Institute for Fiscal Studies

UK public finances and the financial crisis

Carl Emmerson and Gemma Tetlow

Presentation given at workshop on “European public finances through the financial crisis”, ZEW Centre for European Economic Research, Mannheim, Germany, 11 June 2014.

E·S·R·C ECONOMIC & SOCIAL RESEARCH COUNCIL

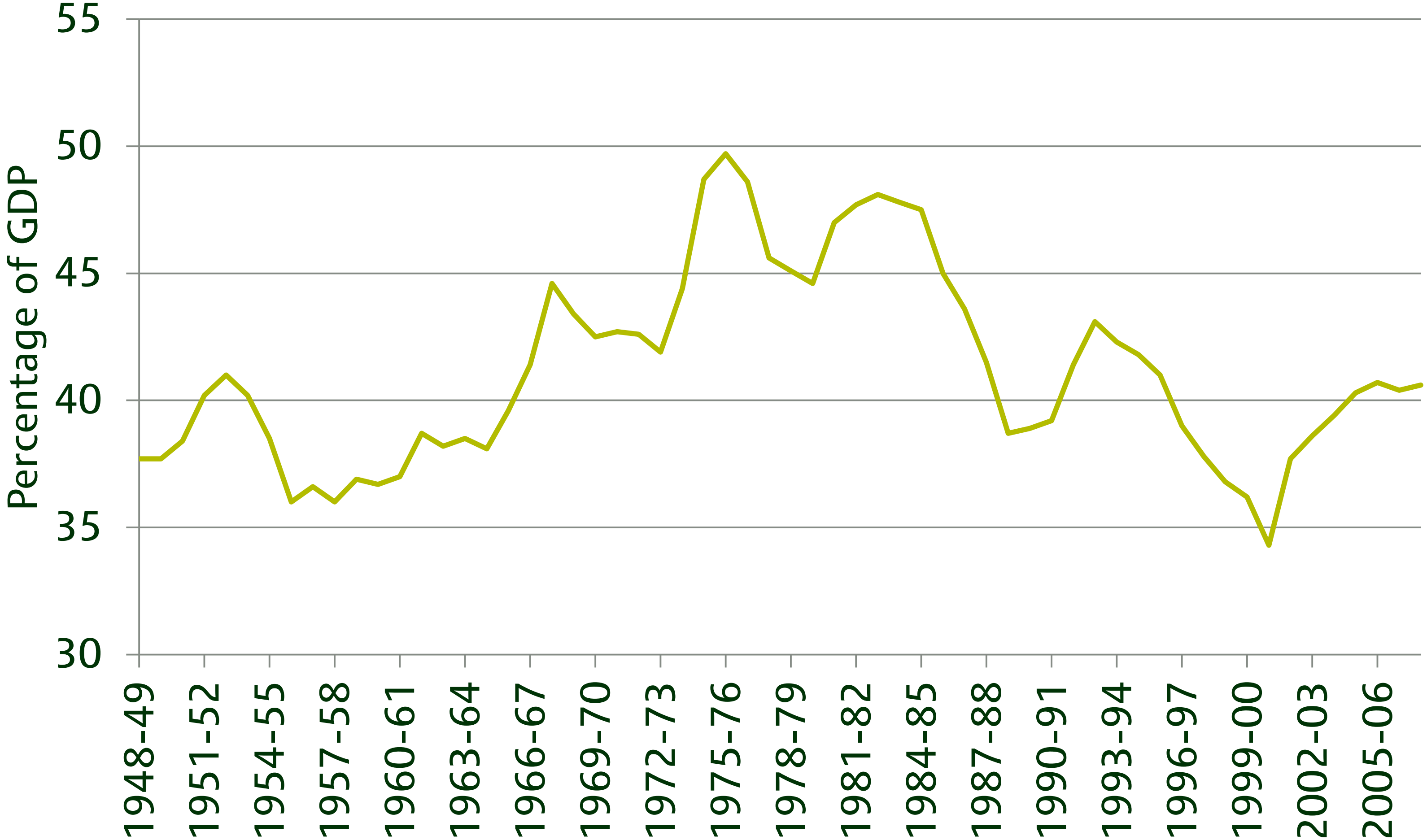
Outline

- Background: the state in the UK
- UK economy before, during and after the crisis
- Fiscal policy before the crisis
- Fiscal effects of the crisis
- Fiscal (and monetary) response to the crisis
  - Changes to taxation, spending and the fiscal framework
  - Distributional effect of changes to taxation and welfare spending
  - Did the tax and spending changes make the system more or less efficient?

- Note:
  - UK fiscal years run from April to March
  - UK public finance aggregates differ from Maastricht definitions

UK spent around 40% of GDP publicly pre-crisis

Total managed expenditure, 1948 to 2007



Source: Office for Budget Responsibility's public finances databank.

