3. Challenges for the UK public finances

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Key findings

The Chancellor's new fiscal targets afford him much more flexibility than his predecessor's.

Fiscal policy is not currently subject to any fiscal targets that can be met or missed in the remainder of this parliament. Mr Hammond's first target pertains to the deficit in 2020–21 – on current forecasts, he could loosen fiscal policy by more than £25 billion in that year and still be on course to meet the target.

The profile of planned deficit reduction is uneven, and even in 2021–22 – after more than a decade of tax rises and spending cuts – the deficit is forecast to be 0.7% of national income.

Real levels of day-to-day public service spending have actually fallen very little overall in the last three years. The rate of reduction is set to speed up after this year, with cuts of nearly 4% due between 2016–17 and 2019–20. In addition, tax is rising as a share of national income and by 2019–20 is due to reach its highest level since 1986–87.

The forecast reduction in the deficit is much slower than that planned before the last general election or the June referendum, largely due to a worse economic outlook.

The government is likely to enact further tax-cutting measures that are not currently reflected in the forecast, which would add to borrowing.

The government is committed to increases in the personal allowance and the higher-rate threshold by the end of this parliament. These measures, combined with the likely continuation of a cash freeze to the rates of fuel duties, would cost £4¼ billion in 2020–21.

Focusing public spending cuts on the day-to-day spending of (unprotected) government departments, while increasing capital spending, is changing the make-up of government spending.

In 2007–08, central government spending on public services comprised 17p of capital spending for every £1 of day-to-day spending. In 2012–13, this had fallen to 13p of capital spending for every £1 of day-to-day. The forecasts imply that in 2021–22 this will increase to 21p of capital spending for every £1 of day-to-day.

By the end of the parliament, public spending on health, pensions and overseas aid will be higher as a share of national income than in 2007–08, while spending on schools, defence and (in particular) public order & safety will be lower.

Uncertainty surrounding the economic forecast is the largest risk to the public finances.

The Office for Budget Responsibility (OBR) downgraded the size of the economy in 2020–21 by 1.2% between March and November, but other forecasters are more pessimistic. If growth is lower than expected, borrowing is likely to increase. The public finances will also deteriorate if the fall in sterling leads to a greater-than-expected increase in household inflation and/or interest rates turn out higher than forecast.

Past forecasting performance suggests there is a one-in-five chance that the deficit in 2021–22 will actually be around or above its current level of 3.5% of national income. More optimistically, there is almost a two-in-five chance that there will be an overall budget surplus in that year.

The main objective of fiscal policy – returning the public finances to balance as soon as possible in the next parliament – will be made harder by forecast sluggish growth and pressures on public spending.

Demographic and non-demographic pressures are projected to put upward pressure of 1.0% of national income on health, social care and pension spending by 2025. Taking into account possible negative effects from lower growth, the government may need to enact further measures worth £40 billion (in 2016–17 terms) in order to eliminate the deficit in the next parliament.

3.1 Introduction

Despite having been enshrined in legislation as recently as October 2015,[1] the government has abandoned its commitment to deliver an overall budget surplus in 2019–20. This occurred in the aftermath of June's vote to leave the European Union (EU) and was subsequently followed by a downgrade in the official economic forecasts in November. The new Chancellor, Phillip Hammond, has said that the previous commitment will be replaced with a less specific pledge to deliver a budget surplus 'as early as possible in the next Parliament'.[2]

Even achieving this is likely to be difficult. The deficit this year is forecast by the Office for Budget Responsibility (OBR) to be £68.2 billion or 3.5% of national income. This is high by UK historical standards. Over the 60 years from 1948 until the eve of the financial crisis and associated recession, average UK government borrowing was 1.9% of national income. After six years of 'austerity', the deficit this year will still be higher than it was 80% of the time in the 60 years before the financial crisis, while debt is now at its highest level as a proportion of national income since 1965–66. And, as stated in Chapter 2, there is probably more uncertainty now over future prospects than at any point in the last 60 years.

This chapter looks in detail at the latest official forecasts for the public finances and discusses some of the key risks around them. Section 3.2 sets out the broad picture on the public finances, including the forecast for the deficit and debt over the next few years and the fiscal targets that the government has set itself. Section 3.3 looks in more detail at the planned fiscal consolidation, how it is to be achieved and how it compares with previous consolidation plans for this parliament. Section 3.4 explores the main risks around the medium-term forecast, while Section 3.5 concludes, with a focus on the challenge of eliminating the deficit in the next parliament. A postscript in Section 3.6 acknowledges the latest set of Bank of England forecasts, which were published on the same day as this document went to print.

3.2 The big picture

The new fiscal targets

Before examining the public finance forecasts for the next few years, it is useful to lay out the government's new fiscal targets – the rules that, if they are to be obeyed, will constrain the operation of fiscal policy. The government's previous fiscal mandate required it to deliver a budget surplus in 2019–20, and every subsequent year as long as economic growth was sufficiently high.[3] Alongside this, a supplementary target required that public sector net debt should fall as a share of national income throughout this

[1] A motion to approve the Charter for Budget Responsibility: Autumn 2015 update was approved by parliament on 14 October 2015 (https://www.parliament.uk/business/news/2015/october/charter-for-budget-responsibility-autum-2015-update/).

[2] Chancellor Phillip Hammond's Autumn Statement 2016 speech, https://www.gov.uk/government/speeches/autumn-statement-2016-philip-hammonds-speech.

[3] For more details on this target, see R. Crawford, C. Emmerson, T. Pope and G. Tetlow, 'Fiscal targets: committing to a path of budget responsibility?', in C. Emmerson, P. Johnson and R. Joyce (eds), *IFS Green Budget: February 2016*, https://www.ifs.org.uk/publications/8129.

parliament. This was missed in 2015–16. A welfare cap required that forecast welfare spending should remain below a certain cap. This was breached in November 2015.

The new Chancellor has abandoned his predecessor's fiscal framework and introduced a new set of targets that allow him more leeway. The main stated objective for fiscal policy is now to 'return the public finances to balance as soon as possible in the next Parliament' as long as the economy is not too weak (a judgement that will be made by HM Treasury, which in effect presumably means the Chancellor himself). While stated as a target for the next parliament, it is to be presumed that this is actually a target for 2024–25, which would be the last full financial year of the next parliament were both this one and the next to run their full course.

Fiscal policy is not currently subject to any fiscal targets that can be met or missed in the remainder of this parliament. The targets do provide checks on fiscal policy before the public finances are returned to balance, however. The fiscal mandate, which applies to 2020–21, requires that the cyclically-adjusted (or structural) deficit – that is, the portion of the deficit that is not thought to be explained by temporary strength or weakness in the economy – be below 2% of national income in that year. Compared with the budget surplus required by the previous fiscal rule (in 2019–20 and beyond), this target provides more headroom in two respects. First, and most importantly, a 2% of national income target requires much less tightening than budget balance. Second, any borrowing in 2020–21 that was thought to be the result of a temporary economic weakness would not affect whether or not the government achieves its target. Headline borrowing could be above 2% of national income as a result of factors deemed to be cyclical and the target would still be met.

The government's fiscal framework also incorporates two other rules: the supplementary debt target and the welfare cap, neither of which is tested in this parliament. The supplementary debt target requires that public sector net debt (PSND) falls as a proportion of national income between 2019–20 and 2020–21 (the first out-turn data for which are due in April 2021). This target refers to the headline measure of PSND. As we discuss below, this target looks to be particularly easy to meet given temporary factors that are likely to reduce PSND in that year. Even setting these factors aside, however, it is not clear that this kind of rule – requiring that debt fall as a proportion of national income between two years in the future – is a useful check on government fiscal policy. In theory, the rule could be met more easily by adding substantially to debt in 2019–20 (and then commensurately reducing it in 2020–21), or by the sale of assets in 2020–21, which reduces this measure of debt but does not affect the underlying health of the public finances if assets are sold for what they are worth.

The welfare cap requires forecast spending on 'welfare-in-scope' – essentially total social security spending less that spent on the state pension and the most cyclical benefits – not to exceed a certain limit. But the new Chancellor has decided that compliance with this rule should only be tested every five years (as opposed to annually as it was under his predecessor George Osborne), with the first test coming after the next general election. More details on the welfare cap are provided in Box 3.1.

Box 3.1. The welfare cap

The government's third fiscal target pertains to welfare spending, and requires that spending on a specified set of welfare items does not exceed a certain cap. Not all welfare spending sits inside the cap, with notable exclusions including the state pension and cyclical benefits such as jobseeker's allowance. This new welfare cap is similar in design to the previous welfare cap, which was first introduced in the March 2014 Budget but has been in breach since the Autumn Statement of 2015. Detailed discussion of that rule can be found in last year's Green Budget.[a] The new cap does differ from the old one in certain respects, all of which move in the direction of making it easier to meet.

- First, the level of the cap is higher than the old one, with the level set at the current forecast level of spending plus 3%, whereas previously spending could only exceed the (then lower) current forecast by 2%.
- Second, under the old target, welfare spending could only use up the 2% margin due to forecasting changes. The new 3% margin can apply to forecasting or policy changes.
- Third, the OBR will be asked to take into account inflation forecast changes and adjust the level of the cap accordingly.
- Fourth, the new target is only to be assessed once every five years (rather than every year), and not until 2021–22. The previous target applied, and was assessed, in every year.

The measure of welfare spending covered by the cap is forecast at £126.0 billion in 2021–22, with a 3% margin worth £3.8 billion in that year. This forecast assumes that the net cuts to social security spending – estimated to reduce spending in 2021–22 by £13.2 billion (see Table 3.2 later) compared with what it would have been without these changes – will all be implemented in full. But aside from the second two years of the freeze to most working-age benefits, and the second two years of the 1%-a-year cuts to social rents, most of these policies will be in place from April 2017.

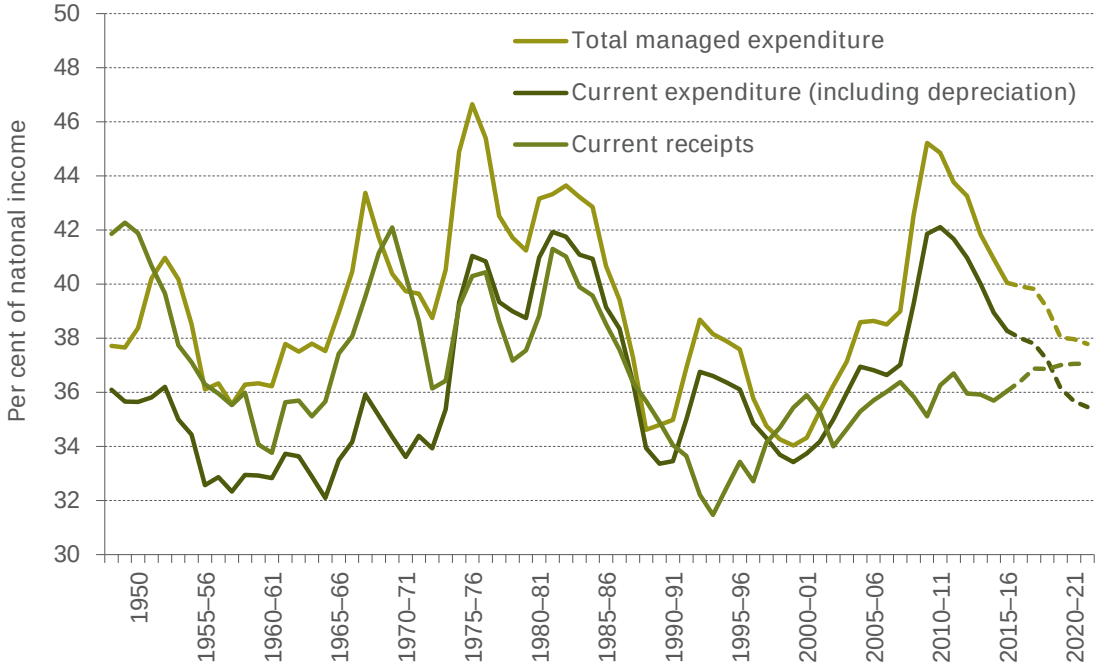
[a] See R. Crawford, C. Emmerson, T. Pope and G. Tetlow, 'Fiscal targets: committing to a path of budget responsibility?', in C. Emmerson, P. Johnson and R. Joyce (eds), *IFS Green Budget: February 2016*, https://www.ifs.org.uk/publications/8129.

Headline deficit and public sector debt

If delivering budget takeaways – in the form of tax rises or spending cuts – is easier following years of budget giveaways, then eliminating the deficit over the next few years will be particularly challenging. Figure 3.1 shows how government spending rose as a fraction of national income during the 2000s, rose sharply as national income fell in the wake of the financial crisis, and has fallen since 2009–10 though it remains higher as a share of national income than it was pre-crisis. The tax burden has changed much less (as cash receipts tend to move more in line with the size of the economy), but is due to rise over the next couple of years. As a result of large cuts to spending as a proportion of national income and, to a lesser extent, net tax rises, the budget deficit (the gap between

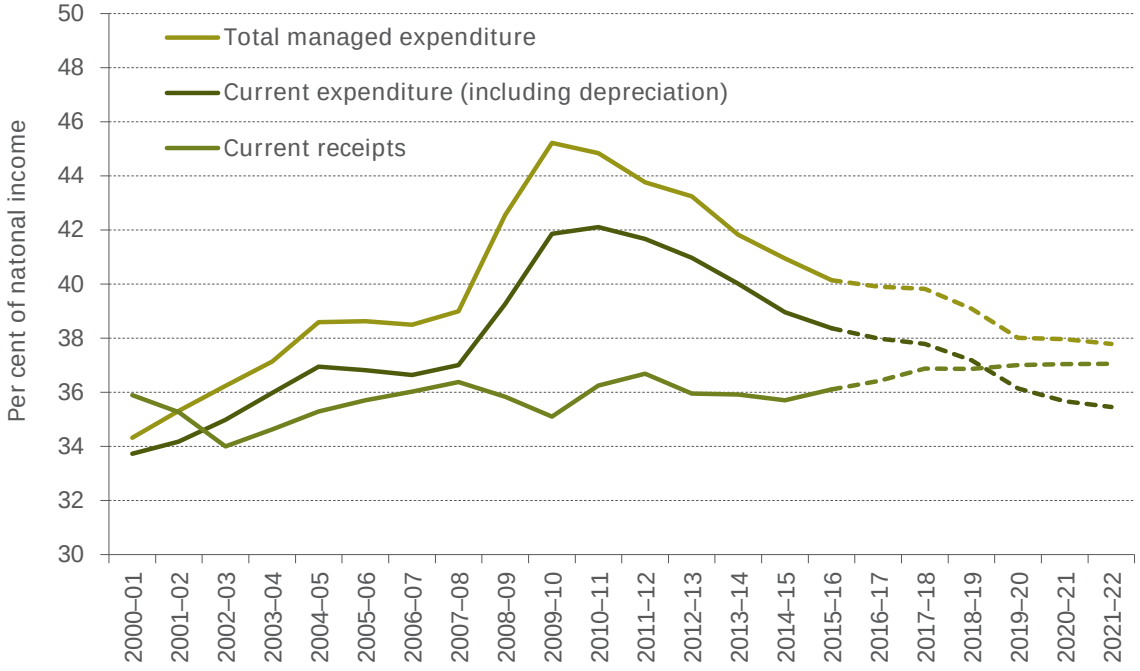
total spending and receipts) has fallen significantly from its peak of 10.1% of national income in 2009–10.

