Eliminating the deficit in this parliament?

Carl Emmerson

Presentation at David Hume Institute seminar,
King Khalid Building, Surgeon’s Hall, Edinburgh, 12 May 2016
Three fiscal targets

• Cap forecast welfare spending
  – introduced to help Chancellors make unpopular benefit cuts rather than allow spending to increase inappropriately
  – March 2016: breached in all five years
Three fiscal targets

• Cap forecast welfare spending

• Reduce public sector net debt as a share of national income every year until a surplus is achieved
  – good reasons to want to reduce indebtedness of the public sector
  – but as of November 2015 was only being achieved via asset sales
  – March 2016 Budget forecast on course to be missed
  – initial out-turn for 2015–16 suggests it has been missed
Three fiscal targets

• Cap forecast welfare spending

• Reduce public sector net debt as a share of national income every year until a surplus is achieved

• New fiscal mandate: achieve a headline surplus every year from 2019–20, unless growth drops below 1%
  – still standing, for now…
Achieving and maintaining a budget surplus would be a break from the past.

Source: Office for Budget Responsibility.

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Source: Office for Budget Responsibility.

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Should we run budget surpluses?

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

• Several potentially good reasons to borrow
  – investment spending
  – output stabilisation
  – adjust gradually to shocks
  – forecast errors
  – tax rate smoothing
The Chancellor’s fiscal mandate

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

• Fiscal mandate is easy to understand and transparent
The 1% escape clause

Source: Office for National Statistics; Office for Budget Responsibility.
Three problems with the fiscal mandate

• Unless we aim consistently for large budget surpluses, significant chance sharp adjustments will be necessary
  – greater than one-in-four chance that deficit in coming year more than 0.5% of national income greater than expected

• Rule might not allow government to respond to lower interest rates with more investment spending
  – optimal level of borrowing will almost certainly depend, at least in part, on the interest rate

• 1% threshold arbitrary, and could increase politicisation of the OBR’s growth forecasts
  – history suggests growth not often around 1%, but the future might not look like the past
Size and timing of the fiscal response

By 2015–16 64% done, 36% to do

Source: Institute for Fiscal Studies.
Size, timing and composition of the fiscal response

Overall 19% tax rises, 81% spending cuts

Source: Institute for Fiscal Studies.
Eliminating the deficit?

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

Source: Office for Budget Responsibility.
Eliminating the deficit in the UK, but not in Scotland

• UK deficit forecast to be eliminated by 2019–20, largely as the result of further tax rises and spending cuts (rather than strong growth)

• What about the gap between receipts and spending in Scotland?

• GERS suggests that in 2014–15 the “Scottish deficit” was a larger share of the economy than that of the UK

• IFS projections, using the latest OBR forecasts, suggest the gap will widen
  – driven by weak outlook for North Sea revenues
Gap between UK and Scotland deficit projected to widen

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<th>Scotland</th>
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<tr>
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Gap = 4.7% of GDP, £7.2bn

Gap = 6.7% of GDP, £12.8bn

Eliminating the deficit in the UK, but not in Scotland

- UK deficit forecast to be eliminated by 2019–20, largely as the result of further tax rises and spending cuts (rather than strong growth)
- What about the gap between receipts and spending in Scotland?
- GERS suggests that in 2014–15 the “Scottish deficit” was a larger share of the economy than that of the UK
- IFS projections, using the latest OBR forecasts, suggest the gap will widen
  - driven by weak outlook for North Sea revenues
- Under Full Fiscal Autonomy (or independence) this would matter a lot
- But Scotland not penalised for this under “no detriment” principle enshrined into the Block Grant Adjustments at least until 2021–22
Impact of tax and benefit reforms on incomes

2. Measures introduced between May 2015 and April 2019

Losses in Scotland slightly smaller, as lose less from cuts to housing benefit for private sector tenants

Gains in Scotland slightly bigger, as lose less from restrictions on contributions to pensions among those with incomes above £150k

Actual and projected change in incomes

Cumulative change in household income

Percentile point

-6% -4% -2% 0% 2% 4% 6% 8% 10% 12% 14%

2015–16 to 2020–21
2007–08 to 2015–16
2007–08 to 2020–21

Public spending to fall to a low level by historical standards

Spending on working age social security to be at lowest level since 1990–91

Lowest level for over 60 years, except 1999–2000 and 2000–01

Sources: Office for National Statistics; Office for Budget Responsibility.
Implications for spending areas

