

2. Public finances: risks on tax, bigger risks on spending?

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Summary

- We are now four years through what is expected to be a nine-year fiscal consolidation. If this is implemented as planned, and if the current economic forecasts turn out to be correct, then by 2018–19 the government would be running a budget surplus. But there remain significant risks to both receipts and spending.
- There is considerable disagreement among independent forecasters over how much spare capacity there currently is in the economy. But the scale of the Chancellor's fiscal consolidation plan means that even, if the most pessimistic forecasters are correct, the planned consolidation would still be sufficient to offset the estimated damage done to public borrowing by the financial crisis. If the most optimistic assessment of the amount of spare capacity in the economy is right, all spending cuts planned beyond 2014–15 could be reversed and the deficit would still be on course to return to pre-crisis trends.
- The increase in revenues over the next five years is forecast to come largely from income tax and capital taxes. The UK is increasingly reliant on a few very-high-income individuals for the former – for example, the top 1% of contributors (around 300,000 individuals) contributed 27.5% of income tax in 2011–12 – while capital tax receipts are particularly hard to forecast and are also disproportionately paid by a relatively small number of individuals.
- The OBR forecasts also assume that fuel duty rates are increased in line with inflation after the general election, which is something the coalition government has never done. Freezing fuel duties through to 2018–19 would cost £4.2 billion.
- Perhaps the greatest risk to the fiscal consolidation is that whoever forms the next government might be unwilling (or unable) to deliver the currently planned cuts to public spending. Even with the Chancellor's mooted £12 billion of further cuts to social security benefits, the implied cuts to public services from 2010–11 to 2018–19 would mean departments facing budget cuts of 17.1% on average. If 'protection' for schools, the NHS and aid spending were continued through to 2018–19, other 'unprotected' departments would be facing average cuts of 31.2%.
- The spending squeeze will be exacerbated by the £6 billion a year of additional commitments made by the government for the years after 2015–16. In addition, a growing and ageing population will increase pressures. The ONS projects that the overall population will grow by about 3.5 million between 2010 and 2018, with the population aged 65 and over growing by 2.0 million. One implication of this is that, even if NHS spending were 'protected' and frozen in real terms between 2010–11 and 2018–19, real age-adjusted per capita spending on the NHS would be 9.1% lower in 2018–19 than in 2010–11.

2.1 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, 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. 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 increase in borrowing. In fact, as a result of additional cuts to spending plans pencilled in by the government for 2018–19 in the 2013 Autumn Statement, the Office for Budget Responsibility (OBR) is forecasting the government will run a surplus (that is, receive more in tax revenues than it spends) in 2018–19.

However, while four years of consolidation have been implemented, and the forecasts for 2018–19 paint a relatively rosy picture for the public finances, huge uncertainty remains. First, there may still be future upward revisions to the size of the permanent damage done to the public finances by the financial crisis and associated recession. Second, revenues may turn out to be lower than the OBR forecasts. Third, there is a risk that the government finds itself unable to implement the fiscal consolidation it has planned. While the majority of the planned tax increases and cuts to benefits have been implemented, the same cannot be said of cuts to spending on public services.

Current plans imply that public service spending in 2018–19 will be reduced to around the share of national income that it was at the end of the 1990s (technically, at its lowest level since at least 1948–49 from when comparable data are available). Even if the £12 billion of further cuts to spending on social security benefits that the Chancellor aspires to are delivered, the outlook for spending on public services would still look very difficult. The plans look tougher still due to the commitments for increased spending in some areas and growing demands on services such as the NHS and long-term care as the numbers of older people increase. It remains to be seen whether this, or a future, government has the political will or popular support to reduce spending on services to the extent required.

In this chapter, we discuss in more detail the risks around the government's fiscal consolidation plan (more detail on the plan itself can be found in Chapter 1). The chapter proceeds as follows. Section 2.2 discusses the uncertainty around the estimated size of the problem dealt by the financial crisis, and therefore the risk that the planned consolidation turns out in future to be insufficient to offset all of the damage done to borrowing. In Section 2.3, we consider the risks to forecast tax receipts. Section 2.4 discusses the risks to planned public spending cuts, and the government's proposed welfare cap as a way of reducing unintended, undesirable increases in social security spending. Section 2.5 concludes.

2.2 Uncertainty around the size of the problem

As described in Chapter 1, the latest forecasts from the OBR imply that the financial crisis opened up a hole in the public finances of 8.6% of national income. This is calculated as

the difference between the level of structural borrowing forecast in Budget 2008 and what we now estimate structural borrowing would be if no new policies had been introduced since then.¹ Crucial to this calculation is the estimate of how much of forecast borrowing is expected to be structural (and therefore will remain, in the absence of policy action, even after the economy has recovered) and how much is expected to be cyclical (and will disappear as the economy recovers to its trend level).

In order to estimate how much of borrowing is cyclical and how much is structural, a concept known as the 'output gap' is used. This measures the difference between the actual level of GDP and the trend (or potential) level of GDP, and therefore how much 'spare capacity' there is in the economy. However, it is difficult enough to measure how much output an economy is actually producing, let alone how much it *could* be producing. The OBR and several other institutions publish estimates of the output gap, but there is no consensus on the best approach to take and there is substantial variation between estimates of past, current and future output gaps.² As described in Chapter 1, the official estimate of the damage done to the public finances by the financial crisis has changed significantly over the last five years, which has largely been driven by changes to the official estimate of the trend level of GDP. In this section, we show how the estimates of the current output gap from different forecasters would, if adopted by the OBR, lead to very different conclusions as to how much fiscal tightening was thought to be required. Under the most pessimistic, all of the tightening planned by Mr Osborne would be required just to offset the additional borrowing that had been caused by the crisis and he would no longer be able to expect a budget surplus in 2018–19. Under the most optimistic, all of the planned spending cuts beyond 2014–15 could be cancelled and sufficient fiscal tightening would still have been delivered to offset the impact of the crisis on the public finances.

In December 2013, the OBR forecast that in 2014 the UK would be operating at 1.8% below its trend level. This is slightly below (i.e. more pessimistic than) the average of the latest estimates of other independent forecasters (2.7%), as shown in Figure 2.1. However, among the other independent forecasters, there is a wide array of estimates for the size of the output gap in 2014, ranging from 0.0% to 6.0%. Also as shown in Figure 2.1, in December 2013 Oxford Economics estimated that the output gap stood at 5.1%, which was a more optimistic assessment than all but one of the other forecasters in the survey used by the OBR. Since then, entirely as a result of the revisions to the National Accounts published by the ONS in December, Oxford Economics has revised down its assessment of the output gap in 2014 to 4.3%. Further details of how this judgement was reached can be found in Chapter 4.

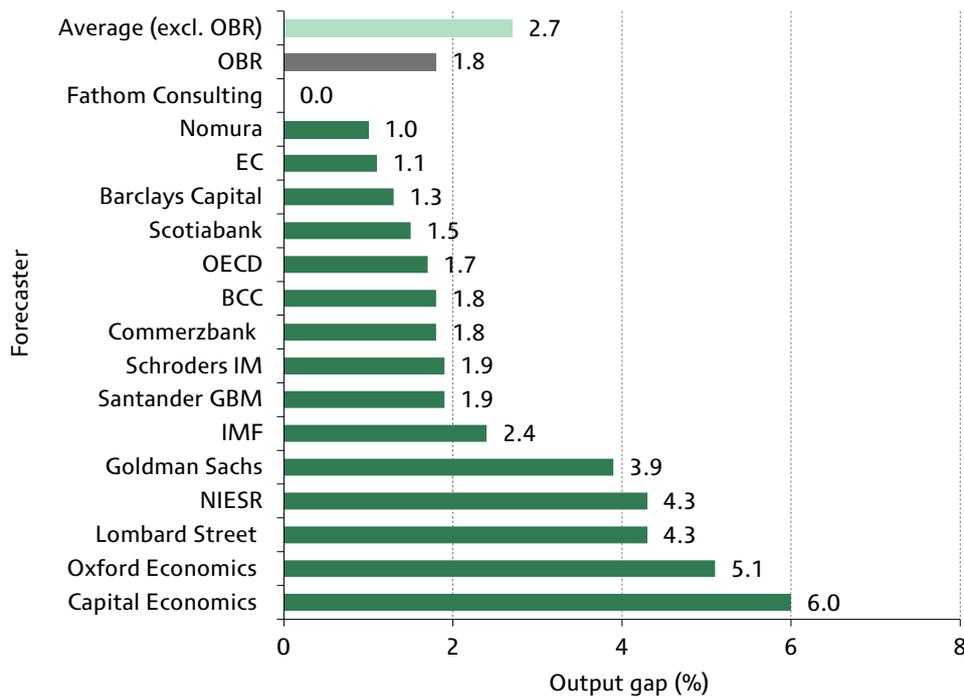
It is possible to quantify the potential impact of different output gap estimates on the level of borrowing – specifically, on the decomposition between structural and cyclical borrowing – and, therefore, on the size of the policy response required to deal with the hit to the public finances from the financial crisis.³ Table 2.1 illustrates the impact of

¹ This is largely on the basis of official costings of policy measures.

² For more detail on the different methods that can be used to calculate the output gap, see, for example, Office for Budget Responsibility, 'Estimating the output gap', Briefing Paper 2, 2011, <http://budgetresponsibility.org.uk/wordpress/docs/briefing%20paper%20No2%20FINAL.pdf>.

³ The relationship between structural borrowing and the output gap is estimated using data on how the public finances have varied with economic cycles in the past. The OBR estimates that a 1 percentage point increase in the output gap reduces the amount of borrowing thought to be structural by 0.7% of national income. However, this does assume that the current period of weak economic performance has the same relationship with government borrowing as that seen in previous economic recessions and booms. (Source: T. Helgadottir,

Figure 2.1. Alternative estimates of the output gap in 2014



Source: Chart 3.3 of Office for Budget Responsibility, *Economic and Fiscal Outlook December 2013*, <http://cdn.budgetresponsibility.independent.gov.uk/Economic-and-fiscal-outlook-December-2013.pdf>.

different output gap assumptions on the amount of tightening required after 2013–14 to deal with the increase in structural borrowing dealt by the crisis – in other words, to put us in a position where structural borrowing would be forecast to be about the same in 2018–19 as it was forecast to be in the medium term in Budget 2008 (1.2% of national income).

Under a pessimistic scenario, taking the smallest estimate of the output gap in 2014 (0.0%, from Fathom Consulting) and combining that with the OBR’s assumptions for the growth in trend GDP, the structural deficit would be around 1.3% of national income

Table 2.1. Impact of different output gap assumptions on the estimated size of the problem and the consolidation required after 2013–14

% of national income Output gap	Size of problem	Tightening required after 2013–14:	
		To deal with problem ^a	To achieve planned surplus in 2018–19 ^b
Pessimistic (0.0%)	9.9%	5.2%	6.7%
OBR (1.8%)	8.6%	4.0%	5.5%
Average (2.7%)	8.0%	3.4%	4.8%
Optimistic (6.0%)	5.7%	1.0%	2.5%

^aTightening required after 2013–14 for structural borrowing in 2018–19 to be forecast to be the same as was forecast for the medium term in Budget 2008 (1.2% of national income).