Figure 3.1. The flows: public sector receipts and spending since 1948



Source: Office for Budget Responsibility, 'Public finances databank', November 2016, http://budgetresponsibility.org.uk/data/.

Figure 3.2. The flows: public sector receipts and spending since 2000–01



Source: Office for Budget Responsibility, 'Public finances databank', November 2016, http://budgetresponsibility.org.uk/data/.

OBR forecasts – which can be seen more clearly in Figure 3.2 – imply that increases in tax revenues, rather than cuts to spending, deliver the bulk of the reduction in the deficit as a share of national income between 2015–16 and 2017–18. Then, between 2017–18 and 2019–20, deficit reduction is mainly forecast to come once again from cuts to spending as a share of national income. From 2019–20, total receipts are forecast to exceed current expenditure (which is total expenditure excluding spending on public sector net investment) which, if delivered, would mean that the UK was running its first current budget surplus since 2001–02.

Beyond 2019–20, the forecasts are based on plans for current spending staying constant in real terms, and hence falling relative to national income, while investment spending rises. Of course, everything is very uncertain that far out, but if the current policy plans do materialise and if the economy develops as forecast, we would see the deficit falling from 1.0% of national income in 2019–20 to 0.9% of national income in 2020–21, the year in which the government's fiscal mandate applies. Of this 0.9% of national income deficit, 0.8% is judged to represent permanent borrowing not related to temporary economic weakness. The target allows this cyclically-adjusted borrowing to be up to 2% of national income, leaving the government with 1.2% of national income (or £26.6 billion in 2020–21) of fiscal headroom, which is equivalent to just over 3% of receipts and spending forecast in that year. The deficit is then forecast to fall gradually again, to 0.7% of national income in 2021–22. In this year, total public spending would be at its lowest share of national income since 2003–04, while revenues would be at their highest share of national income since 1986–87.

As we noted above, the UK's deficit is currently high by historical standards. It is also high by international standards. Table 3.1 shows that, among 28 advanced economies (ranked in the table from the largest economy at the top to the smallest at the bottom), the UK had the fourth largest deficit in 2015, lower than only Japan, Spain and Portugal. Government debt (which is, loosely speaking, the deficits that have been accumulated to date) is also high by international standards. In 2015, the UK ranked sixth, behind Greece, Japan, Portugal, Italy and France. Although it should be noted that the UK's level of debt is not markedly higher than those of economies of a similar size or larger: of the six largest economies in 2015 listed in Table 3.1, only Germany had a significantly lower level of government debt than the UK.

Figure 3.3 shows how the substantial government deficits since 2008 have led to public sector debt increasing sharply. Before the financial crisis, net debt was running at just below 40% of national income but it is now forecast to peak at 90% of national income in 2017–18 before falling over the following four years.

As well as the effects of the deficit, much of the sharp increase in debt in 2016–17 and 2017–18, and subsequent decline, is explained by the monetary policies announced by the Bank of England in August 2016. In particular, this is driven by the new Term Funding Scheme (TFS), under which up to £100 billion of loans are to be made available to UK banks and building societies until the end of February 2018, with the loans to be repaid within four years of being taken out. The liabilities created to make these loans add to public sector net debt but the assets (the value of the expected loan repayments) are not netted off (because they are not deemed to be a short-term financial asset). So this

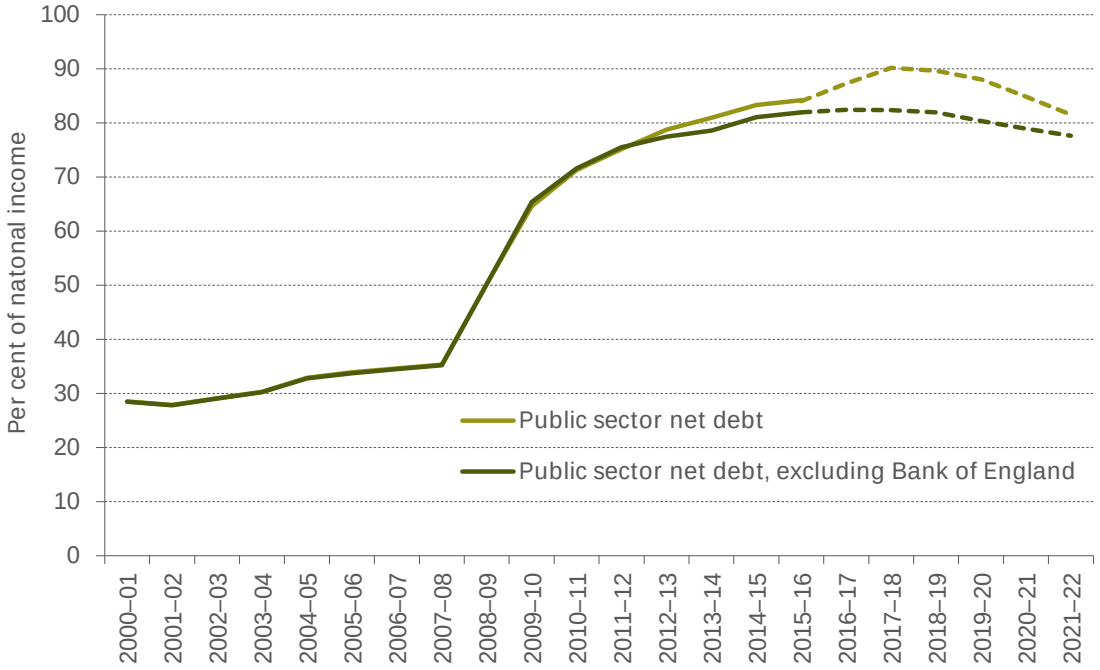
Table 3.1. 2015 deficit and debt in 28 advanced economies

Country (ranked by GDP from largest to smallest)	Deficit		Debt	
	% GDP	Rank	% GDP	Rank
United States	3.5	6	79.8	7
Japan	5.2*	1	125.3*	2
Germany	–0.7	27	47.5	14
United Kingdom	**4.2**	**4**	**80.4**	**6**
France	3.5	5	88.2	5
Italy	2.6	12	113.3	4
Canada	1.3	18	26.3	20
South Korea	–0.3	25	35.7	16
Australia	2.8	9	17.7	22
Spain	5.1	2	79.7	8
Netherlands	1.9	14	34.3	18
Switzerland	0.2*	21	24.5*	21
Taiwan	1.8	16	34.6	17
Sweden	0.0	24	–19.3	26
Belgium	2.6	11	61.0	10
Norway	–5.5*	28	–279.1*	28
Austria	1.2	19	59.1	12
Israel	3.1	7	60.9	11
Denmark	1.7	17	6.5	24
Ireland	1.9	13	67.0	9
Finland	2.7	10	–50.7	27
Portugal	4.4*	3	121.6*	3
Greece	3.1	8	176.6*	1
New Zealand	0.2	23	6.5	23
Lithuania	0.2	22	39.9	15
Latvia	1.8	15	32.0	19
Estonia	–0.4	26	–1.7	25
Iceland	0.5	20	50.6	13

Note: Countries ranked by the size of their economy in 2015 (in dollars). Estimates marked with *. Measures are general government net deficit and general government net debt. These are similar to, but differ slightly from, the public sector measures typically used in the UK and quoted elsewhere in the chapter.

Source: International Monetary Fund, 'World Economic Outlook database', October 2016, https://www.imf.org/external/pubs/ft/weo/2016/02/weodata/index.aspx. Debt for Greece taken from April 2016 database.

Figure 3.3. The stock: public sector debt



Source: Chart 4.12 on page 192 of Office for Budget Responsibility, *Economic and Fiscal Outlook – November 2016*, http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2016/.

scheme adds to public sector net debt when the loans are taken out (in 2016–17 and 2017–18) and reduces it when they are repaid (assumed by the OBR to be four years later in 2020–21 and 2021–22). The second series on Figure 3.3, 'Public sector net debt, excluding Bank of England', strips out the effect of the TFS (and some other measures, which are smaller in terms of their impact on public sector net debt). The OBR forecast for this series peaks in 2016–17 but then falls only slightly over the rest of the forecast horizon.

This uneven debt profile underlies the dangers of focusing on a narrow measure of debt. While affecting headline PSND, arguably the TFS neither weakens nor strengthens the public finances. These issues take on a particular significance over this time horizon because of the government's supplementary debt target (see above). The target requires headline PSND to fall between 2019–20 and 2020–21. But this is exactly the point when a significant portion of the TFS loans are due to be paid back, reducing PSND dramatically. Indeed, the OBR estimates that the government would need to run a deficit of 4% of national income in order not to meet its fiscal target.

Of course, while ignoring the liabilities accrued in order to finance the TFS would lead to a lower estimate of debt, as discussed in detail in Chapter 4, the UK government has other substantial liabilities, such as unfunded public service pensions, that are not included in the National Accounts measure of PSND.

So, with a deficit in the current year that is high by historical and international standards, the OBR forecasts that over the next five years the deficit will continue to fall, albeit at a relatively slow rate beyond 2019–20. Meanwhile, public sector net debt excluding the impact of Bank of England measures, which are expected to be temporary, will remain around 80% of national income.

3.3 Planned deficit reduction through this parliament

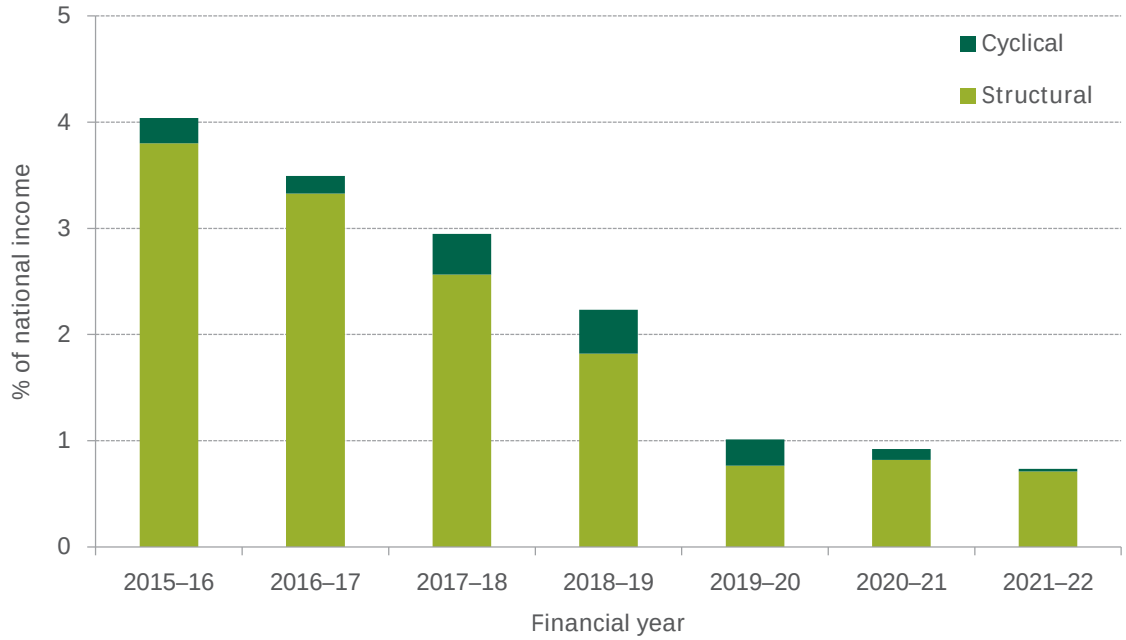
The pace of deficit reduction

As noted above, the deficit remains high by historical standards, forecast to stand at 3.5% of national income, or £68.2 billion, in 2016–17. This is £12.7 billion higher than the OBR forecast for 2016–17 borrowing in March 2016. This increase was not a result of a downgrade to the forecast for economic growth, but arose as a result of weak growth in tax receipts – in particular, income tax, National Insurance contributions (NICs) and stamp duty land tax – and faster growth in local authority spending.

Furthermore, as Figure 3.4 shows, only a small portion of this borrowing (0.2% of national income) is judged by the OBR to be cyclical – that is, a result of temporary economic weakness. So most of the deficit is not expected to disappear simply as a result of economic growth over the next few years. Instead, the majority represents a structural phenomenon that is expected to persist unless dealt with through permanent net tax increases and/or spending cuts.

As set out in Chapter 2, different economic forecasters have come to different assessments of the current size of the output gap, with Oxford Economics judging that there is currently likely to be greater spare capacity in the UK economy than the OBR thinks. Had the OBR concurred with Oxford Economics, then it would deem more of the deficit – around 1.4% of national income – to be cyclical rather than structural. However, despite this, Oxford Economics is not more optimistic than the OBR about the prospects for growth over the next five years (as it has a weaker outlook for trend growth over this period), so it is not the case that under the Oxford Economics scenario the medium-term outlook for the public finances would necessarily be more optimistic.

Figure 3.4. Public sector net borrowing, 2015–16 to 2021–22



Source: Office for Budget Responsibility, 'Public finances databank', http://budgetresponsibility.org.uk/data/.

Given current stated policies, over the next five years the deficit is forecast to decrease in every year as a proportion of national income, reaching 0.7% of national income by 2021–22. The pace of deficit reduction is relatively slow over the next two years (2017–18 and 2018–19). This is largely down to the OBR forecasting that the UK economy will grow by only 1.4% in 2017.

The OBR forecasts that this weak growth will lead to the economy operating further below its sustainable level, leading to an increase in cyclical borrowing of 0.2% of national income in 2017–18. The result is that the relatively large reduction in the structural deficit will result in the headline deficit falling by only 0.5% of national income between 2016–17 and 2017–18. The opposite effect occurs between 2018–19 and 2019–20, when an already large reduction in structural borrowing is accompanied by a fall in cyclical borrowing (of 0.2% of national income) as the economy grows more strongly; the economy is forecast by the OBR to grow by 2.1% in 2019. By the end of the forecast period, the cyclical effect on borrowing has mostly washed out, such that almost all of the borrowing forecast in 2021–22 is thought to be structural rather than cyclical.

This profile for borrowing represents much slower deficit reduction than previously planned by the current government or the coalition government. As recently as March 2016, the government was planning to eliminate the deficit and return the government budget to surplus by 2019–20. The current plans imply that we will still have a deficit of £17 billion two years later.

The profile of deficit reduction is far from even over the forecast horizon. Between 2015–16 and 2019–20, the deficit is set to fall at an average rate of 0.8% of national income per year. Between 2019–20 and 2021–22, it falls by only 0.3% of national income overall. If the rate of deficit reduction between 2019–20 and 2021–22 were to continue beyond the forecast horizon, the budget would not reach surplus until 2027–28. This would be in breach of the government's main stated objective. Furthermore, part of the deficit reduction between 2019–20 and 2021–22 results from a reduction in cyclical borrowing. Structural borrowing (which is what is affected by discretionary changes to fiscal policy) is set to fall even more slowly from 2019–20 than total borrowing.

So, on current plans, further austerity will be required in order to deliver the commitment to eliminate the deficit in the next parliament. One way to do this would be to reduce the deficit in the years beyond 2021–22. This could be achieved by further tax-raising measures being announced after the next general election (as was the case after the previous six general elections) and/or through a deeper cut to public spending as a share of national income than is implied by the latest official forecasts. If the pace of deficit reduction beyond 2021–22 matched the 0.5% of national income per year rate of reduction between 2015–16 and 2021–22, a surplus would be achieved by 2023–24. Of course, the amount of consolidation required during the 2020s to meet the target will depend on how the economy and other factors develop between now and then. Section 3.4 explores the main risks to the forecast.

