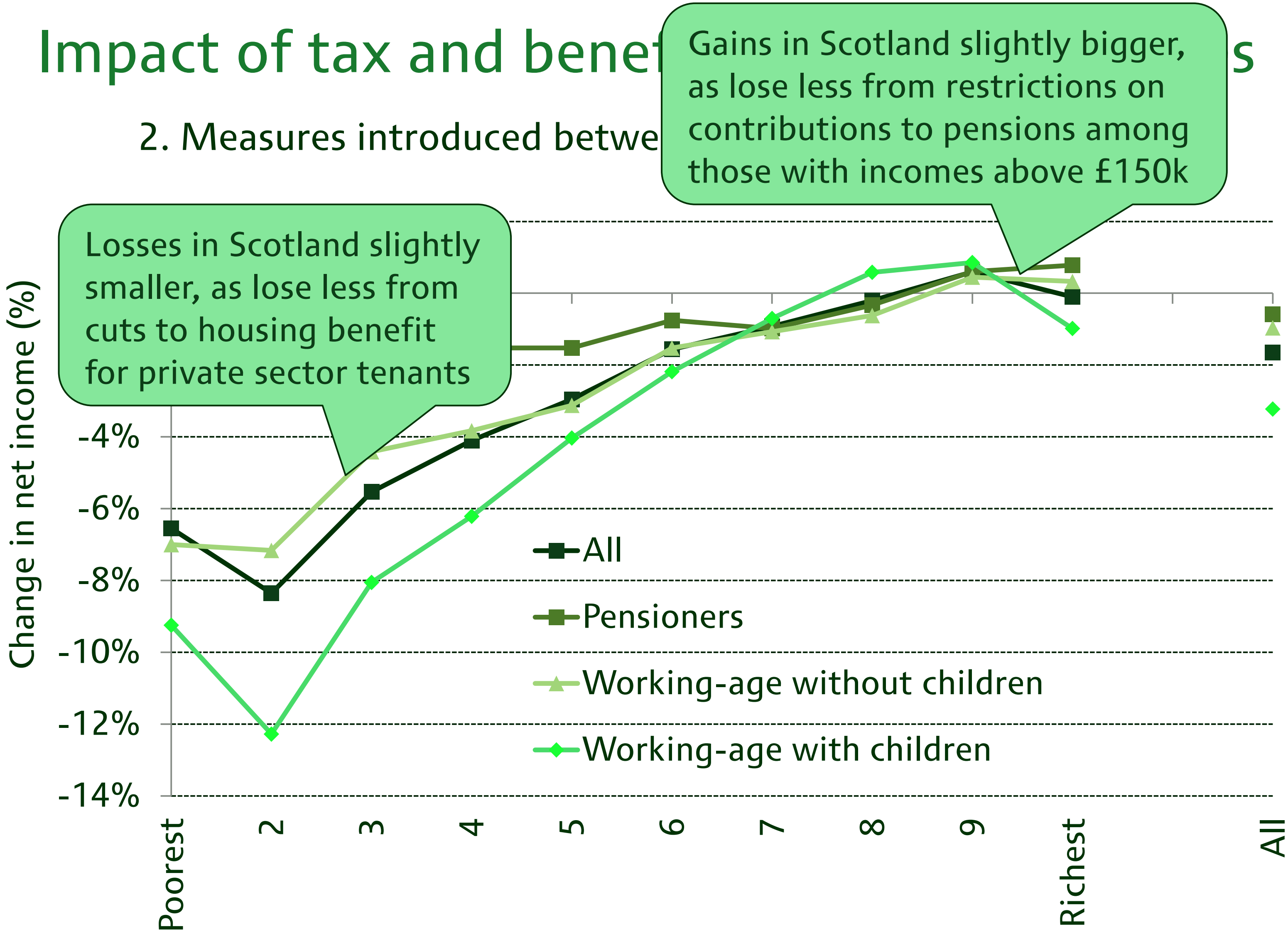
- IFS projections, using the latest OBR forecasts, suggest the gap will widen
  - driven by weak outlook for North Sea revenues
- Under Full Fiscal Autonomy (or independence) this would matter a lot
- But Scotland not penalised for this under “no detriment” principle enshrined into the Block Grant Adjustments at least until 2021–22

