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Economy bouncing back more strongly but policy choices have increased long- run risks to the public finances

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Overview

- Big picture
 - Faster economic growth reflects faster recovery from recession
 - But not permanently higher GDP
 - Structural position of public finances little changed by 2018–19
- Giveaways and takeaways
 - Bottom line of Budget scorecard was close to zero
 - BUT permanent tax giveaways were paid for by unspecified spending cuts and temporary increases in tax revenues
 - Therefore, long-run public finances weakened somewhat
- New welfare cap could reduce risk that borrowing will be higher than expected in future

Changes in borrowing forecasts since Dec 2013

Public sector net borrowing, £ billion

	2012– 13	2013– 14	2014– 15	2015– 16	2016– 17	2017– 18	2018– 19
AS 2013	115.0	111.2	96.0	78.7	51.1	23.4	-2.2
Measures from scorecard	0.0	0.0	0.6	0.6	-0.2	-0.6	-0.4
Other changes	-0.2	-3.4	-1.1	-4.1	-6.4	-6.3	-2.2
Budget 2014	114.8	107.8	95.5	75.2	44.5	16.5	-4.8

Notes: Numbers might not sum due to rounding. All figures for borrowing are on a basis that excludes the Asset Purchase Facility and the impact of the transfer of Royal Mail Pension Plan assets.

Source: HM Treasury; Office for Budget Responsibility; IFS calculations.

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Permanent giveaways: £4.9 billion a year

Including...

- Increase personal allowance to £10,500 from April 2015
 - Costs £1.9 billion a year
- Energy policies for companies
 - Costs £1 billion a year
- Changes to ISA limits
 - Costs £0.6 billion a year
- Reduce income tax on savings income
 - Costs £0.4 billion a year
- Reductions in alcohol duties
 - Costs £0.3 billion a year

Paid for by takeaways?

- Tax rises
 - Tobacco duty increase
 - Machine games duty
 - Company car tax reform
 - Voluntary National Insurance contributions
 - Reduce withdrawal tax rate on private pensions
 - Accelerated payments for tax avoidance schemes
- Spending cuts
 - Higher employer contributions to public service pensions
 - Cuts to departmental budgets

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Permanent tax increases:
raise £0.7bn a year by 2018–19



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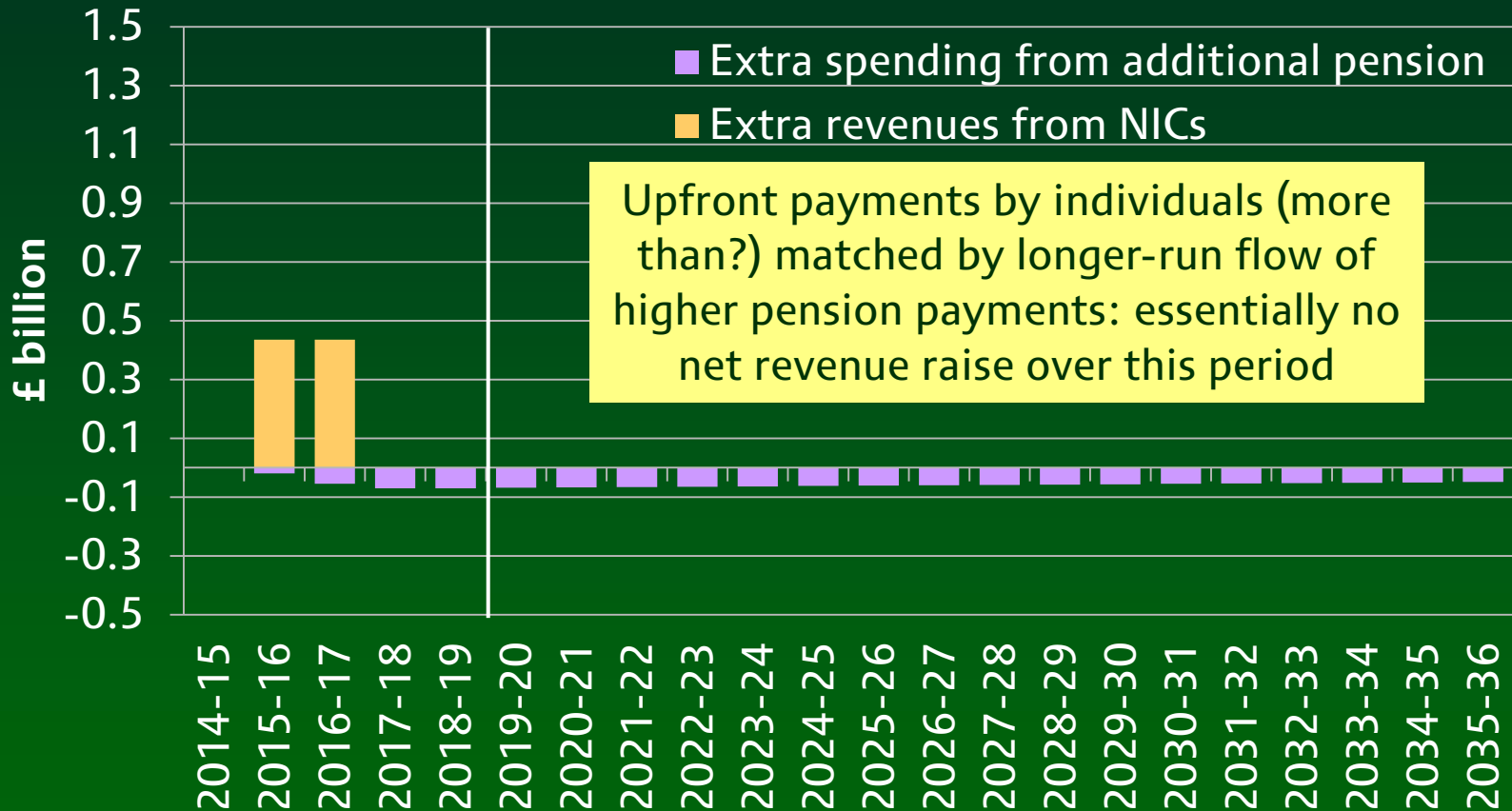
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Voluntary NI contributions: a takeaway?