^bTightening required after 2013–14 for structural borrowing in 2018–19 to be as currently forecast (a surplus of 0.3% of national income).

Note: The OBR’s assumptions for the growth in trend GDP are maintained in all scenarios.

G. Chamberlin, P. Dhami, S. Farrington and J. Robins, ‘Cyclically adjusting the public finances’, Office for Budget Responsibility (OBR), Working Paper 3, 2012, <http://budgetresponsibility.independent.gov.uk/wordpress/docs/Working-paper-No3.pdf>.

larger than currently forecast by the OBR. As shown in Table 2.1, the fiscal consolidation currently planned would still be (just) sufficient to offset all of the permanent increase to borrowing caused by the financial crisis. An additional 5.2% tightening after 2013–14 would be required, and a further 5.5% tightening is currently planned. However, an additional 1.3% of national income tightening (£21 billion in today's terms) would be needed to achieve the structural borrowing levels currently forecast for 2018–19.

Under an optimistic scenario, taking the largest estimate of the output gap in 2014 (6.0%, from Capital Economics) and combining it with the OBR's assumptions for the growth in trend GDP, the structural deficit would be much smaller, with more of current borrowing estimated to be temporary. Specifically, we estimate that it would be around 2.9% of national income smaller than currently forecast by the OBR for 2018–19. If this were the case, the government would only need to implement an additional 1.0% of national income tightening after 2013–14 to offset the damage done by the financial crisis. This means it could afford to reverse all of the spending cuts planned for the four years after 2014–15. If the government still wanted to achieve the 0.3% national income structural surplus in 2018–19 that is currently forecast, it could reverse half of the spending cut planned for 2016–17 and all of that planned for 2017–18 and 2018–19.

Table 2.1 gives an idea of the range of the uncertainty around the amount of fiscal consolidation that would be required beyond 2013–14 arising from different estimates of the current output gap.⁴ Although the contemporaneous output gap will never be observed, as the years progress and more data on the level of GDP become available, it will be possible to be more certain about the size of the fiscal action that was required. However, given this uncertainty in the short term, it is understandable that the Chancellor wishes to build some margin for error into his plans, by planning a larger consolidation than the current estimate of the size of the fiscal problem.

2.3 Risks to future tax revenues

Revenues as a share of national income are forecast by the OBR to increase from 37.4% of national income in 2012–13 to 38.3% in 2018–19. This is a level of revenues last seen in around 2000–01, and is around 1% of national income above the average level of revenues over the past couple of decades. The contribution of tax increases to the overall fiscal consolidation is described in more detail in Chapter 1; in this section, we discuss some of the risks around the forecast increase in revenues.

Policy risk

Little of this forecast increase is planned to come from new policy action that has been announced but not yet implemented. There are two main exceptions. First, an increase in receipts of National Insurance contributions (NICs) of 0.3% of national income is expected from 2016–17 when contracting out into defined benefit pension schemes ends. There seems relatively little political risk that this policy will not be implemented as planned. However, as discussed in Section 2.4, the increased NICs required from public sector employers will increase the cost of providing public services and will put additional pressure on departmental budgets. If a future government increases total

⁴ Different forecasters might also disagree in terms of their predictions for growth in trend GDP.

public spending to reduce this pressure, then the benefit to the public finances of the NICs increase would be partially offset.

Second, the government has announced a number of measures to reduce tax avoidance. Together, the measures announced in the 2013 Autumn Statement are expected to raise an additional 0.1% of national income in revenues by 2018–19. Such expected revenue increases are inherently uncertain, since the size and responsiveness of the tax base (which, by definition, is trying to pay as little tax as possible) are often unknown. For example, the government originally expected to get £5.3 billion in revenue between 2012–13 and 2017–18 from a tax repatriation agreement with the Swiss government, but the latest estimates from the OBR suggest that in fact only £1.9 billion will be received. These additional tax revenues from new anti-avoidance measures should therefore be expected with caution.

There is also the risk that policies that have already been implemented may fail to raise as much revenue in future as is currently forecast. This is particularly true of the bank levy, for example. The rate of the bank levy has been increased in every Budget and Autumn Statement under the coalition government, and the 2014 rate is now more than double that originally intended (0.156% instead of 0.070%) – yet it is expected to raise little more revenue than originally intended (£2.7 billion in 2014–15 instead of £2.4 billion). It could be that further increases in the rate or further broadening of the tax base will be required if future years' receipts are to come in as forecast.

Furthermore, there is a significant risk that future policy action might reduce expected revenues. For example, the above OBR forecasts assume that fuel duties are increased in line with inflation from September 2015 onwards – something the coalition government has shied away from doing since coming to power (and which the last government also avoided in most years from 2001).⁵ If the government did plan to continue holding fuel duties constant in nominal terms, then receipts would be expected to fall £4.2 billion short of the OBR's forecast.

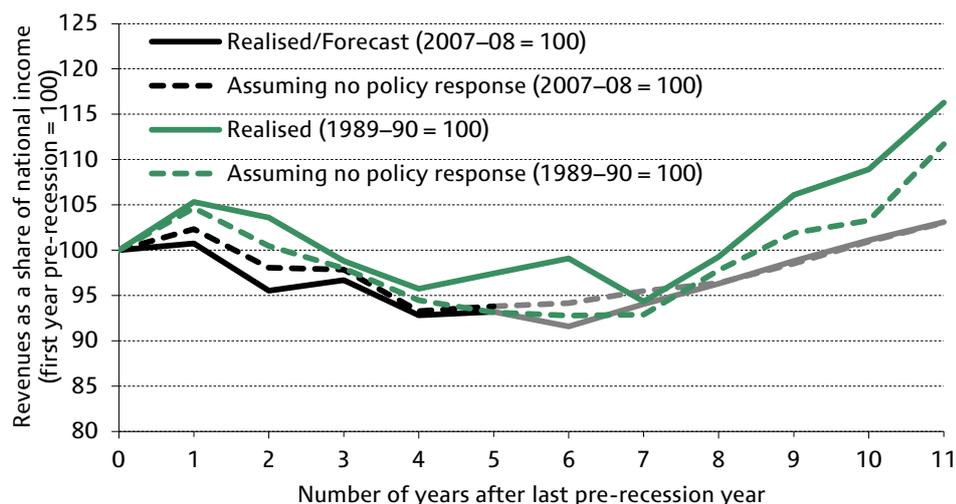
Other risks

The increase in overall revenues between 2012–13 and 2018–19 is being driven by increases in income tax receipts (forecast to increase by 1.0% of national income) and capital taxes (forecast to increase by 0.8% of national income) that are not the result of policy action. How confident can we be that this forecast recovery will occur? Although all recessions and recoveries are different, it is possible to gain some insight into this by comparing the forecast profile for revenues over the latest recession and forecast recovery, with the profile for revenues that occurred following the recession of the early 1990s and subsequent recovery.⁶ This is illustrated in Figure 2.2 for income tax receipts and Figure 2.3 for capital tax receipts. Broadly, one can draw the conclusion that the forecast changes in income tax receipts and capital tax receipts are not out of line with the profile of recovery in receipts after the last recession.

⁵ Before Budget 2011, fuel duty increases were due to occur in April each year. However, through consecutive announcements of postponements and cancellations, no increases in the rates of fuel duties have occurred between 2010 and 2014, and the increase previously planned for April 2015 has so far been postponed until September 2015.

⁶ It should be kept in mind that nominal economic growth was greater in each year after 1989–90 than in the equivalent year after 2007–08.

Figure 2.2. Income tax receipts



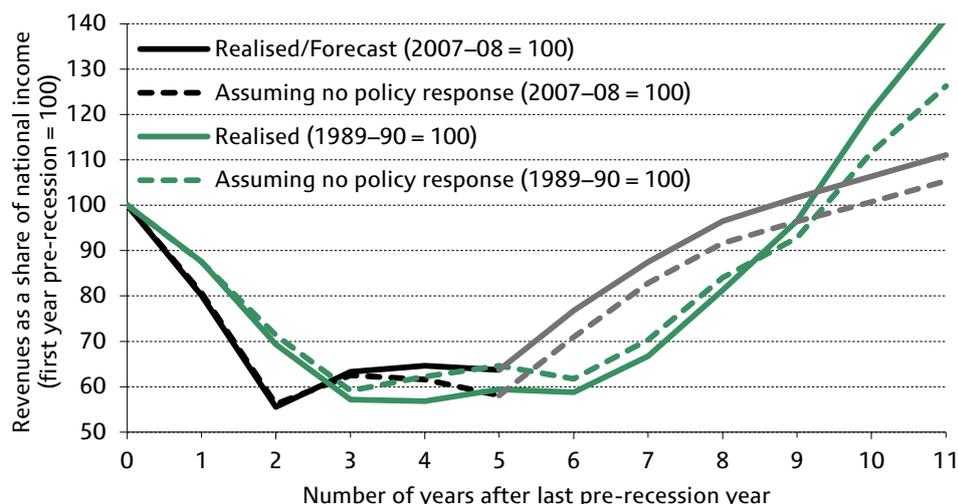
Note: Pre-Autumn Statement 2012, only policies with an impact of more than £50 million are included (see page 9 of T. Helgadottir, G. Chamberlin, P. Dhami, S. Farrington and J. Robins, 'Cyclically adjusting the public finances', Office for Budget Responsibility (OBR), Working Paper 3, 2012, <http://budgetresponsibility.independent.gov.uk/wordpress/docs/Working-paper-No3.pdf>). Beyond that, all tax measures are included. Beyond the forecast horizon, impacts are uprated with nominal GDP – so are assumed to raise/lose a constant share of GDP for ever more. Adjustment assumes policy costings are accurate – as noted by the OBR, it is very difficult to assess how much a policy has raised ex-post, let alone ex-ante. Source: Office for Budget Responsibility, Budget tax measures database, <http://budgetresponsibility.org.uk/category/publications/working-papers/>.

The dashed black line in Figure 2.2 shows how income tax receipts would have changed relative to their 2007–08 share of national income had no new policies been introduced since the start of the recession. It is estimated that income tax receipts as a share of national income would have fallen by 6.7% by 2011–12 (year 4), before starting to recover – reaching 103% of their 2007–08 share in 2018–19. The solid black line shows how total revenues actually changed, and are forecast to evolve going forward, taking into account the government's estimates of the effect of policy on income tax receipts. The net effect of policy changes on income tax receipts is forecast to be negligible, since large income tax increases such as the removal of the personal allowance for those with an income over £100,000 and the tighter restrictions on tax relief for pension contributions (see Chapter 10) are offset by large income tax giveaways such as the increase in the personal allowance to £10,000.

For comparison, the green solid and dashed lines show income tax receipts with and without policy action (respectively) over the period of the 1990s recession and recovery (year 0 is 1989–90). In the 1990s, the path of income tax receipts was similar to that now forecast. Receipts fell somewhat less quickly and picked up more strongly from year 8 (1997–98) onwards than is now forecast, but this is perhaps not surprising given the higher nominal economic growth in each year after 1989–90 than the equivalent year after 2007–08.

The equivalent picture for receipts from capital taxes is shown in Figure 2.3, and again the profiles are remarkably similar in the period since 2007–08 and the period after 1989–90. As with income tax receipts, the recovery is forecast to be slightly weaker up to 2018–19 than was the case at the end of the 1990s, which is consistent with the lower economic growth projected for the current period of recovery.