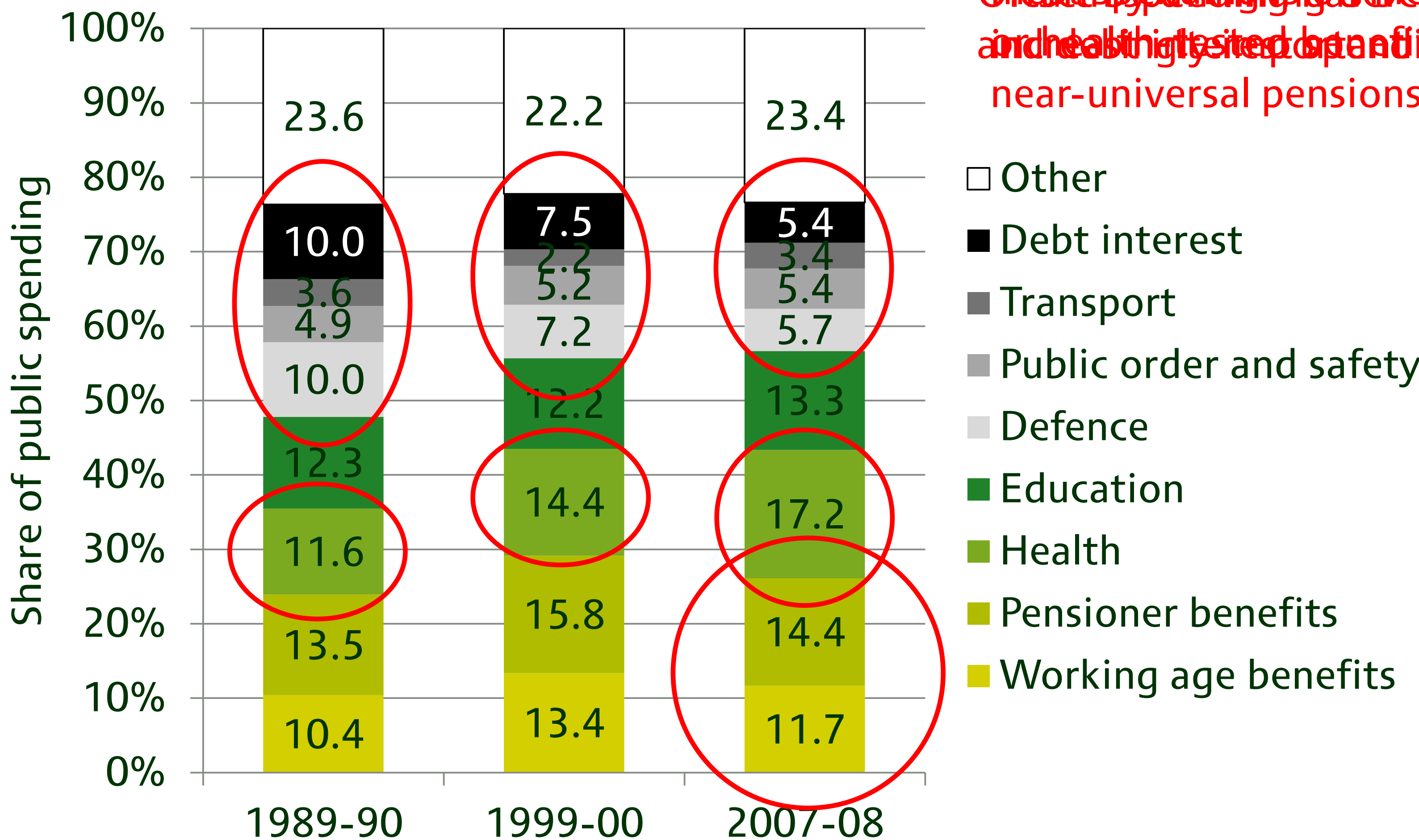
Institute for Fiscal Studies

Composition of spending over time

Total managed expenditure, selected years

Weak contributory principle:

near-universal pensions

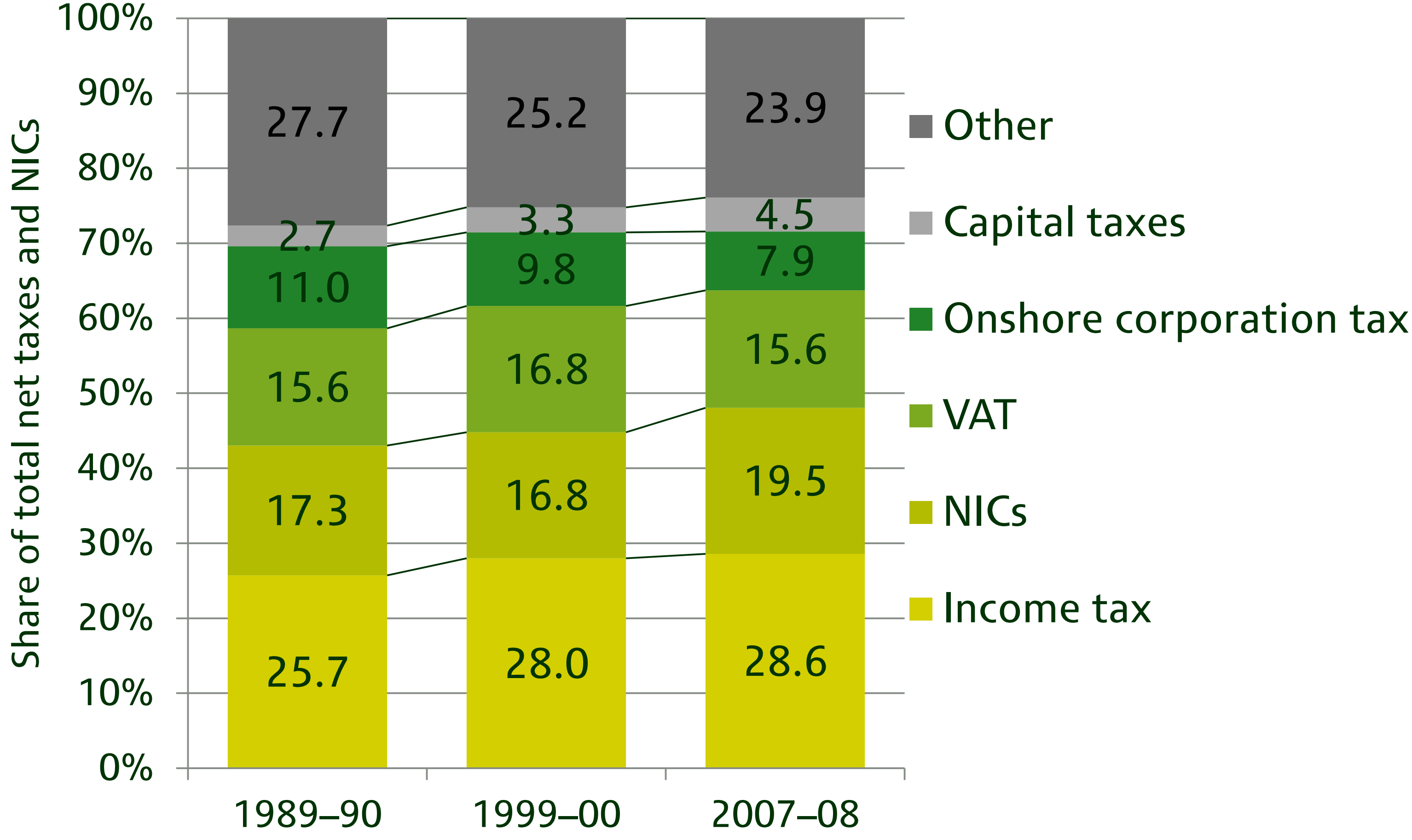


Source: Authors' calculations based on data from HM Treasury and Department for Work and Pensions.

