The Public finances

Paul Johnson

Presentation to David Hume Institute
March 10 2015

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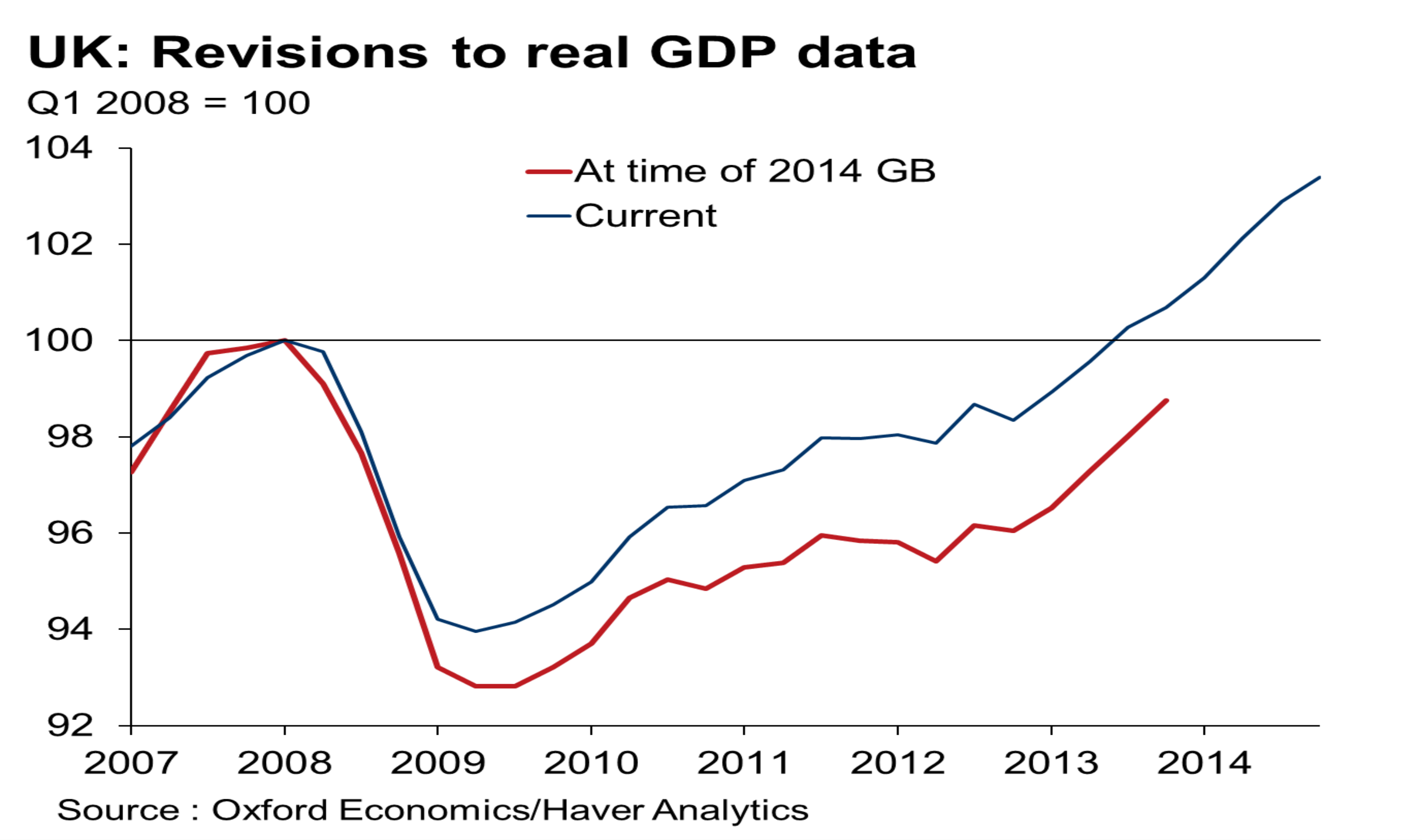
GDP just above 2008 peak

(GDP per capita still below peak and economy at least 15% smaller than expected)



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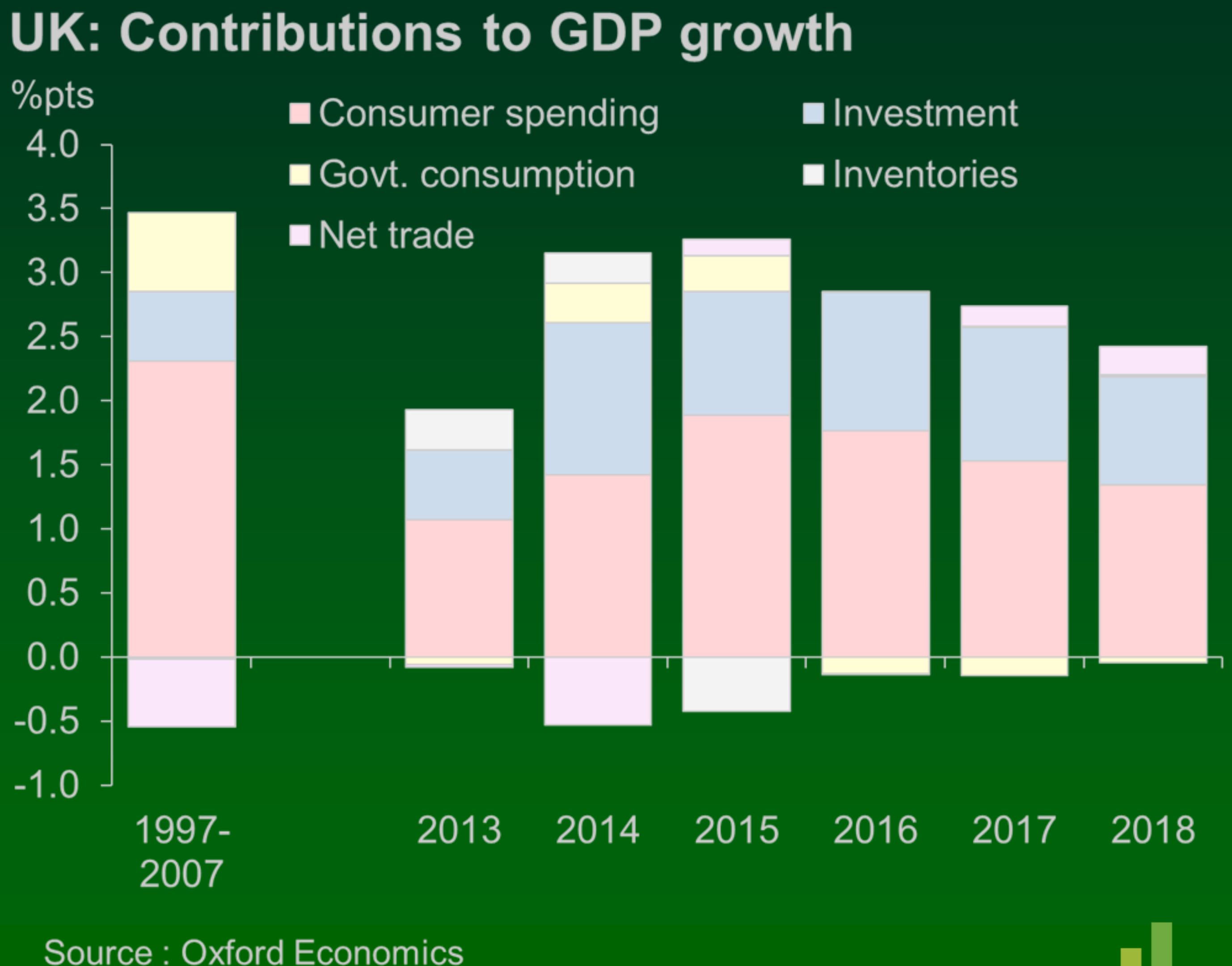
Strong, consumer-led, expansion in prospect