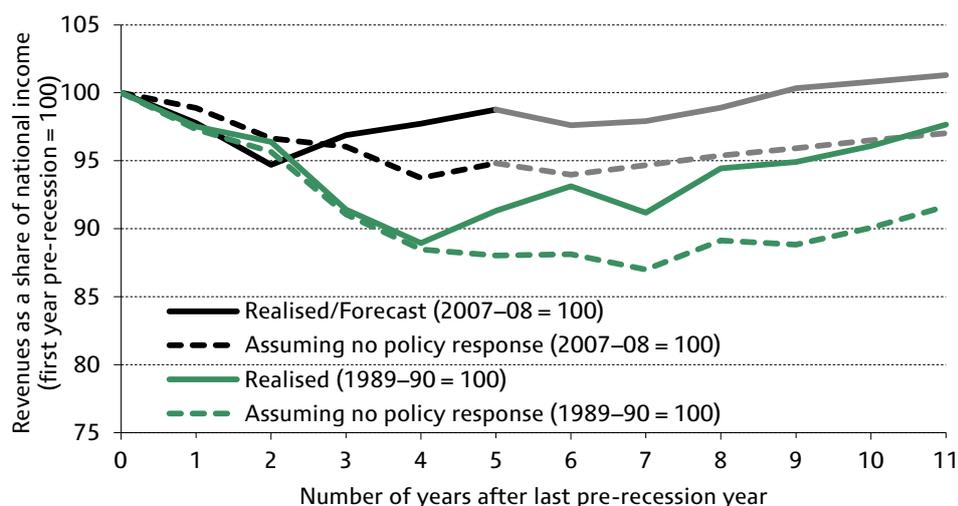
Figure 2.3. Capital tax receipts



Note and source: As for Figure 2.2.

While the forecast recovery in receipts from income tax and capital taxes through to 2018–19 does not seem out of line with the increase seen in the previous recovery, the picture is somewhat different for total revenues (illustrated in Figure 2.4). Total revenues actually fell much more (relative to their pre-recession share of national income) after the recession in the early 1990s than in the wake of the recent financial crisis and recession. In the 1990s, receipts would have fallen to around 87% of their 1989–90 share of national income in the absence of any policy action, while for the current period it is estimated that receipts would only fall to around 94% of their 2007–08 share of national income in the absence of policy action. This is in part driven by onshore corporation tax receipts and VAT receipts having been particularly affected in the early 1990s recession. In addition, the greater fall in national income in the recent recession means that taxes whose tax bases are not automatically affected by the level of national income, such as business rates, have held up particularly strongly when expressed as a share of national income.

Figure 2.4. Total revenues



Note and source: As for Figure 2.2.

One way in which the current recovery has been different from previous recoveries is that in recent years there has been remarkably strong growth in employment given the relatively weak growth in the UK economy. This mix of relatively strong employment growth and weaker average earnings growth has implications for growth in tax revenues – particularly from income tax and NICs. The main determinant of growth in these revenues is the growth in total employment income in the UK economy, which is the product of employment and average earnings growth. However, because of the progressivity of these taxes – in particular of income tax – growth in average earnings creates a larger boost to tax receipts than equivalent growth in employment. This means that the distribution of total employment income, as well as its headline growth, matters for tax receipts.

The OBR estimates that a 1% increase in average earnings (holding employment constant) would boost receipts of income tax and NICs by about 1.5% (or by between £3¼ billion and £4 billion). In contrast, a 1% increase in employment (holding average earnings constant) is estimated to boost these receipts by about 1% (around £2¼ to £3 billion).⁷ So, in other words, a 1% increase in employment income that comes from a boost to average earnings would be expected to increase income tax and NICs receipts by about £1 billion more than a 1% increase in employment income that comes solely from an increase in employment.

A risk to the forecast recovery in income tax and NICs receipts is therefore that the mix of employment growth and average earnings growth turns out differently from what the OBR is currently forecasting – for example, if employment grows but labour productivity is weak. This is what has happened over the last few years: since the March 2012 Budget, the OBR has (for the period 2010 to 2015) revised down its forecast for growth in average earnings but revised up its forecast for growth in employment. To give a sense of this, Table 2.2 illustrates the implications for income tax and NICs receipts of the change in the OBR's forecasts for employment income over 2010 to 2015, between its first forecast in June 2010 and its most recent in December 2013. This shows that in June 2010, the OBR was forecasting that employment would grow by 3.8% and that average earnings would grow by 24.4% over this five-year period. It is now forecasting that employment will grow more quickly (4.8%), but that average earnings will grow significantly less quickly (14.9%). This means that growth in aggregate earnings has been revised down from 29.1% to 20.5%.

Using the OBR's estimates for the responsiveness of income tax and NICs to earnings and employment suggests that the June 2010 forecast implied growth in revenues from these taxes of 43.1% between 2010 and 2015. The subsequent revisions to forecast earnings and employment have reduced this to 28.8%. This is equivalent to a drop in receipts in 2015–16 of £32.3 billion. If this downwards revision to aggregate earnings had instead happened as a result of a drop in both employment and earnings that left the average effective rate of income tax and NICs unchanged from that forecast in the June 2010 Budget, we would have expected receipts of income tax and NICs to be reduced by an estimated £28.9 billion in 2015–16. The additional drop in revenues of £3.5 billion comes from the composition of this downwards revision to growth: because the downwards

⁷ Source: Table 3.2 on page 39 of Office for Budget Responsibility, 'How we present uncertainty' Briefing Paper 4, 2012, <http://budgetresponsibility.org.uk/wordpress/docs/Briefing-paper-No4-How-we-present-uncertainty.pdf>.

Table 2.2. Impact of employment and earnings growth on income tax and NICs receipts between 2010 and 2015, June 2010 Budget and December 2013 EFO compared

	June 2010 Budget	December 2013 EFO
(1) Employment growth (%)	3.8	4.8
(2) Average earnings growth (%)	24.4	14.9
(3) Aggregate earnings growth (%)	29.1	20.5
(4) Implied growth in income tax & NICs receipts (%)	43.1	28.8
Total estimated shortfall in revenues forecast in December 2013 compared with June 2010	n/a	£32.3bn
Estimated shortfall in income tax and NICs receipts from reduction in aggregate earnings	n/a	£28.9bn
Estimated additional shortfall in income tax and NICs receipts from changing composition of aggregate earnings	n/a	£3.5bn

Source: Authors' calculations based on Office for Budget Responsibility, *June Budget 2010*, <http://budgetresponsibility.org.uk/budget-2010/>; Office for Budget Responsibility, *Economic and Fiscal Outlook: December 2013*, <http://cdn.budgetresponsibility.independent.gov.uk/Economic-and-fiscal-outlook-December-2013.pdf>; and table 3.2 on page 39 of Office for Budget Responsibility, 'How we present uncertainty', Briefing Paper 4, 2012, <http://budgetresponsibility.org.uk/wordpress/docs/Briefing-paper-No4-How-we-present-uncertainty.pdf>. £ billion figures based on the latest forecast for receipts in 2015–16.

revision actually reflects an upwards revision to forecast employment and a disproportionate downwards revision to forecast average earnings.

To put this £3.5 billion in context it is worth remembering it is about one-third of the £10.7 billion deliberately forgone as a result of the government's decision to increase the income tax personal allowance to £10,000. In fact, this decision will itself likely have reduced further how tax-rich the composition of growth has been, since it increases the progressivity of the income tax system, which makes earnings growth relatively more important than employment growth to overall tax revenues.⁸

Long-run volatility of receipts

In addition to considering the forecast recovery in receipts through to 2018–19 and whether this is likely to occur, it is also important to think about the end composition of revenues and what this means for the long-run position of the public finances. The tax increases introduced as part of the government's fiscal consolidation plan have typically been announced with some discussion of the characteristics of the losers from the reforms, and much repeated rhetoric about 'ensuring those with the broadest shoulders bear the largest burden'.⁹ However, there has been little attention paid to the changing composition of total revenues and the effect this might have on the cyclical and volatility of revenues, both of which are important for stability in the public finances.

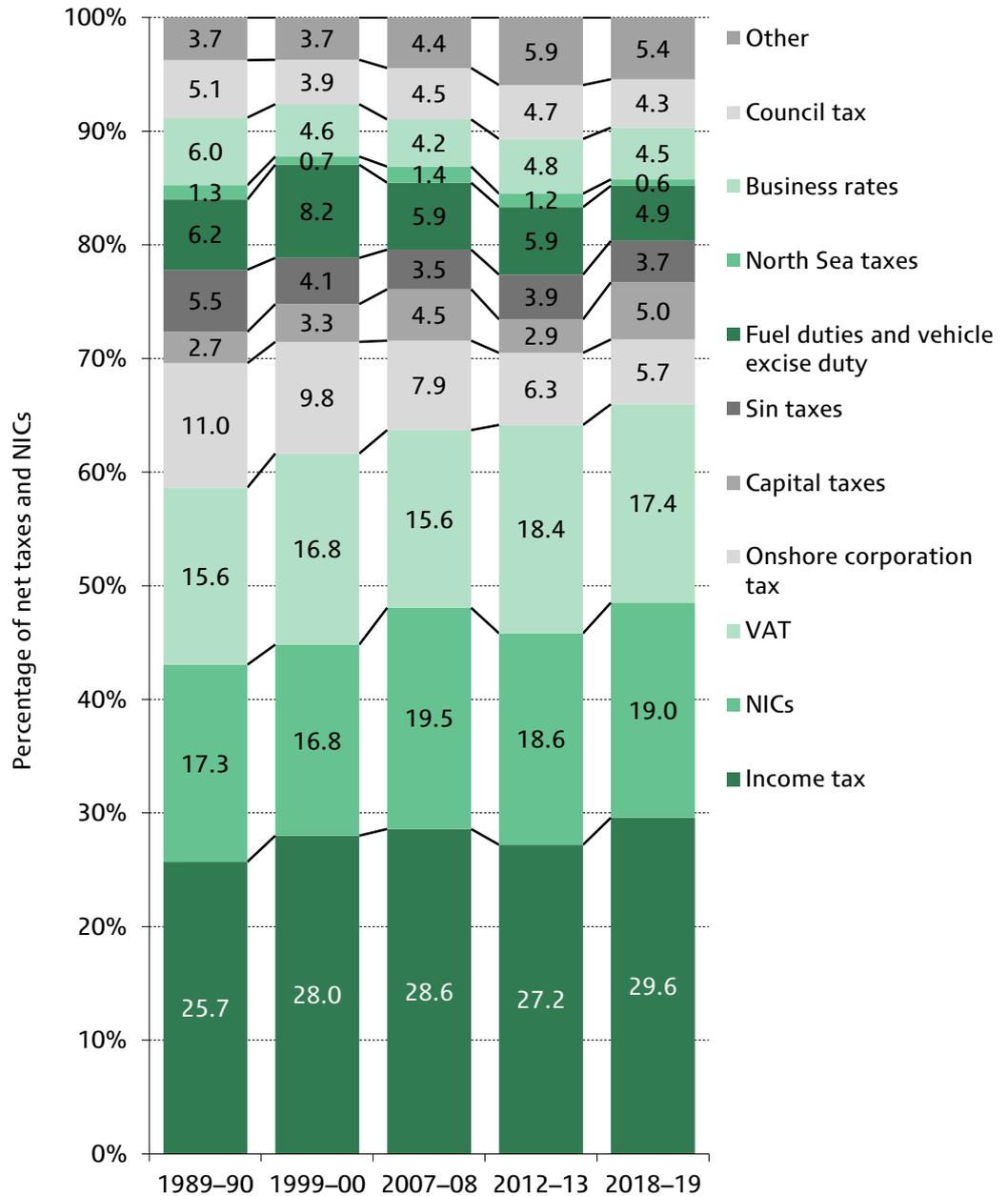
⁸ The methodology employed has not been able to take this into account, which suggests that the £3.5 billion could be an underestimate of the impact of the changing composition of employment income on receipts of income tax and NICs.