- Current (non-investment) departmental spending facing real cuts of 3.7% (£12bn) between 2015–16 and 2019–20
  - NHS, aid, schools, defence protected
  - RDEL outside of Dept of Health, Dept of International Development, Ministry of Defence and schools: –12.8% (£17bn)
  - cuts in Scotland slightly smaller
- Takes the real RDEL cut between 2010–11 and 2019–20 to 10.9%
  - RDEL outside of DH, DfID, MoD and schools: –31.5% (£52bn)
- Public service pension revaluation essentially an additional £2bn RDEL spending cut in 2019–20
  - Increases the real RDEL cut since 2015–16 from 3.7% to 4.3%
- Departments also face pressures from: increased NICs (ending of contracting out); increased minimum wage; apprenticeship levy
  - population growing and ageing
Risks: underlying receipts

• Many risks around public finance forecasts

• Perhaps most obvious uncertainty around the underlying public finances is over the size of the economy
  – if GDP turned out to be 0.7% lower than forecast in 2019–20 this would likely be sufficient to eliminate the forecast surplus
  – forecasts assume that we stay in the European Union, leaving would most likely reduce national income and weaken the public finances

• Other factors matter too: including composition and distribution of GDP, asset prices, etc.

• For example employment and earnings directly affect receipts of PAYE income tax and National Insurance receipts (£262bn)
  – 1% more employment boosts revenues by about 1%; but 1% more earnings boosts revenues by about 1½%
  – mix of earnings/employment growth in last few years has been unfavourable for the public finances
Risks: future policy changes on indexation

• Indexation of fuel duty rates
  – forecasts assume rates will be increased in line with the RPI every April
  – but rates have not increased in nominal terms since April 2011, and were not increased in April 2016 despite low oil price
  – cash freeze would reduce revenues by £2½ billion in 2020–21

• Some other thresholds are frozen in cash terms which might not prove sustainable
  – 40% more additional rate taxpayers since April 2010 due to £150,000 threshold being frozen
  – 50% increase projected over next five years in numbers losing some or all of their child benefit due to the £50,000 threshold being frozen
Risks: future income tax cuts

• **Conservative Party manifesto**
  - personal allowance of £12,500 and a higher-rate threshold of £50,000 by April 2020
  - note: UEL is currently linked to the higher-rate threshold
  - standard indexation would increase these to £12,060 and £47,200, increasing them to £12,500 and £50,000 would cost around £3 billion
  - remember that 43% of adults have incomes too low to pay income tax

• **SNP manifesto**
  - increase personal allowance by a further £250 to £12,750; freeze the higher-rate threshold next April, inflation increases (at most) thereafter
  - SNP estimate that this would boost revenues by a cumulative £1.2 billion over the parliament
  - as the higher-rate threshold in Scotland would be below the UK-wide UEL those in Scotland earning between £46k and £50k would face a combined income tax + employee NICs tax rate of 52%
Gains and losses under Conservative and SNP plans for income tax and NICs

Change in income tax and employee National Insurance contributions

Note: assumes all income from employment, no pension contributions.
Risks: spending

• Public service spending
  – will continued squeeze on public service spending be delivered?
Squeezing public spending by holding down public sector wages

Estimated gap between public and private sector hourly pay

- Raw mean difference
- Projection based on 1% pay award for four years from 2016–17

Notes and sources: see Figure 6.4 of The IFS Green Budget: February 2016.

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Risks: spending

• Public service spending
  – will continued squeeze on public service spending be delivered?

• Social security spending
  – further 4-year freeze in benefit rates will reduce levels significantly in real terms: has not been attempted in last 30 years
  – further delays in transition from Disability Living Allowance to Personal Independence Payments would increase spending
Risks: spending

- Public service spending
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- Debt interest spending
  - 1ppt increase (reduction) in gilt and short rates (from April 2016) would increase (reduce) spending in 2019–20 by around £8 billion
  - 1ppt increase (fall) in RPI inflation (from April 2016) would increase (reduce) spending in 2019–20 by around £5 billion
Summary

• Two of the three fiscal targets set for this parliament already missed
• Achieving and maintaining a budget surplus difficult and commitment to do so in 2019–20 risky
• Scotland’s relative fiscal position forecast to deteriorate
• Continued fiscal tightening:
  – tax and benefit reforms to leave lower income working age households worse off
  – further cuts to spending on many public services
• Many risks remain
  – will economy grow as the OBR expects?
  – will further tax and benefit giveaways follow?
  – will planned cuts to public service spending prove deliverable?
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