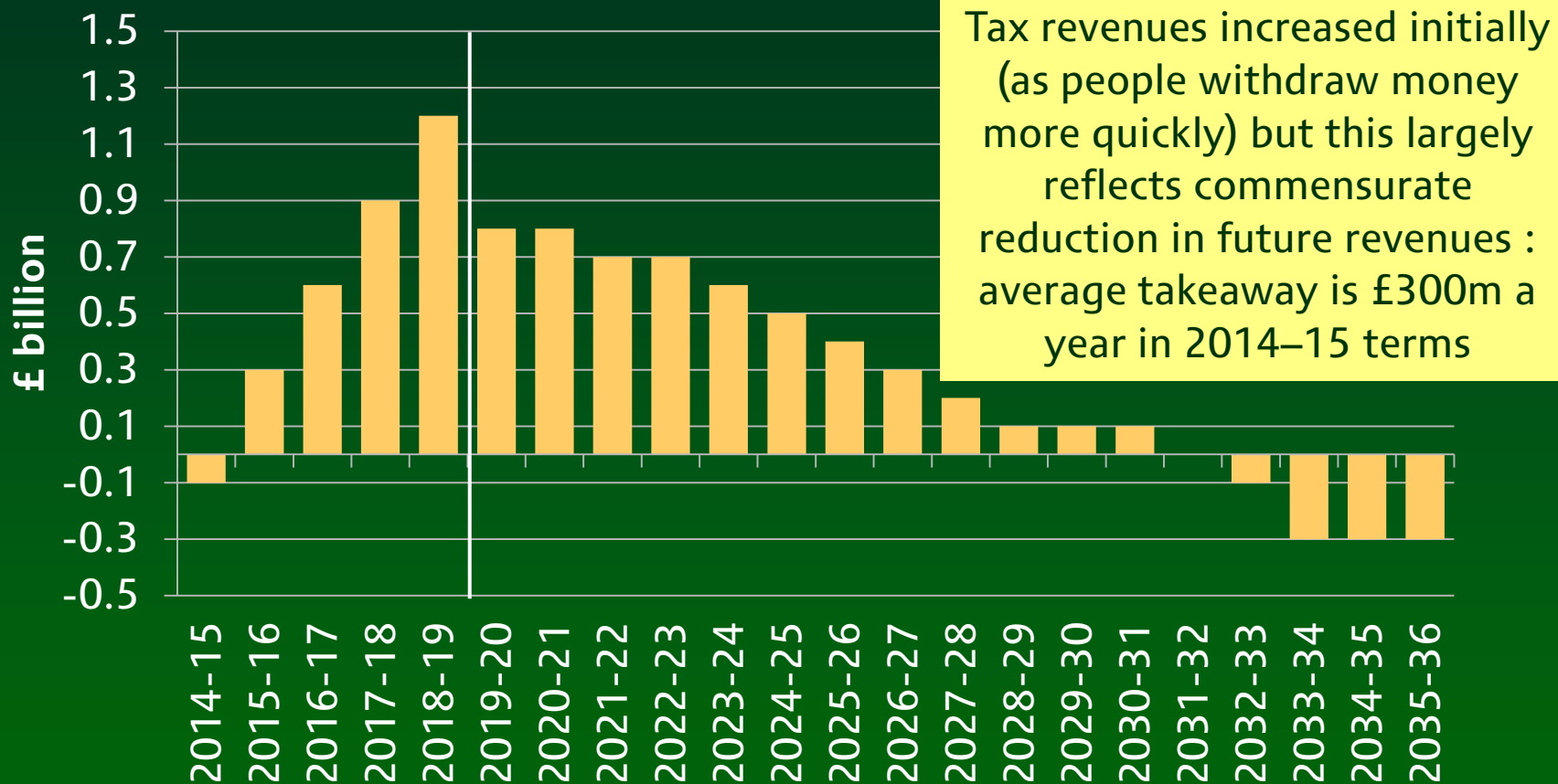
Reduction in borrowing resulting from the policy, £ billion



