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Fiscal Rules and Risks to Revenues

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Eliminating the deficit?

Chart: Current receipts vs Total Managed Expenditure, 2000–01 to 2020–21

Forecast surplus of £10 billion (0.5% of national income)

Source: http://budgetresponsibility.org.uk/data/

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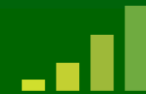

Three fiscal targets

- Reduce public sector net debt as a share of national income every year until a surplus is achieved
  - selling assets to meet this would be contrary to its underlying principle
  - forecasts suggest only on course to be met in 2015–16 and 2016–17 due to asset sales
- Cap forecast welfare spending
  - introduced to help Chancellors make unpopular benefit cuts rather than allow spending to increase inappropriately
  - welfare cap already breached in 2016–17, 2017–18 and 2018–19: not clear it is a real constraint on behaviour
- New fiscal mandate: achieve a headline surplus every year from 2019–20, unless growth drops below 1%

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Should public sector net debt be reduced?

- UK public sector net debt is high compared to:
  - recent history

    … but was above 80% of GDP for extended periods prior to 1967
  - most advanced economies

    … although not compared to the largest economies

- Good reasons to want to reduce debt as a share of national income:
  - might provide more fiscal flexibility in the face of another recession
  - reduce future debt interest commitments

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Public sector net debt projections

% of national income

90
80
70
60
50
40
30
20
10
0

1974–75
1979–80
1984–85
1989–90
1994–95
1999–00
2004–05
2009–10
2014–15
2019–20
2024–25
2029–30
2034–35
2039–40
2044–45
2049–50
2054–55
2059–60
2064–65

Financial year

Out-turn

Forecast

Borrowing 1.5% GDP, expected growth

Borrowing 0% GDP, expected growth

Surplus 0.5% GDP, expected growth

Notes and sources: see Figure 3.4 of *The IFS Green Budget: February 2016*.

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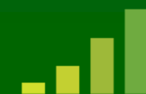

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Achieving and maintaining a budget surplus would be a break from the past

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

% of national income

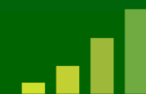
12
10
8
6
4
2
0
-2
-4
-6

Periods of surplus

1948
1950
1952
1954
1956–57
1958–59
1960–61
1962–63
1964–65
1966–67
1968–69
1970–71
1972–73
1974–75
1976–77
1978–79
1980–81
1982–83
1984–85
1986–87
1988–89
1990–91
1992–93
1994–95
1996–97
1998–99
2000–01
2002–03
2004–05
2006–07
2008–09
2010–11
2012–13
2014–15

Financial year

Notes and sources: see Figure 3.1 of *The IFS Green Budget: February 2016*.



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Should we run budget surpluses?

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

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

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The Chancellor’s fiscal mandate

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

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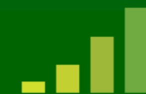
The 1% escape clause

4Q-on-4Q rolling growth rate (%)

Notes and sources: see Figure 3.6 of *The IFS Green Budget: February 2016*.



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Three problems with the fiscal mandate

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

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Risks

- Many risks around public finance forecasts
  - spending and revenues under announced policy will differ from forecast
  - further policy changes will be made
- Perhaps most obvious uncertainty around the underlying public finances is over the size of the economy
  - Oxford Economics pessimistic scenario has GDP 0.7% lower than the OBR forecasts in 2019–20
  - this would likely be sufficient to eliminate the forecast surplus
- Other factors matter too: including composition and distribution of GDP, oil prices, asset prices, etc.

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Risks to underlying revenues

- Earnings and employment
  - directly affect PAYE income tax and National Insurance (≈£262bn)