Institute for Fiscal Studies

Changing composition of revenues

Net taxes and national insurance contributions, selected years

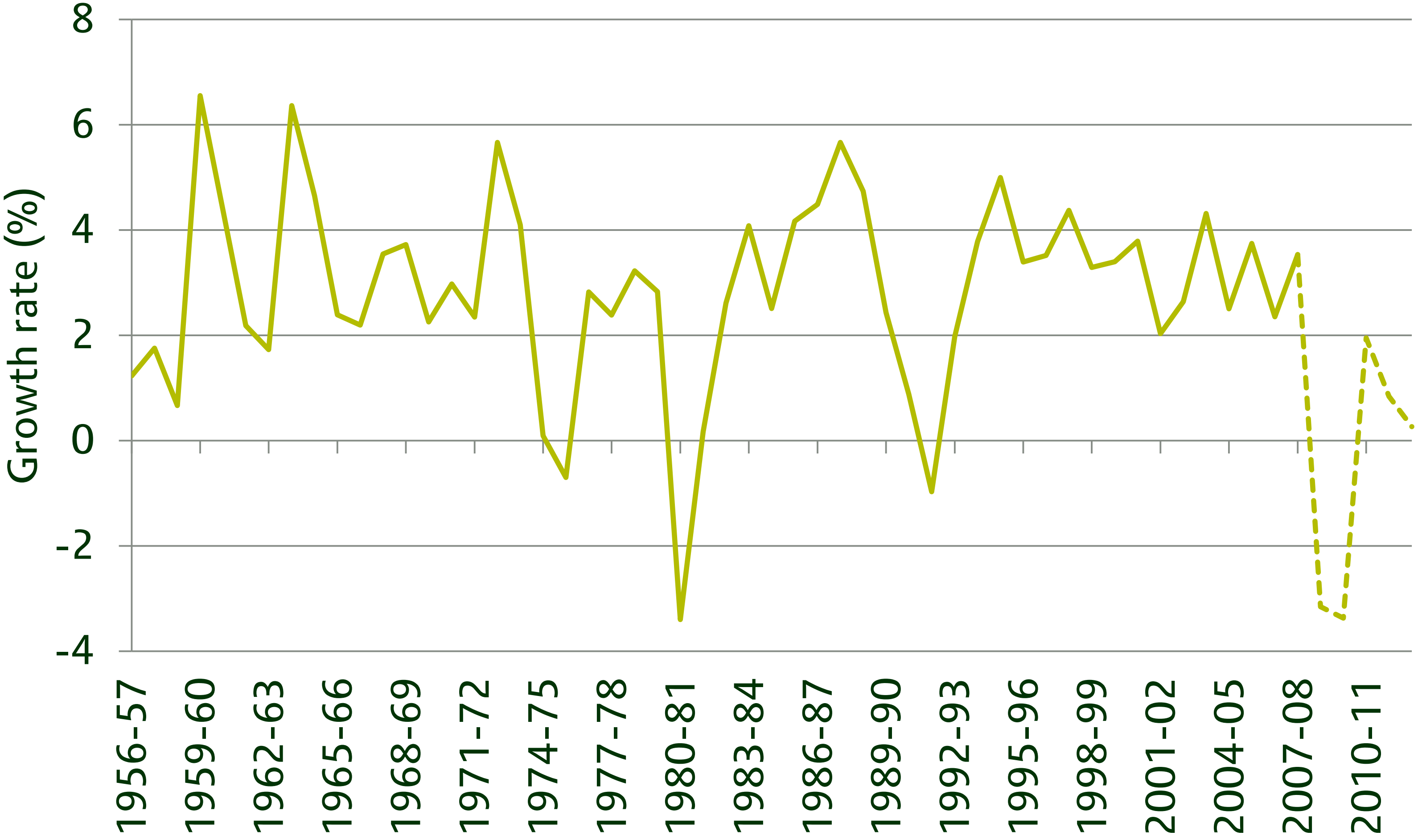


Source: Figure 2.5 of *IFS Green Budget: February 2014*.

Institute for Fiscal Studies

GDP growth had averaged 3.2% a year over the decade up to 2007–08

Real GDP growth rate, 1956 to 2012

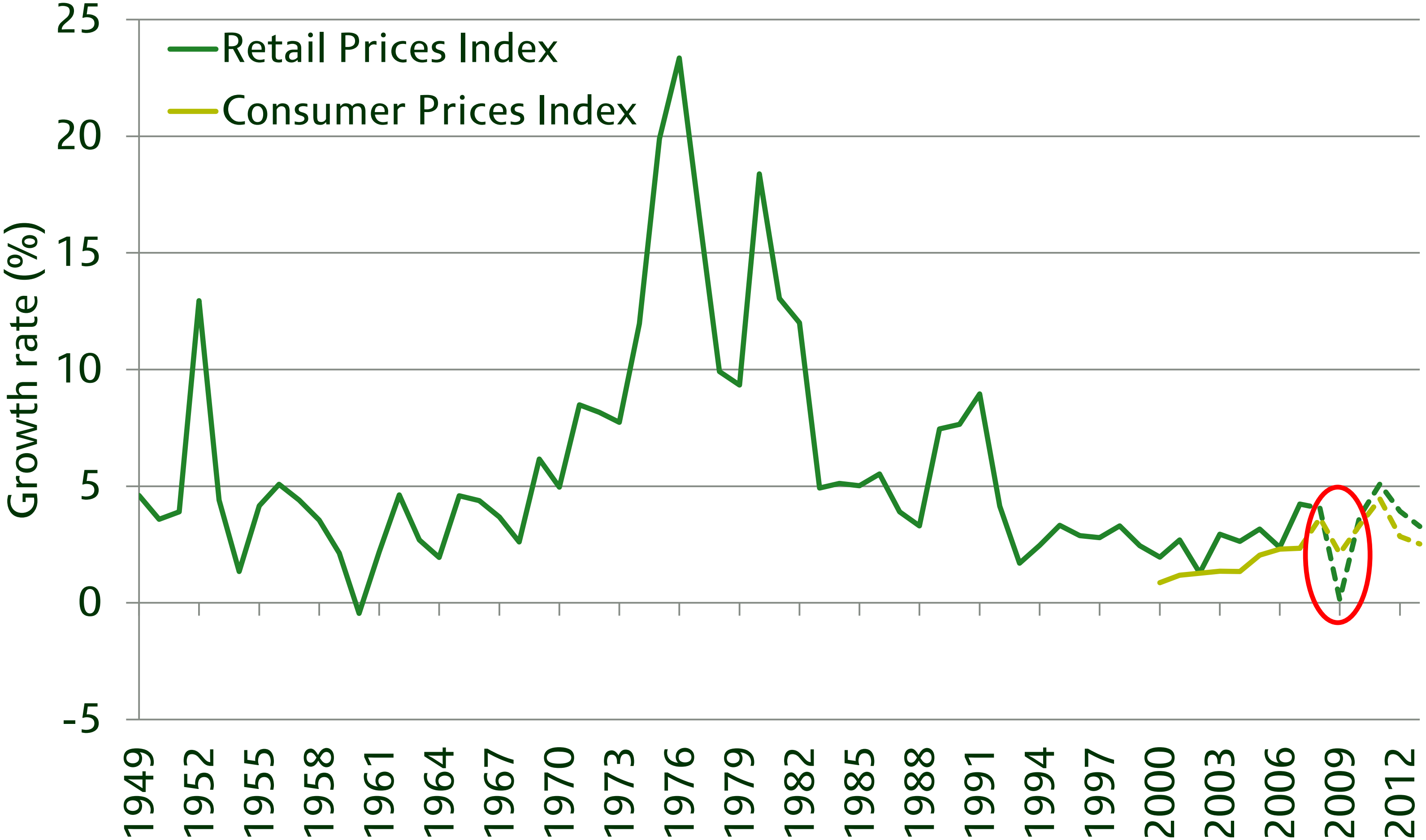


Source: Office for National Statistics, Quarterly National Accounts (series ABMI).