Composition of the consolidation

Table 3.2 sets out how reductions in borrowing between 2015–16 and 2021–22 are to be achieved. The deficit is to be reduced through a combination of net discretionary tax rises, discretionary cuts to spending on social security benefits and a squeeze on departmental spending over the next five years.

Table 3.2. Consolidation plan, November 2016: change in deficit since 2015–16 (£bn)

	2016–17	2017–18	2018–19	2019–20	2020–21	2021–22
Total new measures	**–14.8**	**–21.5**	**–37.1**	**–60.1**	**–58.1**	**–65.7**
Of which:						
Net discretionary tax rises	–9.6	–9.6	–12.0	–16.7	–14.4	–14.4
Net discretionary cuts to welfare spending	–1.5	–4.2	–7.5	–12.2	–12.8	–13.2
Impact from a real freeze to DEL (relative to constant share of GDP)	–8.0	–12.2	–19.8	–28.7	–37.6	–47.1
Additional impact from a real cut to DEL	4.3	4.5	2.3	–2.6	6.8	9.0
DEL total (relative to constant share of GDP)	*-3.7*	*-7.7*	*-17.6*	*-31.2*	*-30.9*	*-38.1*
Underlying changes	7.0	4.5	7.6	6.1	2.8	6.9
Change in deficit since 2015–16	–7.8	–17.1	–29.5	–54.1	–55.3	–58.8
Deficit (£76.0 billion in 2015–16)	**68.2**	**59.0**	**46.5**	**21.9**	**20.7**	**17.2**

Note: DEL refers to departmental expenditure limits, and refers to OBR definitions (PSCE in RDEL and PSGI in CDEL) rather than Treasury ones. Numbers may not sum due to rounding.

Source: Table 2.17 of Office for Budget Responsibility, *Economic and Fiscal Outlook Supplementary Fiscal Tables: Expenditure – November 2016*, http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2016/; Office for Budget Responsibility, *Economic and Fiscal Outlook*, June 2010 to November 2016, http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2016/; authors' calculations.

Net discretionary tax rises

A measure of the size of the net tax rises can be taken from looking at the 'budget scorecard' in successive fiscal events. This gives an estimate of the revenue effects of each measure, in each year, relative to a counterfactual of not doing that measure. On this basis, tax changes coming into effect since 2015–16 involve a net tax rise, though this comprises a large gross tax cut offset by an even larger gross tax rise. These net tax rises are frontloaded in the current parliament and, in fact, are the biggest contributor to a falling deficit in 2016–17.

- Of the £9.6 billion net tax rise in 2016–17, £5.4 billion is from measures announced before the 2015 general election (with the abolition of contracting out into defined benefit pension schemes announced in the March 2013 Budget raising £5.5 billion in 2016–17), with a further £4.2 billion announced in the four fiscal statements since the general election.

- This £4.2 billion of net tax rises in 2016–17 from measures announced since the general election arises from tax cuts that amount to a total giveaway of £3.7 billion and tax rises that amount to a total takeaway of £7.9 billion. The tax cuts include above-inflation increases in the income tax personal allowance and higher-rate threshold (costing £1.2 billion in 2016–17) and a freeze to rates of fuel duties (£0.4 billion). The larger tax rises include the introduction of a new dividend tax regime (raising £2.8 billion in 2016–17), an increase in the rate of insurance premium

tax (IPT, £1.6 billion) and a higher rate of stamp duty land tax for those purchasing second and subsequent residential properties (£0.7 billion).

- Beyond 2016–17, further tax cuts arise, most prominently, from a further increase in the personal allowance and higher-rate threshold (in April 2017), a further freeze to rates of fuel duties (in April 2017), a new main home allowance in inheritance tax (in April 2017) and cuts to the rate of corporation tax (in April 2017 and April 2020), while the larger tax increases include the introduction of the apprenticeship levy (in April 2017; see Chapter 8), increases in vehicle excise duty on the purchase of new cars (in April 2017), yet another increase in the rate of IPT (in June 2017) and a restriction in pension contribution limits for those on very high incomes (which came into effect from April 2016, but raises significantly more from 2018–19 onwards).

- Overall, a net tax rise of £14.4 billion (0.6% of national income) is set to take place between 2015–16 and 2021–22. This comprises a gross tax rise of £34.7 billion and a gross tax cut of £20.3 billion. Between 2015–16 and 2019–20, the net tax rise is actually slightly larger, at £16.7 billion, while between 2019–20 and 2021–22 there is a small net tax cut planned overall (in particular from a cut to the rate of corporation tax).

Net discretionary cuts to welfare spending

As with tax changes, a measure of the size of welfare cuts can be taken from successive 'budget scorecards'. Again this provides an estimate of the impact on spending of each measure, in each year, relative to a counterfactual of not doing that measure. Under that counterfactual, other factors could be pushing welfare spending up (or, in principle, down). For example, growth in the private rented sector has been an underlying pressure pushing up housing benefit spending. So while a welfare cut means that spending is lower than it would otherwise have been in that year, overall welfare spending could still be rising over time.

Net cuts to welfare taking effect after 2015–16 reduce spending and therefore borrowing in 2019–20 by £12.2 billion (0.6% of national income), as shown in Table 3.2. Almost all of these cuts represent action taken by the Conservative government since May 2015.[4] The impact of the welfare cuts is backloaded in the current parliament.

- Large contributors to this cut are a four-year freeze to the rates of most working-age benefits from April 2016 to April 2019 inclusive (cutting spending by £4.9 billion in 2019–20), reductions in the generosity of universal credit (in particular for in-work claimants through large cuts to 'work allowances', £2.9 billion in 2019–20) and cutting means-tested support for families with more than two children (for new births from April 2017 only, £1.1 billion in 2019–20).

- The four-year freeze to rates cuts spending by a larger amount over time. This is due not only to more years of the freeze applying, but also to rising inflation meaning that the nominal freeze in later years corresponds to a larger real cut in those years. In addition, while the other major changes will have been implemented by April 2017, they typically only apply to new claimants and therefore will represent a bigger

[4] For the purposes of this analysis, we are not counting the move from RPI to CPI for uprating the rates of most benefits, which significantly reduced future spending relative to what it would have been and which was announced in the June 2010 Budget as a measure affecting spending in this parliament.

spending cut in future years. As a result, the effect of the welfare cuts on spending increases particularly sharply between 2017–18 and 2019–20.

Central government spending on public services

For departmental expenditure limits (DELs) – that is, central government spending on the delivery and administration of public services – we compare spending plans with what spending would have been had it been kept constant as a share of national income. In normal times, and over the longer term, this is a sensible neutral assumption as it keeps the size of the state constant over time.

The change in spending relative to keeping spending constant as a share of national income is decomposed into two components in Table 3.2: first, the change in DELs as a share of national income that would arise from freezing spending in real terms; and second, the increase or cut to DEL that is actually planned in real terms. As long as the economy is growing in real terms (which it is forecast to do in each of the next five years), then the former will always represent a cut in spending relative to national income (and typically a significant one). The latter figure shows whether or not DELs are rising relative to economy-wide inflation.

We have already shown that significant cuts to welfare spending, and even larger net tax rises, are planned for the period from 2015–16 to 2021–22. But when compared with a counterfactual of keeping DELs constant as a share of national income, we find that by far the largest part of the consolidation comes through a squeeze on the spending of government departments.

- Over the period 2015–16 to 2021–22, overall departmental spending is set to increase by £9.0 billion in real terms, which comprises a real cut in day-to-day spending (of £11.1 billion in 2021–22 prices) and a real increase in investment spending (of £20.1 billion in 2021–22 prices). Figures 3.9 and 3.10, later in this chapter, set out more details on the size and profile of DEL, separately for day-to-day spending and capital spending, over the next five years.

- However, the economy is forecast to grow much more quickly than prices over the forecast period. Compared with increasing spending in line with national income since 2015–16, the current plans imply a cut of £38.1 billion in 2021–22. This comprises a cut to day-to-day spending (of £52.4 billion) offset by an increase in investment spending (of £14.3 billion). Overall, departmental spending is set to fall from 18.7% of national income in 2015–16 to 17.1% in 2021–22.

- The cuts to DEL in the current parliament (both in real terms and when measured relative to holding them constant as a share of national income) are backloaded with, for example, total DEL rising in real terms between 2015–16 and 2017–18 despite being cut over the period from 2015–16 to 2019–20.

In total, the effect of fiscal consolidation from 2015–16 to 2021–22 reduces the deficit by £65.7 billion (2.8% of national income). The overall reduction in the deficit is actually slightly smaller than the total effect of measures, because underlying changes to receipts and spending (not attributable to new policy measures) are estimated to push up the cash level of the deficit over the forecast period. The deficit is therefore set to be £17.2 billion in

2021–22, down from £76.0 billion in 2015–16, through a combination of net tax rises, welfare cuts and, most prominently, a large squeeze on departmental spending.

Consolidation plans for this parliament compared

While this consolidation, totalling £65.7 billion of which £60.1 billion is to come by 2019–20, is substantial, the result is a much slower pace of deficit reduction than previously planned. The government previously intended to be in surplus at least two years before 2021–22, whereas the current plans imply we will still have a deficit in that year. We therefore compare plans for deficit reduction as they now stand (as was presented in Table 3.2) with the plan as of March 2016 (the last before the June 2016 EU referendum) and as of March 2015 (the last before the May 2015 general election). We focus on the period from 2015–16 until the end of this parliament in 2019–20. While the current forecast extends beyond that year, we have seen above that the vast majority of planned fiscal consolidation from 2015–16 to 2021–22 is set to be in place by 2019–20. This also enables comparison with previous plans, which were made over different forecast horizons.

The successive consolidation plans are outlined in Table 3.3 and displayed graphically in Figure 3.5. The 2015–16 deficit is now thought to have been slightly higher than the estimate in March 2016 or the forecast in March 2015. However, the main differences between the plans occur between 2015–16 and 2019–20. The 2019–20 deficit is now forecast to be £21.9 billion – a position around £30 billion weaker than the planned surpluses as of March 2015 and March 2016.

Table 3.3. Consolidation plans for this parliament as of November 2016, March 2016 and March 2015 (£bn)

	Nov. 2016 (latest)	March 2016 (pre referendum)	March 2015 (pre general election)
Deficit in 2015–16	**76.0**	**72.2**	**75.3**
Total measures	**–60.1**	**–75.6**	**–69.9**
Of which:			
Net discretionary tax rises	–16.7	–21.9	–4.5
Net discretionary cuts to welfare spending	–12.2	–13.4	–0.7
Impact from a real freeze to DEL	–28.7	–32.3	–37.3
Additional impact from a real cut to DEL	–2.6	–8.0	–27.3
DEL total (relative to constant share of GDP)	*-31.2*	*-40.3*	*-64.6*
Underlying changes	6.1	–7.0	–12.4
Deficit in 2019–20	**21.9**	**–10.4**	**–7.0**

Note and source: See Table 3.2.

The higher planned deficit now compared with previous plans is explained, at least in part, by a reduction in the size of measured fiscal consolidation. The planned composition of the consolidation has also changed.

- Before the 2015 general election, the forecast implied that almost all of the fiscal tightening planned would occur through departmental expenditure restraint, with only £5.2 billion of additional net tax rises or welfare cuts.[5] The plans of that time also implied that we would reach a surplus in 2018–19, increasing spending in line with national income thereafter (giving a so-called 'roller-coaster profile').[6]

- After the general election, a series of new tax rises and welfare cuts were announced, while the squeeze on departmental spending was eased. The date by which a surplus was to be achieved was pushed back – from 2018–19 to 2019–20 – with the overall scale of the planned consolidation increasing slightly.

- Between March and November of last year, the change in consolidation plans is more modest. The measured cut to departmental spending is now lower. Partly this reflects a larger real increase in capital spending and a smaller real cut to departmental spending (of £3 billion of 'efficiency savings' planned in 2019–20, £1 billion is now to be spent rather than banked). The cut to public spending is also now smaller as a proportion of national income. The OBR now expects the economy to grow more slowly than it expected in March. This means that a given set of cash spending plans will represent a larger share of future national income and, therefore, a smaller cut to spending as a share of national income.[7]

However, differences in the size of the planned fiscal consolidation alone are not sufficient to explain differences in the 2019–20 deficit across these plans. Even if there had been no change to the fiscal consolidation plan, the deficit would have been higher under the November 2016 forecast than under either of the March forecasts (see the '2019–20 no measures' series in Figure 3.5). According to the November 2016 forecast, the deficit would be on course to increase between 2015–16 and 2019–20 (by £6 billion) had no policy measures been enacted, whereas under the March 2015 forecast it would have been on course to fall (by £12 billion). This £18 billion deterioration in the underlying position largely reflects a weaker economic outlook and highlights that economic performance is crucial in determining the path of the public finances.

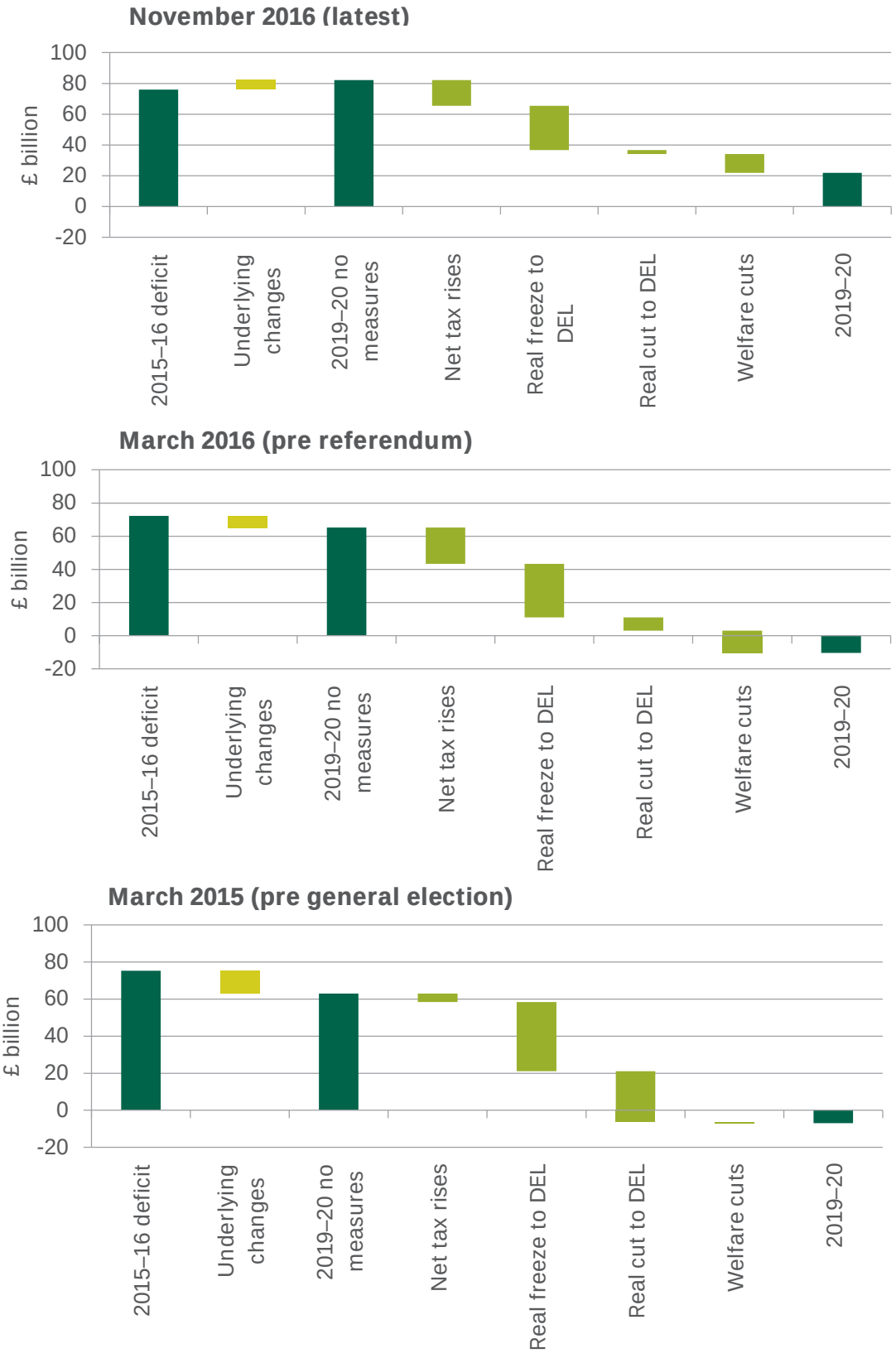
So the deficit is now set to be larger, and to persist for longer, than the government plans implied before the May 2015 general election or before the June 2016 EU referendum. Of the £28.9 billion deterioration in the deficit in 2019–20 (from the surplus of £7.0 billion forecast in the March 2015 Budget to the deficit of £21.9 billion that is now being forecast),

[5] Here we are using official forecasts. While at the time the Conservative Party pledged to make £12 billion of additional cuts to welfare by 2017–18 they were not adopted as part of the official coalition government's plans.