⁹ Spending Round 2013 speech delivered to parliament by Chancellor Osborne, 26 June 2013, <https://www.gov.uk/government/speeches/spending-round-2013-speech>.

The changing composition of receipts

The government might be concerned if the exchequer becomes increasingly reliant on one particular revenue source, as it increases the risk that a shock to one revenue source would have serious implications for total revenues (and therefore probably also for borrowing). This risk is smaller when revenues are raised from a variety of different sources, rather than all being concentrated on one particular type of activity or one particular group of taxpayers.

Figure 2.5. Changing composition of UK net taxes and NICs receipts



Note: ‘Capital taxes’ includes capital gains tax, stamp duties and inheritance tax. ‘Sin taxes’ includes tobacco duty, alcohol duties, and betting and gaming duties. This figure shows the breakdown of ‘net taxes and NICs receipts’, which is different from ‘total revenues’ as it excludes revenues from interest and dividends as well as ‘gross operating surplus, rent, and other receipts and adjustments’.

Source: HM Treasury, HMRC, OBR forecasts (see ‘Composition of revenues’ in <http://www.ifs.org.uk/fiscalFacts/taxTables>).

Figure 2.5 shows how the composition of net taxes and NICs receipts has changed over time.¹⁰ Assuming the OBR forecasts prove correct, in 2018–19 the public finances will be more reliant than before on the main taxes on household incomes and expenditure (income tax, NICs and VAT), with 66% of receipts forecast to come from these taxes compared with 59% in 1989–90, 62% in 1999–2000 and 64% in 2007–08. The share of receipts from capital taxes (capital gains tax, stamp duties and inheritance tax) is also forecast to increase, to 5.0% in 2018–19, from 4.5% in 2007–08 and 2.7% in 1989–90. This would be the largest share of total receipts from capital taxes since at least 1978–79 (the earliest date for which comparable data are available). By contrast, the public finances are forecast to become less reliant on streams such as corporation tax, taxes on motoring and other excise duties.

Although over time there has clearly been a substantial change in the composition of revenue, these changes have been gradual, and the expected direction over the next few years represents a continuation of recent trends. Another concern is that *within* some revenue streams, there has been an increase in the proportion of receipts coming from particular groups. This is most noticeable in the case of income tax, which is the largest single contributor to total tax revenues, and stamp duty land tax (SDLT).

- HMRC data released in September 2013 estimated that the share of income tax contributions made by the top 1% of contributors (ranked by contribution size) would rise to 27.5% by 2011–12, compared with 21.3% in 1999–2000 and 11% in 1979.¹¹ To put it another way, the income tax paid by 300,000 or so very high-income individuals accounts for 7.5% of *all* tax revenue. These individuals will of course also pay large amounts of VAT and, in all likelihood, pay a large fraction of total capital taxes.
- In 2012–13, 30% of revenues from SDLT on residential properties was paid in respect of transactions valued at over £1 million.¹² These accounted for just 1% of all residential property transactions. In 2012–13, transactions in just two local authorities – Westminster and Kensington & Chelsea – accounted for more than 14% of all revenues from residential transactions, while just 10 local authorities (nine of them in London and one in Surrey) accounted for 29% of revenues (revenues from non-residential transactions were even more geographically concentrated). In 2012–13, London accounted for 41% of all SDLT on residential properties, compared with 27% in 1997–98.¹³

This increased concentration of revenues from fewer individuals is significant and increases the sensitivity of the government's overall revenue position to the incomes and tax payment behaviour of these individuals.

¹⁰ 'Net taxes and NICs' is a slightly different definition of receipts than headline 'current receipts', as the former excludes revenues from interest and dividends as well as 'gross operating surplus, rent, other receipts and adjustments'. These other items accounted for around 7% of headline receipts in 2012–13.

¹¹ The top 1% of contributors are estimated to have paid 26.9% of total income tax revenues in 2012–13 and are expected to pay 29.8% in 2013–14. These figures should be used with caution, though, as they will be affected by higher-income individuals shifting income between 2012–13 and 2013–14 in order to take advantage of the reduction in the additional rate of income tax from 50% to 45% in 2013–14. Source: <http://www.hmrc.gov.uk/statistics/tax-statistics/table2-4.pdf> and table 2.3 of *Inland Revenue Statistics 1994*.

¹² Residential property transactions accounted for 71% of revenues from SDLT in 2012–13, and 95% of all transactions in 2012.

¹³ HMRC data, available at <http://www.hmrc.gov.uk/statistics/transactions/annual-transactions.pdf> and <http://www.hmrc.gov.uk/statistics/stamp-duty/stamp-tax-sep13.pdf>.

Cyclicalities of revenues

Different sources of revenue are more or less cyclical (that is, they are affected differently by movements in the economic cycle) and therefore a changing composition of total revenues will affect how cyclical total government revenues are. Greater cyclicalities of revenues has the cost that it is harder for the government to forecast the future public finance position, and borrowing will be influenced to a greater extent by the position of the economy. On the other hand, fluctuations in national income will be automatically dampened to a greater degree by changes in government borrowing (an increase in the 'automatic stabilising' effect of the tax system).

In a 2012 working paper, the OBR estimated how responsive a number of different taxes are to the economic cycle.¹⁴ It found that onshore corporation tax from non-financial corporations and capital taxes were the most responsive: a 1 percentage point increase in the output gap is estimated to reduce onshore non-financial corporation tax revenues by 0.10% of national income¹⁵ and reduce capital tax revenues by 0.08% of national income. By contrast, income tax, NICs and VAT were found to be much less responsive: a change in the output gap is estimated to have roughly the same effect on these revenues as on the level of national income, and so the share of national income raised from these taxes would be largely unaffected.

Given the changing composition of revenues illustrated in Figure 2.5, we might expect the cyclicalities of overall revenues to be increased by the increased proportion of revenues from capital taxes, but reduced by the reduced proportion from onshore corporation tax. If we take the OBR's estimate of the sensitivity of each revenue stream to the economic cycle, and weight these according to the composition of total revenues in 2018–19 (adjusting for the position in the economic cycle), we estimate that a 1 percentage point increase in the output gap would reduce net taxes and NICs by 0.20% of national income. This compares to an estimated reduction in net taxes and NICs of 0.18% of national income if we instead weight by either the 2007–08 or the 1999–2000 composition of revenues.¹⁶ In other words, a 1% (cyclical) fall in GDP would result in a temporary fall of £25.5 billion (in today's terms) under the 2018–19 tax system, a £24.9 billion fall under the 2007–08 tax system or a £24.8 billion fall under the 1999–2000 tax system. This suggests that the long-run position for revenues that we are forecast to reach in 2018–19 is not one with a substantially different sensitivity to the economic cycle.

Other volatility

Revenues can, of course, be volatile in a way that is unrelated to the real economic cycle. For example, recent analysis by the OBR of its own forecast errors has shown that the evolution of economic determinants in nominal rather than real terms is actually more important for forecasting revenues: so, for example, lower real growth that is also associated with higher-than-expected inflation may leave total receipts (both in nominal terms and as a share of national income) broadly unchanged.¹⁷ In addition, revenues from

¹⁴ T. Helgadottir, G. Chamberlin, P. Dhami, S. Farrington and J. Robins, 'Cyclically adjusting the public finances', Office for Budget Responsibility (OBR), Working Paper 3, 2012, <http://budgetresponsibility.org.uk/pubs/Working-paper-No3.pdf>.

¹⁵ Financial sector corporation tax receipts fall by less than 0.01% of national income.

¹⁶ The share of corporation tax coming from financial corporations is only available from 2000–01, so we have assumed that this share was the same in 1999–2000 as it was in 2000–01. Since this is unlikely to be true over a longer time period, we have not produced numbers for the overall cyclicalities of revenues in 1989–90.

¹⁷ See chapter 3 of Office for Budget Responsibility, *Forecast Evaluation Report, October 2012* (<http://budgetresponsibility.org.uk/wordpress/docs/23690-OBR-Web-Only.pdf>).

capital taxes are sensitive to house prices and the number of housing transactions and to the prices of stocks and shares, while North Sea revenues are sensitive to oil and gas prices and production – all of which can move in ways unrelated to the position of the wider economy. The increased proportion of revenues accounted for by capital taxes projected for 2018–19 is likely to result in an increase in the overall volatility of tax revenues, though the effect is likely to be small. Any increase would, however, feed through into increased uncertainty in future public finance forecasts.

Summary

Revenues as a share of national income are forecast to increase between 2013–14 and 2018–19 (from 37.4% to 38.3%), and the majority of this increase is projected to be a cyclical recovery as the economic position improves. This recovery is similar to the recovery in receipts experienced in the wake of the recession in the early 1990s.

If the recovery takes longer than currently forecast, revenues would increase less quickly, and the government may not achieve a budget surplus by 2018–19, but the long run public finance position would not be particularly affected. On the other hand if, as described in Section 2.2, the recovery does not materialise and the OBR revises its estimate of the output gap, the size of the problem that needs to be dealt with will increase and the government may be required to take further permanent policy action. But some independent forecasters – including Oxford Economics (see Chapter 4) – are more optimistic than the OBR about the amount of spare capacity in the economy that currently exists. If correct this would translate into a smaller fiscal repair job being necessary than is currently planned by Mr Osborne.

There are few tax increases planned for the future. However, questions remain over whether the government will implement the future increases in the rates of fuel duties (in line with inflation) which the OBR forecasts assume will occur. If the government were unable or unwilling to introduce these then they would need to find £4.2 billion from other tax increases in order to leave their borrowing plans for 2018–19 unaltered. In addition it is clear from the political debate that there are increasing pressures for tax cuts – see the discussion in Chapter 7 of possible further increases to the income tax personal allowance or the introduction of a 10p starting rate of income tax.