Source: Chart 4.1 of Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2014*.

Reduce tax rate on withdrawals from private pensions: a takeaway?

Reduction in borrowing resulting from the policy, £ billion

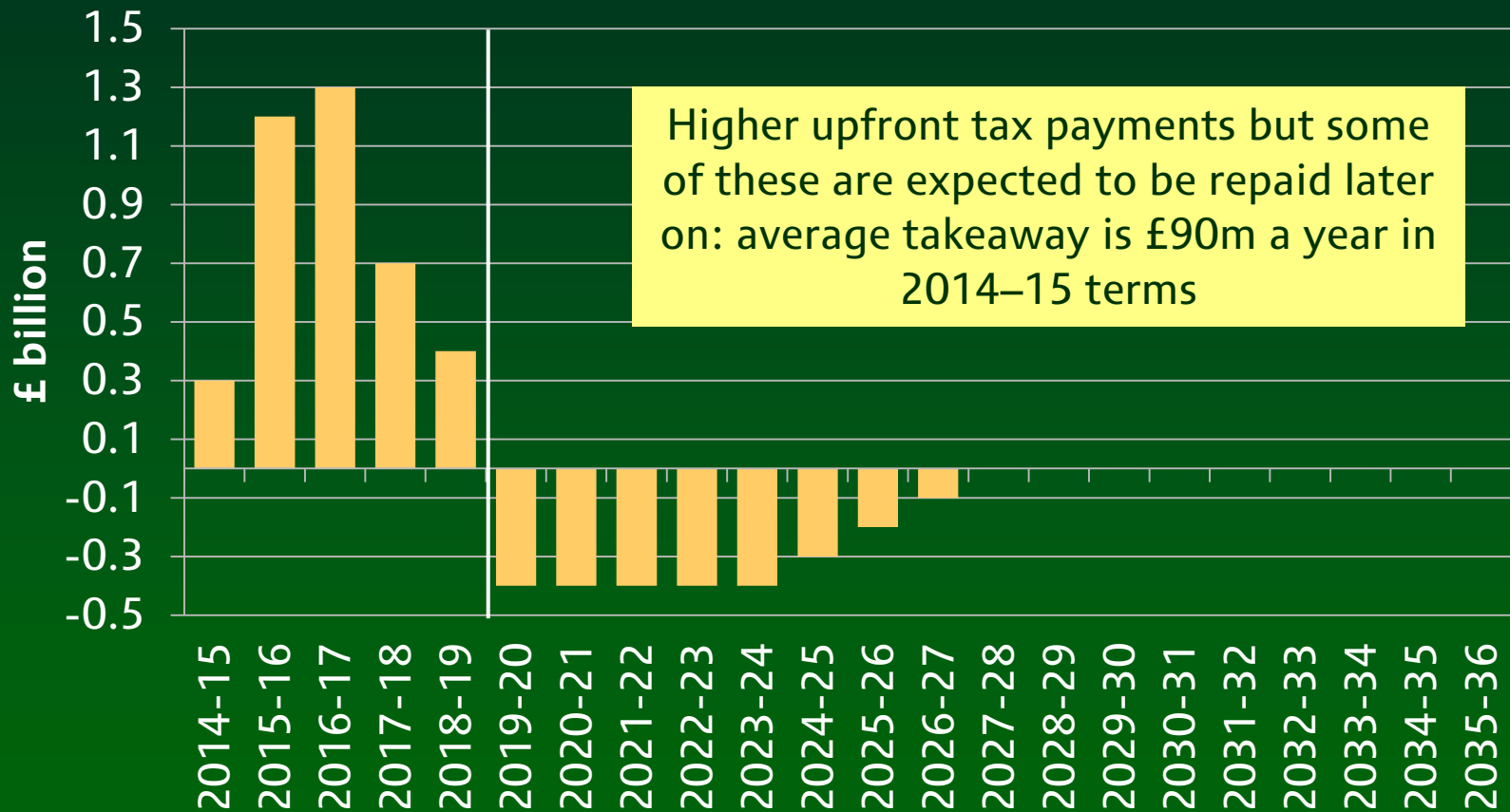


Source: Chart 4.1 of Office for Budget Responsibility, *Economic and Fiscal Outlook: March 2014*.



Accelerated payments for tax avoidance schemes: a takeaway?

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Why do higher employer contributions to public service pensions reduce borrowing?

- GAD in the process of completing preliminary valuations of unfunded public service pension schemes
 - Treasury expects them to conclude that liabilities are higher than thought
 - Extra £1 billion of pension contributions to be made by public sector employers (from 2015–16 onwards)
- Departments hand over additional contributions to the Treasury
 - Increases pressure on departments' budgets
- For public sector as a whole:

Net public service pension spending $=$ Payments to retirees $-$ Contributions received from current employees and employers

- *Decreases* measured public spending and borrowing in short-run
- But *increases* future public spending

What do yesterday's announcements mean overall for cuts to departmental spending? (1/2)

- OBR forecasts from December 2013 suggested
 - 20.4% cut to departmental spending between 2010–11 and 2018–19
- Two offsetting things happened yesterday
 1. Decrease in forecast non-departmental spending
 - Lower debt interest spending
 - Lower welfare spending as a result of lower inflation and unemployment
 2. Discretionary cuts to total planned spending in 2018–19
- OBR forecasts now suggest
 - 19.8% cut to department spending between 2010–11 and 2018–19
 - Picture therefore broadly unchanged

What do yesterday's announcements mean overall for cuts to departmental spending? (2/2)

- Picture broadly unchanged
 - 19.8% cut to department spending between 2010–11 and 2018–19, compared to 20.4% estimated in IFS Green Budget in February
- But...
 - Departments will now also have to pay higher pension contributions from within these budgets
- ...and worth remembering that cuts to come are still significant
 - By end of 2014–15 expect to have implemented 8.9% cut to departmental spending
 - This leaves 11.9% cut to come in the next Parliament
 - If continue 'protecting' NHS, schools and overseas aid, cut to 'unprotected' departments could be 35.6% by 2018–19

Paid for by takeaways?

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Permanent tax increases:
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Bring revenues forward: little permanent increase



- Spending cuts

- Higher employer contributions to public service pensions
- Cuts to departmental budgets

Tough choices on public service spending remain



Big picture for the UK's long-run public finances...