[6] See Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2015 (http://budgetresponsibility.org.uk/efo/economic-fiscal-outlook-march-2015/).

[7] Since March, there have also been changes to planned tax rises and welfare cuts. A smaller measured tax rise arises due to changes to the way corporation tax receipts are recorded, which means that a policy change that pushed the timing of receipts into 2019–20 from earlier years no longer affects the headline numbers. A smaller measured total welfare cut is due to the reversal of a policy that would have reduced the generosity of Personal Independence Payments (a disability benefit). The government announced the reversal of this policy two days after the March 2016 budget.

Figure 3.5 Consolidation plans pre-election, pre-referendum and now



Note and source: See Table 3.2.

£10.0 billion – or one-third – is down to a reduction in the estimated impact of measures to be implemented over this period. The remaining two-thirds is a deterioration in the underlying fiscal forecast, driven by a worse economic outlook. As a result, in 2021–22, more than a decade after the fiscal consolidation began, we are still forecast to have a deficit of £17.2 billion, or 0.7% of national income.

3.4 Medium-term risks

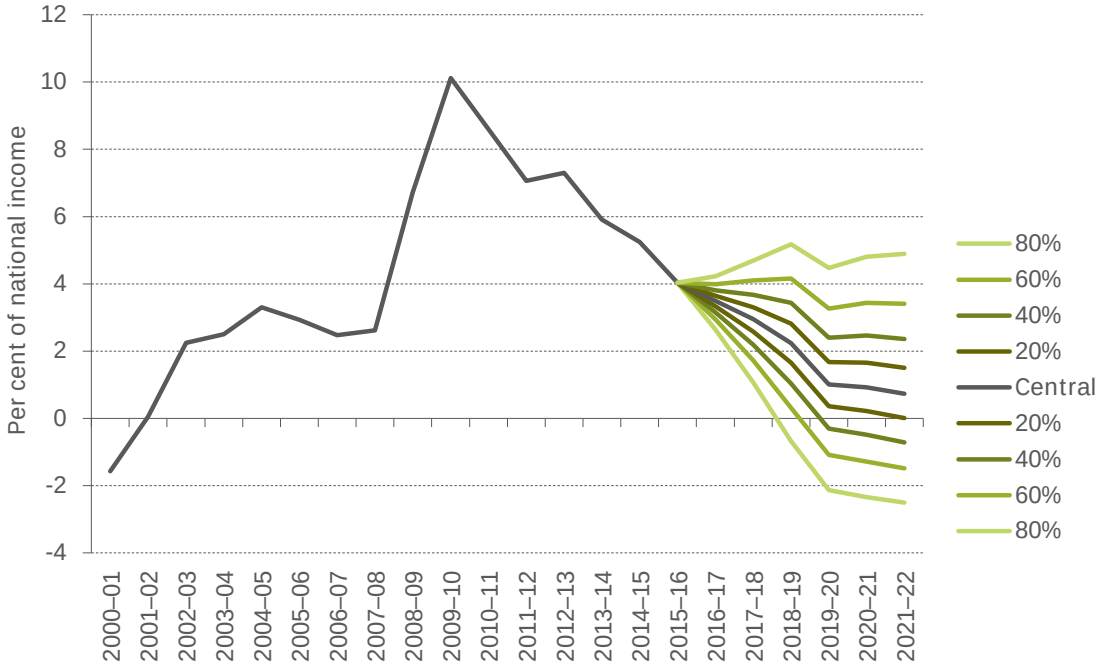
The previous section set out the reduction in the deficit over the next few years forecast by the OBR. This section looks at some of the key risks around this forecast. Before turning to examine the specific risks that we have identified, one potential guide to the uncertainty around the OBR's central forecast for borrowing is to look at the extent to which out-turns for borrowing have deviated from previous official forecasts. Data made available by the OBR make it relatively easy to do this for forecasts going back as far as Roy Jenkins's last Budget (in March 1970). To the extent to which the amount of uncertainty that existed when these previous forecasts were made is comparable to the amount of uncertainty that we now face, this might provide a good guide to the degree to which we might expect eventual borrowing to deviate from the latest forecasts.

There are (at least) two reasons why this analysis might understate the amount of uncertainty in the latest forecasts. First, as stated in Chapter 2, there is probably more uncertainty now over future prospects than at any point in the last 60 years. Second, eventual out-turns may have differed from previous forecasts as a result of subsequent policy action: to the extent to which previous Chancellors have implemented new policies in an attempt to bring borrowing back towards their previous forecasts (e.g.by spending surprise surpluses), the headline out-turns will understate the true underlying uncertainty. On the other hand, we might hope that we have, over time, become better at forecasting – for example, whereas previous forecasting errors may have been due to politically-motivated wishful thinking by Chancellors, this will not be the case with the OBR.

The OBR's central forecast, based on current policy, is for a 0.7% of national income deficit in 2021–22 (as set out in the previous section). However, as the fan chart shown in Figure 3.6 indicates, based on previous forecast errors there is a 20% chance that the deficit will in fact be greater than 3.4% of national income (i.e. around or above the level forecast for 2016–17) but – more optimistically – almost a 40% chance that there will be an overall budget surplus. In fact, on this measure, there is still a one-in-three chance that the government will meet its recently-abandoned target of delivering a headline budget surplus in 2019–20.

Broadly speaking, there are two types of reasons why borrowing might turn out differently from forecast. First, the OBR's forecasts are based on current policy, so changes to policy that affected revenues or spending could lead to borrowing turning out differently from forecast. Second, economic growth – or the impact that growth has on revenues and spending – could turn out differently from forecast. Of course, in practice, both will occur. Future Budgets will contain policy measures that will affect the public finances, while the level and composition of economic growth – and its impact on revenues and spending – will differ in many ways from the OBR's (and for that matter anyone else's) central forecast.

Figure 3.6. Probabilities of public sector net borrowing outcomes



Source: Chart 5.5 on page 211 of Office for Budget Responsibility, *Economic and Fiscal Outlook – November 2016*, http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2016/.

So in this section we turn first to look at likely policy risks on revenues and then at likely policy risks on spending. We then look at the degree to which the public finances could be affected by outcomes for the economy, or for the relationship between the economy and the public finances, that are different from what the OBR has forecast.

Policy risks: taxation

The OBR forecasts are intended to be a central forecast on the basis of current stated policy. To achieve this, they include the impact of tax and benefit changes that have been announced for implementation in future years and included in 'budget scorecards'. As a result, the OBR does not include any judgement over the impact on the public finances of tax and benefit changes that have not yet been scored. One has to draw the line somewhere and this may be a sensible delineation – but it does mean that, for example, the impact of measures committed to in election manifestos, party conference speeches, government Green Papers and even within Budget documents (unless on the scorecard) are not automatically included. Currently, there are at least two areas where there are good reasons to think that tax policy as currently scored in Budget documents is particularly unlikely to persist.

The first relates to income tax thresholds. In his Autumn Statement speech the Chancellor reaffirmed a pledge in the Conservative party's general election manifesto: 'And I can confirm today that, despite the challenging fiscal forecasts, we will deliver on our commitment to raising the allowance to £12,500, and the higher rate threshold to £50,000, by the end of this Parliament'.[8] This is also confirmed in the actual Autumn Statement document: 'The government will meet its commitment to raise the income tax personal allowance to £12,500 and the higher rate threshold to £50,000, by the end of this

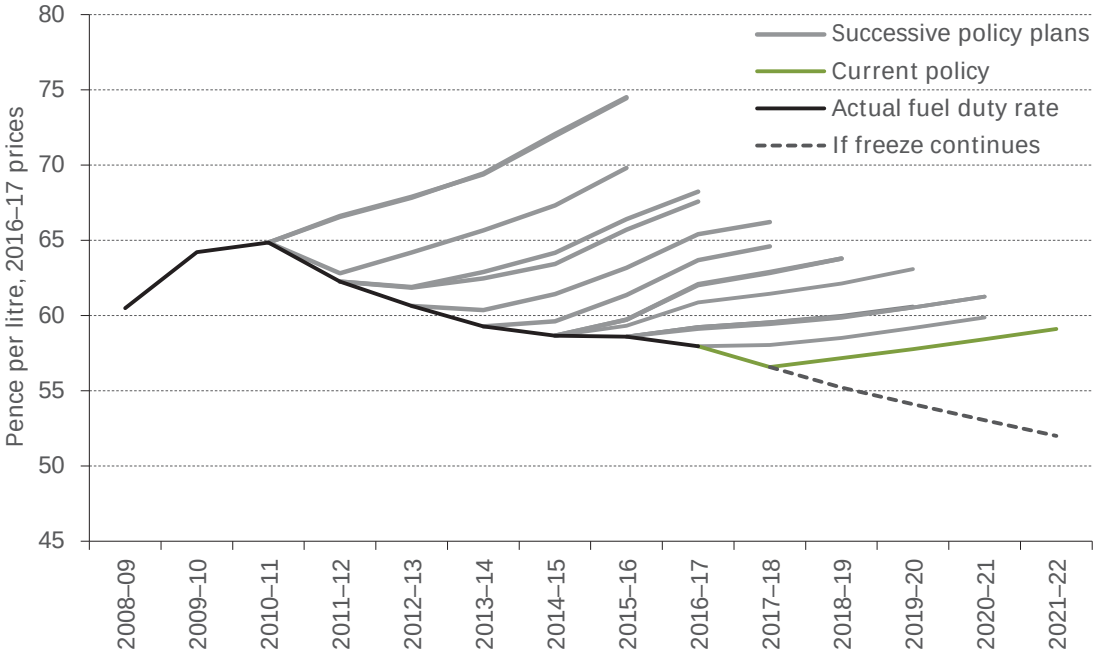
[8] See https://www.gov.uk/government/speeches/autumn-statement-2016-philip-hammonds-speech.

Parliament'.[9] But the government has not yet decided to score the policy. And, as a result, the OBR has not yet included it in its forecasts.

By default, both of these thresholds increase in cash terms over time anyway, in line with inflation. Hence, because the targets have been set in cash terms, the actual generosity of the tax cut depends on both how quickly it is implemented and what the rate of inflation is. The later it is done, and the higher inflation is, the smaller the giveaway this policy would represent relative to what would have happened anyway by default. Introducing the policy in April 2020 – i.e. one month before the end of the current parliament if the parliament runs for a full five years – would result in the smallest tax cut. We estimate that this would, under the latest OBR forecasts for the Consumer Prices Index (CPI), cost £1¾ billion (in 2016–17 terms).[10]

Our costing of the policy has changed considerably over recent months as the outlook for inflation has changed. Prior to the EU referendum, when the outlook was for less inflation over the next few years than is now expected, we estimated that it would cost £2.8 billion. Prior to the Autumn Statement, we used forecasts from the Bank of England, which imply higher inflation over the next few years than the OBR forecast, and estimated that it would cost just £1.0 billion.[11]

Figure 3.7. Successive plans for fuel duty rates



Source: Slide 8 of S. Adam, 'Tax and benefit reforms', IFS Autumn Statement 2016 analysis, https://www.ifs.org.uk/uploads/publications/budgets/as2016/as2016_sa.pdf.

[9] Paragraph 4.5 on page 35 of HM Treasury, *Autumn Statement: November 2016*, https://www.gov.uk/government/publications/autumn-statement-2016-documents.

[10] This costing was produced using the IFS tax and benefit model, TAXBEN, run on data from the Family Resources Survey. The authors would like to thank Tom Waters for his help in producing this estimate.

[11] See page 36 of C. Emmerson and T. Pope (2016), 'Winter is coming: the outlook for the public finances in the 2016 Autumn Statement', IFS Briefing Note BN188, https://www.ifs.org.uk/uploads/publications/bns/BN188.pdf.

The second likely tax change relates to the indexation of rates of fuel duties. Formal policy is for these to increase in line with inflation (as measured by the discredited Retail Prices Index) each April. But recent practice has been for indexation to be cancelled: as a result of the Chancellor's announcement in the Autumn Statement, 2017–18 is set to be the seventh year in a row without the rates being uprated in line with inflation. These freezes represent a significant tax cut: rates of fuel duties in 2017–18 will be 13% lower in real terms (when deflated by the not discredited Consumer Prices Index) than they were in 2010, with this real-terms cut reducing annual government revenues by an estimated £3½ billion (or 16% and £4½ billion lower relative to default RPI indexation).[12] A comparison of the successive plans for fuel duty rates, with the eventual out-turn, is shown in Figure 3.7.

In its November 2016 *Economic and Fiscal Outlook*, the OBR highlights these successive policy changes: 'The possibility that the actual path of fuel duty rates policy will differ from the Government's current stated policy is a risk that we consider worth noting'. Arguably, rather than increasing in line with the RPI in April 2018, April 2019 and April 2020, it is more likely that rates of fuel duties continue to be frozen throughout the rest of this parliament. This would represent a tax cut reducing revenues by an estimated £2½ billion in 2020–21 (in 2016–17 terms).[13] The upwards revision to forecasts for inflation over the next two years seen since the EU referendum imply that continuing to freeze fuel duties would now be more expensive than previously thought. As fuel duties are a major source of revenue for the government, forecast to bring in £27.9 billion in 2016–17, the unwillingness of consecutive Chancellors Mr Osborne and Mr Hammond to stick to plans to increase the rates in line with inflation – including in the March 2016 Budget after the oil price had fallen considerably and still in just the first year of a new parliament – presents an increasing challenge for the public finances.