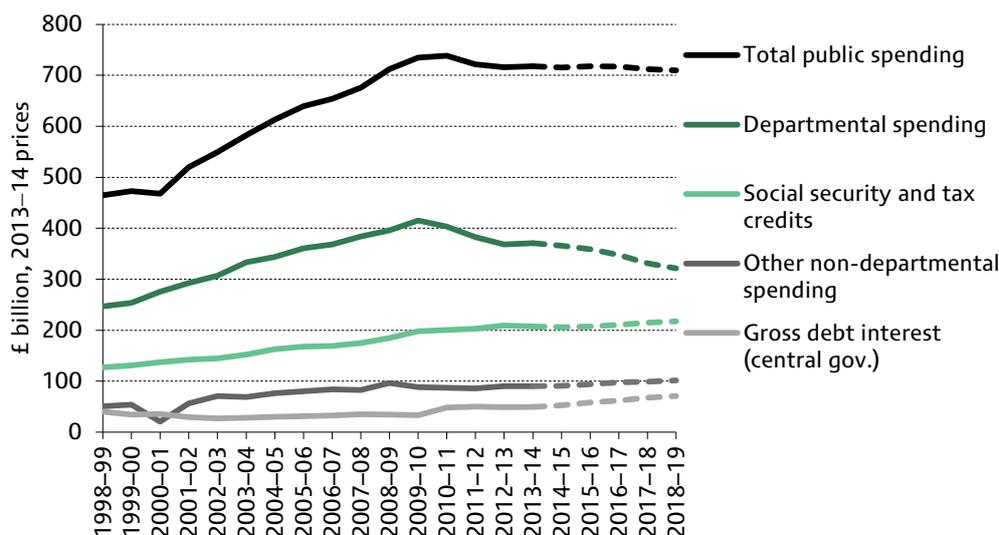
Finally, the Treasury should bear in mind that the 2018–19 composition of revenue does involve an increased concentration of tax revenues among the household sector, and on higher income individuals in particular. This might have important implications for the sensitivity of total revenues to the circumstances of a relatively small group of agents.

2.4 Uncertainty around future public spending

The government's current fiscal consolidation implies cutting total public spending from 46.3% of national income in 2010–11 to 38.2% by 2018–19. Given that the economy is forecast to grow over this period, this would be achieved if total spending were cut in real terms by 3.8% over the eight-year period. This overall picture, however, masks some very different trends for different areas of public spending. This is illustrated in Figure 2.6 and Table 2.3.

Real central government debt interest spending is forecast to increase by 46.9% over this eight-year period, while non-debt interest spending is being cut by 7.4%. Social security and tax credit spending is forecast to increase by 8.5% (assuming there are no further

Figure 2.6. Total public spending



Source: Forecasts are from OBR *Economic and Fiscal Outlook December 2013* and DWP *Benefit Expenditure Tables*. Out-turn data are from ONS (total public spending (series KX5Q) and central government gross debt interest (series NMFx)), DWP *Benefit Expenditure Tables* (social security and tax credits), and HM Treasury, *Public Expenditure Statistical Analyses*, various years (departmental spending).

Table 2.3. Changes in components of spending, 2010–11 to 2018–19

	Total real change:		
	2010–11 to 2015–16	2015–16 to 2018–19	2010–11 to 2018–19
Total spending	-2.7% (-£20.2bn)	-1.1% (-£8.0bn)	-3.8% (-£28.3bn)
<i>Less:</i>			
Debt interest	+20.7% (+£9.9bn)	+21.7% (+£12.6bn)	+46.9% (+£22.5bn)
Total less debt interest	-4.4% (-£30.1bn)	-3.1% (-£20.6bn)	-7.4% (-£50.8bn)
<i>Less:</i>			
Social security	+3.7% (+£7.4bn)	+4.6% (+£9.6bn)	+8.5% (+£17.0bn)
<i>Of which:</i>			
<i>Pensioner benefits (GB)</i>	+8.7% (+£9.0bn)	+2.3% (+£2.6bn)	+11.2% (+£11.7bn)
<i>Other</i>	-1.7% (-£1.7bn)	+7.4% (+7.0bn)	+5.6% (+£5.4bn)
Public service spending	-7.7% (-£37.5bn)	-6.7% (-£30.2bn)	-13.8% (-£67.8bn)
<i>Of which:</i>			
Departmental (DEL)	-11.1% (-£44.7bn)	-10.5% (-£37.6bn)	-20.4% (-£82.3bn)
Other non-departmental	+8.2% (+£7.1bn)	+7.9% (+£7.4bn)	+16.8% (+£14.6bn)
<i>Of which:</i>			
<i>Public service pensions</i>	+114.9% (+£5.6bn)	+21.1% (+£2.2bn)	+160.3% (+£7.8bn)
<i>Locally-financed spend by local authorities</i>	+2.4% (+£0.7bn)	+7.7% (+£2.3bn)	+10.3% (+£3.0bn)
<i>Other</i>	+1.6% (+£0.8bn)	+5.4% (+£2.9bn)	+7.0% (+£3.7bn)

Note: 'Debt interest' is central government gross debt interest. 'Social security' includes tax credits. 'Public service pensions' is central government net public service pension payments.

Source: As for Figure 2.6.

cuts to social security after 2015–16, although the Chancellor has expressed a desire for more). The forecast real increase between 2010–11 and 2015–16 is being driven by increases in spending on pensioner benefits: both the number of pensioners and the average spend per pensioner are forecast to increase. Total spending on working-age benefit recipients, on the other hand, is forecast to fall by 1.7%. By contrast, over the following three years, the forecast increase in social security spending is being driven by both an increase in spending on pensioner benefits and an increase in spending on non-pensioner benefits.¹⁸

Total public spending less that on debt interest payments and social security – broadly public service spending – is forecast to fall by 13.8% between 2010–11 and 2018–19. Within that, departmental spending (technically the ‘departmental expenditure limit’ (DEL) – the spending by Whitehall departments on the administration and delivery of public services) is projected to fall by 20.4%. This is because other areas of non-debt interest, non-social security spending (such as locally financed spending by local authorities and net public service pension payments) are projected to increase by 16.8%.

Further cuts to other spending (or tax increases) could reduce cuts to departmental spending

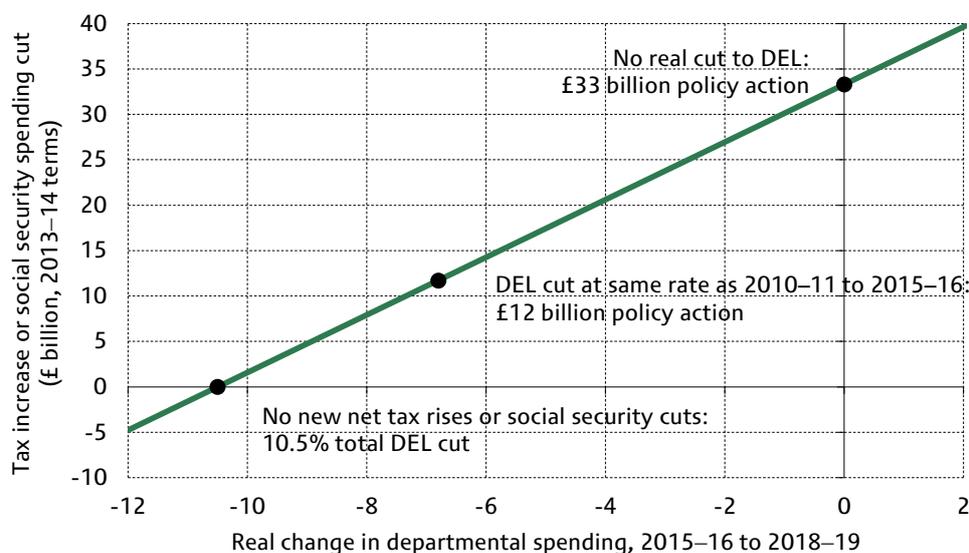
For the three financial years starting after the planned date of the next general election (2016–17, 2017–18 and 2018–19), departmental spending has not been explicitly planned by the government – it is the residual between announced levels of total spending and the OBR’s projections for social security and other non-departmental spending. If the government were to change its plans by either increasing total spending or reducing non-departmental spending, then the implicit cut to departmental spending would be lower than that illustrated in Figure 2.6.

Assuming that the government is unwilling to increase its plans for borrowing, Figure 2.7 shows the trade-off the government faces over those three years between cuts to departmental spending and consolidation elsewhere (such as cuts to social security spending or tax increases).¹⁹ As was illustrated in Figure 2.6, current plans imply that departmental spending will be cut by 10.5% (an average of 3.6% per year) over the three years 2016–17, 2017–18 and 2018–19. If instead the government wanted to slow the pace of cuts, and only cut departmental spending at the same rate as over the period 2010–11 to 2015–16 (an average of 2.3% per year), this would require an additional £12 billion (in today’s terms) of benefit cuts or tax increases (or some combination of these). Chancellor George Osborne has expressed a desire to introduce £12 billion of additional welfare cuts after the next election in order to achieve this slower rate of cuts

¹⁸ The 7.4% increase in spending on non-pensioner benefits between 2015–16 and 2018–19 shown in Table 2.3 overstates the increase in benefit going to these individuals. The introduction of universal credit involves a reclassification of the ‘negative tax’ component of tax credits as ‘spending’. This has the effect of increasing spending in the government accounts, and therefore puts additional pressure on public service spending given a fixed total spending envelope. However, it does not represent an increase in the overall benefit going to tax credit recipients, as it is offset by an increase in recorded tax revenues. Excluding this effect, the increase in spending on non-pensioner benefits is around 5%. This is mainly the result of forecast increases in spending on housing benefit, employment and support allowance, and personal tax credits.

¹⁹ There is little other non-departmental spending that the government has direct control over and could reallocate to departmental spending. For example, debt interest payments are determined by the public sector debt stock and market interest rates, while locally-financed spending by local authorities, spending on the BBC and spending financed by environmental levies all have offsetting revenue streams. Perhaps the only significant area of non-departmental spending that could be cut is net public service pensions. This is the amount currently being paid out in pensions to individuals for previous work in the public sector less pension contributions paid by current members of these schemes. The most obvious way this could be cut would be through a further increase in the required contribution rates.

Figure 2.7. Trade-off between tax increases or further benefit cuts and smaller cuts to departmental spending (assuming no change in borrowing)



to departmental spending. If the government wanted to go so far as to freeze departmental spending in real terms between 2015–16 and 2018–19, this would require an additional £33 billion in today's terms (rather than £12 billion) to be raised from lower benefit spending and/or higher taxation.

To put these figures in context, raising £12 billion in extra tax revenues would require policy action of the order of around a 2½ percentage point increase on the main rate of VAT or a 3 percentage point increase on the basic rate of income tax. Raising £33 billion would require even greater action (for example, 7 percentage points on the main rate of VAT or 8½ percentage points on the basic rate of income tax).²⁰

Alternatively, if the £12 billion were to come from further cuts to social security spending, this would require an average cut of around 6% across all state pensions, benefits and tax credits. If the state pension were to be protected, an average cut of around 11% would be required, increasing to around 13% if all pensioner benefits were protected.

Departmental spending in the absence of further cuts to non-departmental spending

Current plans (i.e. in the absence of any new policies that increase borrowing, increase taxes or cut non-departmental spending) imply departmental spending will be cut by an average of 3.6% a year in real terms between 2015–16 and 2018–19 – on top of the 2.3% a year real-terms cuts between 2010–11 and 2015–16. By 2018–19, this would leave total departmental spending 20.4% below its 2010–11 level.

The cuts to departmental spending have been allocated between departments up to 2015–16, with the 2010 Spending Review setting departments' budgets for the four years 2011–12 to 2014–15, and the 2013 Spending Round setting departments' budgets for

²⁰ See HMRC, 'Direct effects of illustrative tax changes', December 2013, <http://www.hmrc.gov.uk/statistics/expenditures/table1-6.pdf>.