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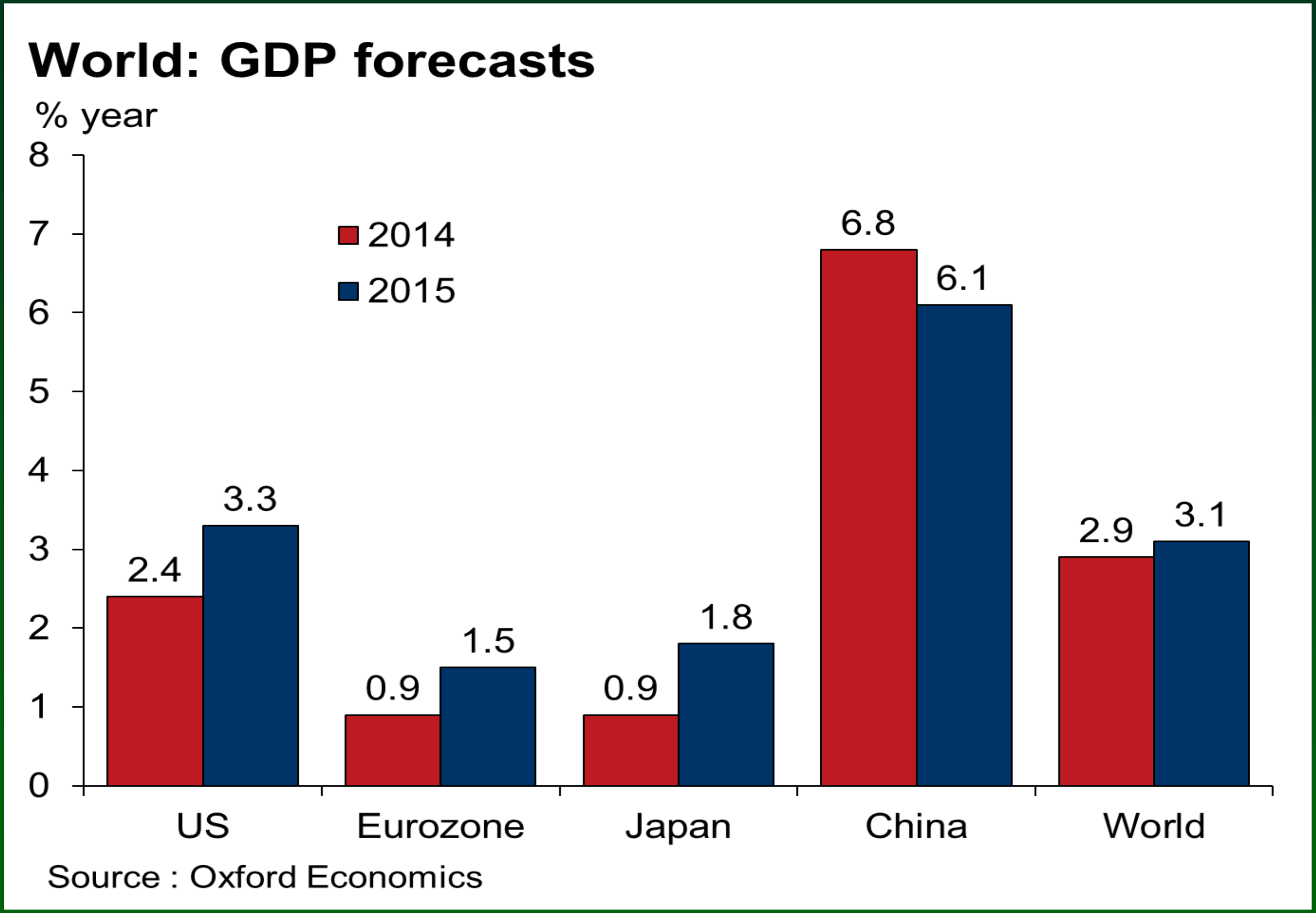
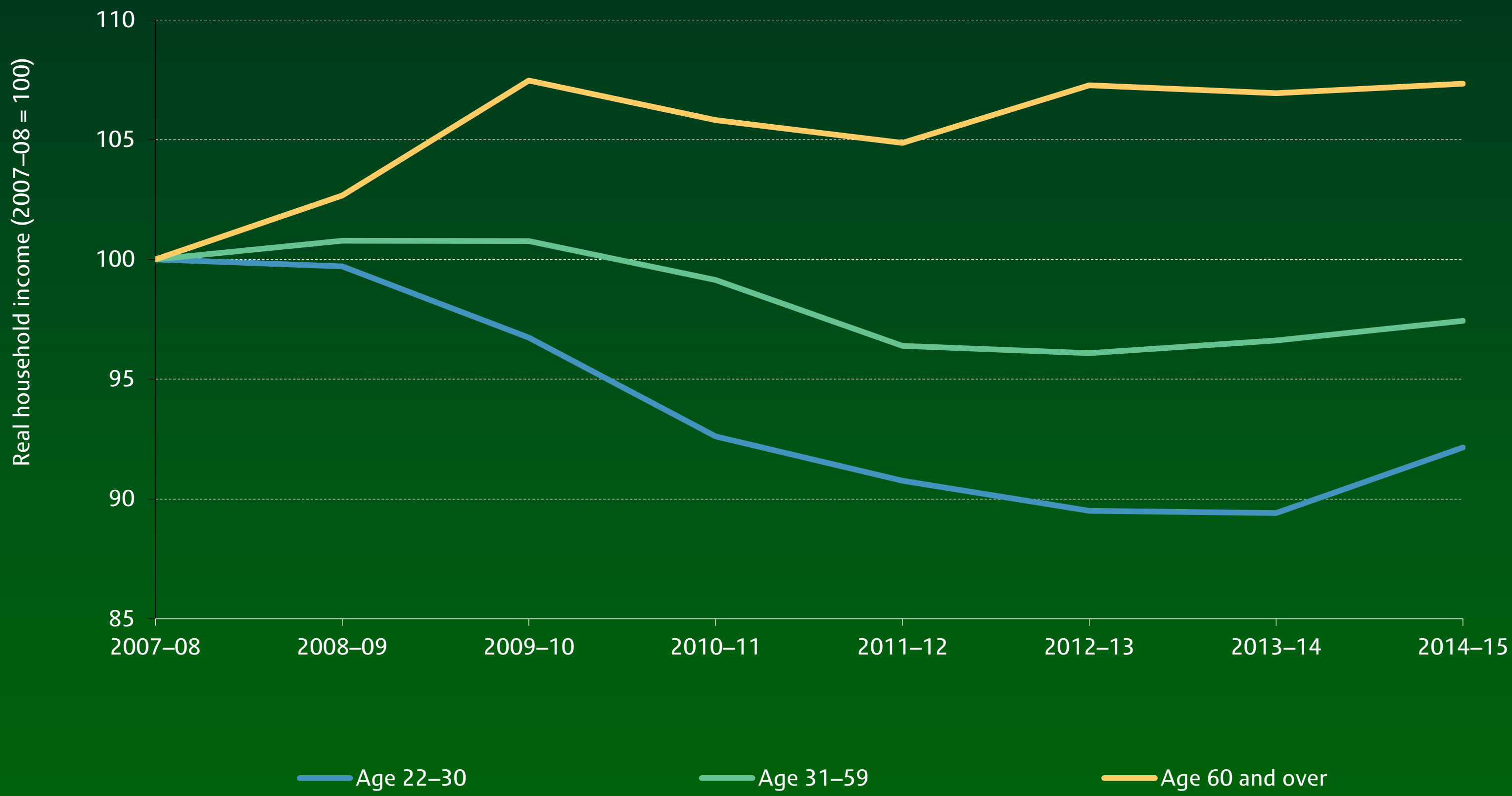
In context of strengthening world economy



Household incomes since 2007-08



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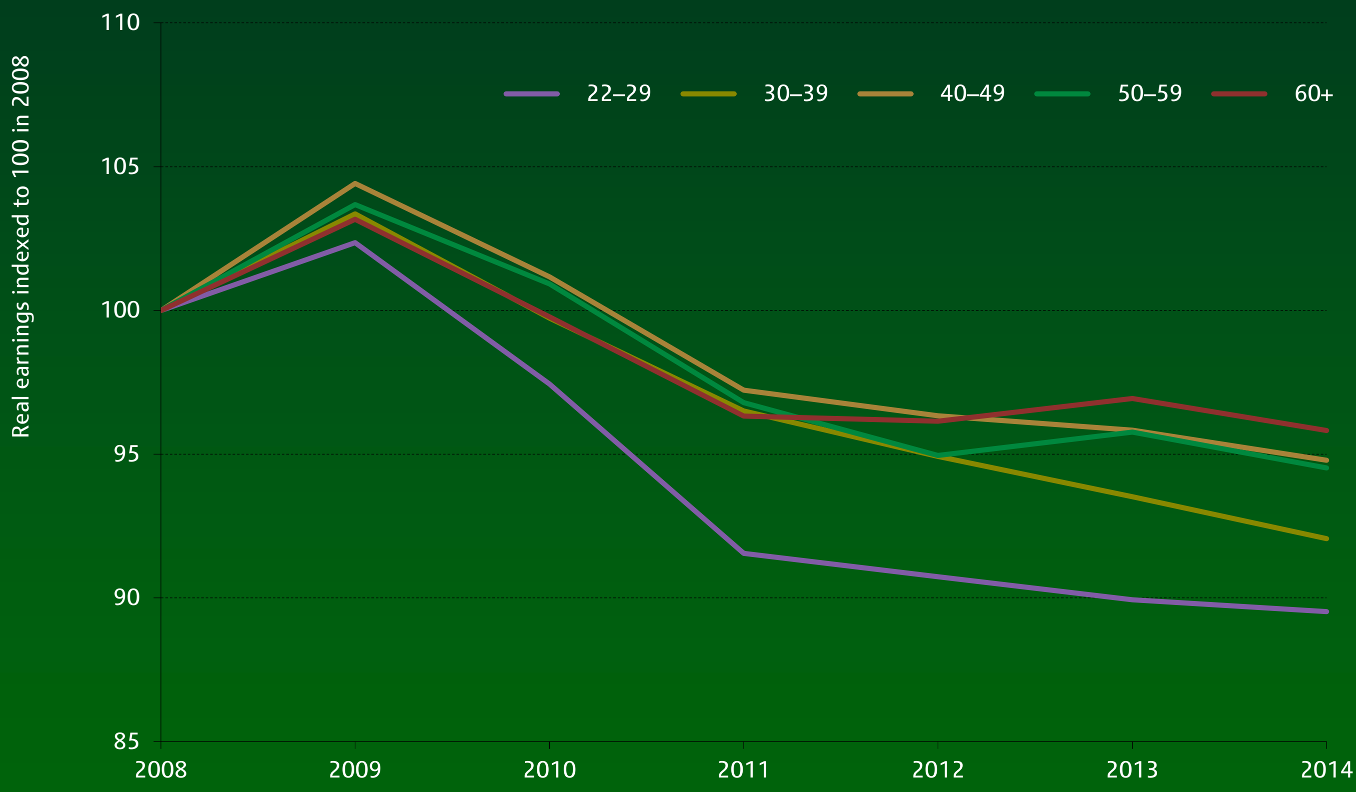
Real weekly median earnings by age group