In total, increasing the income tax personal allowance to £12,500 and the higher-rate threshold to £50,000 in April 2020, and also freezing fuel duties in April 2018, April 2019 and April 2020, would reduce revenues in 2020–21 by an estimated £4¼ billion (in 2016–17 terms), or 0.2% of national income. The OBR's longer-run projections (beyond 2021–22) assume that parameters in the tax system will be uprated in line with national income (rather than inflation).[14] If the government were to increase income tax thresholds in line with inflation instead, it could raise the effective tax burden through a fiscal drag effect (whereby incomes grow more quickly than thresholds). On the other hand, there must also be a risk that fuel duties continue to be frozen in cash terms, not even increasing in line with inflation, let alone national income. If this were the case, fuel duties would raise an ever smaller share of national income going forwards.

Impact of previous tax reforms on revenues

One way to consider how new measures might affect tax revenues in the future is to look at the direction of reforms in the past. This can be done by collating the information on successive budget scorecards – an exercise that the OBR has done for all Budgets, Autumn

[12] Authors' calculation using https://www.gov.uk/government/statistics/direct-effects-of-illustrative-tax-changes.

[13] Authors' calculations based on the latest OBR forecasts for the RPI and the HMRC ready reckoner (https://www.gov.uk/government/statistics/direct-effects-of-illustrative-tax-changes).

[14] See Office for Budget Responsibility, *Fiscal Sustainability Report*, January 2017, http://budgetresponsibility.org.uk/fsr/fiscal-sustainability-report-january-2017/.

Statements and Pre-Budget Reports back to the Budget of 1970.[15] This allows us to look at the estimated impact on revenues in 2016–17 of each budget measure. Moreover, the OBR spreadsheet provides a breakdown into each broad tax and, through applying some judgements to the data, can be further split into whether there was a change to a standard rate or threshold or whether the change did something else to the tax base.

The right-hand part of Table 3.4 shows that the Budgets and Autumn Statements of George Osborne and Phillip Hammond since June 2010 contain tax-cutting measures that are estimated to have reduced revenues by £54 billion in 2016–17. This has been more than offset by the tax-raising measures that are estimated to have boosted revenues in the same year by £70 billion. Changes to the main rates and thresholds of income tax, NICs and corporation tax make up half of the giveaway but less than one-tenth of the takeaway. In contrast, the increase in the main rate of VAT from 17½% to 20% makes up one-fifth of the takeaway (and there have been no cuts to the rates of VAT over this period). Other changes to the main taxes represent a greater share of the takeaways than of the giveaways over this period (these will include changes such as the large restrictions to pension tax relief affecting mainly those on very high incomes that have been seen

Table 3.4. Estimated impact of budget measures since 1997 on revenues in 2016–17, by type of tax change

	Brown/Darling				Osborne/Hammond			
	Tax takeaways		Tax giveaways		Tax takeaways		Tax giveaways	
	£bn	% of total	£bn	% of total	£bn	% of total	£bn	% of total
Total	138	100	82	100	70	100	54	100
Of which:								
Income tax rates & thresholds	17	12	26	32	3	4	16	29
NICs rates & thresholds	29	21	13	16	1	2	5	9
VAT rates	0	0	0	0	14	20	0	0
Corporation tax rates	1	1	10	12	0	0	7	12
Other IT/NICs/VAT/CT	53	39	19	24	33	47	13	24
Other taxes	37	27	14	17	19	27	14	27

Note: Table takes all measures from budget scorecards since 1997 and looks at their estimated impact on revenues. Those measures estimated to have no impact are ignored. Measures allocated to categories based on the OBR's tax definition and a judgement over whether the measure is a change to a standard rate or threshold or to something else.

Source: Authors' calculations using Office for Budget Responsibility, 'Policy measures database', 1 December 2016, http://budgetresponsibility.org.uk/data/.

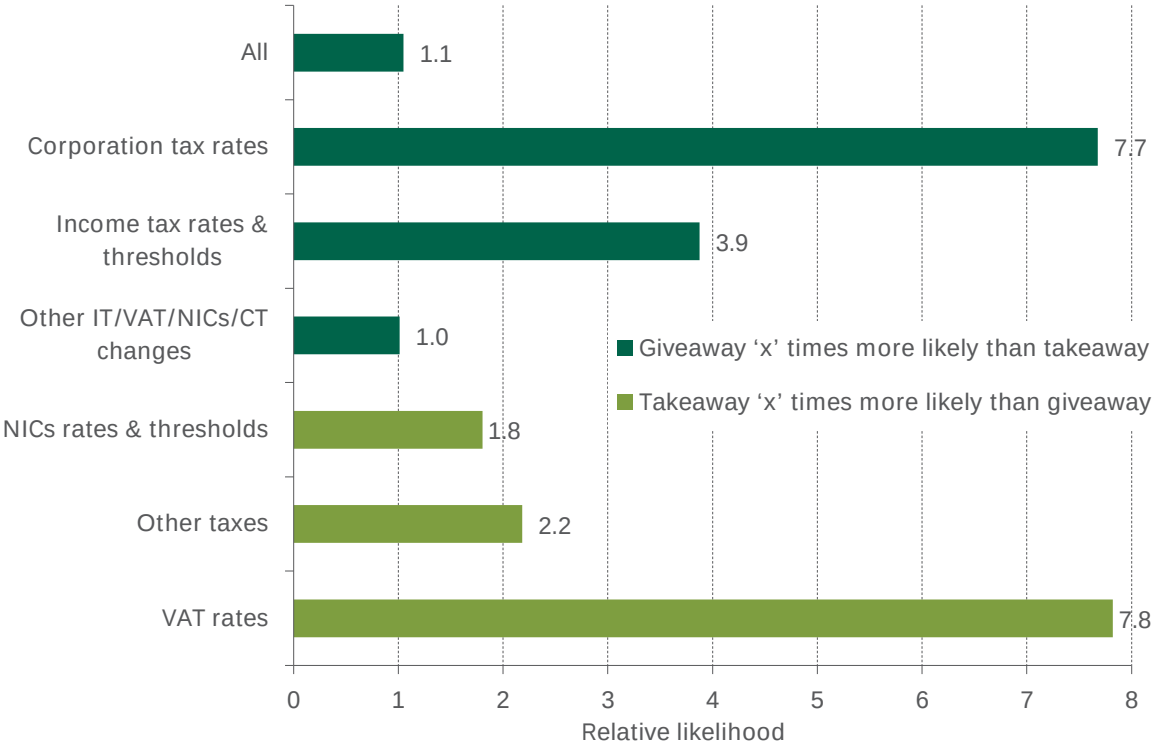
[15] Office for Budget Responsibility, 'Policy measures database', 1 December 2016, http://budgetresponsibility.org.uk/data/.

since 2010). Changes to other taxes make up just over a quarter of both the giveaways and the takeaways.

The left-hand part of Table 3.4 does the equivalent exercise for the Pre-Budget Reports and Budgets of Gordon Brown and Alistair Darling. Again the tax takeaways are larger in aggregate than the tax giveaways: the takeaways are estimated to boost revenues in 2016–17 by £138 billion, while the giveaways are estimated to total £82 billion. As was the case with the period since June 2010, changes to the main rate of corporation tax, and to the main rates and allowances of income tax, made up a larger share of the giveaways than of the takeaways, while other changes to the main taxes also made up a larger share of the takeaways than of the giveaways. But there are also some noticeable differences: under the Labour governments from 1997, changes to the main rates and allowances of NICs and to other taxes made up a larger share of the takeaways than of the giveaways, no permanent changes were made to the main rate of VAT.

Figure 3.8 takes all measures from fiscal events since March 1970 (over which period the gross tax cuts are estimated to be slightly larger in scale than the gross tax rises) and provides a summary measure of the relative likelihood of tax-raising compared with tax-

Figure 3.8. Relative likelihood of budget measures being a giveaway or a takeaway by broad type of measure (weighted by size of measure), all measures since April 1970



Note: Figure takes all measures from budget scorecards since April 1970 and looks at their estimated impact on revenues. Those measures estimated to have no impact are ignored. Measures allocated to categories based on the OBR's tax definition and a judgement over whether the measure is a change to a standard rate or threshold or to something else.

Source: Authors' calculations using Office for Budget Responsibility, 'Policy measures database', 1 December 2016, http://budgetresponsibility.org.uk/data/.

cutting measures by the broad type of tax. Changes to the main rates of VAT, to other taxes and to the main rates and thresholds of NICs were more likely to boost than to reduce revenues, while changes to the rates of corporation tax or to the main rates and thresholds in income tax were more likely to reduce than to boost revenues. The lack of symmetry in how governments have chosen to increase and to cut taxes could reflect a sensible desire to move the tax system in a particular direction. For example, cuts to the rates of corporation tax are likely to have been a particularly good way to reduce taxes in a growth-friendly way and as a response to the pressures of globalisation. But they may, at least in part, reflect a tendency to cut taxes that are more salient and to increase taxes that are less high-profile.

At the very least, the evidence presented in Figure 3.8 shows that when further significant tax rises are announced – perhaps after the next general election in order to meet the Chancellor's stated objective of eliminating the budget deficit – history suggests increases in VAT, increases in NICs or increases in smaller taxes will be disproportionately likely to occur, whereas raising revenues through increases in corporation tax rates or income tax rates will be significantly less likely.

Policy risks: public spending

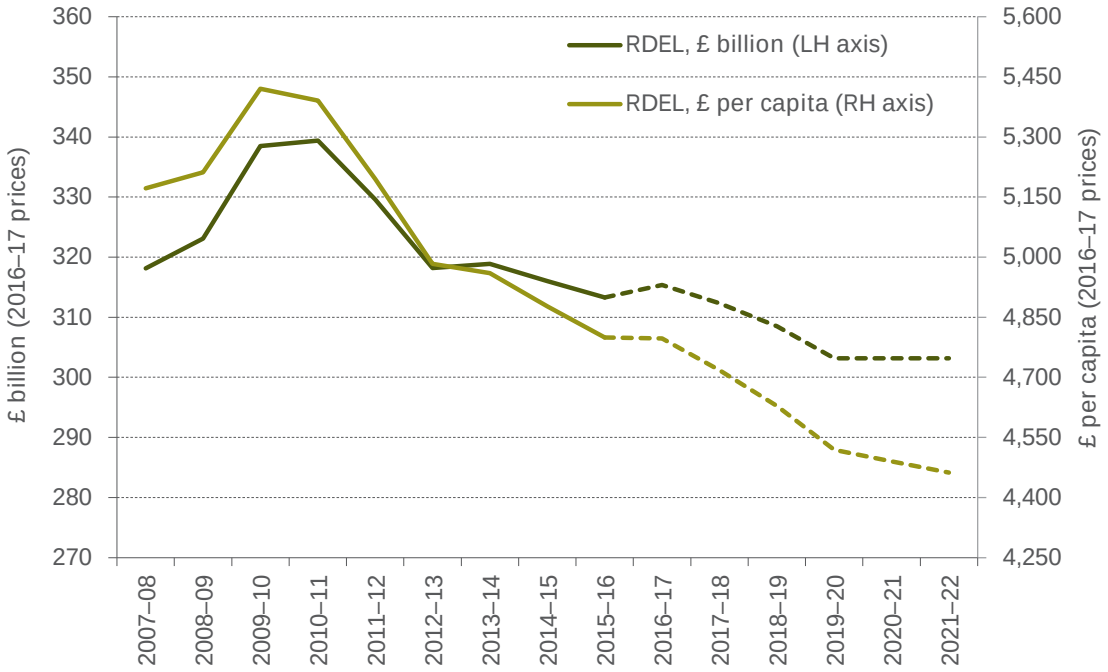
There are also risks to the public finances from possible policy changes affecting public spending. This subsection considers some of these risks.

One assumption that the OBR has made is that the government will continue to spend an amount equal to the UK's projected contribution to the EU budget, net of the UK's rebate (£13.4 billion in 2020–21). That does not mean it expects that we will continue to pay what we do into the EU, but rather that the government will choose to spend any saving. As the government has indicated, it may directly support some of the spending that the EU currently does in the UK (e.g. on poorer regions or on agriculture). It is quite possible that the government will choose to spend less than £13.4 billion – not least because the UK pays more into the EU budget than the EU spends in the UK – so there is some upside risk here. In recent years, the amount the UK contributes to the EU budget, net of both the rebate and the spending done by the EU in the UK, has been running at about £8 billion a year.

The biggest spending risks, though, are probably associated with the biggest spending items. In particular, will the government be able to deliver the further significant cuts to resource DELs that are planned? Recent out-turns, along with the latest forecasts, for DEL are presented below. Figure 3.9 shows these for 'resource DEL' – that is, day-to-day spending – while Figure 3.10 shows the equivalent figures for capital DEL. The two series in each figure show the totals in real terms (the darker line, using the left-hand scale) and in real terms per capita (the lighter line, using the right-hand scale).

In terms of resource DEL, over the three years to 2012–13 spending was cut by 6% in real terms from its 2009–10 level. But since then the cuts have been more modest, with the three years from 2012–13 to 2015–16 seeing a cut to RDEL of 1.5%. Spending is forecast to grow slightly in 2016–17. After this year, though, the plan is to accelerate cuts again. In the three years to 2019–20, a total cut of 3.9% is forecast. (This includes the £3 billion of yet-to-be-identified 'efficiency savings' to be delivered in 2019–20, with £1 billion of these savings to be recycled into higher spending.) Overall RDEL is forecast to be £12.2 billion lower in 2019–20 than in 2016–17. Population growth over this whole period means that if these

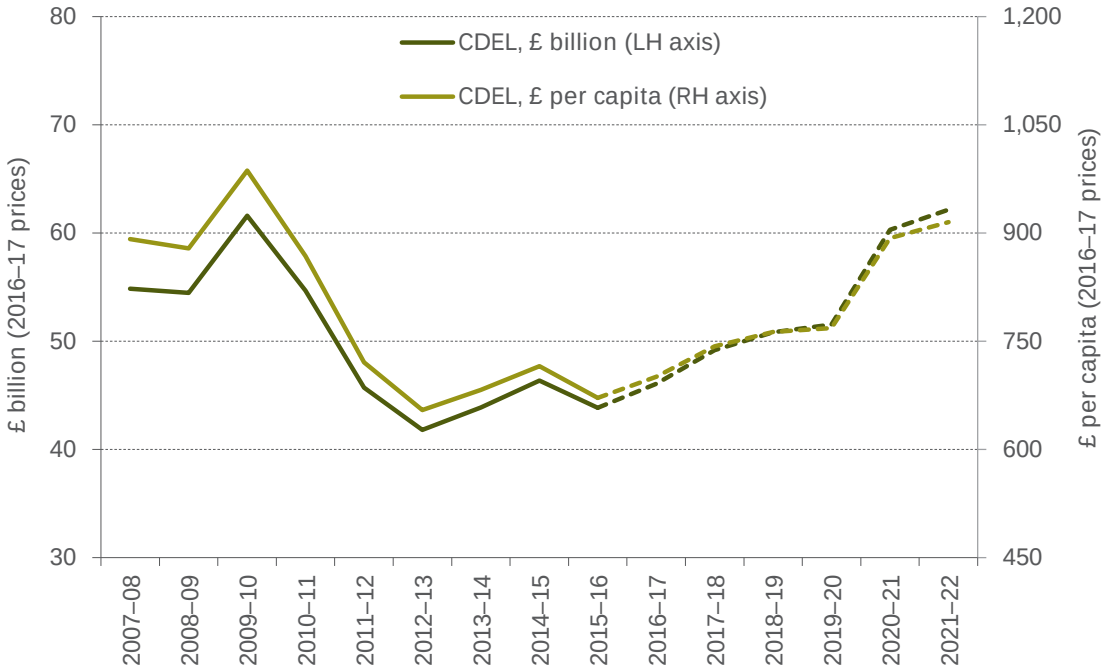
Figure 3.9. Forecast resource DEL



Note: Series adjusted by the OBR to remove historical discontinuities.