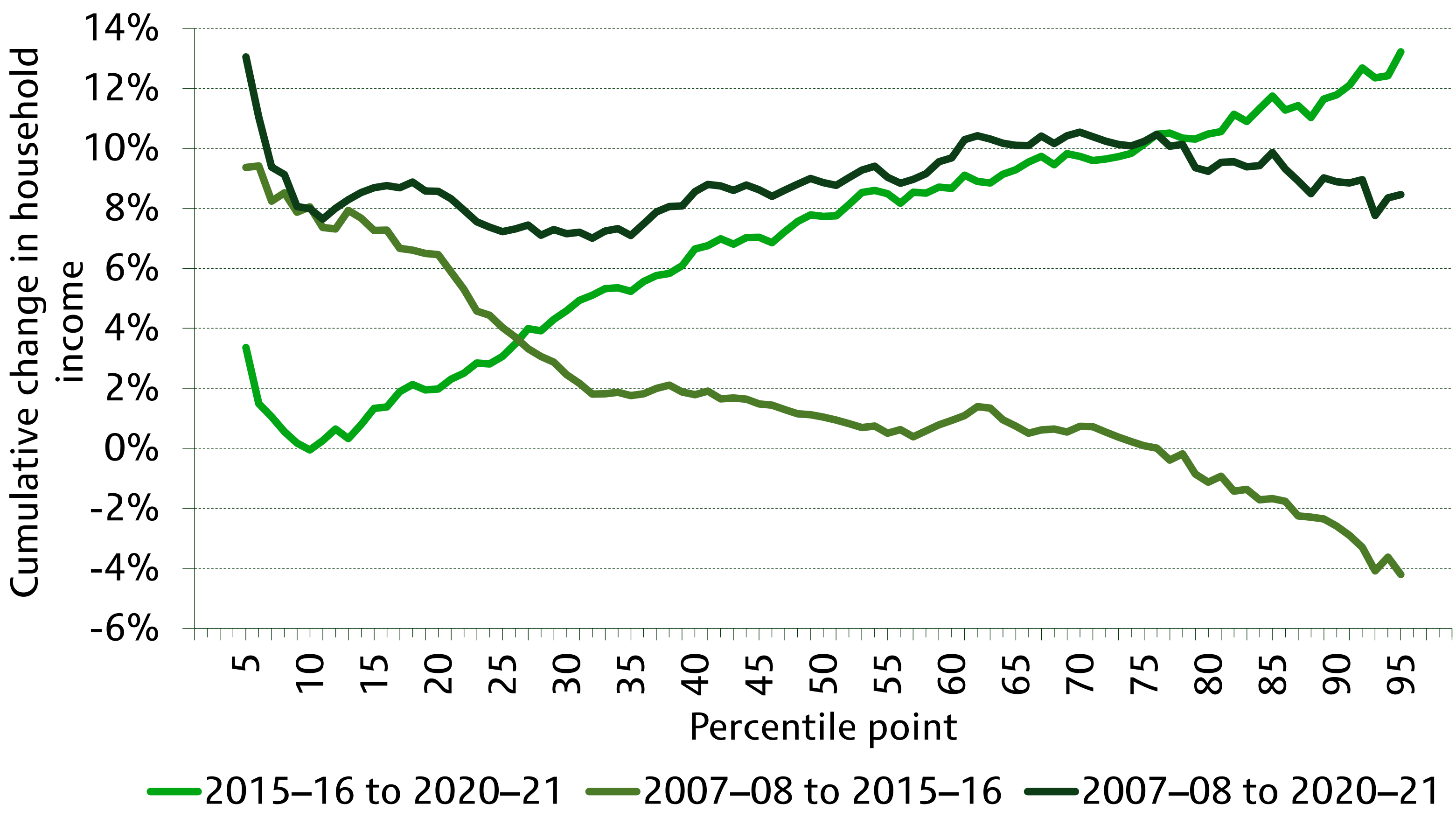
Impact of tax and benef s

2. Measures introduced betwe



Source: Elming and Hood (2016)
(http://www.ifs.org.uk/uploads/budgets/budget2016/budget2016_weah.pdf)