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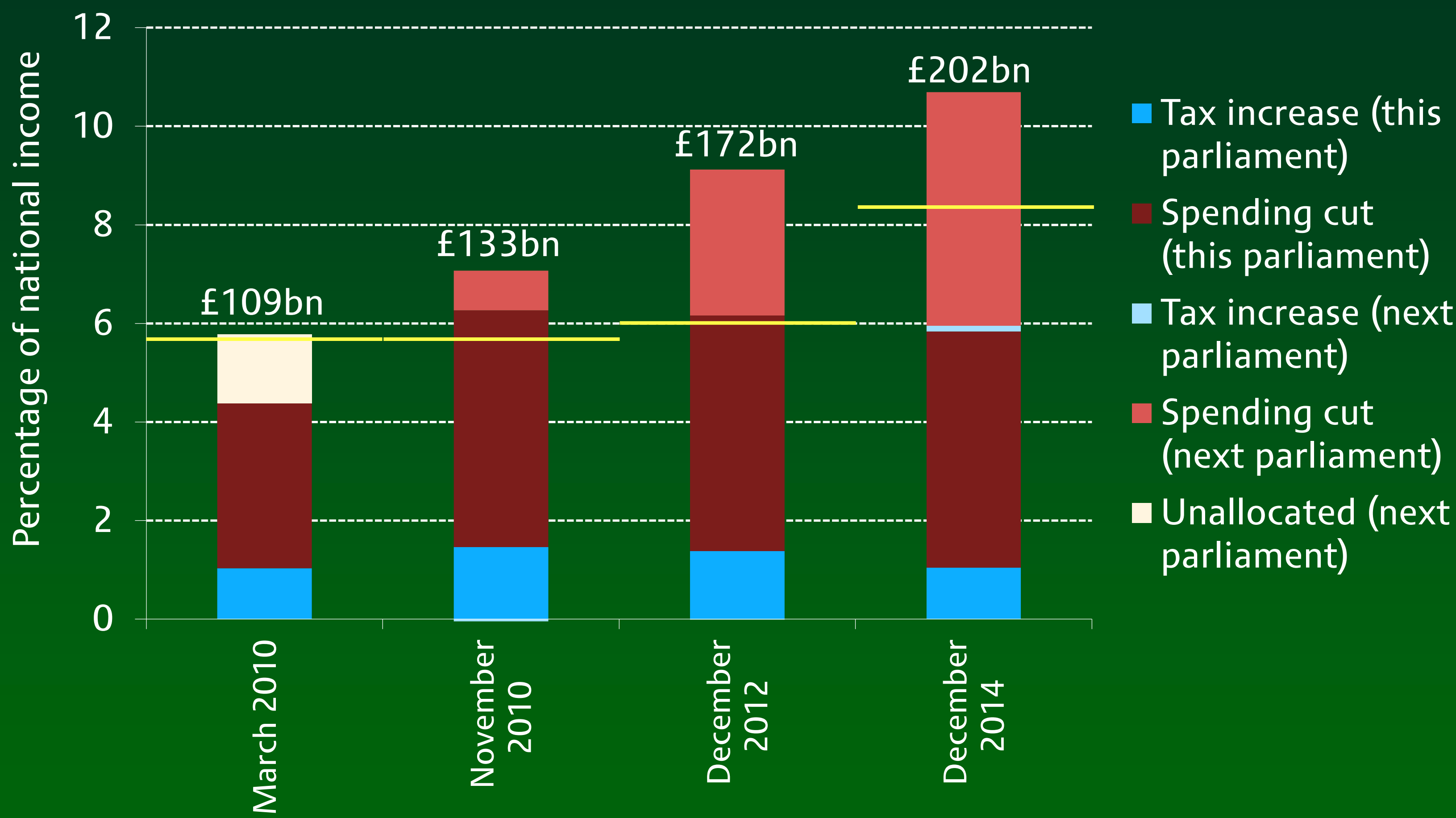
Underlying weakness in the public finances and the fiscal response



Yellow line shows the estimated underlying increase in structural borrowing since March 2008.
Notes and sources: see Figures 1.3 to 1.6 of *The IFS Green Budget: February 2015*.

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The December 2014 plan: international comparison

- Comparison of IMF forecasts for structural borrowing in 32 advanced economies shows that the UK is forecast to have:
  - the 4th largest structural borrowing at the peak during the crisis
  - implemented the 7th largest consolidation up to 2015
  - (essentially) the 2nd largest structural borrowing in 2015
  - the largest planned fiscal consolidation between 2015 and 2019
  - the 18th largest (or 15th smallest) structural deficit in 2019

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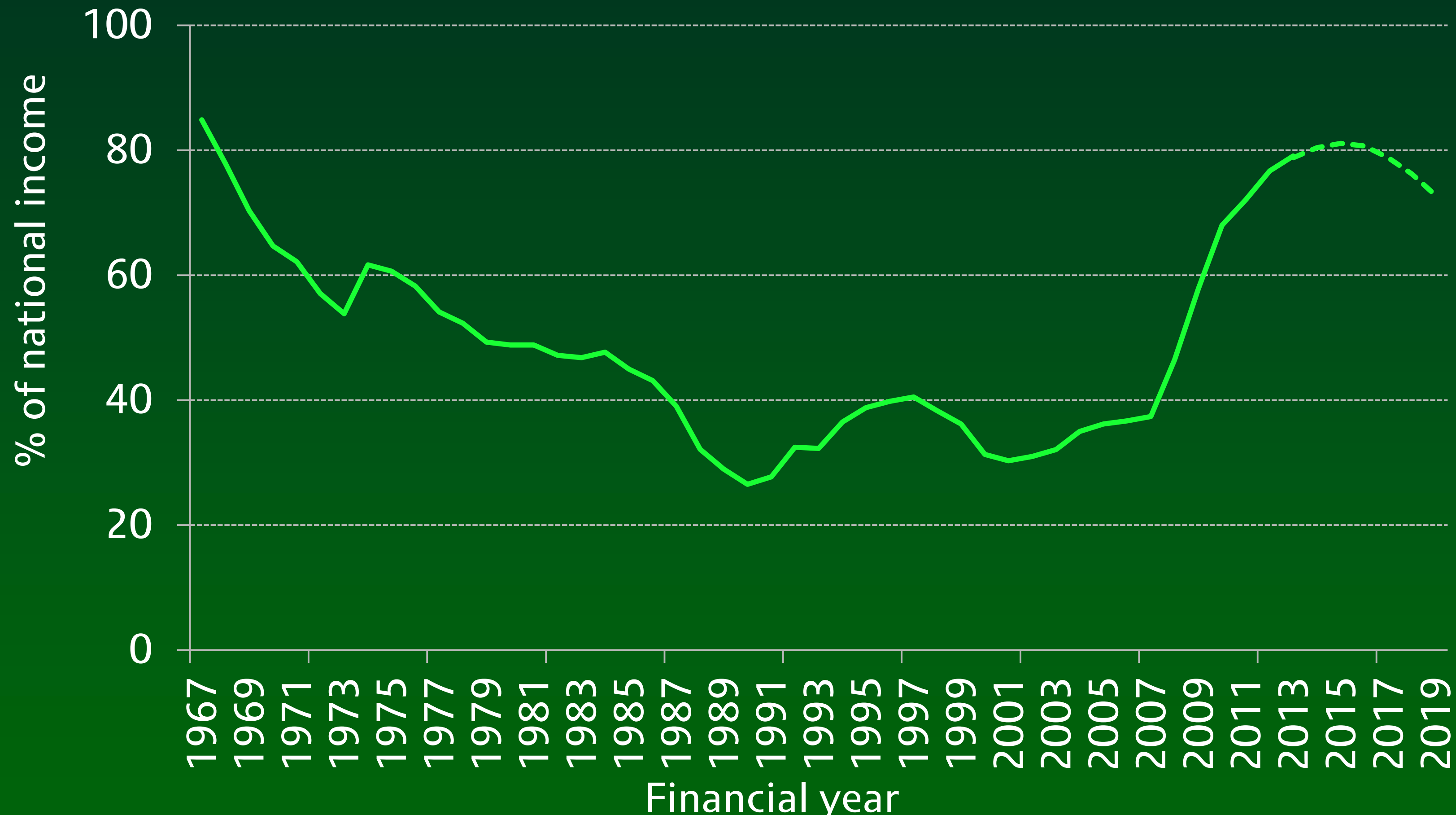
Public sector debt high by recent historical standards



Notes and sources: see Figure 5.2 of *The IFS Green Budget: February 2015*.