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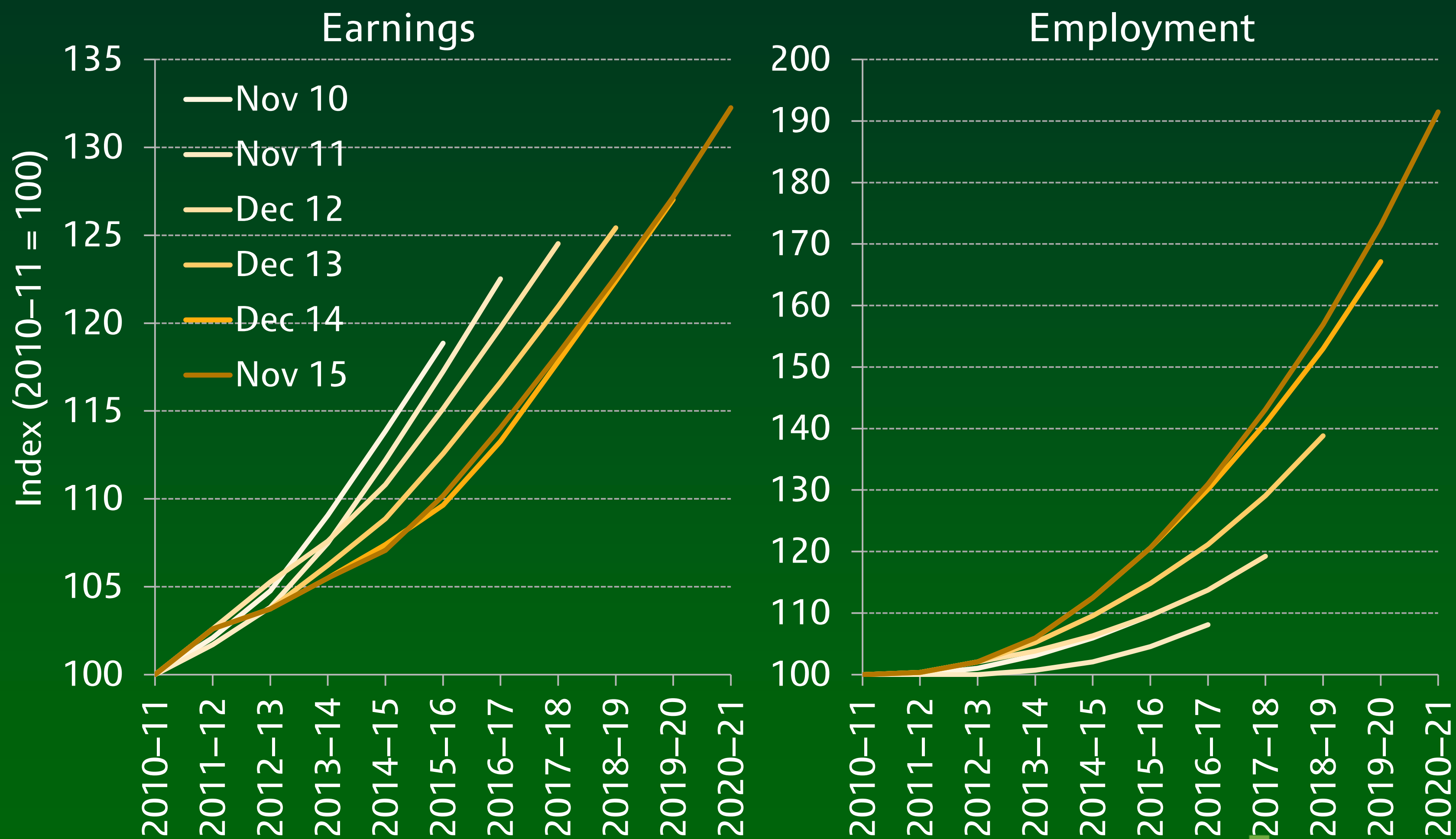
Risks: income tax and NICs revenues vulnerable to earnings and employment growth



Notes and sources: see Figures 5.2 & 5.3 of *The IFS Green Budget: February 2016*.