2015–16. Actual cuts to departments’ budgets have been larger than those announced at these two spending reviews, as departments have both underspent and (in some cases) had their allocations reduced by the government just a few months after the spending reviews had ‘set’ plans.

The cuts have been allocated very unequally to date. Some areas of spending – the NHS, schools and Official Development Assistance (ODA) – have been ‘protected’ from cuts,²¹ and the departments responsible for them have seen parts of their budgets ‘protected’ accordingly, while other departments have been tasked with delivering significant budget reductions. The largest planned cut to spending is within the Department for Communities and Local Government (DCLG), which has seen its Communities budget (a large proportion of which is government spending on subsidising social housing) cut by 79.0% in real terms between 2010–11 and 2015–16 (compared with a real cut to overall DEL of 11.1%).²²

The implications of the government’s decision to protect spending on the NHS, schools and aid are summarised in Table 2.4. Together, spending on the NHS, schools and aid accounted for around 40% of total departmental spending in 2010–11, and therefore protecting spending on these areas meant the cuts elsewhere needed to be nearly twice as large as they would have been had the pain been shared equally: while total DEL is planned to be cut by 2.3% a year between 2010–11 and 2015–16, ‘unprotected’ DEL is planned to be cut by 4.6%. By 2015–16, while total departmental spending will be 11.1% lower than in 2010–11, departmental spending on areas other than the NHS, schools and aid will have been cut by 21.0%.

Table 2.4. Implications of continuing ‘protection’ through to 2018–19

	Average annual real change (%):			Cumulative real change (%):		
	2010–11 to 2015–16	2015–16 to 2018–19	2010–11 to 2018–19	2010–11 to 2015–16	2015–16 to 2018–19	2010–11 to 2018–19
Total departmental spending (DEL)	-2.3	-3.6	-2.8	-11.1	-10.5	-20.4
<i>Of which:</i>						
Health	0.7	0.0	0.5	3.8	0.0	3.8
Schools	0.3	0.0	0.2	1.3	0.0	1.3
Aid (ODA)	6.0	2.7	4.7	33.5	8.3	44.6
Other (‘unprotected’)	-4.6	-7.0	-5.5	-21.0	-19.7	-36.6
<i>If an additional £12 billion welfare cuts used to fund additional DEL in 2018–19</i>						
Total DEL	-2.3	-2.3	-2.3	-11.1	-6.8	-17.1
<i>Of which:</i>						
Other (‘unprotected’)	-4.6	-4.5	-4.6	-21.0	-12.9	-31.2

Note: Table illustrates the effect of continuing ‘protection’ for spending on health, schools and overseas aid in 2016–17, 2017–18 and 2018–19, where this ‘protection’ is taken to mean a real freeze in spending for health and schools and an increase in aid spending in line with the growth in GDP.

²¹ The government has pledged to increase real spending on the NHS, and maintain real spending on schools, each year through to 2015–16, and to spend 0.7% of gross national income on ODA from 2013 onwards.

²² The Department for Communities and Local Government is unique in that it has two separate DELs. The ‘DCLG: Local Government’ DEL includes revenue support grant, national non-domestic rates, and related grants to local authorities in England that support services that are typically the overall responsibility of other government departments (such as police and social services). The ‘DCLG: Communities’ DEL includes the department’s main programme expenditure and administration costs. Cuts in the DCLG budget have been adjusted for the effects of financial transactions associated with Right to Buy.

If the 'protection' for NHS, schools and ODA spending is maintained through to 2018–19, the outlook for 'unprotected' areas will again be worse than that for total departmental spending. Table 2.4 illustrates that while total DEL is currently implied to fall by 10.5% between 2015–16 and 2018–19, unprotected areas of DEL would face cuts of 19.7% – bringing the total real cut to these areas of spending between 2010–11 and 2018–19 to 36.6%.

Table 2.4 also illustrates how the cuts to DEL, and the unprotected areas of DEL, might look if the government were to announce £12 billion of additional welfare cuts by 2018–19 and allocate that money to DEL instead. This would leave total DEL facing cuts of an average 2.3% a year in real terms over the whole period – resulting in a total cut of 17.1% by 2018–19. The unprotected areas of DEL (assuming the current protections for the NHS, schools and ODA are maintained) would then be facing a cut of 12.9% between 2015–16 and 2018–19 (a 31.2% cut between 2010–11 and 2018–19).

Are the cuts to departmental spending deliverable?

Perhaps the most significant risk to the government's current fiscal consolidation plan will lie in the difficulty of delivering cuts on this scale. There is one cause for optimism here: departments have actually underspent relative to their budgets so far. However, there are also two important reasons why the figures in Table 2.4 actually understate the pain from the planned spending cuts. These issues are discussed in turn below.

Underspends by departments to date

Despite the large budget reductions faced by departments since 2010–11, so far most have not spent their entire allocated budget each year. In 2011–12 departmental spending was £8.8 billion less than was planned a year ahead, while in 2012–13 total DEL was underspent to the tune of nearly £11.7 billion – over 3% of total departmental spending. The underspends expected from individual departments in 2012–13 were set out by the Treasury in the 2013 Budget. The departments with the largest expected underspends were unsurprisingly the largest departments (Health, Education and Defence), but smaller departments such as Transport and DCLG Communities were expected to underspend larger proportions of their budgets. This is perhaps particularly surprising for DCLG Communities, which is expected to deliver a larger cut to its budget between 2010–11 and 2015–16 than any other department.

One possible explanation for these underspends is that departments have looked ahead to the cuts they need to deliver by 2015–16 and decided that over-delivering on the cuts up to 2012–13 would leave them better placed to keep within their tight budgets going forwards. Alternatively, it could be that the penalties faced by departments for overspending mean that departments treat budgets as spending caps rather than spending targets.

The OBR incorporates an assumed underspend against the budgets the Treasury has set out for departments in each year going forwards: £7 billion in 2013–14 and £3 billion in each of 2014–15 and 2015–16. This assumption actually itself creates a risk to spending, since it means that if departments were to spend all of their allocated budgets in future years, that would result in total DEL being higher than forecast by the OBR.

However, the Treasury has so far proved adept at 'managing' departments so that they do not spend more than (or even all) their budgets. For example, in the 2013 Budget, the Treasury revealed exceptional underspending by departments, and some spending pushed forward into 2013–14 and 2014–15 (labelled as 'exceptional inter-period

flexibility') – which conveniently reduced spending in 2012–13 just enough to ensure that borrowing was forecast to fall between 2011–12 and 2012–13. In the 2013 Autumn Statement, the Treasury reduced the size of the reserve in 2013–14 'as a downpayment on expected reductions to departmental budgets' and it reduced departmental budgets in 2014–15 and 2015–16 'to lock in lower levels of spending'.²³

So far, the government has promised very tight spending control and then has more than delivered on that promise. That might be a positive indication for the deliverability of further cuts, though inevitably it must become harder to make the cuts as budgets shrink.

Additional spending commitments

Even the scale of cuts set out in Table 2.4 disguises some additional pressures on DEL that will be experienced from 2016–17 onwards.

One such pressure is the cost of additional policies that the government has announced over the last couple of years without making any additional money available to departments to fund them. Some of these are existing policies that only start to cost money (or cost more money) from 2016–17 onwards – for example, the ending of contracting out into defined benefit pension schemes, which will increase employer NICs in the public sector (by £3.3 billion per year), the Dilnot reforms to social care funding (costing around £1.0 billion per year) and the new tax-free childcare scheme (costing an additional £0.4 billion per year from 2016–17 – see Chapter 8). Others are policies announced in the 2013 Autumn Statement for which additional money was made available up to 2015–16 (since departments' budgets have been set up to that point) but not in subsequent years – for example, the extension of free school meals (costing around £0.8 billion per year) and abolishing the cap on higher education student numbers (costing around £0.7 billion per year by 2018–19). All these additional cost pressures will need to be borne from within DEL budgets, and therefore they make the pressure on other spending areas greater than the headline DEL cuts would suggest. Together, the policies listed above amount to over £6 billion – around 2% of the total DEL budget – and this money will have to be made available through an equivalent reduction in other areas of departmental spending.

Demographic pressures

A second important reason why the figures in Table 2.4 understate the pressure on departments is that they express the spending cuts relative to the real-terms (i.e. inflation-adjusted) level of spending in 2010–11. However, we would actually normally expect real spending on public services to *increase* over time, for two reasons. First, the UK population is growing over time, which will increase demand for many public services and therefore require an increase in spending on these services. Second, growth in national income per capita over time means the population is getting richer, and this is normally associated with demand for higher-quality public services and therefore again higher spending. If public service spending were to keep pace with both population growth and the growth in national income per capita, it would increase in line with national income growth, and public service spending as a share of national income would remain constant over time.

²³ Paragraphs 1.73 and 1.74 of HM Treasury, Autumn Statement 2013, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263942/35062_Autumn_Statement_2013.pdf.

Table 2.5 describes how the growth in public service spending has compared with population growth and the growth in national income per capita in the past, and Figure 2.8 shows public service spending as a share of national income. Between 1978–79 and 1997–98, there was real growth in public service spending of an average 1.2% per year, which easily outstripped population growth but was less than the growth in national income, since national income per capita grew strongly on average across the period. Public service spending as a share of national income therefore fell over this period, from 31.0% in 1978–79 to 23.4% in 1997–98. However, over the period 1997–98 to 2007–08, growth in public service spending exceeded combined population growth and national income per capita growth; as a result, public service spending increased as a share of national income from 23.4% to 27.8%.

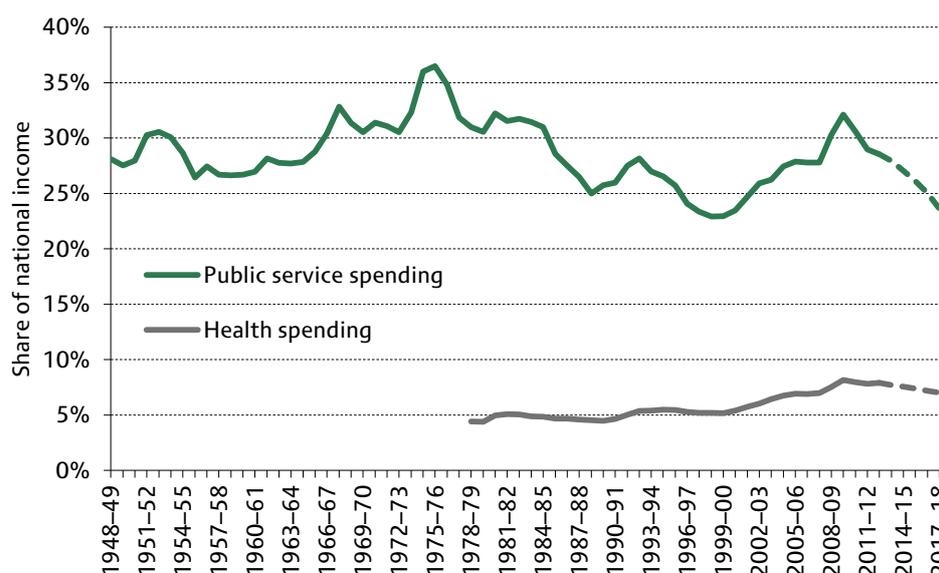
Table 2.5. Comparing the growth of public service spending with population and per capita national income growth

Average annual real growth in:	1978–79 to 1997–98	1997–98 to 2007–08	2007–08 to 2010–11	2010–11 to 2018–19
Population	0.2	0.5	0.8	0.7
GDP per capita	2.5	2.7	-2.2	1.2
GDP	2.7	3.2	-1.5	1.9
Public service spending	1.2	4.9	1.7	-1.7

Note: Public service spending is defined as total spending less gross debt interest payments, social security spending and tax credit spending.