Source: Table 2.17 of Office for Budget Responsibility, *Economic and Fiscal Outlook Supplementary Fiscal Tables: Expenditure – November 2016*, http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2016/.

Figure 3.10. Forecast capital DEL

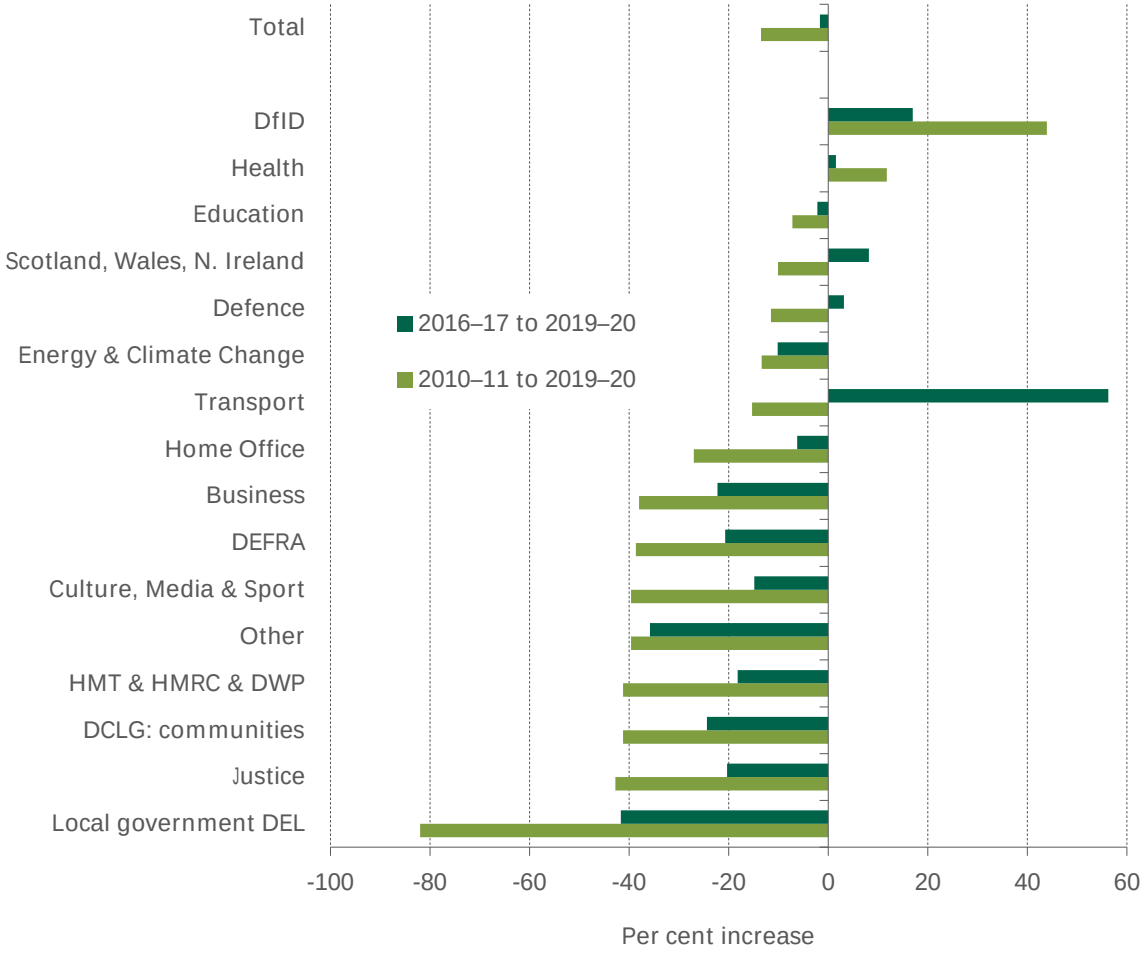


Note and source: As for Figure 3.9.

planned cuts to RDEL are delivered, spending per capita would be 16.6% lower in 2019–20 than its peak a decade earlier in 2009–10, and 12.6% lower than the pre-crisis level seen in 2007–08.

Delivering these cuts may not be easy given the squeeze over recent years. As an example of the pressures building in some areas, in the 2016 Autumn Statement the Chancellor needed to allocate additional funds to the Ministry of Justice in order to finance additional prison officers (an extra £125 million in 2017–18, £245 million in 2018–19 and £185 million in 2019–20). As set out in Chapter 5, there will be continued pressure for additional funding for the NHS and social care. It remains to be seen whether the government can continue with the largely successful delivery of cuts it has managed since 2010, or whether political and other pressures for additional spending will become overwhelming.

Figure 3.11. Planned real change to departmental expenditure limits, by department



Note: The cut to the local government DEL is due to reforms allowing local authorities to retain increasing amounts of revenue from business rates. Therefore it does not provide an indication of the cut to local authorities' overall budgets.

Source: Authors' calculations using table 1.10 of HM Treasury, *Public Expenditure Statistical Analyses*, 2015 and 2016 editions (https://www.gov.uk/government/collections/public-expenditure-statistical-analyses-pesa) and GDP deflators from Office for Budget Responsibility, 'Public finances databank', January 2017, http://budgetresponsibility.org.uk/data/.

The plans for capital DELs tell a different story. While CDEL was cut by almost one-third over the three years from 2009–10 to 2012–13, it has since increased. It is forecast to increase in each of the next five years, with a particularly sharp increase in 2020–21. Overall CDEL is forecast to be £5.5 billion higher in 2019–20, and £16.1 billion higher in 2021–22, than it is in 2016–17. If the forecasts are met, then CDEL in 2021–22 would, in real terms, be slightly above its previous peak in 2009–10 and would be 13.3% above its pre-crisis level in 2007–08. In terms of CDEL per capita, the level forecast in 2021–22 is 7.2% below its peak in 2009–10 but 2.6% above its pre-crisis level in 2007–08.

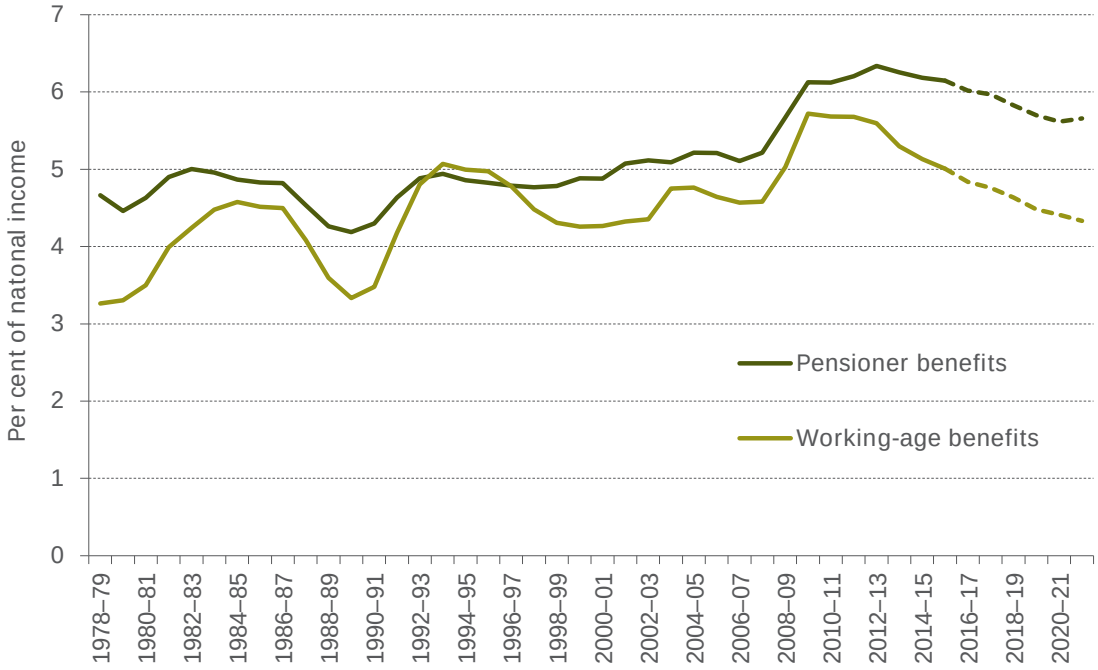
As a result of the different trends in RDEL and CDEL, there is set to be a large shift in the mix of total DEL spending over this period. In 2007–08 there was 17p of CDEL for every £1 of RDEL. By 2012–13 this had fallen to 13p of CDEL for every £1 of RDEL, whereas the forecasts imply that in 2021–22 it will increase to 21p of CDEL for every £1 of RDEL.

Overall departmental spending is planned to be cut in real terms over the period from 2016–17 to 2019–20, with these planned cuts coming on top of those already delivered over the period since 2010–11. These cuts have not been shared equally across all departments. The implied plans (on the departmental arrangements that existed at the time of the Spending Review) are presented in Figure 3.11. The Department for International Development (DfID), the Department of Health and the Ministry of Defence are all set to see their budgets rise in real terms over the period 2016–17 to 2019–20. In addition, while the Department for Transport is having its day-to-day budget cut, it has been allocated a significant increase in its capital budget (as part of the planned overall increases in the capital budget set out in Figure 3.10), such that its overall budget is forecast to increase significantly over the next three years. In contrast, several other departments have spending allocations that imply deep cuts – for example, the Ministry of Justice, the communities budget of the Department for Communities and Local Government (DCLG) and the Department for Culture, Media and Sport.

Total spending comprises DEL and annual managed expenditure (AME). The greater part of AME spending is on social security benefits (including tax credits). Total spending on social security benefits (in Great Britain, i.e. excluding spending in Northern Ireland), as a share of national income, is shown for the period since 1978–79 in Figure 3.12. This shows that in 2016–17, spending on pensioner benefits is forecast to be 6.0% of national income, which is 0.8% of national income higher than in 2007–08 prior to the recession. Over the same period, spending on working-age benefits has risen by 0.2% of national income, from 4.6% of national income in 2007–08 to a forecast 4.8% of national income in 2016–17. The forecasts imply that spending both on pensioner benefits and on working-age benefits will fall as a share of national income.

Despite the fact that the state pension age for both men and women will be 66 by October 2020 (compared with 65 and 60 respectively in 2010), spending on pensioner benefits, while falling over the next few years, will still be higher as a fraction of national income than in any year before 2008–09. Spending on working-age benefits, by contrast, will be below its level (as a fraction of national income) in most of the 2000s and roughly back to its level in the late 1990s (and mid 1980s). This largely reflects cuts to the generosity of working-age benefits being brought in over the next few years, notably the nominal freeze in the rates of most working-age benefits up to and including April 2019, and the continued expansion of universal credit which, for new claimants, will be at levels less generous on average than the tax credits and benefits it is replacing.

Figure 3.12. Outlook for spending on benefits and tax credits



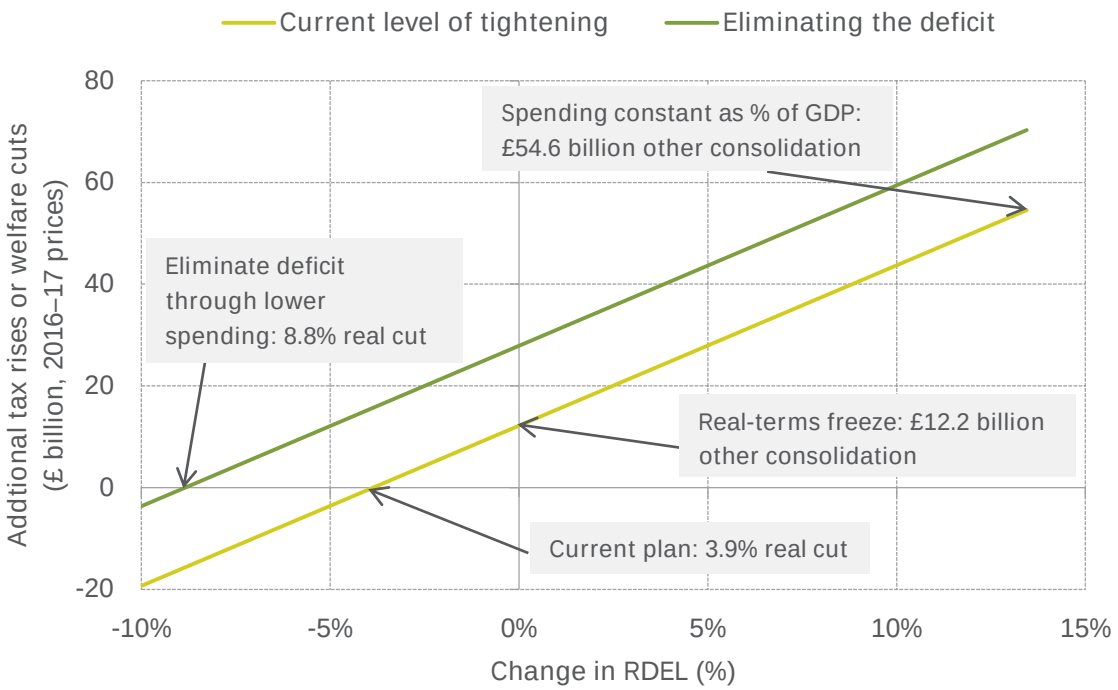
Note: Great Britain only.

Source: Table 'GB welfare' of Department for Work and Pensions, *Benefit expenditure and caseload tables 2016*, 21 December 2016, https://www.gov.uk/government/publications/benefit-expenditure-and-caseload-tables-2016.

Future spending plans depend not only on delivering these cuts but also on spending on incapacity benefits and disability benefits coming in on target. A significant reform to disability benefits – the replacement of disability living allowance with personal independence payment – that is intended to reduce spending significantly is still in the process of being rolled out. Reforms to both incapacity benefits and disability benefits have failed to deliver anything like the envisaged cuts to spending in the recent past. As set out in Chapter 6, this has led to the forecasts for spending on these benefits being revised up significantly. A downside risk to the public finances is that the numbers receiving these benefits – and therefore the amount being spent on them – come in above forecast.

The above analysis has described the implications of the current plans for cutting public spending as a share of national income over the next five years. Of course, the government could decide to change its plans. One aspect of making such a change is quantified in Figure 3.13. Currently, a 3.9% decrease in real-terms day-to-day spending is planned between this year and 2021–22. The government could ease the pressure on day-to-day spending by either borrowing more, cutting capital spending by more, cutting welfare by more or raising taxes by more. If the government wanted to keep day-to-day spending constant in real terms, this would require additional consolidation elsewhere and/or borrowing of £12.2 billion (in 2016–17 prices). Holding day-to-day spending constant as a proportion of national income would require an additional £54.6 billion of tightening elsewhere and/or additional borrowing.

Figure 3.13. Deficit reduction trade-off between cuts to day-to-day spending by central government on public services and tax rises/welfare cuts, 2016–17 to 2021–22



Note: Based on current plans for changes to RDEL. Deflated to 2016–17 prices using GDP deflator.