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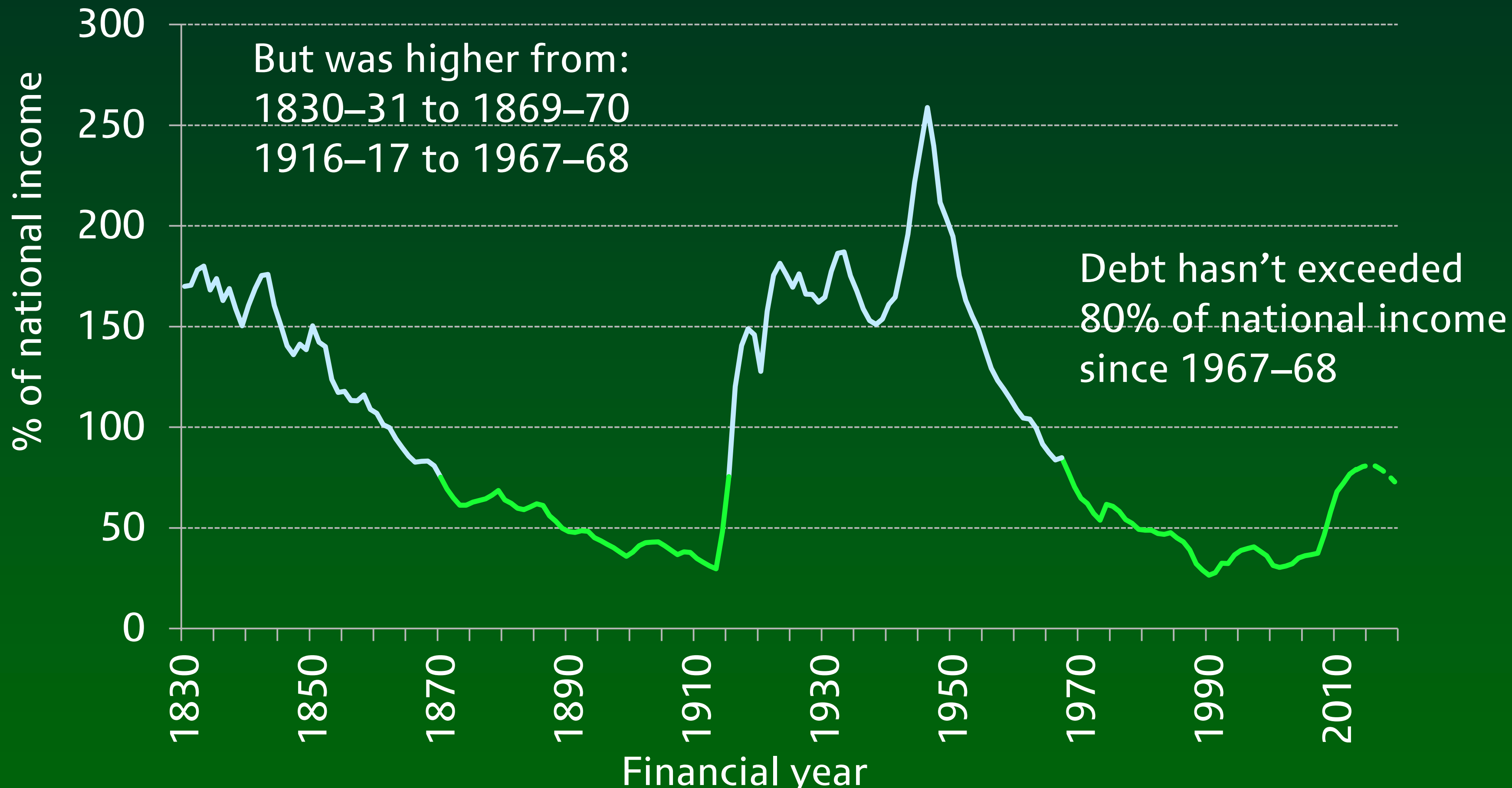
Public sector debt high by recent historical standards



Notes and sources: see Figure 5.2 of *The IFS Green Budget: February 2015*.

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Debt: the parties' plans

- Three main parties have fiscal rules which require debt to fall as a share of national income
- If throughout 2020s you achieve:
  - 1% of national income budget surplus: debt/GDP 27 percentage points (ppts) lower
  - balanced budget: 19ppts lower
  - balanced current budget, maintain investment spending: 9ppts lower

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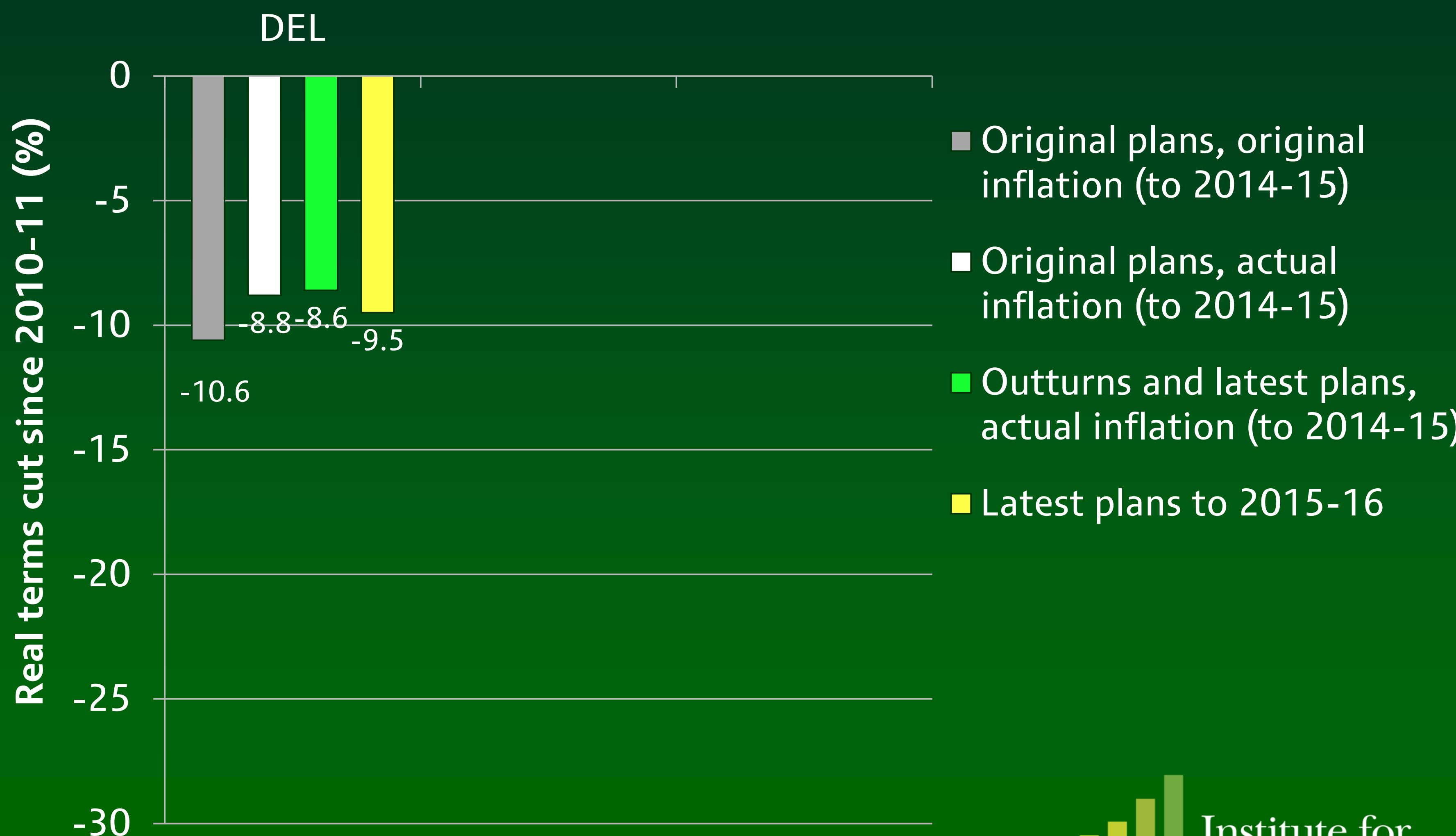
Cutting spending and keeping it down difficult