Institute for Fiscal Studies

Inflation had been low and stable since the mid-1990s but rose during the crisis

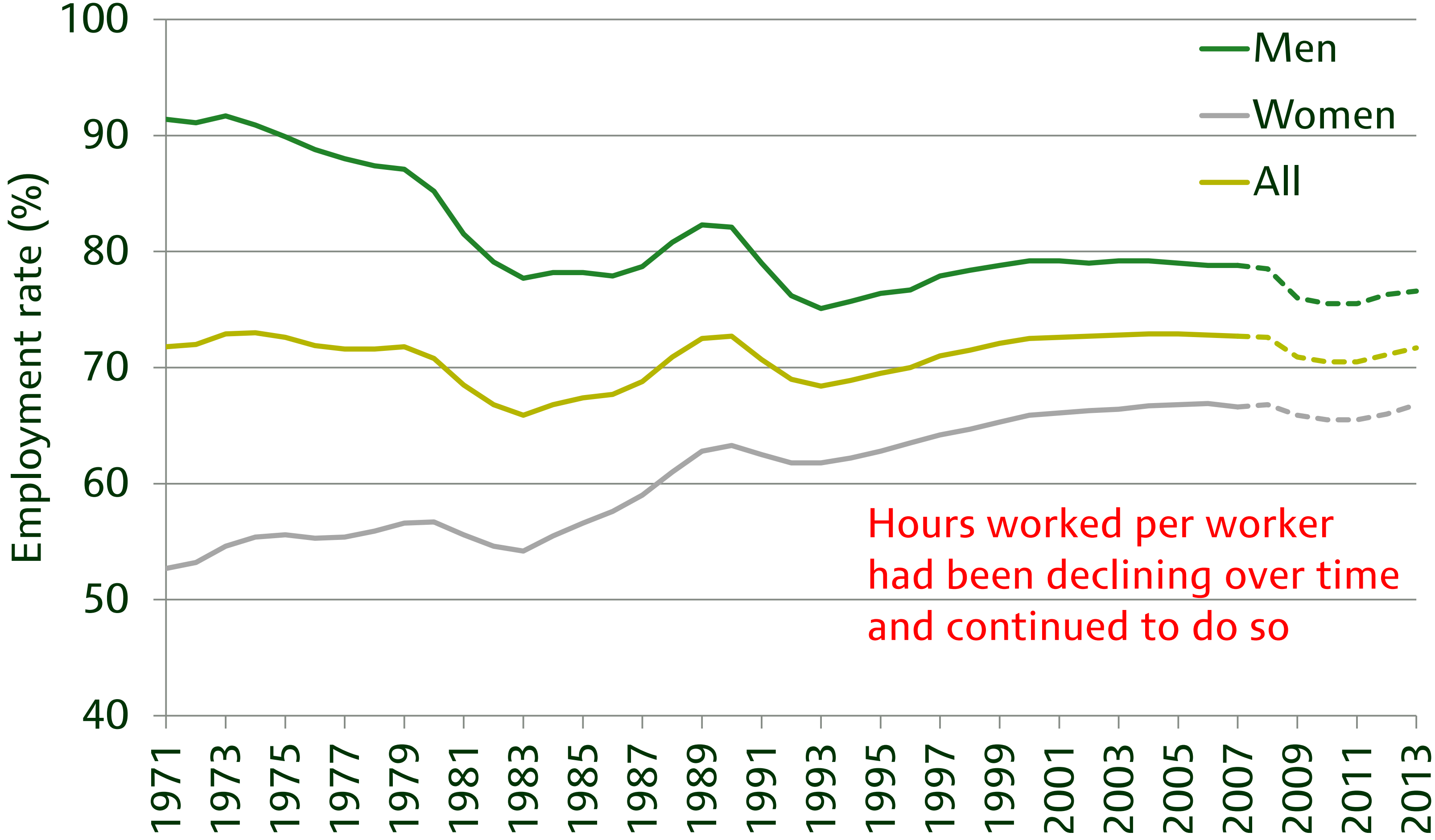
Growth in prices, 1949 to 2007



Source: Office for National Statistics (series DODO, DODP, DODQ, CZVJ, CRAB, CHAW, D7BT, KAB9, KAC4, KAC7).