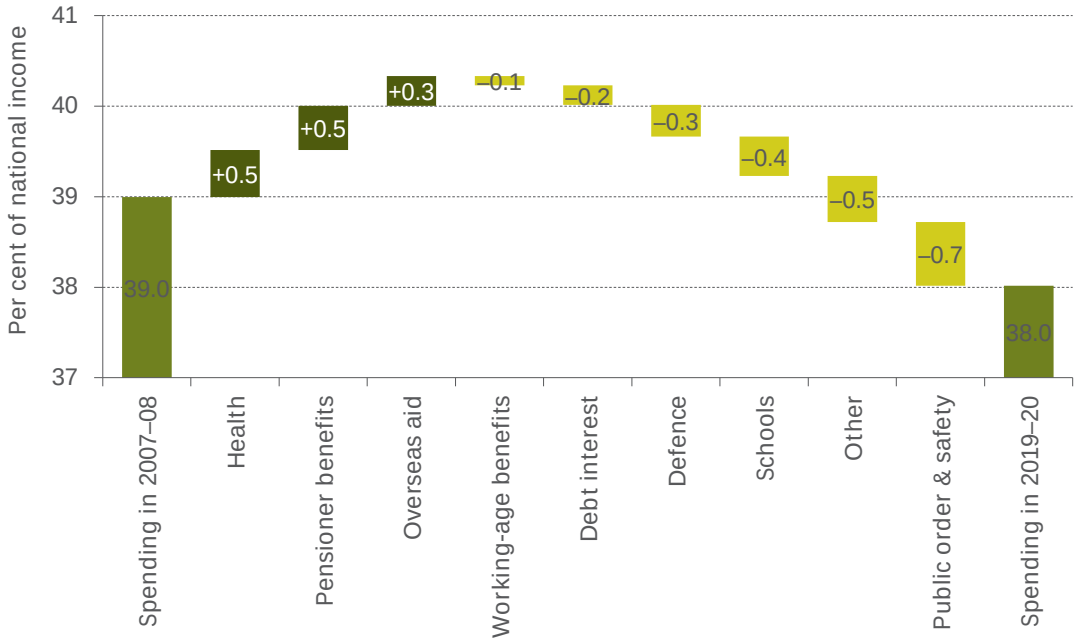
Source: Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2016.

Figure 3.13 also shows how this equation would change if the government wanted to eliminate the deficit by 2021–22. This would satisfy the fiscal target of returning the public finances to balance 'as soon as possible in the next parliament' and would require a further 0.7% of national income tightening. This could be achieved over the period to 2021–22 by cutting day-to-day spending by 8.8% in real terms (rather than the 3.9% cut currently planned), or by some combination of lower day-to-day spending and greater consolidation from elsewhere.

One result of choices over spending priorities made over the last decade has been to alter not just the level but also the make-up of public spending. Figure 3.1 showed that in the financial year before the financial crisis struck, 2007–08, total public spending was equal to 39.0% of national income. In the last year of the current parliament (assuming it runs its full course), total public spending is forecast to be 38.0% of national income. But this decline of 1.0% of national income disguises the fact that spending in some areas is forecast to have increased as a share of national income, whereas spending in some other areas is forecast to have fallen quite considerably.

Figure 3.14 shows that spending on health, pensioner benefits and overseas aid will all have increased as a share of national income since 2007–08 (by a total of 1.3% of national income). Despite the large increase in public sector net debt (shown in Figure 3.3), the fall in government borrowing costs will mean that debt interest payments are forecast to be a smaller share of national income in 2019–20 than in 2007–08. Spending on defence (notwithstanding the protection from cuts in the current parliament), schools and (in particular) public order & safety, alongside other elements of government spending that don't fall within these categories, are also forecast to be lower as a fraction of national

Figure 3.14. Public spending as a share of national income, 2007–08 and 2019–20 compared



Note: Figure decomposes the change in total managed expenditure. Working-age and pensioner benefits refer to Great Britain spending only. Overseas aid spending figure for 2007–08 actually refers to 2007, and the figure for 2019–20 is estimated assuming the UK spends 0.7% of GDP. Figures for defence, schools and public order & safety all refer to spending by function. Estimates for 2019–20 obtained by assuming: defence – growth in line with the Ministry of Defence budget; schools – real freeze to total spending; public order & safety – growth in line with the aggregate budget of the Home Office and the Ministry of Justice.

Source: Authors' calculations using data from the Office for Budget Responsibility, 'Public finances databank', January 2017, http://budgetresponsibility.org.uk/data/; Department for Work and Pensions, *Benefit expenditure and caseload tables: Autumn Statement 2016*, https://www.gov.uk/government/publications/benefit-expenditure-and-caseload-tables-2016; Department for International Development, *Statistics on International Development 2016*, https://www.gov.uk/government/statistics/statistics-on-international-development-2016; and HM Treasury, *Public Expenditure Statistical Analyses*, various years, https://www.gov.uk/government/collections/public-expenditure-statistical-analyses-pesa.

income in 2019–20 than they were in 2007–08. The sizeable cut to spending on public order and safety is in large part due to the fact that a large portion of this spending is from the Home Office and the Ministry of Justice (three-quarters of the total in 2015–16, with the remainder coming from DCLG and the devolved administrations) and the budgets of those two departments are planned to be cut by one-third in real terms over the period from 2010–11 to 2019–20 (see Figure 3.11).

Economic risks

The biggest uncertainty surrounds the economic forecast on which the borrowing numbers are based. This is always the case – the cash size of the economy is a particularly important determinant of tax revenues – but is especially relevant given additional uncertainty over the path of the economy in the next few years and considerable disparity among forecasters. Between March and November, the OBR downgraded the cash size of the economy in 2020–21 by 1.2%. This was driven entirely by a fall in real GDP growth over

the forecast period, with the GDP deflator index at broadly the same level as in March. At the same time, the OBR increased its forecasts for CPI and RPI inflation.

While these were negative changes, a number of other forecasters have suggested that the economic shock resulting from the UK leaving the EU might be more severe. Here we focus on the other independent, public sector forecaster, the Bank of England, which had presented its November forecast for the economy just three weeks before the OBR published its analysis. In this forecast, the Bank of England expects the economy to grow by less, and inflation to increase by more, than the OBR. The Bank of England November forecast is broadly in line with the average of independent forecasters surveyed by HM Treasury,[16] making it an interesting alternative scenario for the path of the economy. Here we consider how different the public finances might look if the world were to evolve in line with this Bank of England forecast.

Of course, forecasts for the economy are subject to revision. Recent data have been more positive than expected, meaning that an upgrade to the forecast in the short run may be likely. However, medium- to long-term prospects for the UK economy may be worse than in November. Since then, the Prime Minister has said the UK will leave the single market and may leave the customs union. Both theory and the available modelling suggest that remaining in the single market would be likely to mean stronger UK economic performance than a free trade agreement with the EU.[17]

Economic growth

The most important determinant of the public finance forecast is the cash size of the economy. Departmental expenditure is set in cash terms, so a change in the size of the economy does not, at least by default, affect the cash level of spending. On the other hand, tax revenues tend to increase in line with the cash size of the economy. We might also expect that slower growth would reduce the proportion of national income taken in tax revenues, as our tax system is progressive. For example, if every individual's income falls by the same proportion, the progressivity of the income tax system would mean that the average income tax rate on individuals' incomes would fall.

In November, the OBR downgraded the cash size of the economy in 2020–21 by 1.2%. As mentioned above, this resulted almost entirely from a downgrade to real GDP. Comparing the forecasts of March and November, lower economic growth increases borrowing, in total, by £8.2 billion (in 2016–17 terms) in 2020–21, or 0.42% of national income (see Table 3.5). This arises from lower tax revenues (with the main effect arising from lower employment income) being slightly offset by lower expenditure (with the main effect arising from lower average earnings growth, which slows the rate at which state pension payments are uprated).[18] Importantly, the vast majority of the downgrade to national

[16] The most recent survey in which HM Treasury collected medium-term forecasts was in November 2016. See HM Treasury, *Forecasts for the UK Economy: November 2016*, https://www.gov.uk/government/statistics/forecasts-for-the-uk-economy-november-2016.

[17] See, for example, M. Ebell and J. Warren, 'The long-term economic impact of leaving the EU', *National Institute Economic Review*, May 2016, 236, 121–38, http://dx.doi.org/10.1177/002795011623600115 and S. Dhingra, G. Ottaviano, T. Sampson and J. Van Reenen, 'The consequences of Brexit for UK trade and living standards', Centre for Economic Performance, Brexit Analysis 2, 2016, http://cep.lse.ac.uk/pubs/download/brexit02.pdf.

[18] The 'triple lock' stipulates that the state pension will increase in line with the largest of inflation (as measured by the CPI), average earnings growth and 2½% each year. Lower average earnings growth (if it was previously above 2½%) therefore reduces spending on the state pension.

income is thought to be permanent. The output gap is only forecast to be 0.1% of national income in 2020–21, so the OBR does not expect that lower growth over the next few years will be offset by higher growth in the future. Overall, this forecast gives us a national income elasticity for the public finances as a whole, implying that over this period a 1% fall in national income increases the deficit by 0.35% of national income (as 0.35 = 0.42/1.2).

The Bank of England's November forecast for (real) national income growth runs until the end of 2019. Compared with the OBR's March forecast – as shown in Figure 3.15 – the Bank's forecasts imply that the economy would grow by 2.3 percentage points less from 2016 to 2019, which would leave the economy 1.8% smaller in 2019 than the OBR forecast in March (and 0.6% smaller than the OBR's November forecast). Even at the end of this forecast horizon, growth is relatively sluggish (an annualised rate of 1.6%), implying that the downgrade to growth may be thought by the Bank to persist beyond 2019. Making the perhaps optimistic assumption that the Bank would forecast no further downgrade beyond 2019, and assuming that the composition of the Bank's downgrade is the same as that of the OBR, the deficit would be 0.22% of national income, or £4.3 billion (in 2016–17 terms), higher than the OBR's November forecast in 2020–21 (and £12.5 billion higher than the OBR forecast in March). If the Bank of England anticipated further downgrades beyond 2019, or if its downgrade was more tax-rich than that forecast by the OBR, the increase in borrowing could be larger still.

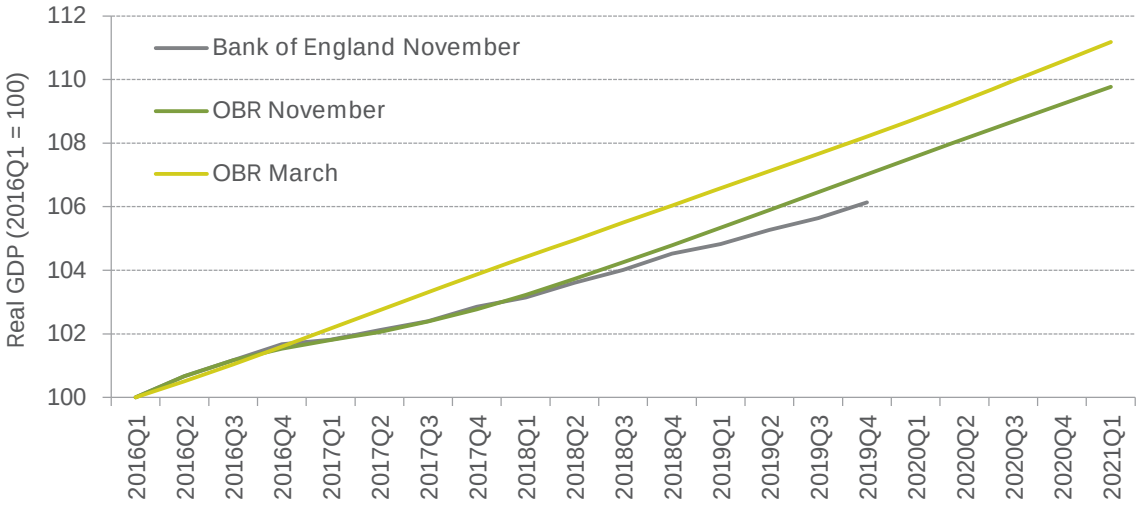
Table 3.5. Changes in borrowing as a result of lower economic growth

Income component	Change in 2020–21 (£ billion, 2016–17 terms)
Tax receipts	–9.1
Of which:	
Employment income	–8.7
Consumer spending	–0.3
Corporate profits	–0.2
Investment	+1.1
Other	–1.0
Spending	–0.9
Of which:	
Pension spending	–1.1
Other	+0.2
Total borrowing	**+8.2**

Note: Change in 2020–21 refers to change in tax revenues for tax components and change in spending for spending components.

Source: Annex B of Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2016*, http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2016/.

Figure 3.15. Forecasts for national income compared



Source: Bank of England, *Inflation Report*, November 2016, http://www.bankofengland.co.uk/publications/Pages/inflationreport/2016/nov.aspx; Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2016*, http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2016/.

There is much uncertainty – even more so than is usually the case – over the likely rate of economic growth in the next few years. Even if the OBR's growth forecast is approximately correct, however, it is still possible that the effect on the public finances will be quite different. For a given change in national income, the effect on the public finances depends on the composition of that change. For example, Chapter 7 discusses how the mix of remuneration between standard employees, the self-employed and those working for their own incorporated companies matters for the resulting tax revenues. To give another example, Table 3.5 shows that lower investment increases receipts in the short run (because investment costs are not used to offset taxable profit today). If the same fall in national income materialised less as a result of lower investment but rather through a larger fall in average earnings, the deterioration in the public finances would be larger.

We noted above that the November OBR forecast implied that a 1% fall in national income corresponded with a 0.35% of national income increase in borrowing. This reflects a relatively modest impact. Analysis from the OBR shows that typically a 1% fall in national income will lead to a 0.5% of national income increase in the deficit.[19] Should the downgrade to national income prove to be more tax-rich (say, with lower income growth but higher investment), the borrowing position could worsen further, increasing the deficit throughout the forecast horizon. Specifically, if a 1% fall in national income were to mean a 0.5% of national income increase in borrowing, the downgrade to the public finances (over and above the November forecast) would be £3.5 billion (0.2% of national income) if the OBR growth forecast were correct and £9.7 billion (i.e. £17.9 billion less £8.2 billion, which is equivalent to 0.5% of national income) if the economy grows as the Bank of England forecast in November. These scenarios are set out in Table 3.6.

[19] See paragraph 5.48 of Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2016*, http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2016/.

Table 3.6. Effect on borrowing of different downgrades to national income

Forecaster	Downgrade to GDP (relative to OBR March forecast)	Increase in borrowing if elasticity 0.35% (£ billion, 2016–17 terms)	Extra borrowing if elasticity 0.5% (£ billion, 2016–17 terms)	Total increase in borrowing if elasticity 0.5% (£ billion, 2016–17 terms)
OBR (November)	1.2%	8.2	3.5	11.8
Bank of England (November)	1.8%	12.6	5.4	17.9

Note: Figures may not sum due to rounding.