- Implied cuts are large
  - 2009–10 to 2014–15 already represents largest period of consecutive cuts to public service spending per head since Second World War
- Additional pressures in next parliament
  - easiest cuts presumably done first
  - public sector wage restraint harder when private sector wages growing
  - public service pensions to cost public sector employers £4.7 billion per year more due to recent revaluation and increased employer NICs
- Longer-term pressure: growing and ageing population
  - even with optimistic assumptions over health spending, projected to add 3.9% of national income to spending over next fifty years

Real terms DEL cuts since 2010-11: original and latest plans



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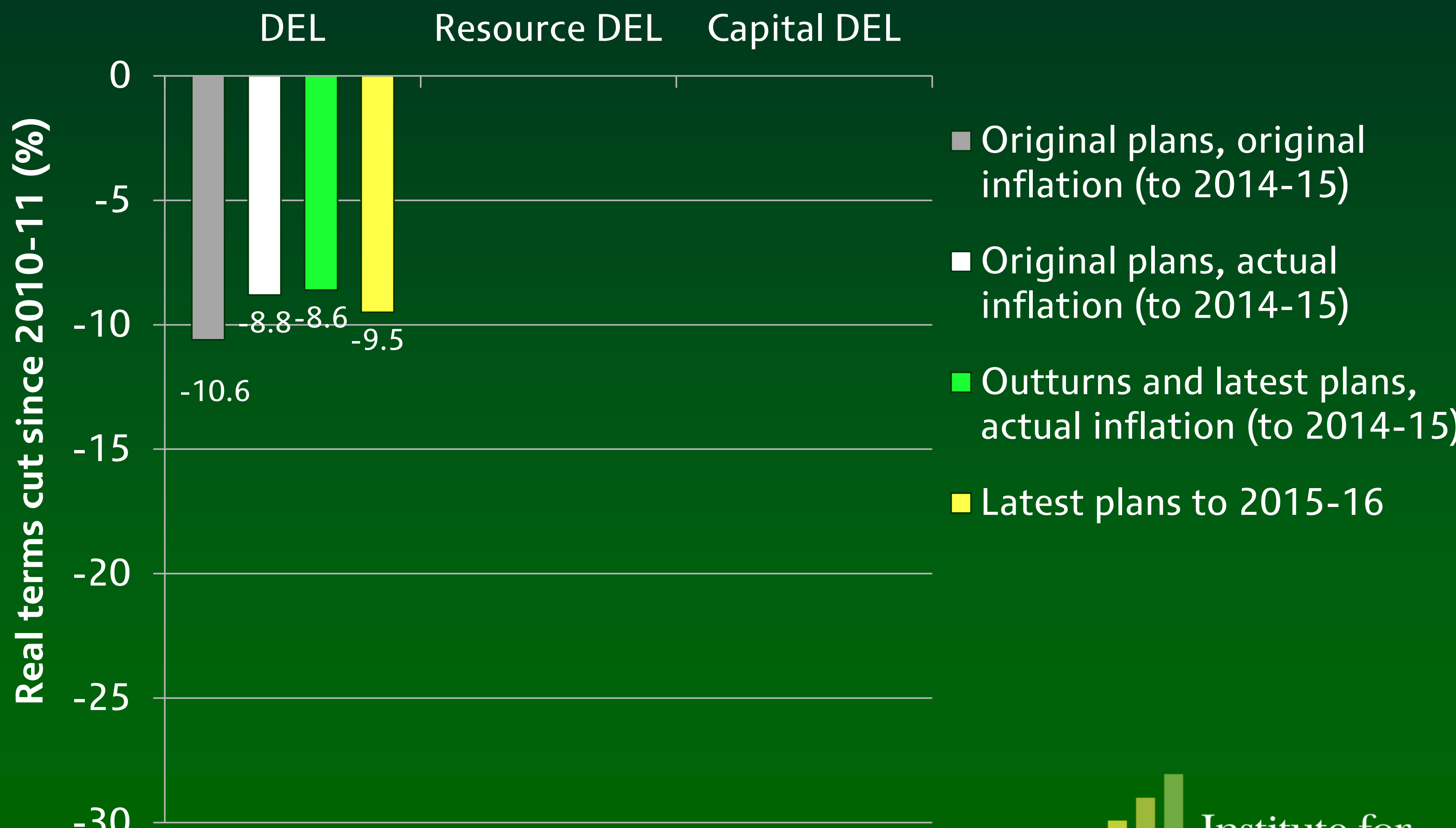

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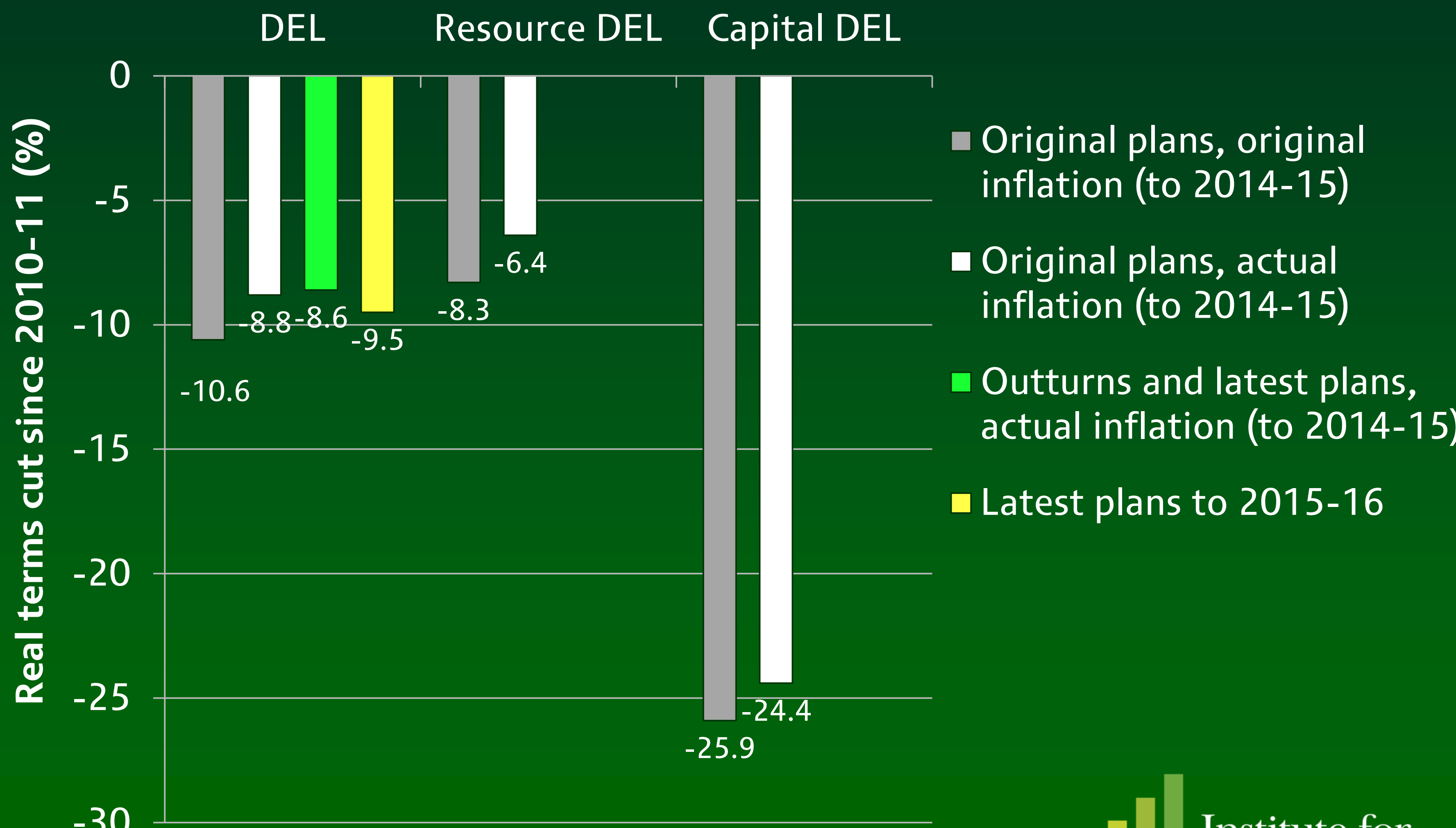