Employment rates had been rising steadily since mid-1990s

Employment rate among those aged 16 to 64, 1971 to 2013

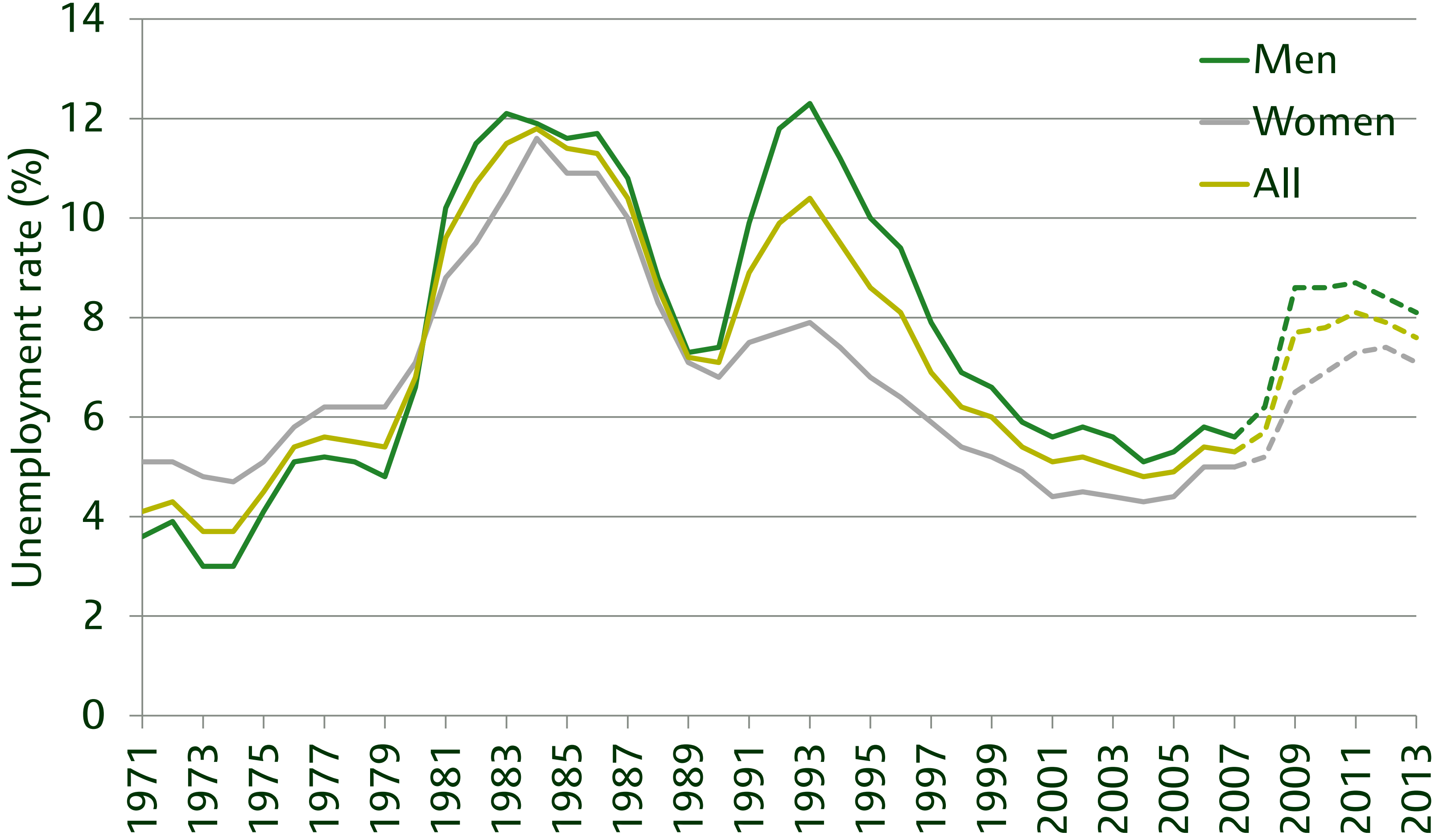


Source: Office for National Statistics (series LF24, MGSV, LF25).

Institute for Fiscal Studies

Unemployment peaked at much lower level than seen during previous recessions

Unemployment rate among those aged 16 to 64, 1971 to 2013

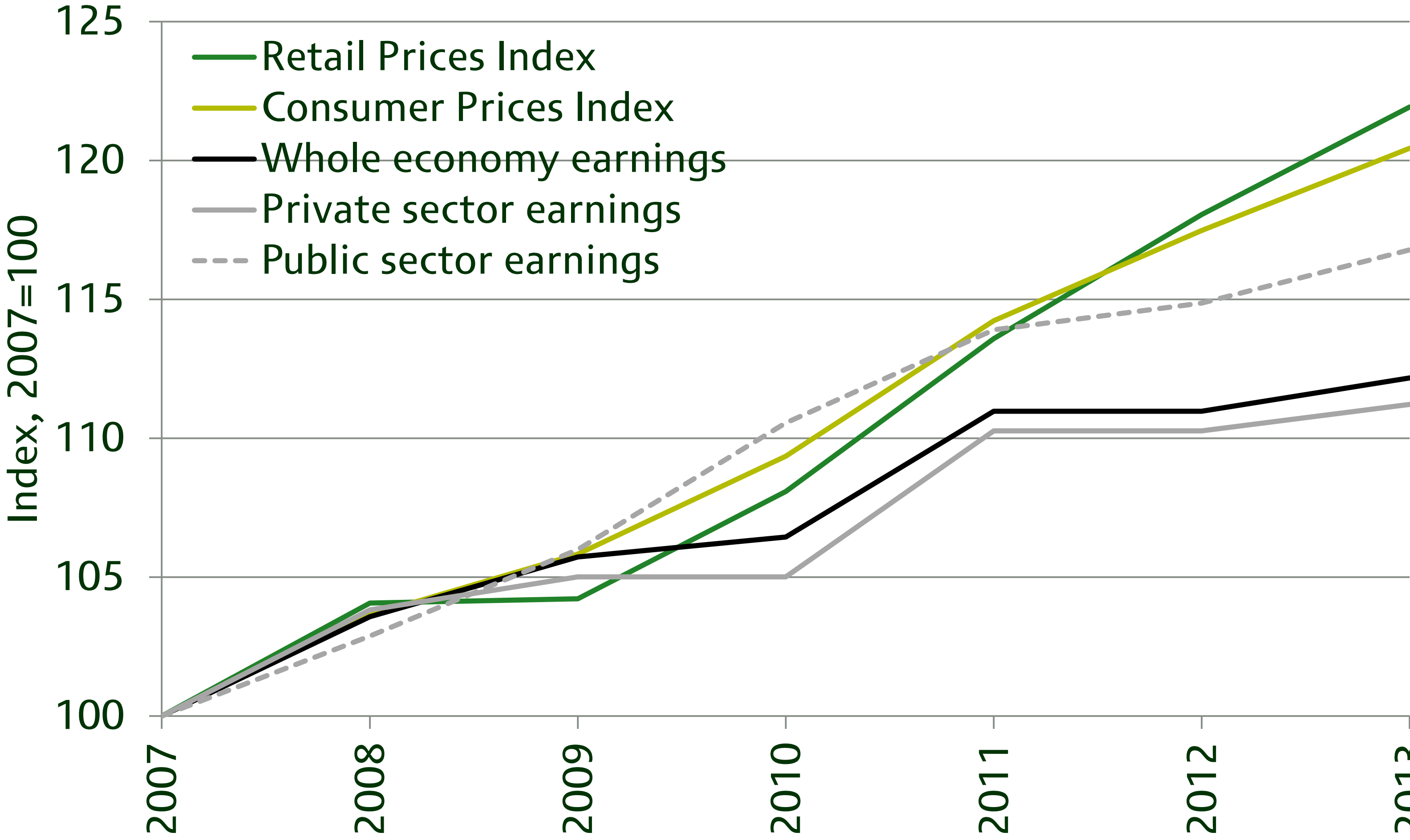


Source: Office for National Statistics (series MGSX, MGSY, MGSZ).

Institute for Fiscal Studies

Average real earnings have fallen

Growth in prices and average weekly earnings, 2007 to 2013



Source: Office for National Statistics (series DODO, DODP, DODQ, CZVJ, CRAB, CHAW, D7BT, KAB9, KAC4, KAC7).