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Risks to underlying revenues

- Earnings and employment
  - directly affect PAYE income tax and National Insurance (≈£262bn)
- Volume of residential property transactions
  - affect revenues from stamp duty land tax (≈£8bn)

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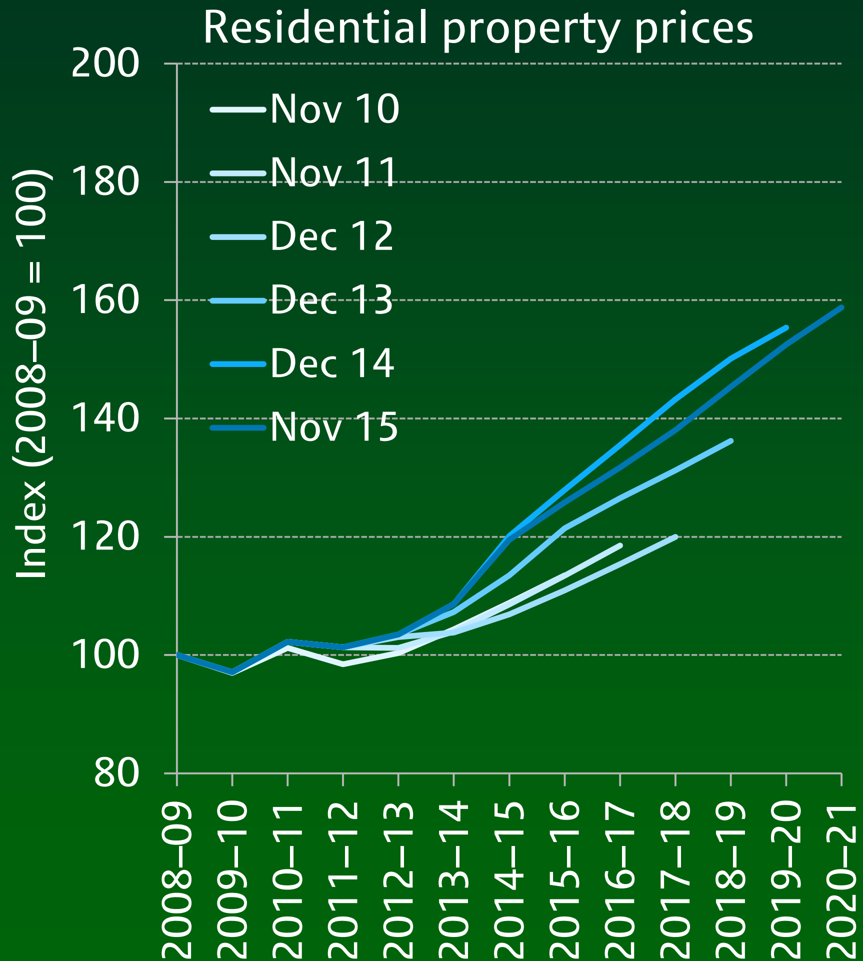
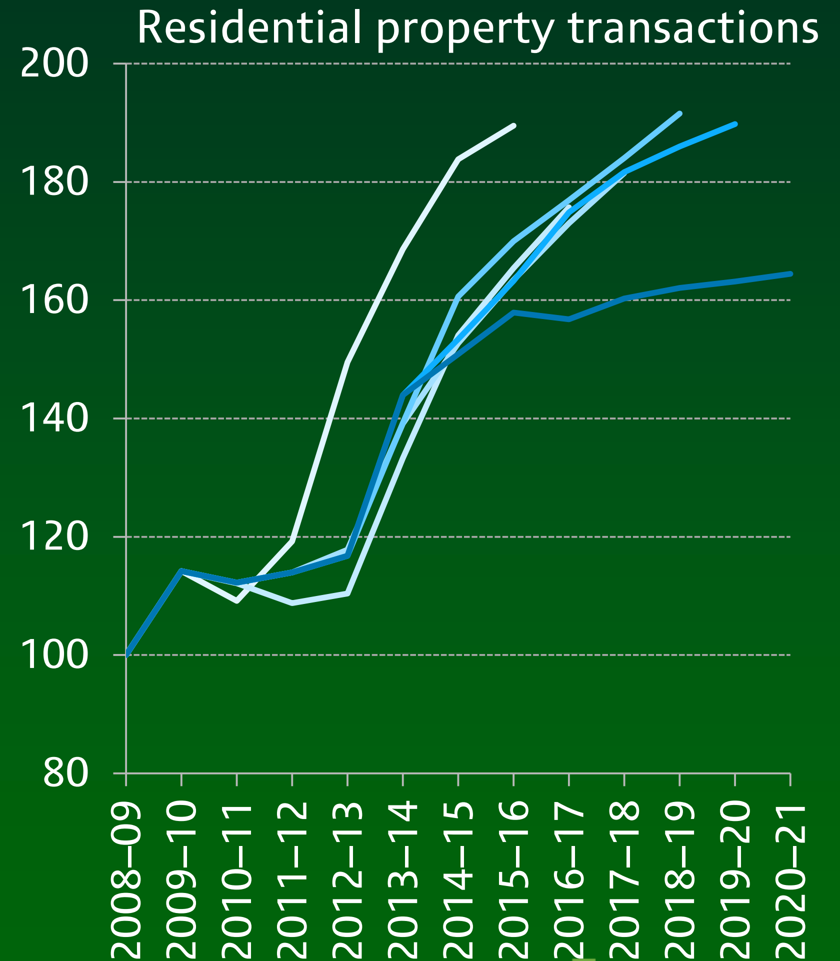
Risks: stamp duty revenues vulnerable to residential property market