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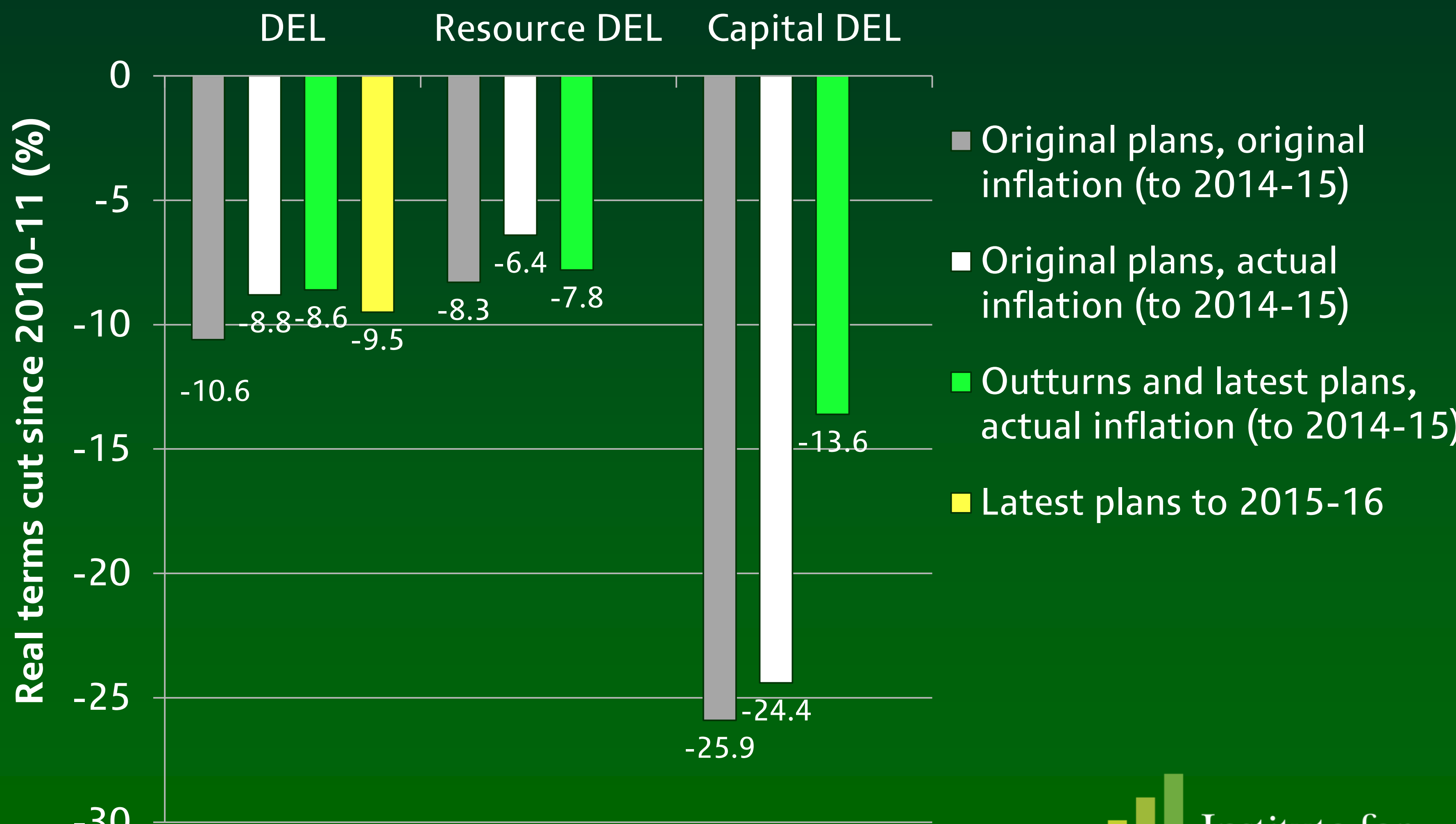

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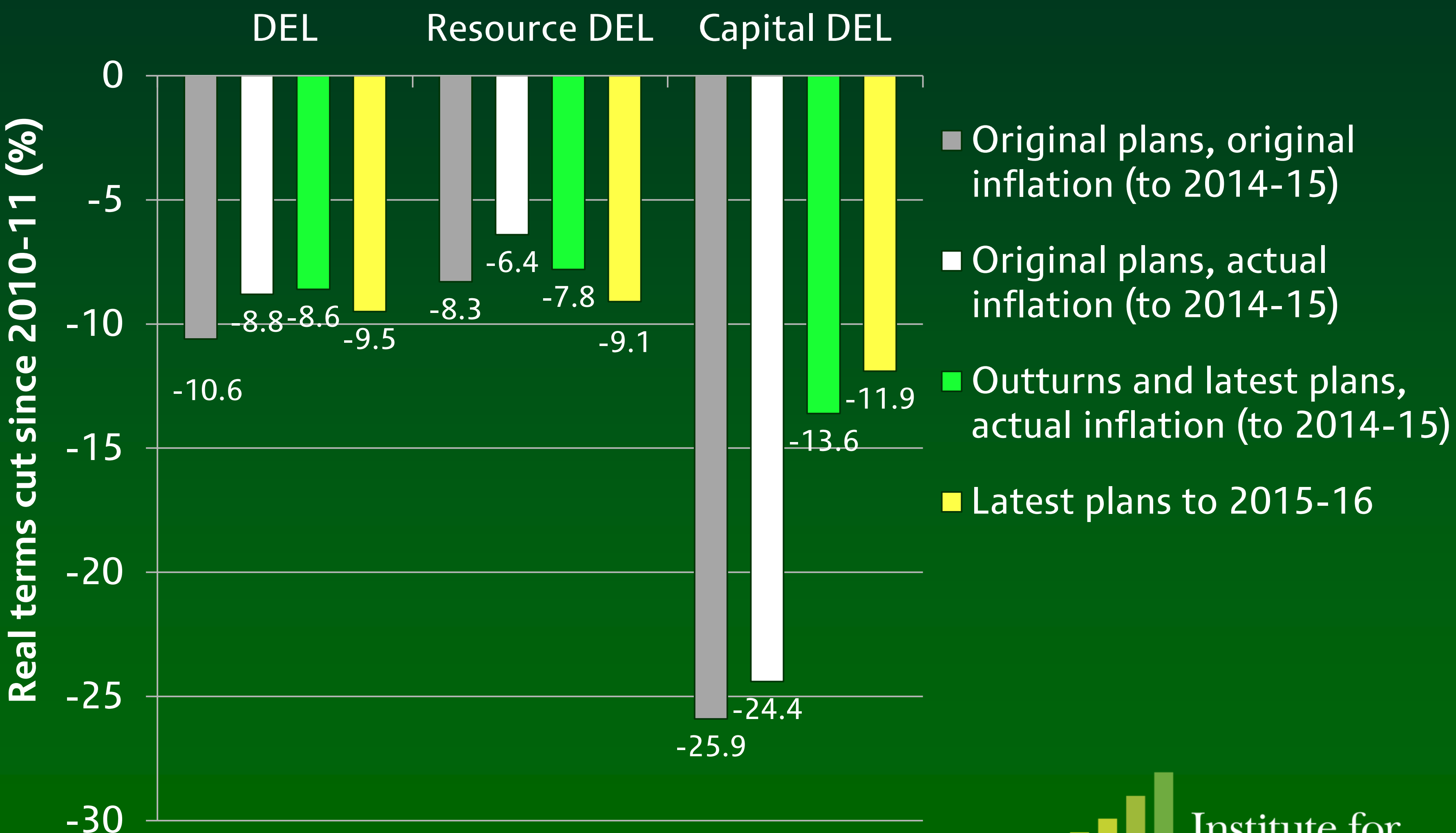

Notes and sources: see Table 7.2 of *The IFS Green Budget: February 2015*.