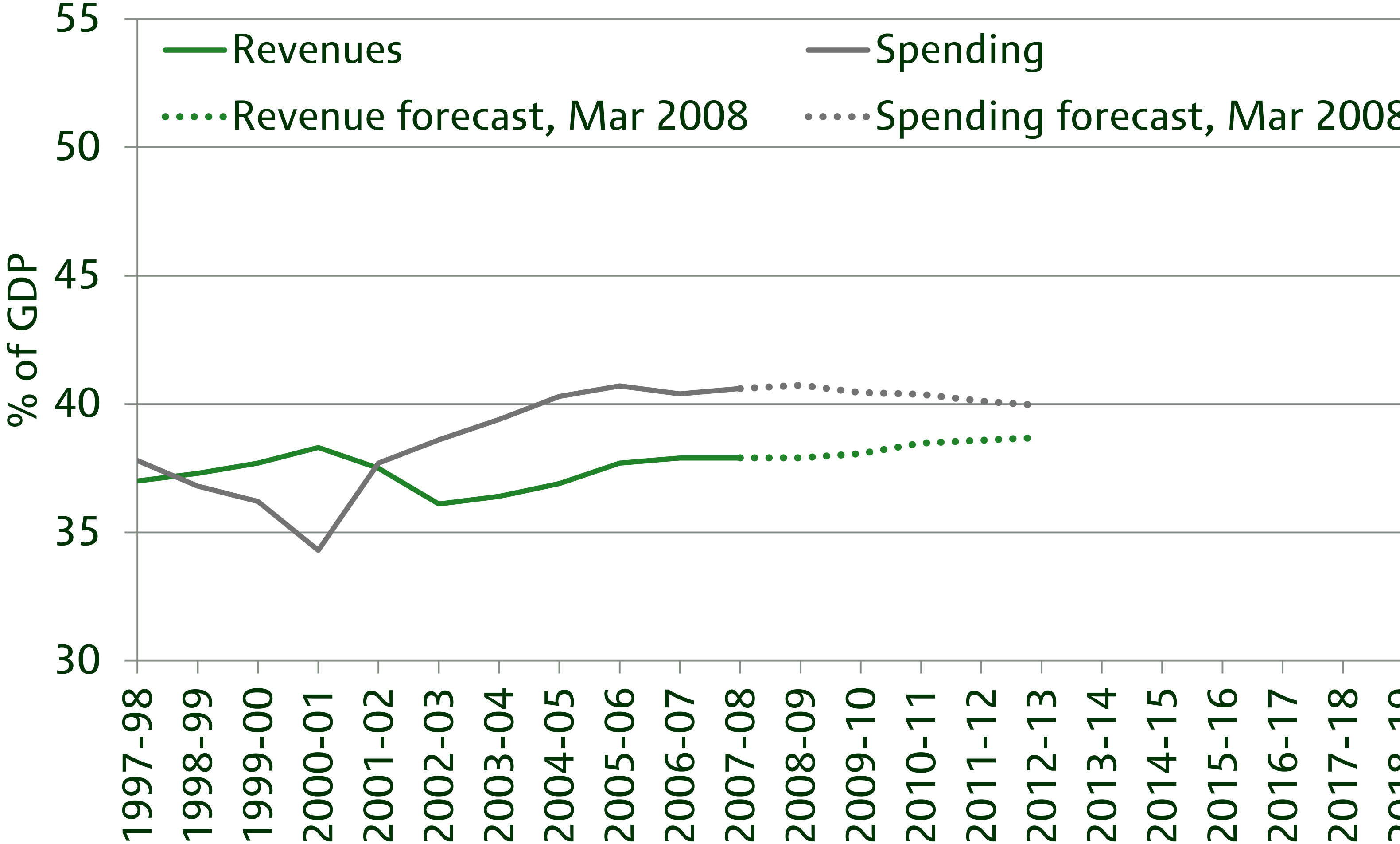
Institute for Fiscal Studies

UK fiscal policy prior to the crisis

- Two fiscal rules
  - **Golden rule:** current budget must be in balance or surplus over the course of an economic cycle
  - **Sustainable investment rule:** debt must not exceed 40% of GDP
  - No official sanctions for breaching these
  - Perception that "the goalposts were moved" – redating the cycle
- Economic and fiscal forecasts produced by HM Treasury, officially controlled by the Chancellor of the Exchequer
- Public service spending totals set in cash terms for 3-year periods
  - 2007 Comprehensive Spending Review: covered 2008–09 to 2010–11
  - Intended to be 'tight': cutting public service spending as % of GDP
- Default was for (most) tax thresholds and benefit rates to increase in line with Retail Price inflation each year
  - Few reforms had been announced pre-crisis but not yet implemented: reduction in generosity of disability insurance, increase in pension eligibility age for women

Pre-crisis plan was for fiscal consolidation by 2012–13

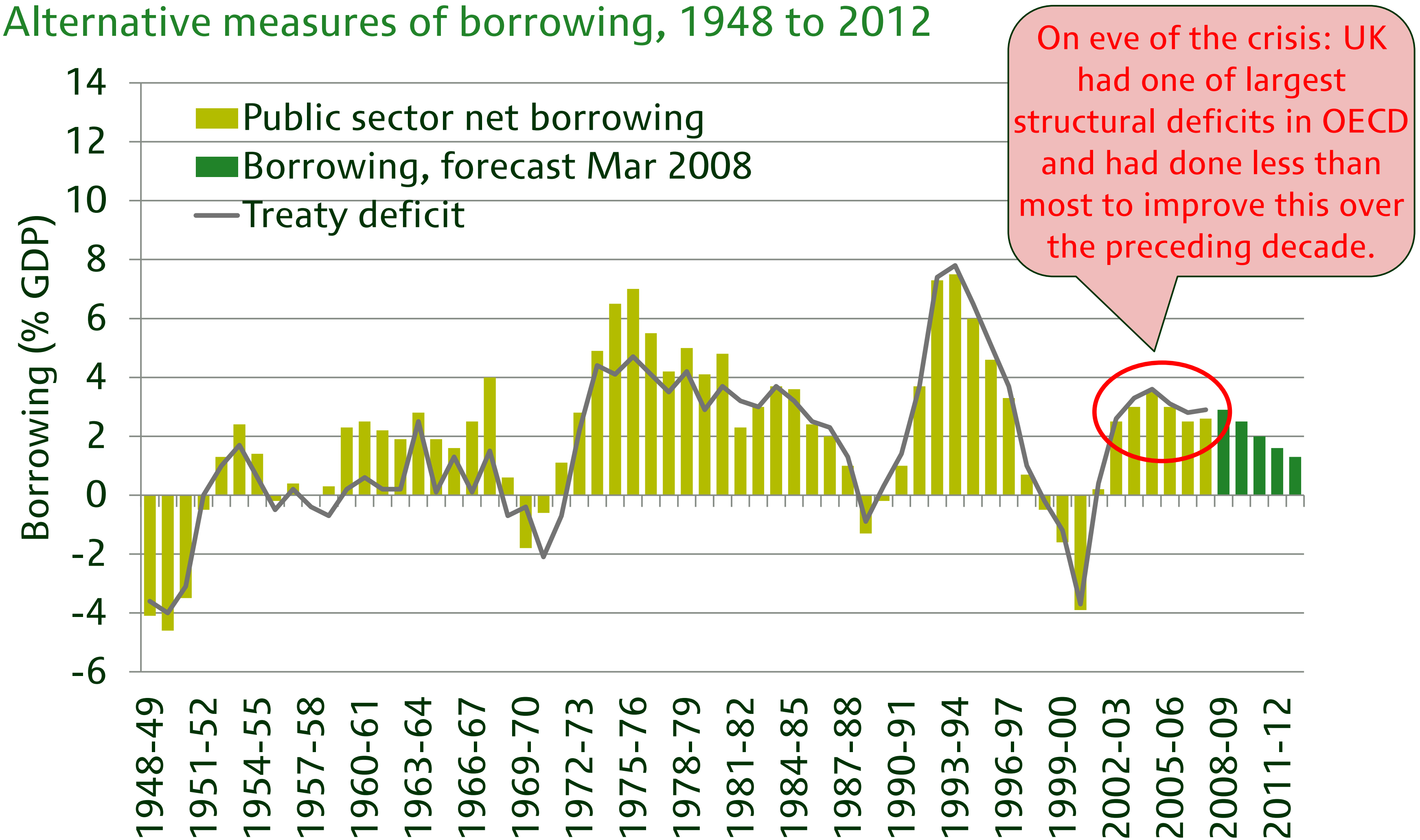
Public sector receipts and total managed expenditure, 1997 to 2018



Source: Office for Budget Responsibility's public finances databank and authors' calculations.