- Current coalition government initially implemented policies that strengthened short- and long-run public finances
- Additional tax increases and spending cuts aimed at reducing short-term borrowing and thus longer-run debt interest spending
 - Budget June 2010, Spending Review 2010
- Legislated to increase the state pension age more quickly
 - Spending Review 2010, Autumn Statement 2011

...but now the government seems to be getting into bad habits

- Recently: a series of policies that weaken and/or increase risk to longer-run public finances
 1. Permanent giveaways funded by temporary revenue raisers
 2. Permanent spending commitments, but with no (or only temporary) additional money

...but now the government seems to be getting into bad habits

1. Permanent giveaways funded by temporary revenue raisers

– Budget 2013:

- Personal allowance increase and fuel duty freeze “funded” by ending contracting out for defined benefit schemes
- Latter policy raises money in short-term but matched by similar liabilities in the longer-term

– AS 2013:

- New student loans “financed by selling the old student loan book”
- Economically nonsense as selling an asset for what it is worth does not strengthen the public finances

– Budget 2014:

- Personal allowance increase, changes to savings taxation, alcohol duty cuts “funded” by voluntary NICs, DC pension reforms, accelerated payments

...but now the government seems to be getting into bad habits

2. Permanent spending commitments, but with no (or only temporary) additional money
 - Budget 2013:
 - Ending contracting out into DB pensions increases public sector employer NICs (£3.7bn a year)
 - Dilnot social care funding (£1.0bn a year)
 - Tax-free childcare scheme (£0.8bn a year)
 - AS 2013:
 - Free school meals extension (£0.8bn a year)
 - Scrapping cap on HE student numbers (£0.7bn a year from 2018–19)
 - Energy prices and efficiency measures (£0.4bn a year)
 - Budget 2014:
 - Higher contributions to public service pension schemes (£1bn a year)

...but now the government seems to be getting into bad habits

- Recently: a series of policies that weaken and/or increase risk to longer-run public finances
 1. Permanent giveaways funded by temporary revenue raisers
 2. Permanent spending commitments, but with no (or only temporary) additional money
- Enjoying short-term political gain at the cost of weaker long-run public finances?

New cap on welfare spending could reduce future downside risk to public finances

- Cap applies to ‘welfare in scope’, defined as central government spending on benefits and tax credits but excluding
 - Jobseeker’s allowance and housing benefit for those receiving JSA
 - State pension spending
- OBR forecasts this will be £119.5bn in 2015–16, out of total welfare spending of £218.8bn
 - Rising to £126.7bn in 2018–19
 - Cap has been set at the forecast level in each year
 - This cap, and any future changes to it, must be approved by Parliament
- OBR will judge compliance with the cap in each Autumn Statement
 - Cap breached if policy action has caused forecast to exceed cap or if forecasting changes have caused forecast to exceed cap by >2%
 - If breached, Chancellor must attempt to take policy action to deal with this or obtain Parliamentary approval to increase cap



How constraining is the 2% forecasting margin?

- Recent experience suggests that forecasting changes can cause upwards revisions to 'welfare in scope' of this scale
- Example:
 - Between Budget 2011 and Budget 2012 economic forecast deteriorated significantly
 - As a result, forecast for welfare spending increased
 - Forecast for welfare in scope spending in 2015–16 was more than 2% higher in Budget 2012 than it had been in Budget 2011
- Suggests this forecasting margin could be constraining
 - May require government to take action in future if faced with a situation like 2012

Summary

- Big picture
 - Apparent strength of the public finances in 2018–19 little changed
 - Stronger economic recovery reduces short-term borrowing
 - Measures that raise revenue and cut spending offset tax giveaways and spending increases elsewhere
- But the UK's long-run public finances have been made a bit riskier
 - Permanent tax giveaways have been “paid for” by temporary revenue raisers and unspecified spending cuts
 - Although the new welfare cap could limit some of the downside risk on public finances