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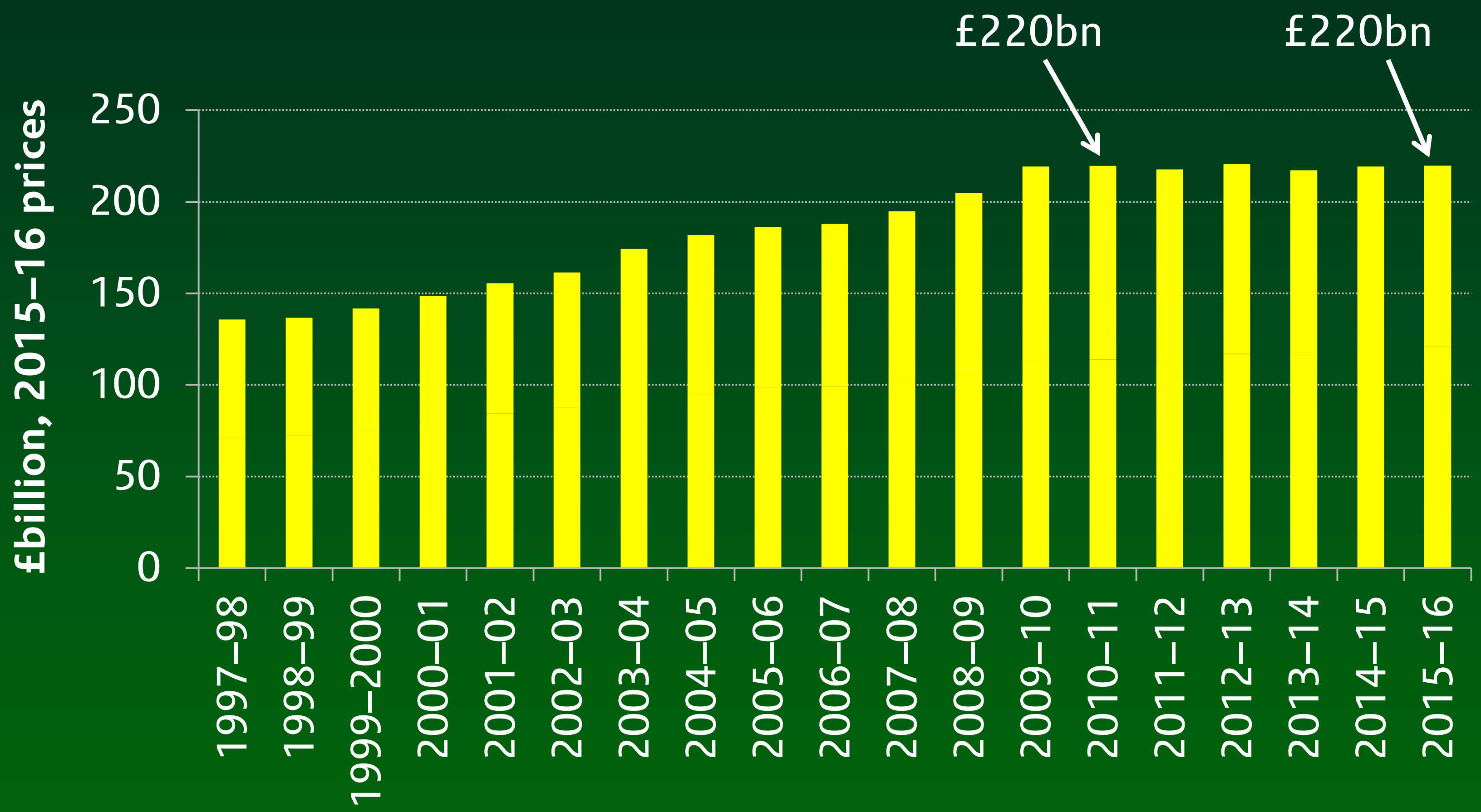
Social security spending: 1997–98 to 2015–16



Notes and sources: see Figure 9.1 in Green Budget document

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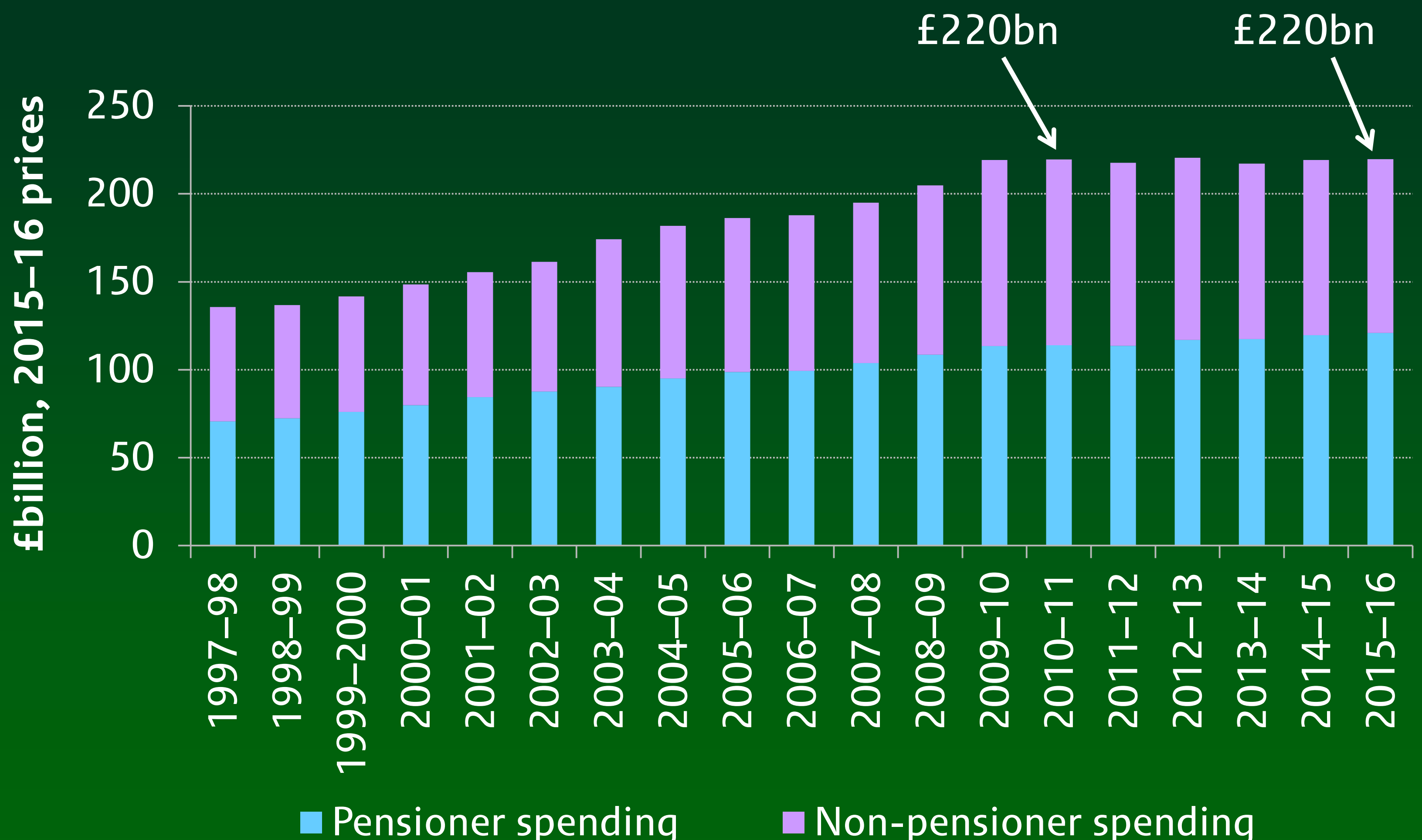

Notes and sources: see Figure 9.1 in Green Budget document

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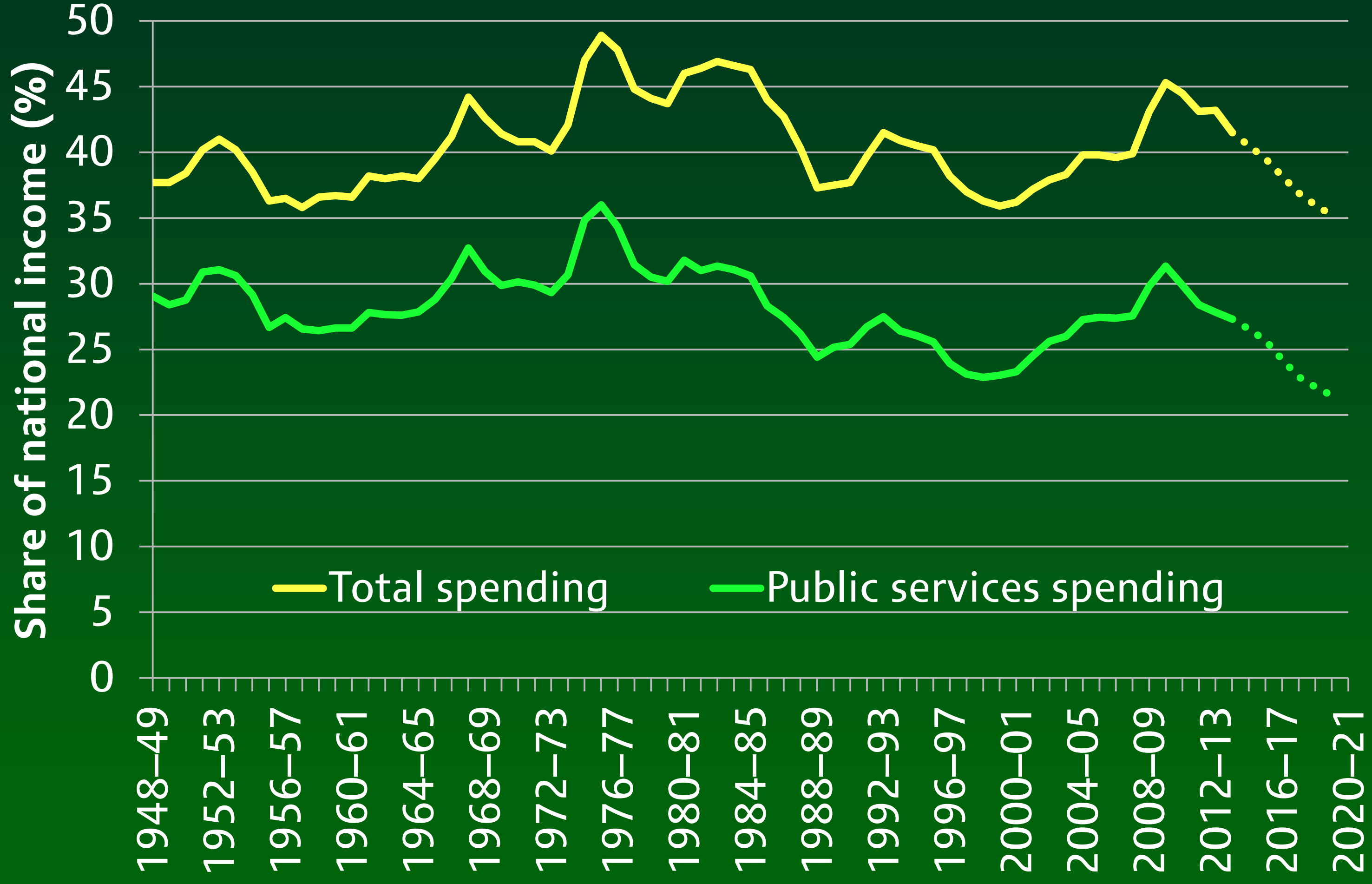
Public spending in context



Notes and sources: see Figure 7.1 of *The IFS Green Budget: February 2015*.