Borrowing was forecast to fall to 1¼% of GDP…

Alternative measures of borrowing, 1948 to 2012

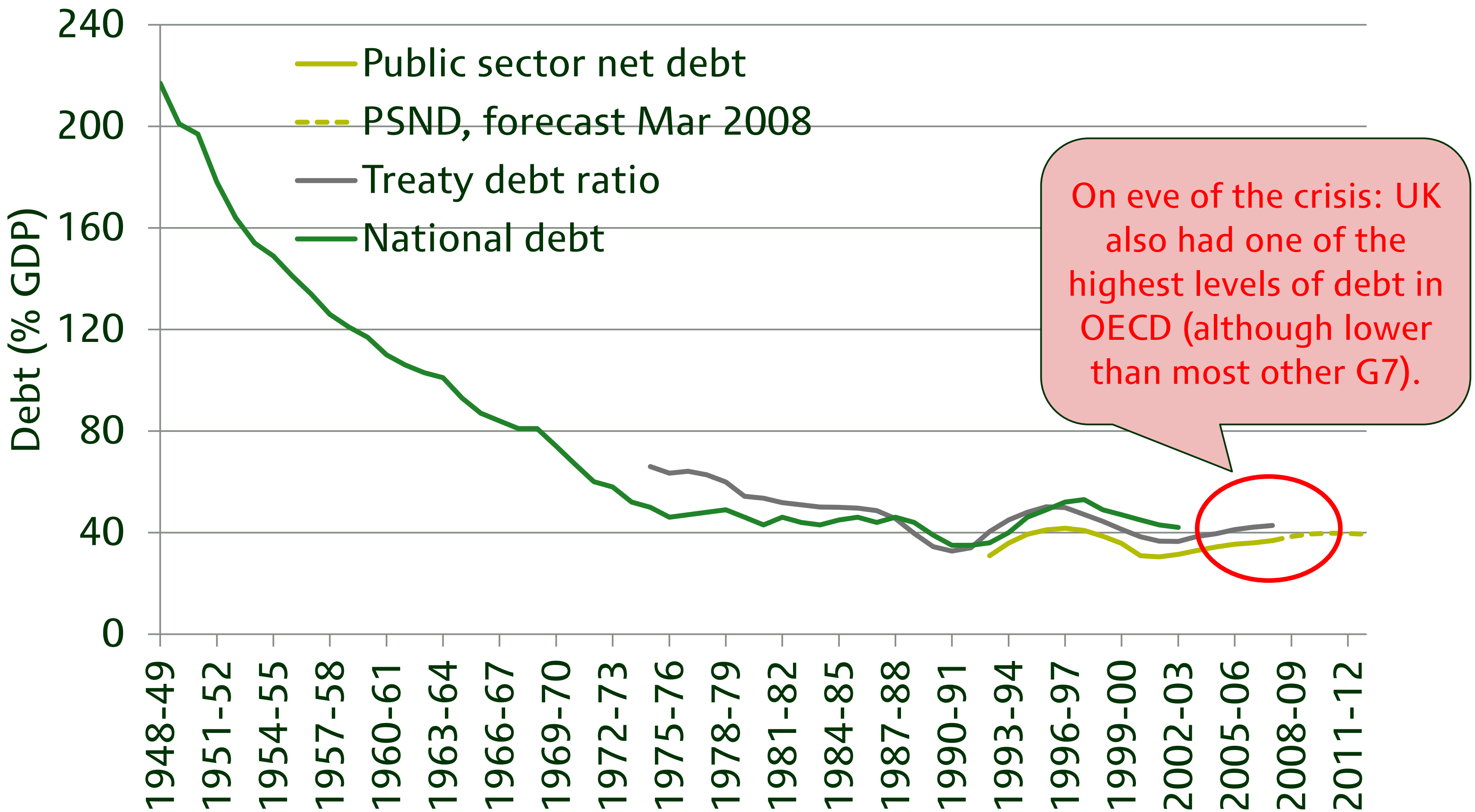


Source: Office for Budget Responsibility's public finances databank and authors' calculations.