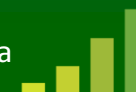
Cuts to departmental spending

% real terms cut to departmental spending

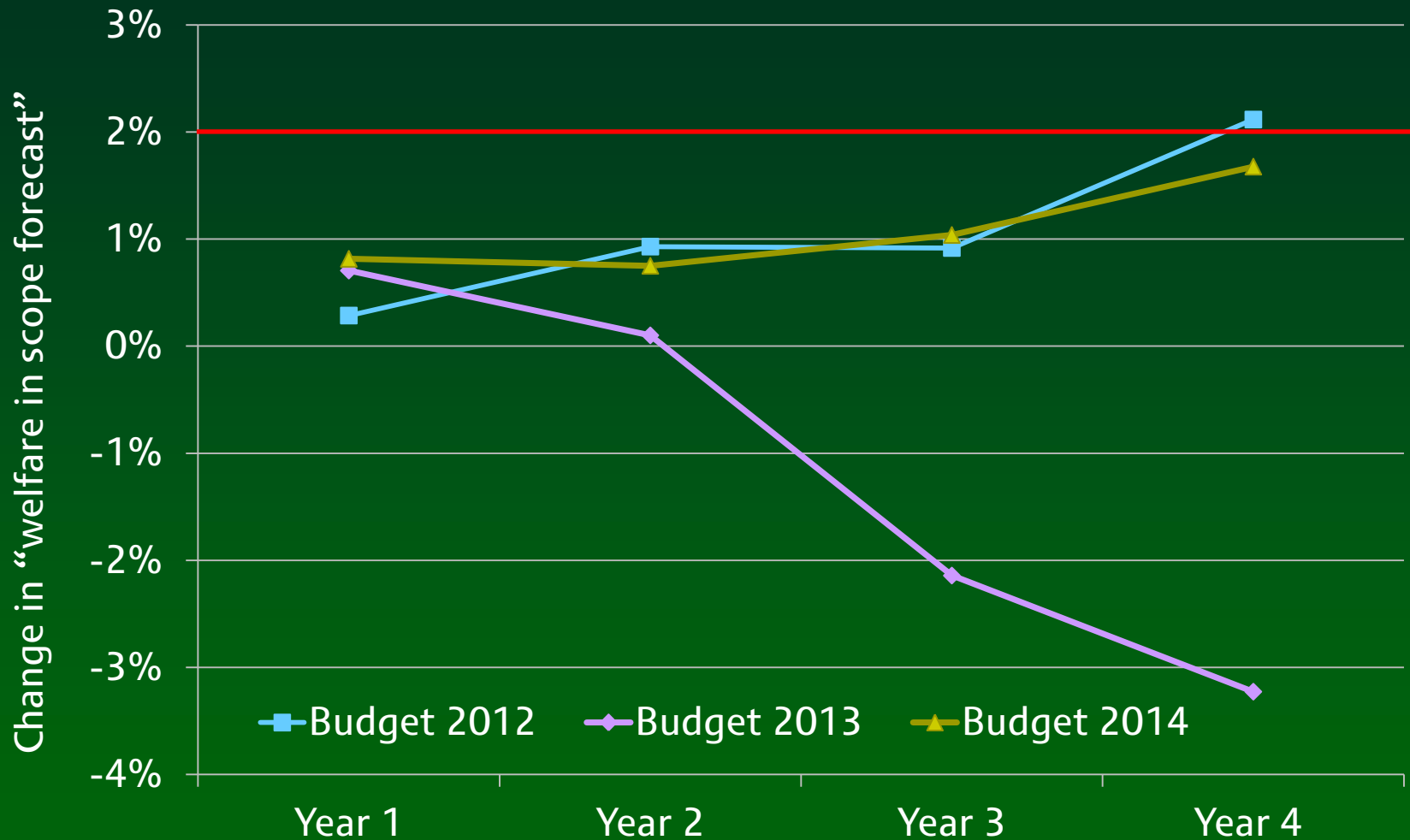
	2010–11 to 2018–19	2010–11 to 2014–15	2014–15 to 2018–19	2010–11 to 2013–14
Green Budget 2014				
All departments:				
Average annual cut	2.8	2.4	3.2	2.8
Cumulative cut	20.4	9.3	12.2	8.1
Budget 2014				
All departments:				
Average annual cut	2.7	2.3	3.1	3.0
Cumulative cut	19.8	8.9	11.9	8.6
‘Unprotected’ departments:				
Average annual cut	5.4	4.6	6.1	n/a
Cumulative cut	35.6	17.3	22.1	n/a

Notes: Figures for ‘unprotected’ departments assume that ‘protection’ currently afforded to NHS, schools and overseas aid is continued to 2018–19.

Source: Chapter 2 of *IFS Green Budget: February 2014*. Additional authors’ calculations using data from HM Treasury and Office for Budget Responsibility.



Change in “welfare in scope” forecast since previous budget



Source: Authors' calculations based on figures from the Office for Budget Responsibility, HM Treasury and Department for Work and Pensions.