Actual and projected change in incomes



Source: Browne and Hood (2016) (http://www.ifs.org.uk/publications/8171)

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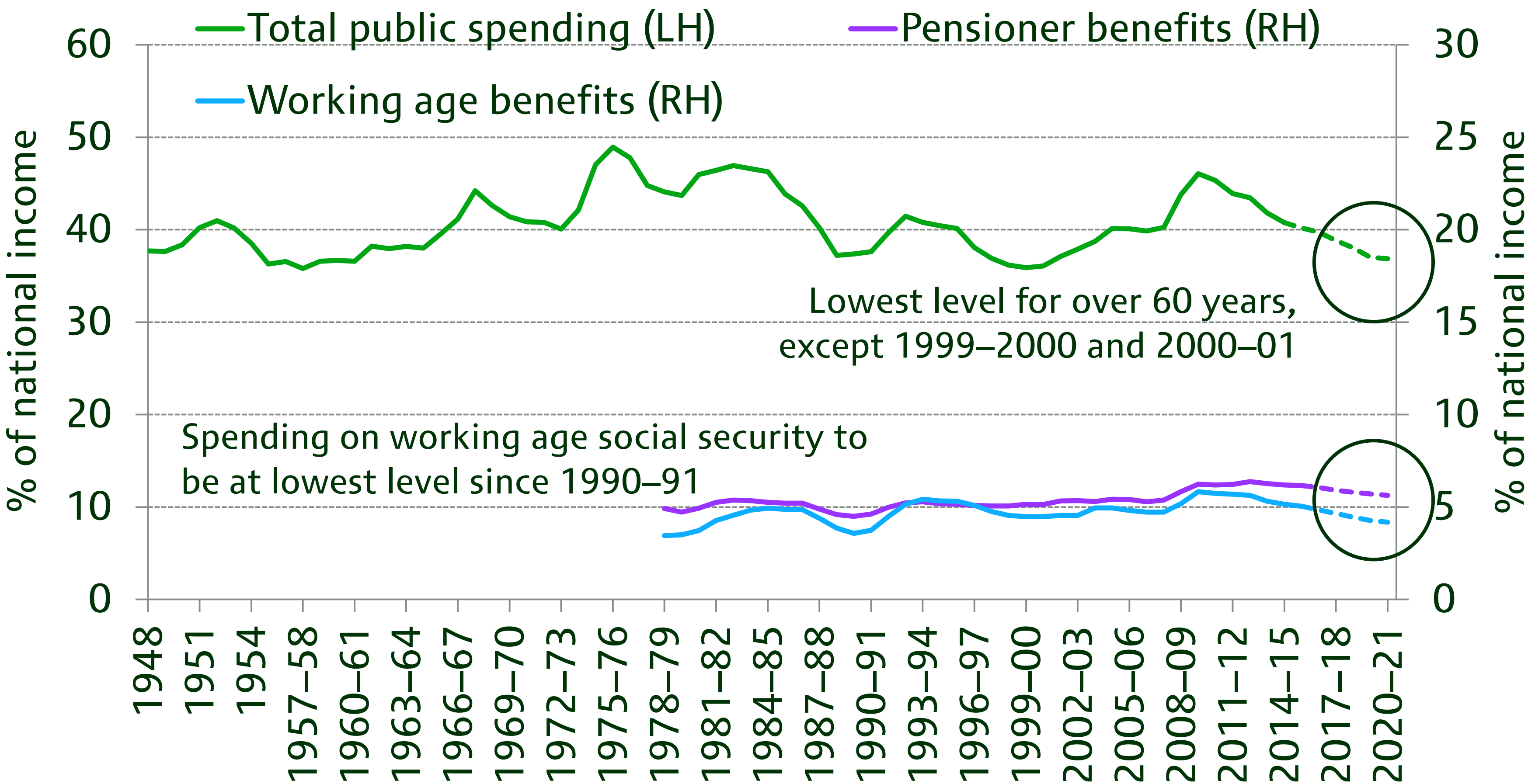
Public spending to fall to a low level by historical standards



Sources: Office for National Statistics; Office for Budget Responsibility.