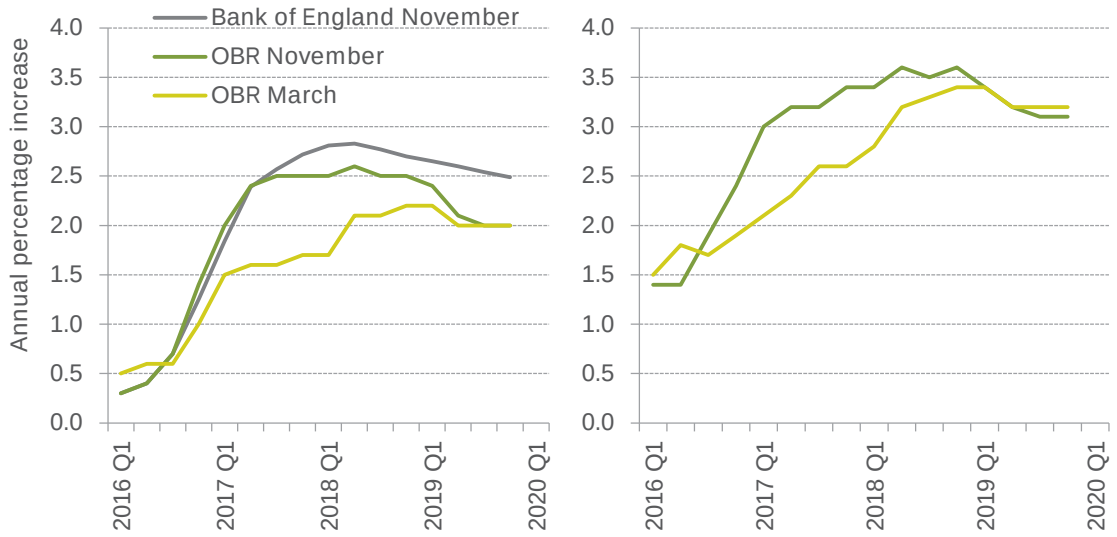
Source: See Figure 3.15.

Furthermore, we may expect this larger elasticity to reflect more accurately the long-run public finance cost of lower national income over the forecast horizon. While lower investment over the next few years boosts corporation tax receipts, in the longer term we would expect that lower investment to be reflected in lower profits and/or lower wages. This would hinder, rather than help, the public finances, meaning that the long-run cost to the public finances of lower growth in the next five years might well be larger than the borrowing increase forecast for 2020–21.

Consumer price inflation

While economic growth was downgraded between March and November, forecasts for consumer price inflation (the CPI and RPI) increased substantially (see Figure 3.16). This is

Figure 3.16. CPI (left panel) and RPI (right panel) inflation forecasts compared



Note: CPI stands for Consumer Prices Index. RPI stands for Retail Prices Index. The Bank of England does not provide a forecast for the RPI.
Source: See Figure 3.15.

largely due to a forecast rise in imported inflation as a result of the depreciation of the pound. This kind of inflation, resulting from the cost of imports, does not increase the cash size of the UK economy, so does not result in higher nominal tax receipts. But holding the cash size of the economy constant, higher consumer price inflation does lead to higher borrowing via higher spending on inflation-linked payments and lower tax revenues. This is because the CPI is used to uprate many direct tax thresholds (such as the income tax personal allowance and higher-rate threshold) and, despite the freeze to most working-age benefits, it is still used to uprate some benefits and it is also used in the uprating of public service pensions. While a higher rate of inflation as measured by the RPI will boost revenues from excise duties and business rates, it also pushes up spending on index-linked debt (although this is only a one-off effect unless higher inflation persists).

Overall, the forecast increase in consumer price inflation between March and November 2016 weakened the public finances by £2.8 billion in 2020–21, increasing spending by £2.1 billion and reducing receipts by £0.7 billion. However, as set out in Figure 3.16, the Bank of England forecast in November that the CPI would reach a higher peak than the OBR forecast, and that inflation would remain higher for longer. The Bank of England does not publish a forecast for the RPI. But if we assume that its RPI forecast would exceed the OBR's forecast by the same amount as with the CPI, then this would increase borrowing by a further £1.1 billion in 2020–21.[20]

Interest rates and quantitative easing

A final set of economic risks affect debt interest spending. Debt interest spending is affected by: (i) the stock of public sector debt; (ii) the average interest rate (or gilt rate) that applies to the stock of debt; and (iii) what proportion of the debt is held by public sector institutions rather than the private sector.[21] Between March and November, the forecast for debt interest spending fell. This was the combined effect of a larger projected stock of debt being more than offset by lower gilt rates on new debt (or old debt being refinanced) and an expansion of the Bank of England's Asset Purchase Facility, which meant that more government debt was held by another public sector institution. Further details of gilt issuance, and the holdings of the Bank of England, can be found in Chapter 9.

Since November, interest rates have risen. Ten-year gilt yields are on average 0.2 percentage points higher than at the time of the November forecast. The OBR ready reckoner implies that, were gilt rates to be 0.2 percentage points higher across the whole forecast period, debt interest spending could increase by around £1 billion by 2021–22.[22]

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[20] The RPI increased by less than the CPI between March and November 2016 mostly because the RPI includes housing costs in its basket and interest rates fell between March and November. However, any additional increase in the CPI is likely to be due to the Bank's judgement of how the pound's depreciation is likely to pass through to prices. This is likely to increase the CPI and RPI by the same amounts. Calculations based on Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2016. Effects of CPI and RPI inflation on spending and receipts derived from changes in those indices and the appropriate revisions to the forecast. Almost all of the £1.1 billion here arises from higher spending, with the effect on receipts of higher RPI and CPI inflation broadly offsetting one another.

[21] In particular, the debt interest payments due on gilts held by the Asset Purchase Facility (APF) do not count towards public sector debt interest. The only debt interest paid on these gilts is the cost for the Bank of England to finance the purchase of the debt, which is the base rate set by the Monetary Policy Committee. This currently stands at 0.25%, far below the gilt rates on the debt held in the APF.

[22] See supplementary table 2.36 of Office for Budget Responsibility, *Economic and Fiscal Outlook*, November 2016, http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2016/.

Increases in the Bank of England bank rates also push up debt interest spending (via the interest payment on the liabilities held by the APF to purchase gilts). The OBR forecast is based on the bank rate increasing slowly over the next few years, such that in the first quarter of 2022 it is still running at 0.9%.[23] If the Bank of England were to increase the bank rate (the effective public sector net interest payment on gilts held by the APF) by more than the OBR assumes, this would also increase forecast debt interest spending. Every 1 percentage point increase in the bank rate leads to £4¼ billion more debt interest spending (shown in Table 3.7 later).

There is a broader, longer-term risk on debt interest spending, however. In the period since 2007–08, the stock of debt has more than doubled as a proportion of national income. But interest rates have fallen substantially, and the APF has purchased a sizeable proportion of the existing debt stock, such that the amount spent on debt interest is set to be lower as a proportion of national income in 2019–20 than it was in 2007–08 (see Figure 3.14). While recent history has taught us that forecasts for interest rates can fall even when they are at historically low levels, in the longer run gilt rates seem likely to rise and the APF is to be unwound. In 2020–21, public sector expenditure on debt interest is forecast to be almost £10 billion lower as a result of APF intervention. With the national debt set to remain high as a proportion of national income for a prolonged period, and with that debt needing to be refinanced over time, there is a likelihood that debt interest spending will impose a larger burden on public expenditure in the future. For a further discussion of these risks, see Chapter 9.

3.5 Conclusion

The deficit remains high and government plans imply further fiscal tightening over the next few years. In 2016–17, most of the measures to reduce the deficit are tax rises rather than spending cuts. But over the parliament as a whole, the largest tightening occurs through departmental spending restraint. The current forecasts imply an uneven profile of deficit reduction: an average decline in the deficit of 0.6% of national income a year between 2015–16 and 2018–19, a drop of twice that amount in 2019–20, and then hardly any more planned beyond that, such that the deficit is forecast still to be 0.7% of national income in 2021–22. Perhaps even more so than usual, the forecasts are uncertain. A cocktail of economic and policy risks mean that these forecasts could be subject to sizeable revisions going forwards.

In order to meet the government's main fiscal objective – to restore the public finances to balance as early as possible in the next parliament – the Chancellor (or his successor) would more-likely-than-not have to enact further fiscal tightening beyond 2021–22. Of course, the scale of fiscal tightening required will to a large extent depend on how the uncertainties considered in Section 3.4 materialise over the forecast period. If, for example, the economy grows less quickly than the OBR expects, the government delivers its policy commitments on income tax thresholds, and fuel duties remain frozen in nominal terms, the deficit would most likely be higher in 2021–22, requiring more tightening for the target to be met. If, on the other hand, the economy grows more quickly than forecast and the UK government banks rather than spends savings from reducing, or even eliminating, the UK's net EU contributions, the required consolidation

[23] See chart 3.8 on page 49 of Office for Budget Responsibility, *Economic and Fiscal Outlook: November 2016*, http://budgetresponsibility.org.uk/efo/economic-and-fiscal-outlook-november-2016/.

would most likely be smaller. But further challenges and risks that affect the public finances after 2021–22 will be relevant for whether – or at least how easily – the deficit can be eliminated.

According to the latest OBR projections, the next parliament is likely to be beset by relatively sluggish growth.[24] They anticipate that productivity growth will be hampered by uncertainty surrounding the UK's post-EU trade arrangements until the mid 2020s (real growth averages 2.2% per year in the first half of the 2020s, and 2.4% in the second half of that decade). Also factoring in downgrades between March and November forecasts, overall the economy is set to be 1.9% smaller by the mid 2020s than the OBR expected in March 2016.

Even this may understate the downside economic risks during the 2020s. Though the OBR assumes a decade of lower productivity growth (from 2016–17 to 2025–26) while the UK establishes its new trade arrangements, it has not downgraded longer-run growth prospects. That is, the OBR does not assume that the UK will grow less quickly outside the EU than it would have done within the union. If longer-run growth were to be lower – because, say, the UK was less open to trade – the economy might grow more slowly still. This would likely manifest itself during the 2020s, making it even more difficult for the government to balance the budget.

Should economic growth progress sluggishly over the next decade, tax revenues (in cash terms) would be likely to grow more slowly. At the same time, factors not linked to the pace of economic growth are likely to place upwards pressure on spending. In particular, an ageing population leads to higher state pension and long-term care spending. As older people use more health care, health costs are also set to rise. Additionally, the OBR anticipates that non-demographic factors, such as health care becoming more expensive as new technologies are developed, will place further upward pressure on health spending (see Chapter 5 for a more detailed discussion of the factors affecting health spending).

Overall, the OBR estimates that the combined effect of these factors is to place upward pressure on spending of around 1.0% of national income by 2025–26. That is, compared with a baseline in which these factors were unchanged between 2021–22 and 2025–26, satisfying the same demands will cost an additional 1.0% of national income. These pressures may be particularly important because current forecasts imply that spending on these three areas will actually fall by 0.5% of national income between 2016–17 and 2021–22 (helped by significant increases in the state pension age). What this means is that simply to keep pension promises and keep pace with rising demands for health and social care beyond 2021–22, the projections suggest we will need to increase annual spending by about £20 billion over the next parliament.

Of course, these pressures need not mean that borrowing increases by 1.0% of national income. However, they mean that, whatever level of borrowing the government aims for, achieving its plans will be more difficult – either public spending on pensions, health and social care will be less able to match demand, taxes will be higher, or spending on other areas will be lower. Given large spending cuts already achieved (and with more planned

[24] Office for Budget Responsibility, *Fiscal Sustainability Report*, January 2017, http://budgetresponsibility.org.uk/fsr/fiscal-sustainability-report-january-2017/.

over the next five years), these additional pressures could make even a relatively modest reduction in borrowing during the next parliament more difficult.

Demographic pressures and economic performance are not unrelated. To the extent that these public spending cost increases will occur no matter how the economy grows, these pressures will be more (less) burdensome if the economy grows less (more) quickly than the OBR assumes. However, regardless of the level of economic growth, demographic and non-demographic public spending pressures represent a substantial (and increasing) fiscal challenge through the 2020s and beyond.

Table 3.7 presents an illustrative scenario for the next parliament, and the scale of fiscal consolidation that might be required in order to meet the fiscal target of budget balance. If we assume growth up to 2020 were to materialise as the Bank of England's November forecast implies, the government fulfils its commitment to increase income tax thresholds, and fuel duties remain frozen, this would lead to borrowing being £8 billion (in 2016–17 terms) higher in 2020 than the OBR forecasts. However, this could be offset by the government banking a large slice of the net contribution to the EU budget (which would broadly enable the government to replace funds currently spent by the EU in the UK).

So assuming that the deficit in 2021–22 is the same as the OBR forecasts (0.7% of national income, £14¼ billion in 2016–17 terms), the challenge would be made larger by the pressures of an ageing population, equal to 1.0% of national income by 2025. Furthermore, if the GDP downgrade up to 2021–22 (again based on the Bank of England's November forecasts) affects the public finances by more beyond that (because lower investment initially increases tax revenues, but will lead to revenues being lower in the longer run), this could add a further 0.3% of national income to borrowing. Taking these factors into account, consolidation may have to total £40 billion in 2016–17 terms (2% of national income) in the next parliament in order to bring the public finances into balance. In this scenario, lower growth beyond 2020 does not increase the scale of consolidation (because spending and tax thresholds are assumed to grow in line with national income), but the slower growth is beyond 2020, the smaller any real-terms increase in spending on public services will be.

Table 3.7. Possible scale of fiscal consolidation required in the next parliament

	Cost (£ billion, 2016–17 terms)	Cost (% of national income)
Forecast deficit in 2021–22[a]	14¼	0.7%
Pressure from ageing population	19½	1.0%
True long-run elasticity is 0.5% for GDP downgrade[a]	5½	0.3%
Total	**39¼**	**2.0%**
Note: Potential risk from higher base rate[b]	*4¼ per 1ppt rise*	*0.2% per 1ppt rise*

[a] These numbers are lower than those presented earlier in the chapter as all figures in this table are in 2016–17 terms.

[b] Assumes APF holdings of £435 billion.

Note: This calculation assumes economic growth matches the Bank of England November forecast, tax thresholds are uprated in line with national income beyond 2021–22 and spending (before demographic change is taken into account) increases in line with national income. Numbers may not sum due to rounding.

Still the greatest impact comes from how the economy performs. Should it perform better (or worse) than assumed by the Bank of England in November, this will be reflected in a smaller (or larger) required consolidation. However, faster growth may also be accompanied by higher debt interest spending (as interest rates tend to rise as the economy performs better). This would be the reverse of what has happened in recent years, when the public finance impact of disappointing economic performance has been cushioned to some extent by lower interest rates. A further risk surrounds migration. If the economy follows the OBR's 'low migration' scenario (105,000 net inward migration per year, rather than 185,000 per year), this would lead to lower economic growth (by 0.2 percentage points per year on average from 2022–23 to 2025–26) and would increase borrowing in 2025–26 by a further 0.1% of national income through lower tax receipts.

Given the fiscal risks that lie ahead – within the current forecast horizon and beyond – the main stated objective of fiscal policy (to balance the public finances by 2024–25) seems likely to prove to be a difficult task. Should risks materialise unfavourably over the next decade, it is perfectly conceivable that even by 2024–25, a full 14 years after the process of fiscal consolidation began, the deficit would not be eliminated.

3.6 Postscript

At the time of writing, the most recent Bank of England forecast was presented in the November *Inflation Report*. Since then, the Bank of England has released its February forecast. This upgraded economic growth over the next few years relative to its November forecast, and the Bank no longer expects the economy to grow more slowly than the OBR expects. Had we used the February forecast in our analysis, the 'Bank of England' growth scenario explored above would have been similar to the OBR growth scenario (see Table 3.6). The analysis in Sections 3.4 and 3.5 remain instructive, however. Forecasts are likely to be subject to (upwards and downwards) revisions over the next few years, and given that the Bank's November forecast was broadly in line with the average of independent forecasters surveyed by HM Treasury, it remains a plausible alternative economic scenario to consider.