Source: Population figures from Office for National Statistics, <http://www.ons.gov.uk/ons/taxonomy/index.html?nscl=Population+Estimates+by+Age+and+Sex> and <http://www.ons.gov.uk/ons/rel/npp/national-population-projections/2012-based-projections/rft-table-a3-1-principal-projection---uk-population-single-year-of-age.xls>. GDP from ONS series BKT.L. Public service spending derived as the residual between ONS series KX5Q (TME), gross debt interest spending (JW2P) and social security spending (authors' calculations, based on DWP expenditure data, <https://www.gov.uk/government/publications/benefit-expenditure-and-caseload-tables-2013>). Forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook December 2013*, <http://cdn.budgetresponsibility.independent.gov.uk/Economic-and-fiscal-outlook-December-2013.pdf>.

Figure 2.8. Public service spending and health spending



Note: Dashed lines are forecasts. Health spending projection assumes health spending frozen in real terms from 2012–13 onwards.

Source: As for Tables 2.5 and 2.6.

In marked contrast to these previous two decades, public service spending is on average being cut by 1.7% a year over the period from 2010–11 to 2018–19 – despite this being a period in which the population is forecast to grow by 0.7% a year on average. Public service spending *per person* is therefore projected to fall by 2.4% per year on average. National income per capita is also projected to grow over this period, by 1.2% a year on average. Public service spending as a share of national income is therefore projected to fall – from 30.6% in 2010–11 to just 22.6% in 2018–19. This would be a very similar level of public service spending to the level in the late 1990s (22.9% of national income in 1998–99 and 1999–2000).

The UK population is not only increasing in size, but also changing in terms of its demographic composition. Increasing life expectancies and past changes in birth rates mean that the proportion of individuals at older ages is increasing. For example, the ONS projects that between 2010 and 2018 the UK population will grow by 3.5 million, with the population aged 65 and over increasing by 2.0 million; the proportion of the population aged 65 and over will increase from 16.5% to 18.6%. This ageing of the population will put even greater pressure on some areas of public service spending because many public services are disproportionately used by older people.

Health spending is one area of particular concern. Estimates from the Department of Health imply that in 2011 that approximately seven times as much was spent on an average 80-year-old as on an average 30-year-old.²⁴ If health spending were to be increased in line with population growth and changing demographics (but the level of spending for each person of a given age were held constant in real terms), then this would imply an average real increase in health spending of 1.2% a year between 2010–11 and 2018–19. Therefore, even if total spending on the NHS were frozen in real terms between 2010–11 and 2018–19, real per capita age-adjusted spending on the NHS would be 9.1% less in 2018–19 than in 2010–11 (although it should be noted the true rate of inflation faced by the NHS will differ from economy-wide inflation and, over the recent period, will have been depressed by the current squeeze on public sector pay).

Furthermore, Table 2.6 illustrates that over the past two decades not only has health spending increased by more than the need implied by demographic pressures, but also it has outpaced demographic pressures and growth in national income per capita combined. Spending on health going forwards may be protected (in that it is frozen in real terms between 2010–11 and 2015–16 while other departmental spending is being cut), but this will still be an unprecedented squeeze for the health service.

The real spending cuts highlighted in Table 2.4 therefore understate the difficulty involved in sticking to the government's spending plans. Demographic pressures will increase demand for public services such as health and long-term care in particular, but also for education and for all other areas of public spending where the increasing population feeds through into an increase in demand and consequently an increasing cost of provision. In addition, rising national income per capita may mean that individuals expect public services to be of higher quality, which would take increased spending to deliver.

²⁴ Age profiles for different components of health spending from Department of Health, 'Resource allocation: weighted capitation formula', 2011, <https://www.gov.uk/government/publications/resource-allocation-weighted-capitation-formula>. Relative significance of different components of spending from HM Treasury, *Public Expenditure Statistical Analyses*, 2013, <https://www.gov.uk/government/collections/public-expenditure-statistical-analyses-pesa>.

Table 2.6. Historic growth in health spending compared with demographic pressures and per capita national income growth

Average annual growth in health spending	1978–79 to 1997–98	1997–98 to 2007–08	2007–08 to 2010–11	2010–11 to 2018–19
Actual	3.6	6.3	3.0	0.0
Needed to keep pace with demographic change	0.4	0.7	1.1	1.2
Needed to keep pace with demographic change and GDP per capita growth	3.0	3.4	–1.1	2.4

Note: Realised health spending beyond 2015–16 (the last year for which plans are available) assumes a real freeze in health spending.

Source: Health spending from historic editions of HM Treasury, *Public Expenditure Statistical Analyses* (PESA). Population numbers from Office for National Statistics, December 2012 release. Nominal GDP from ONS series BKTL. Forecasts from Office for Budget Responsibility, *Economic and Fiscal Outlook December 2013*, <http://cdn.budgetresponsibility.independent.gov.uk/Economic-and-fiscal-outlook-December-2013.pdf>.

The government's current spending plans imply that public service spending will fall to a historic low of 22.6% of national income in 2018–19. If future governments judge this too low, and do not want to increase borrowing, they will need either higher taxes or lower social security spending.

Capping welfare spending

Given the government's unwillingness to increase its total spending plans, a further risk to DEL is that the OBR's forecasts for social security and tax credit spending increases. However, in the June 2013 Spending Round, the Chancellor announced his intention to set a cap on a large proportion of social security and tax credit spending, reducing the risk that this will increase and crowd out spending on DEL.

The rationale behind having a cap on welfare spending is a perception that governments find it difficult to curb unexpected, undesirable increases in benefit spending, since this invariably requires unpopular decisions over how to make the benefit system less generous. Three striking examples of instances of sharp increases in spending on social security spending that were possibly unintended are:²⁵

- Over the four-year period starting in April 1990, real spending on invalidity benefit grew by an annual average of 12% per year. This cumulated to total growth of 56%, arising from a 53% increase in the number of claimants and a 2% rise in spending per claimant.
- Over the same four-year period, real spending on housing benefit grew by an annual average of 17% per year. This cumulated to total growth of 84%, arising from an 18% increase in the number of claimants and a 56% increase in spending per claimant as private rents grew faster than private incomes.
- Over the 13-year period from April 1997, real spending on disability living allowance and attendance allowance grew in real terms by an annual average of 5% per year. This cumulated to total growth of 91%, arising from a 62% increase in the number of claimants and an 18% increase in spending per claimant.

²⁵ Source: Authors' calculations using data from Department for Work and Pensions, *Historic and Forecast Benefit Expenditure and Caseload Data 2013*, <https://www.gov.uk/government/publications/benefit-expenditure-and-caseload-tables-2013>. 'Real terms' is defined relative to the GDP deflator.

A cap on welfare spending could instead force the government to make active policy decisions about a desirable level of social security spending, rather than allowing social security spending to simply drift upwards.

The rest of this section discusses the definition of spending that the Chancellor has said will be covered by the cap and how the cap will operate in practice – details of which were announced in the 2013 Autumn Statement.²⁶

What is to be covered by the cap?

The measure of spending that the Chancellor is choosing to cap is total spending on social security benefits and tax credits, excluding:

- spending by local authorities on support for council tax and discretionary housing payments, since these are outside of central government control;
- spending on jobseeker's allowance (JSA) and housing benefit for those receiving JSA, since these items of spending are the most cyclical and therefore spending on them is particularly likely to deviate temporarily from previous forecasts;²⁷
- spending on the state pension, since the government argues that increases in the state pension age are a more sensible way of limiting future spending on this item.

Excluding spending that is (largely) outside of central government control is sensible. Otherwise, a breach of the cap could be triggered purely as a result of the policy decisions of local authorities. Excluding spending that might deviate only temporarily from previous plans also seems appropriate – arguably, particularly so if higher spending only occurred during periods when the economy was operating below its sustainable level. So, for example, unanticipated temporary weakness in the economy would typically push up spending on JSA and housing benefit, but this additional spending should fade away once the economy recovers, and it might well be inappropriate to offset the temporary boost to spending with a reduction in the generosity of benefits. Excluding spending on JSA and on housing benefit for those receiving JSA (and, once JSA is rolled into universal credit (UC), excluding UC spending on those with no net earnings who are subject to full conditionality) therefore seems sensible, but it should be noted that there are also other parts of the social security budget that might rise and fall temporarily over the economic cycle for good reasons, such as spending on tax credits, and these are still included with the definition of 'welfare in scope'.

By far the largest area of spending excluded from 'welfare in scope' is spending on the state pension. To the extent to which forecast spending on state pensions rises due to upward revisions to expected longevity that are likely to persist, then responding with further increases in the future state pension age to control state spending seems a coherent response – but, since this policy lever takes a long time to operate, state pension spending is likely to remain higher than previously forecast in the medium term. But if current pensioners were, on average, living longer, there could be a case for reducing the weekly level of their state pension too. This could help reduce medium-term pension

²⁶ See paragraphs 1.45 to 1.50 of HM Treasury, *Spending Round 2013*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/209036/spending-round-2013-complete.pdf and paragraphs 1.93 to 1.118 of HM Treasury, *Autumn Statement 2013*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263942/35062_Autumn_Statement_2013.pdf.

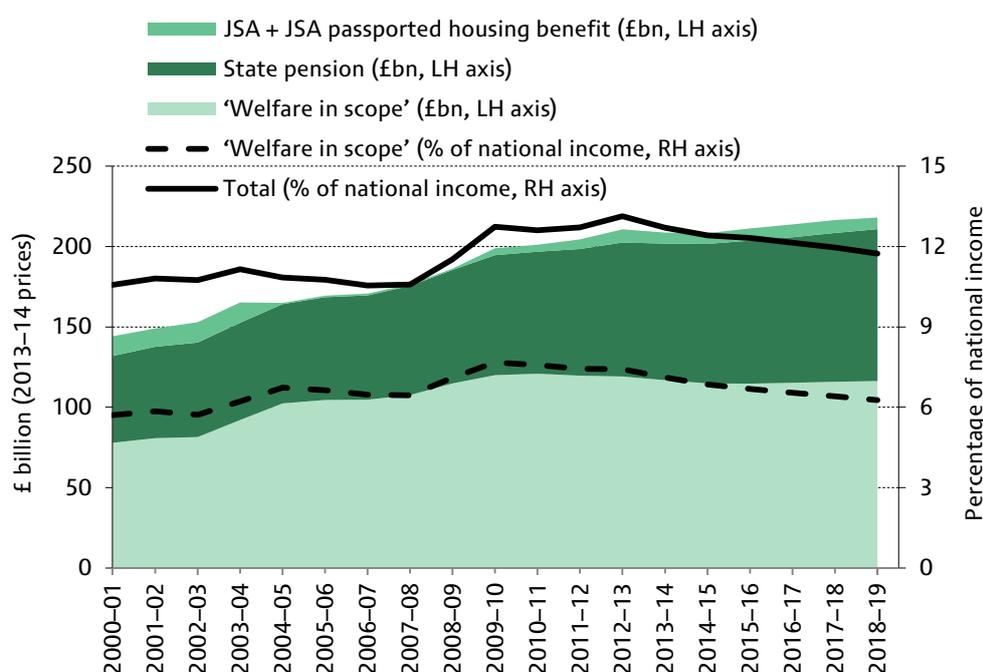
²⁷ Once JSA is rolled into universal credit (UC), the cap will instead exclude UC spending on those with no net earnings who are subject to full conditionality.

spending, but would come at the cost of transferring some longevity risk from the taxpayer to the current pensioner population.