Implications for spending areas

- Current (non-investment) departmental spending facing real cuts of 3.7% (£12bn) between 2015–16 and 2019–20
  - NHS, aid, schools, defence protected
  - RDEL outside of Dept of Health, Dept of International Development, Ministry of Defence and schools: –12.8% (£17bn)
  - cuts in Scotland slightly smaller
- Takes the real RDEL cut between 2010–11 and 2019–20 to 10.9%
  - RDEL outside of DH, DfID, MoD and schools: –31.5% (£52bn)
- Public service pension revaluation essentially an additional £2bn RDEL spending cut in 2019–20
  - Increases the real RDEL cut since 2015–16 from 3.7% to 4.3%
- Departments also face pressures from: increased NICs (ending of contracting out); increased minimum wage; apprenticeship levy
  - population growing and ageing

Risks: underlying receipts

- Many risks around public finance forecasts
- Perhaps most obvious uncertainty around the underlying public finances is over the size of the economy
  - if GDP turned out to be 0.7% lower than forecast in 2019–20 this would likely be sufficient to eliminate the forecast surplus
  - forecasts assume that we stay in the European Union, leaving would most likely reduce national income and weaken the public finances
- Other factors matter too: including composition and distribution of GDP, asset prices, etc.
- For example employment and earnings directly affect receipts of PAYE income tax and National Insurance receipts (≈£262bn)
  - 1% more employment boosts revenues by about 1%; but 1% more earnings boosts revenues by about 1½%
  - mix of earnings/employment growth in last few years has been unfavourable for the public finances

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Risks: future policy changes on indexation

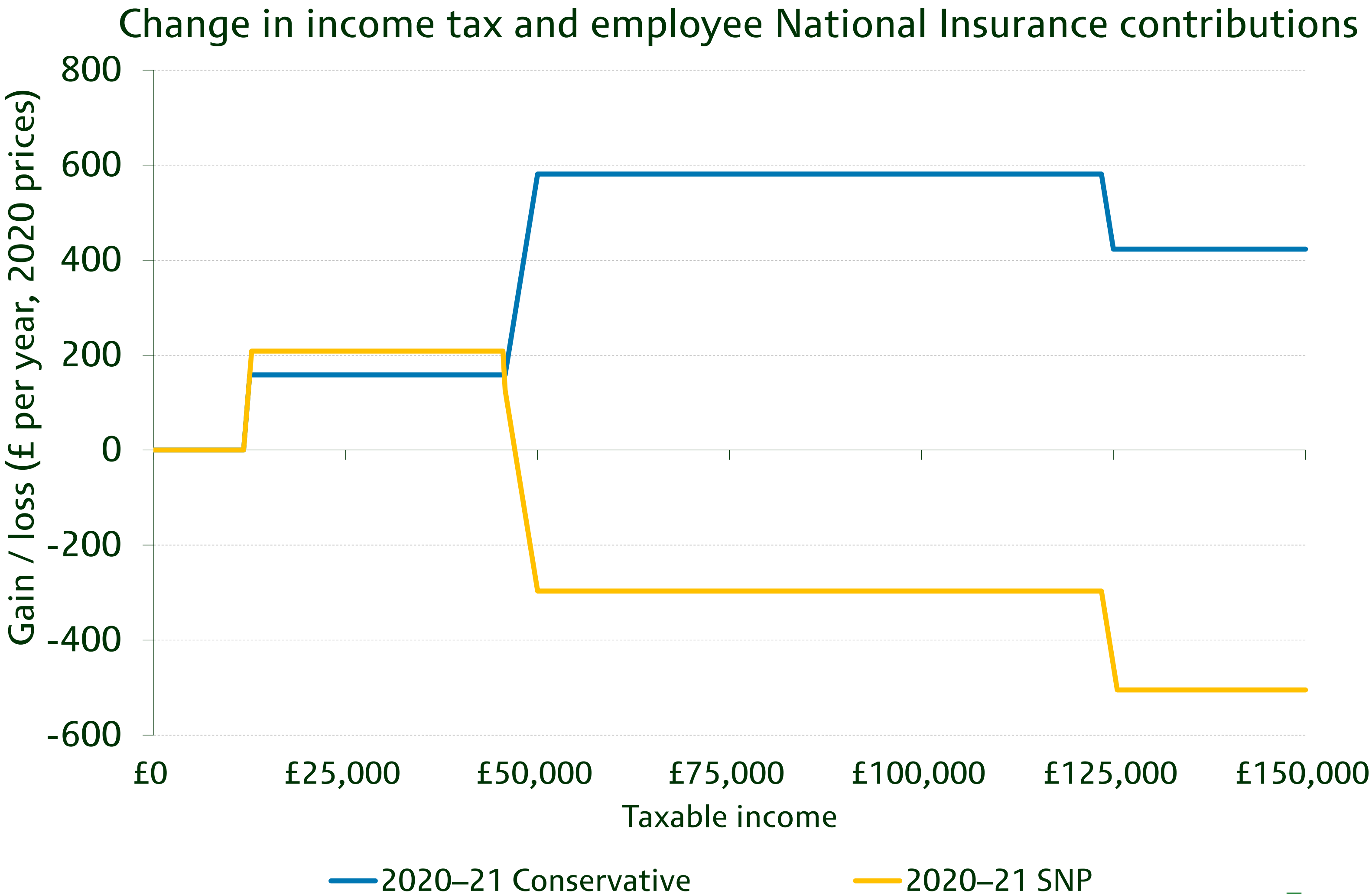
- Indexation of fuel duty rates
  - forecasts assume rates will be increased in line with the RPI every April
  - but rates have not increased in nominal terms since April 2011, and were not increased in April 2016 despite low oil price
  - cash freeze would reduce revenues by £2½ billion in 2020–21