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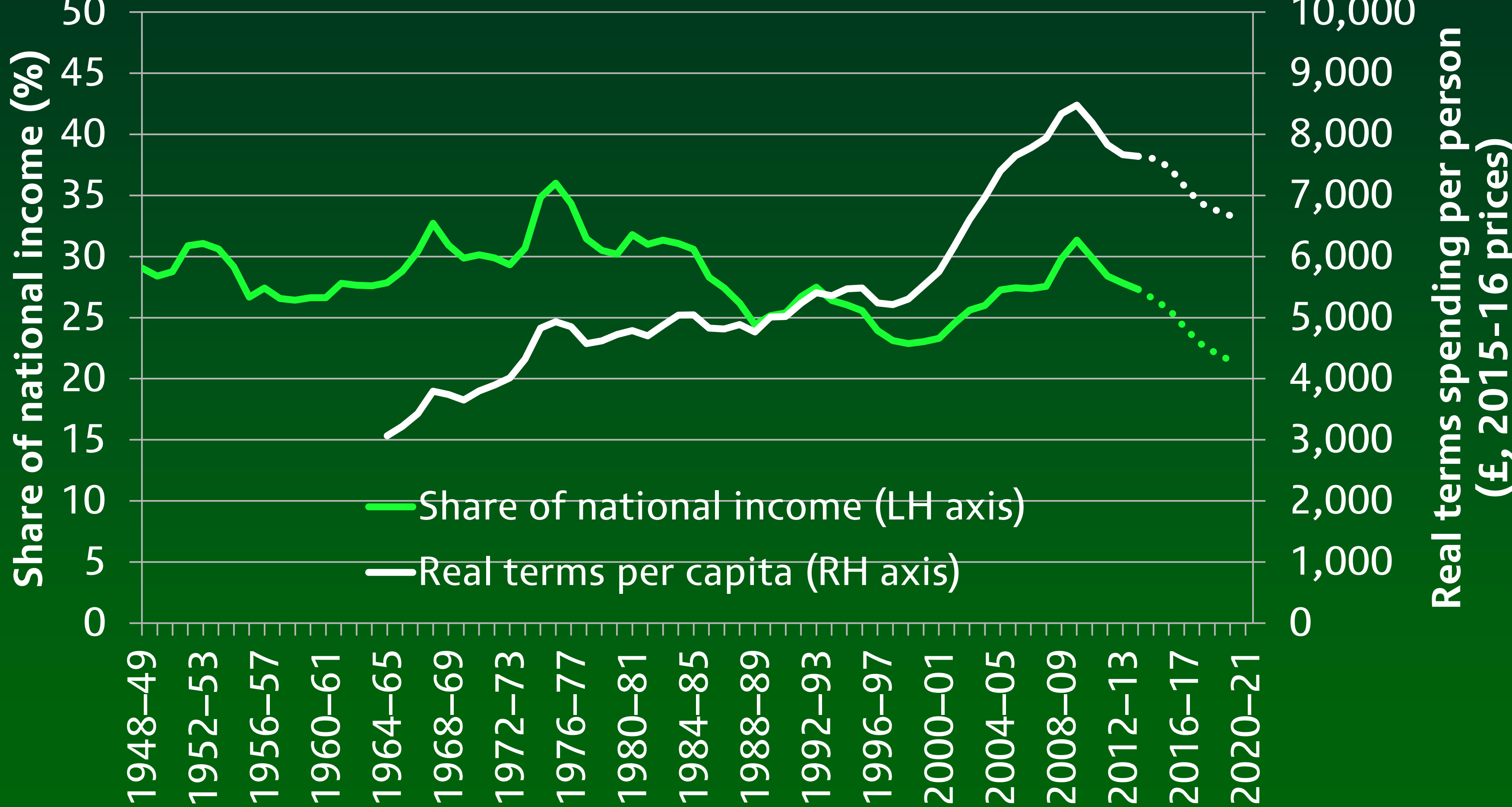
Public services spending in context



Notes and sources: see Figure 7.1 of *The IFS Green Budget: February 2015*.

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Parties' fiscal rules

- All three main UK parties have fiscal rules that would allow smaller cuts than the £51 billion implied by coalition plans
- Conservatives are aiming for a budget surplus
  - Consistent with £21bn smaller cuts to departmental spending in 2019-20
- Labour/Liberal Democrats would exclude investment spending from their targets
  - Could reduce cuts to departments by £45bn in 2019-20 (and even more on capital spending by departments)
- Though cost would be borrowing and debt falling less quickly
- In addition, changes to tax/social security spending could reduce (or increase) the cuts to departmental spending

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Departmental cuts: alternative scenarios

	Real change 2015–16 to 2019–20:		Real change 2010–11 to 2019–20:	
	%	£ billion	%	£ billion
2014 Autumn Statement plans	–14.1			

Notes and sources: £ billion figures in 2015-16 prices. See Table 7.7 of *The IFS Green Budget: February 2015*.

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Departmental cuts: alternative scenarios

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Given parties' fiscal rules and stated intentions:				

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Conservatives	–6.7	-24.9		

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Given parties' fiscal rules and stated intentions:				
Conservatives	–6.7	-24.9		
Labour	–1.4	–5.2		

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Given parties' fiscal rules and stated intentions:				
Conservatives	–6.7	-24.9		
Labour	–1.4	–5.2		
Liberal Democrats	–2.1	–7.5		

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	%	£ billion	%	£ billion
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Given parties' fiscal rules and stated intentions:				
Conservatives	–6.7	-24.9	–16.5	–53.1
Labour	–1.4	–5.2	–10.8	–43.3
Liberal Democrats	–2.1	–7.5	–11.3	–45.7

Notes and sources: £ billion figures in 2015-16 prices. See Table 7.7 of *The IFS Green Budget: February 2015*.

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Risks in forecasts for receipts

- Three risks to revenue forecasts
  - growth will differ from the forecast
  - composition of growth will differ from the forecast
  - policy will be changed

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Composition of growth will differ from the forecast

- Receipts of income tax and NICs affected by the composition as well as the level of aggregate employment income
- Recent years have demonstrated this
  - aggregate employment income growth, 2009–10 to 2015–16,
    - June 2010: 29.1%
    - December 2014: 21.1%
  - receipts £26.2bn lower because of lower aggregate employment income
  - in addition, different composition of growth (more employment, lower earnings) reduced revenues by further £6.5bn
- Recent reforms have slightly increased sensitivity of revenues to how growth is distributed
  - income tax has been made more progressive
  - increased reliance on capital taxes

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Policy risk: upside risk for revenues

- General elections
  - with notable exception of spring 1992, pre-election budgets appear relatively restrained
  - recent history suggests elections associated with a subsequent boost to government revenues (1992, 1997, 2001, 2005, 2010)

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Policy risk: downside risks risk for revenues

- Forecasts assume rates of fuel duties indexed in line with the (discredited) RPI
  - recent history suggests this won't happen: 5-year cash freeze would cost £4.1bn in 2019–20, CPI-indexation would cost £1.8bn
- Income tax personal allowance and higher-rate threshold CPI uprated
  - we estimate 5.1 million higher-rate taxpayers in 2015–16, fiscal drag increases this by 1.2 million in 2020–21 and by 2.8 million in 2025–26
- Some thresholds frozen in cash terms
  - £100k and £150k income tax thresholds
  - £50k and £60k child benefit takeaway thresholds:
    - we estimate 1.2m families lose some/all child benefit in 2015–16
    - fiscal drag would result in 50% increase by 2020–21
    - and a more than doubling by 2025–26

In conclusion

- There remains a substantial deficit
- There are significant differences between the parties in how much of it to deal with
- Spending cuts may not be easy
- Some risks on tax revenues