Forecasts for spending on the state pension may exceed previous forecasts for other reasons: for example, due to underestimates of either the state pension entitlements of new pensioners or the cost of the government's preferred indexation method (the 'triple lock', which is to increase the state pension by the greater of growth in the CPI, average earnings and 2.5%, and therefore implies the level of the state pension rising relative to both prices and earnings over the longer term in rather an odd way). In these cases, it is less clear that an increase in the future state pension age would be the most obvious policy response, and a mechanism forcing the government to assess its policy on state pension spending might be beneficial.

Figure 2.9 shows (on the left-hand axis) the amount spent (in real terms) by central government on social security benefits and tax credits since 2000–01, together with the latest official forecasts through to 2018–19. This spending is decomposed into state pensions, 'welfare in scope', and spending on JSA and housing benefit for JSA recipients. In 2013–14, spending on 'welfare in scope' is forecast to be £116.8 billion compared with

Figure 2.9. Social security and tax credit spending in, and out, of scope of the welfare cap



Note: Total social security and tax credit spending excludes spending on council tax support and discretionary housing payments. Spending converted into 2013–14 prices using the GDP deflator.

Source: Total social security spending derived from Office for Budget Responsibility, *Economic and Fiscal Outlook December 2013*, <http://cdn.budgetresponsibility.independent.gov.uk/Economic-and-fiscal-outlook-December-2013.pdf> and Department for Work and Pensions, *Benefit Expenditure and Caseload Tables 2013*, December 2013, <https://www.gov.uk/government/publications/benefit-expenditure-and-caseload-tables-2013>. 'Welfare in scope' from chart 1.12 on page 34 of HM Treasury, *Autumn Statement 2013*, https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/263942/35062_Autumn_Statement_2013.pdf. State pension spending for Great Britain from Department for Work and Pensions, *Benefit Expenditure and Caseload Tables*, December 2013, <https://www.gov.uk/government/publications/benefit-expenditure-and-caseload-tables-2013> and for Northern Ireland from Department for Social Development, *NI Benefits Statistics Summary: state pension*, September 2013 and September 2011, http://www.dsdni.gov.uk/index/stats_and_research/benefit_publications.htm. GDP from Office for Budget Responsibility, *Public Finances Databank*, 9 January 2014, <http://budgetresponsibility.org.uk/data/>.

total central government spending on social security benefits and tax credits of £208.7 billion. Of the £116.8 billion covered by 'welfare in scope', roughly £28 billion will be benefits to pensioners other than the state pension (in particular pension credit, housing benefit, disability living allowance, attendance allowance and winter fuel payments) and roughly £89 billion will be on benefits and tax credits paid to working-age families.

Also shown in the graph (on the right-hand axis) is both total spending and spending on 'welfare in scope' measured as a share of national income. Between 2000–01 and 2013–14, spending on state pensions grew slightly faster in real terms than spending on 'welfare in scope' (3.5% per year compared with 3.2%) and both grew more quickly than the economy as a whole (1.4% per year). Over the next five years, the forecasts suggest that spending on state pensions will grow much more quickly than spending on 'welfare in scope' (increasing by 2.2% per year compared with a fall of 0.1% per year) although slightly less quickly than the economy as a whole (2.5% per year).

How will the cap operate?

The level of the cap for 'welfare in scope' in each of the four financial years 2015–16 to 2018–19 will be announced by the Chancellor in his March 2014 Budget. Each subsequent Autumn Statement will then announce the cap for one further year – so, for example, the 2014 Autumn Statement will set the level of the cap for 2019–20. The Chancellor's choice of cap, and any changes he or she wishes to make to it, must be approved through a vote in Parliament. The cap will be set in cash terms – so, for example, would not automatically increase if inflation turned out to be greater than anticipated – but the Chancellor will presumably set the cap taking into account expectations about future inflation.

Alongside each Budget and Autumn Statement, the OBR will produce a forecast for spending on 'welfare in scope', and alongside each Autumn Statement, it will formally assess the Chancellor's compliance with the cap. If the Chancellor is assessed to be in breach of the cap, he or she would either need to announce policy action at that Autumn Statement to reduce spending in scope or obtain the approval of Parliament to increase the cap.

Assessing whether the cap is breached is not quite as simple as comparing forecast 'welfare in scope' with the level of the cap. Sensibly, if the OBR judges that forecast spending is in excess of the cap solely as a result of a classification change, then this would not constitute a breach of the cap. In addition, if a breach only occurs as a result of a forecasting change (rather than as the result of an explicit policy change), then the breach has to be of a certain size in order to require a policy response. The size of this 'forecast margin' is yet to be announced by the Chancellor.

The argument for allowing a 'forecast margin' is that it is not clear that a policy response is merited if, for example, a cap of £100 billion is exceeded purely because of a forecasting change of £0.1 billion. However, the cost of allowing this flexibility is twofold. First, it makes the operation of the cap more complicated and therefore more difficult to communicate. This in turn potentially risks a lack of clarity, with the possibility of external commentators disagreeing on whether or not the government is keeping within the spirit of its own cap. Second, the distinction between a policy change and a change in the underlying forecast may not in practice be clear-cut. For example, would an effective advertising campaign that led to an increase in the take-up of universal credit constitute a policy change or a change in the underlying forecast? Since there is not necessarily a right

or wrong answer to this question, it is certainly preferable that the independent OBR assesses compliance with the cap, rather than the Chancellor.²⁸ However, an altogether simpler approach would be to do away with the 'forecast margin' entirely and instead set the cap slightly higher in the first place. Of course, the downside of this is that a slightly higher cap could allow higher spending than would have been deemed desirable to persist.

In addition to forecasting 'welfare in scope' alongside each Budget and Autumn Statement, and formally assessing compliance with the cap alongside each Autumn Statement, the OBR has been tasked with producing an annual report on trends in and drivers of spending on 'welfare in scope'. This is a sensible addition to the OBR's remit, and will provide an important, frequent review of spending on individual components of the social security and tax credit budget. However, it would be sensible to widen the scope of this report to cover all social security spending rather than just 'welfare in scope'. It is hard to see the rationale for excluding from this additional scrutiny spending on areas such as JSA, or housing benefit for JSA recipients, not least because there could be significant interactions between spending on these benefits and spending on other social security benefits.

Summary

The new welfare cap could lead to better policymaking if it forces decisions to be made that would otherwise have been avoided. But the presence of such a cap does not mean that better policymaking will automatically follow.

The new welfare cap does not guarantee that spending on certain benefits will not be allowed to rise unplanned in future. For example, it is possible that while some spending rises unexpectedly and in an unplanned way, falls in spending on other benefits offset this by a sufficient amount to ensure that overall spending on 'welfare in scope' remains below the cap. In this scenario, the cap would not require policy action, but if the unplanned spending rise would have led to a breach of the cap if other benefits had behaved as expected, it is hard to see why that should not be the case just because of better fortune (for the exchequer) elsewhere in the social security budget. The OBR's annual report on trends in welfare spending should, however, help highlight the need for policy action in this case.

There are at least three potential cases where breaching (or increasing) the cap might be a sensible course of action. First, there could be an unexpected economic downturn and some elements of spending covered by the cap could be counter-cyclical. Second, higher inflation associated with higher incomes might warrant a higher nominal level of spending on benefits. Third, there could be a desire to make the benefit and/or tax credit system more generous.

Finally, if cuts are deemed to be the right response to higher projected welfare spending, then good policymaking would require the cuts implemented to be well argued and well designed, rather than simply the quickest or politically easiest to achieve.

If the new welfare cap does bind, then nominal spending on 'welfare in scope' would be less likely to exceed the Chancellor's cap, making public spending forecasts less uncertain and reducing one risk to the public finances. However, the consequence of this is that the real incomes of those potentially receiving benefits included in 'welfare in scope' will now

²⁸ In addition, it would also increase clarity were the OBR to set out clearly whether or not the cap would have been breached under different judgements.

be subject to greater risk, since if the cap might now bind, then it must be more likely than before that these benefits will subsequently be subject to cuts.

2.5 Conclusion

The UK government is almost four years through what is now planned to be a nine-year fiscal consolidation plan, with tax increases and spending cuts designed to reduce borrowing by 10.1% of national income. This is a greater fiscal contraction than is required to offset the latest estimate of the permanent damage done to borrowing by the financial crisis and, if successfully implemented, would leave the public finances in a strong position by recent standards. The OBR is forecasting a cyclically-adjusted surplus in 2018–19, and a simple projection under the assumption of ‘unchanged policy’ suggests that even the pressures from the ageing population would not now have a significant adverse effect on public debt until around the 2050s.

Much uncertainty remains, however, and there is still a risk that economic prospects turn out worse than currently forecast by the OBR. The permanent damage done to the economy and to public borrowing by the financial crisis can only be estimated, and estimates have changed over time as more data become available. Future revisions could require the government to do a larger (or smaller) fiscal tightening in order to deal with this permanent problem, although caution against this eventuality is built into the Chancellor’s fiscal consolidation plan, in that he is aiming to do more than is currently estimated to be required to deal with the permanent borrowing problem. Although the forecast recovery in receipts is not unprecedented, increased reliance on a decreasing proportion of taxpayers is a further source of risk to the current consolidation plan.

Even if the OBR’s economic forecasts turn out to be correct, the key question that remains is whether the planned fiscal consolidation *can* be implemented. While virtually all of the tax increase and benefit spending cuts planned are in place, considerable cuts to public service spending are still required in future. These cuts have not yet been delivered, and in terms of the cuts planned for after 2015–16, they have not even been allocated between departments. While this is understandable since these financial years start after the next general election, it does increase the uncertainty over the effect of these cuts on public service provision and quality, and therefore the acceptability of these cuts to voters. Current plans imply that public service spending as a share of national income in 2018–19 will be back around the level it was in the late 1990s (technically, at its lowest level since at least 1948–49 from when comparable data are available), and it is far from certain that the current or a future government will have the political will to see state provision of services reduced to this extent. Over the next 15 months as the political parties present their plans for borrowing, taxes and spending, it is to be hoped that some of this uncertainty will be resolved. But the experience of the last general election – where all three of the main UK political parties provided details of only a minority of the fiscal tightening they had planned – suggests that this hope might unfortunately be in vain.