- Some other thresholds are frozen in cash terms which might not prove sustainable
  - 40% more additional rate taxpayers since April 2010 due to £150,000 threshold being frozen
  - 50% increase projected over next five years in numbers losing some or all of their child benefit due to the £50,000 threshold being frozen

Risks: future income tax cuts

- Conservative Party manifesto
  - personal allowance of £12,500 and a higher-rate threshold of £50,000 by April 2020
  - note: UEL is currently linked to the higher-rate threshold
  - standard indexation would increase these to £12,060 and £47,200, increasing them to £12,500 and £50,000 would cost around £3 billion
  - remember that 43% of adults have incomes too low to pay income tax
- SNP manifesto
  - increase personal allowance by a further £250 to £12,750; freeze the higher-rate threshold next April, inflation increases (at most) thereafter
  - SNP estimate that this would boost revenues by a cumulative £1.2 billion over the parliament
  - as the higher-rate threshold in Scotland would be below the UK-wide UEL those in Scotland earning between £46k and £50k would face a combined income tax + employee NICs tax rate of 52%

Gains and losses under Conservative and SNP plans for income tax and NICs

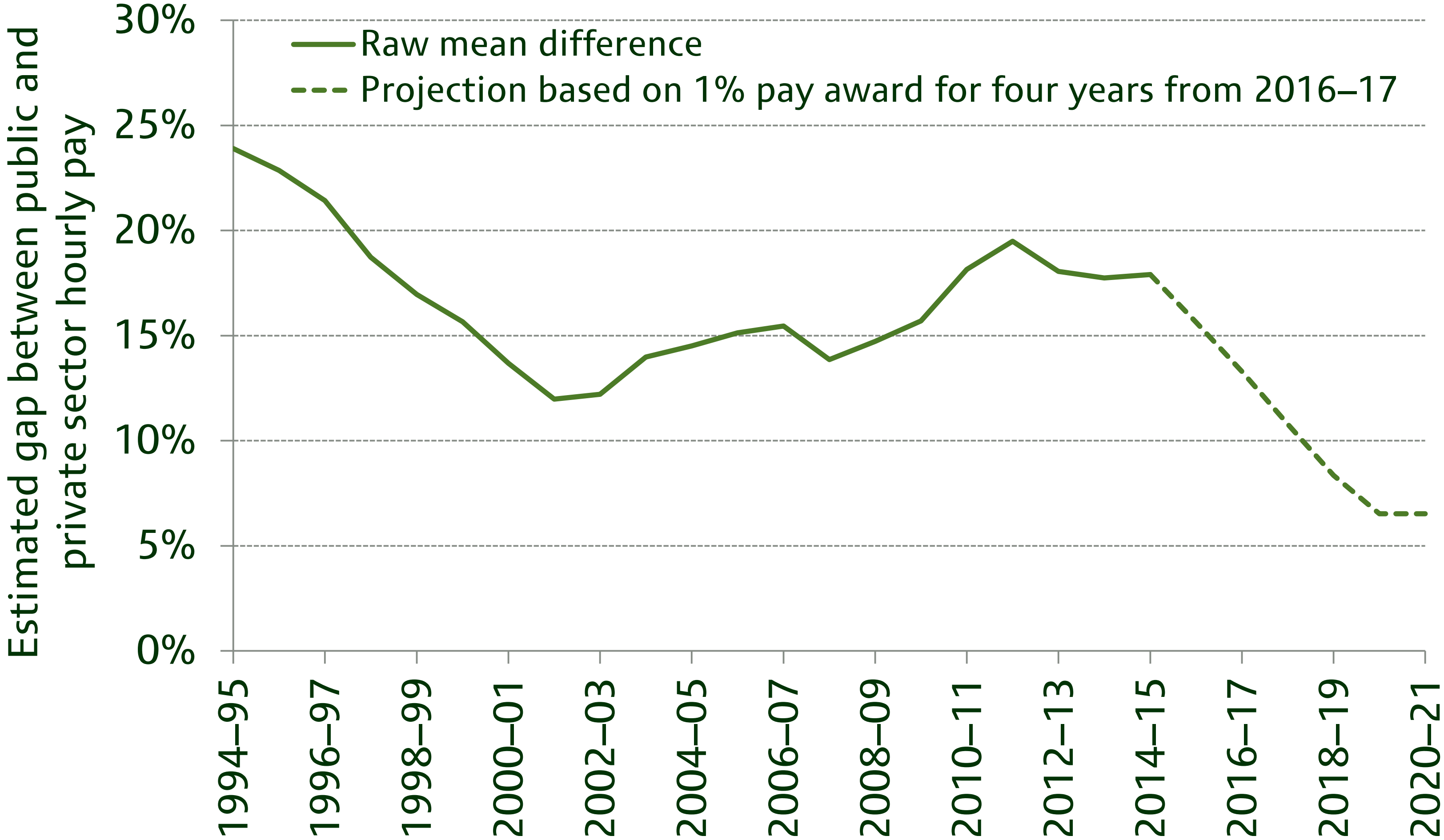


Note: assumes all income from employment, no pension contributions.

Risks: spending

- Public service spending
  - will continued squeeze on public service spending be delivered?

Squeezing public spending by holding down public sector wages



Notes and sources: see Figure 6.4 of *The IFS Green Budget: February 2016*.

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Risks: spending

- Public service spending
  - will continued squeeze on public service spending be delivered?
- Social security spending
  - further 4-year freeze in benefit rates will reduce levels significantly in real terms: has not been attempted in last 30 years
  - further delays in transition from Disability Living Allowance to Personal Independence Payments would increase spending