Notes and sources: see Figures 5.7 & 5.8 of *The IFS Green Budget: February 2016*.

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- Oil prices
  - falls directly depress revenues from North Sea oil and gas production
  - but OBR estimates this is slightly more than offset by increases in revenues from fuel duties and taxes on increased onshore activity

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North Sea oil prices and revenues

Forecast receipts from offshore taxes downgraded by £3.7bn in 2015–16

Price in pounds

Forecast, Mar 14

Forecast, Nov 15

£ per barrel

0
10
20
30
40
50
60
70
80
90

1987
1989
1991
1993
1995
1997
1999
2001
2003
2005
2007
2009
2011
2013
2015
2017
2019

Notes and sources: see Figure 5.10 of *The IFS Green Budget: February 2016*.

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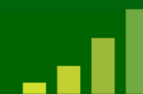

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- Equity prices
  - falls directly depress revenues from capital taxes (≈£14bn)
  - further loss from personal and corporate taxes related to the performance of the financial sector

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FTSE All-Share Index and capital tax receipts

July to November 2015:
equity prices downgraded by 7.4% in 2020–21;
forecast capital tax receipts down by £2bn

November 2015 to January 2016:
equity prices down by another 7.4%;
suggests capital tax receipts down by another £2bn

Actual
OBR forecast July 2015
OBR forecast November 2015
Latest projection

Index

5000
4500
4000
3500
3000
2500
2000
1500
1000
500
0

1972 1974 1976 1977 1979 1981 1983 1985 1987 1989 1991 1993 1995 1997 1999 2001 2003 2005 2007 2009 2011 2013 2015 2017 2019 2021

Notes and sources: see Figure 5.9 of *The IFS Green Budget: February 2016*.

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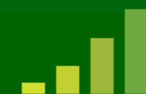

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Risk to revenues from promised tax cuts

- Income tax cuts
  - Conservative Party manifesto commits to a personal allowance of £12,500 and a higher-rate threshold of £50,000 by April 2020
  - standard indexation would increase these to £11,900 and £46,100
  - increasing them to £12,500 and £50,000 would cost around £8 billion

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Risks to revenues from more generous uprating

- Indexation of fuel duty rates
  - forecasts assume rates will be increased in line with the RPI every year from this April
  - but rates have not increased in nominal terms since April 2011
  - cash freeze would reduce revenues by £3 billion in 2020–21
- Some other thresholds are frozen in cash terms which might not prove sustainable
  - 40% more additional rate taxpayers since April 2010 due to £150,000 threshold being frozen
  - 50% increase projected over next five years in numbers losing some or all of their child benefit due to the £50,000 threshold being frozen

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Risk to revenues from pensions tax reform

- Income tax relief given on (most) pension contributions, while (most) pension withdrawals subject to income tax
- Chancellor to announce in Budget whether to retain status quo or whether to implement one of two radical reforms:
  1. move to flat-rate income tax relief on contributions, with tax treatment of pension income unchanged
  2. income tax levied on pension contributions not pension income
- Major reform could have significant and complicated impact on the level and timing of tax revenues
  - budget surplus in 2019–20 could be achieved with temporary revenues
  - but this would be contrary fiscal mandate's underlying principle

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