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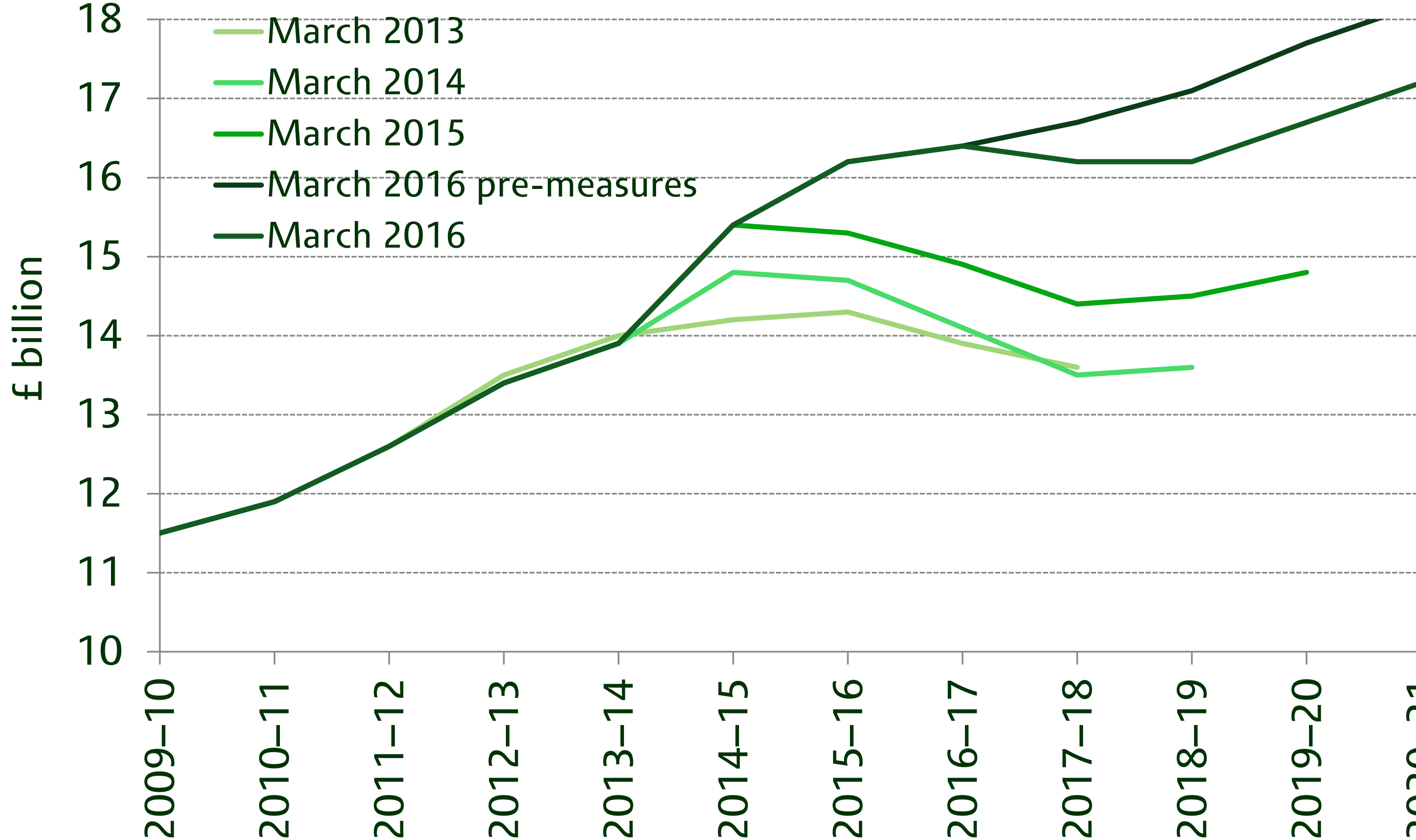
Revisions to expected costs of disability benefits



Source: Office for Budget Responsibility

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- Debt interest spending
  - 1ppt increase (reduction) in gilt and short rates (from April 2016) would increase (reduce) spending in 2019–20 by around £8 billion
  - 1ppt increase (fall) in RPI inflation (from April 2016) would increase (reduce) spending in 2019–20 by around £5 billion

Summary

- Two of the three fiscal targets set for this parliament already missed
- Achieving and maintaining a budget surplus difficult and commitment to do so in 2019–20 risky
- Scotland's relative fiscal position forecast to deteriorate
- Continued fiscal tightening:
  - tax and benefit reforms to leave lower income working age households worse off
  - further cuts to spending on many public services
- Many risks remain
  - will economy grow as the OBR expects?
  - will further tax and benefit giveaways follow?
  - will planned cuts to public service spending prove deliverable?

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