Institute for Fiscal Studies

…and debt was forecast to peak just below 40%

Alternative measures of debt, 1948 to 2012



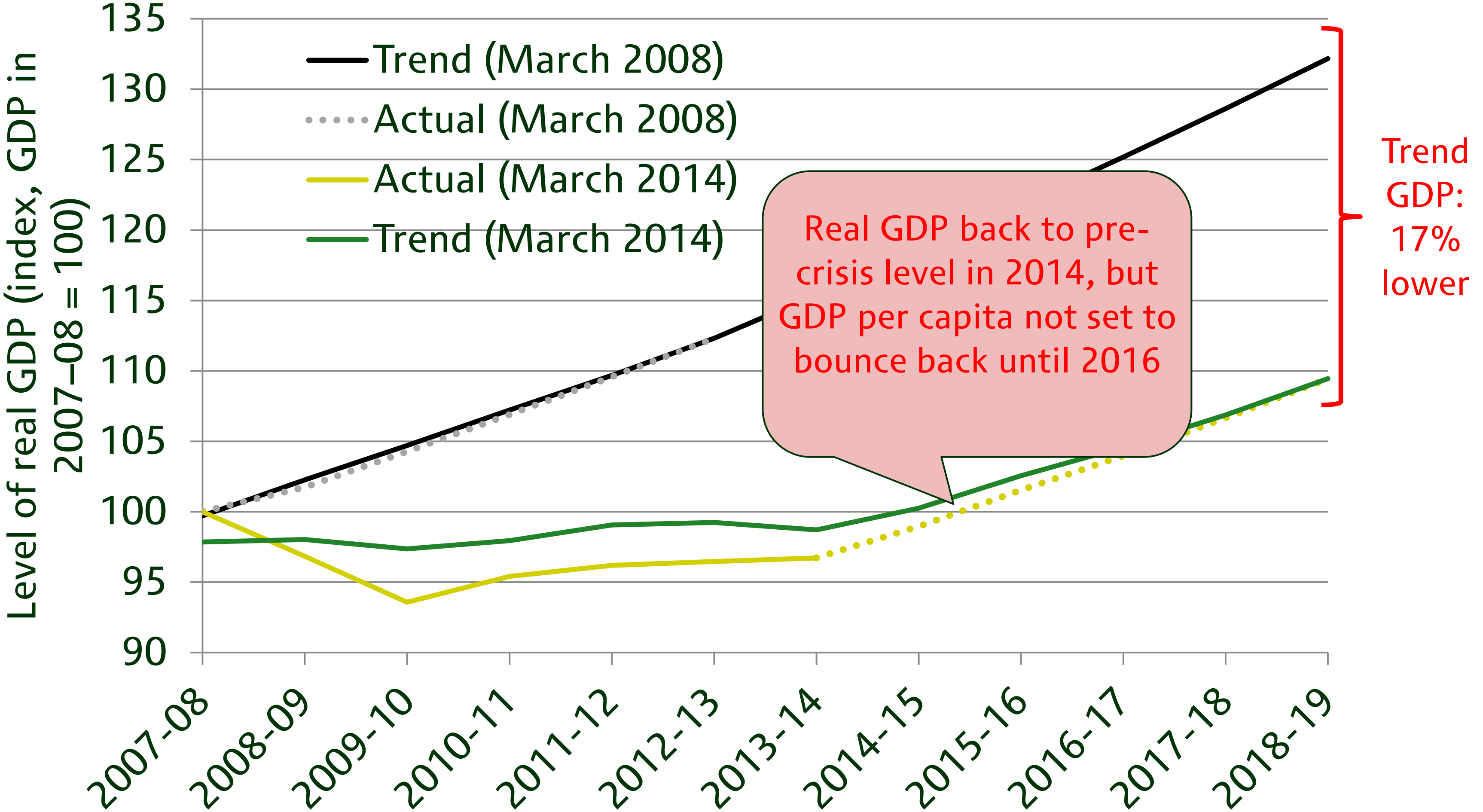
Source: Office for Budget Responsibility's public finances databank.

Institute for Fiscal Studies

Effect of the crisis on UK's public finances

- Level of trend GDP now forecast to be permanently lower than previously expected

A large hit to future potential output?



Source: Authors' calculations based on HM Treasury and Office for Budget Responsibility forecasts and Office for National Statistics data on outturns.

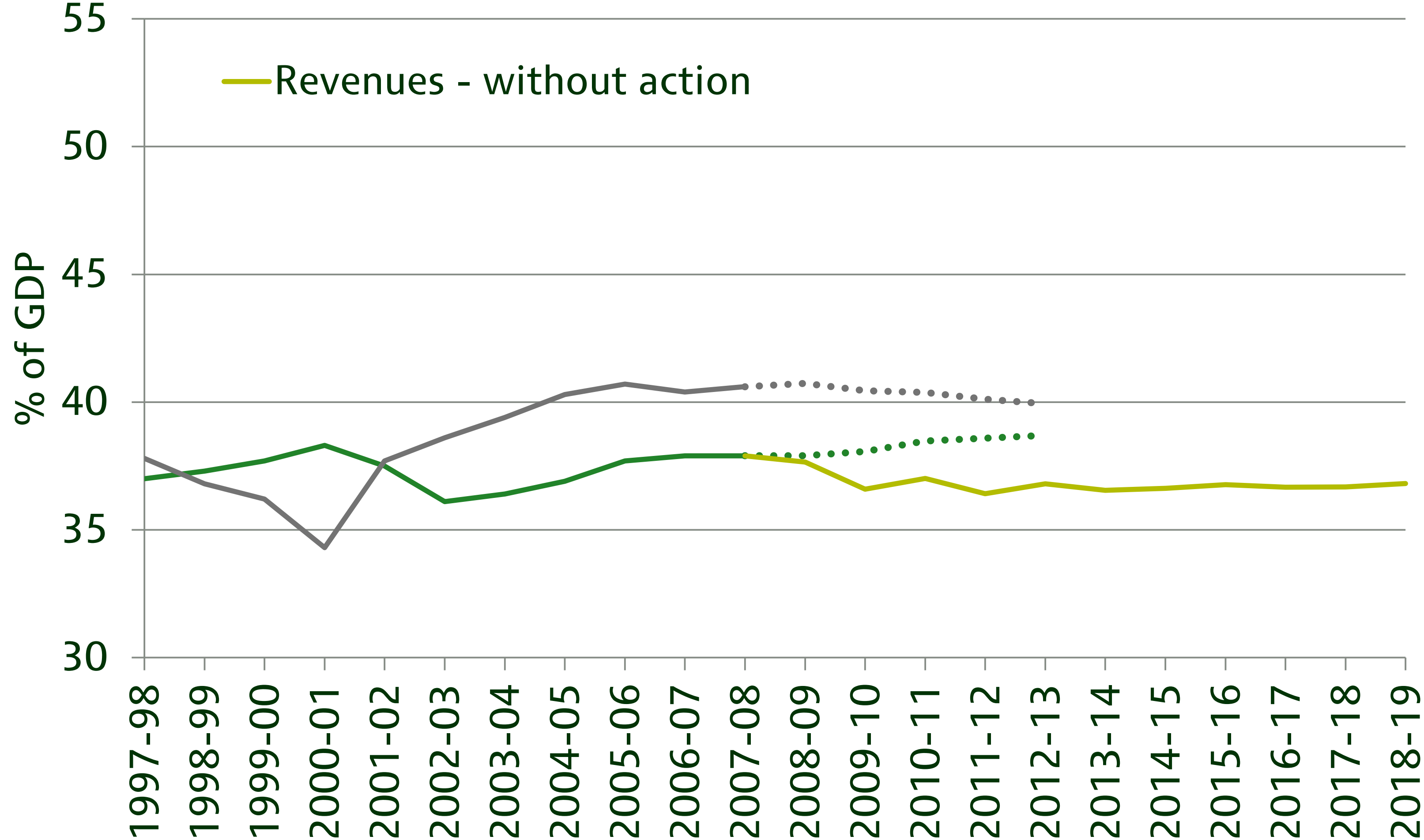
Institute for Fiscal Studies

Effect of the crisis on UK's public finances

- Level of trend GDP now forecast to be permanently lower than previously expected
- Tax revenues fell as GDP fell in cash/real terms
  - Small fall as % of GDP due to fiscal drag and compositional changes
  - Falls in housing prices and transactions reduced stamp duty revenues
  - Falls in stock prices reduced capital taxes and associated with lower bonus payments
  - Financial sector contraction reduced corporation tax revenues

Spending and revenues, without action

Public sector receipts and total managed expenditure, 1997 to 2018



Source: Office for Budget Responsibility's public finances databank and authors' calculations.

Institute for Fiscal Studies

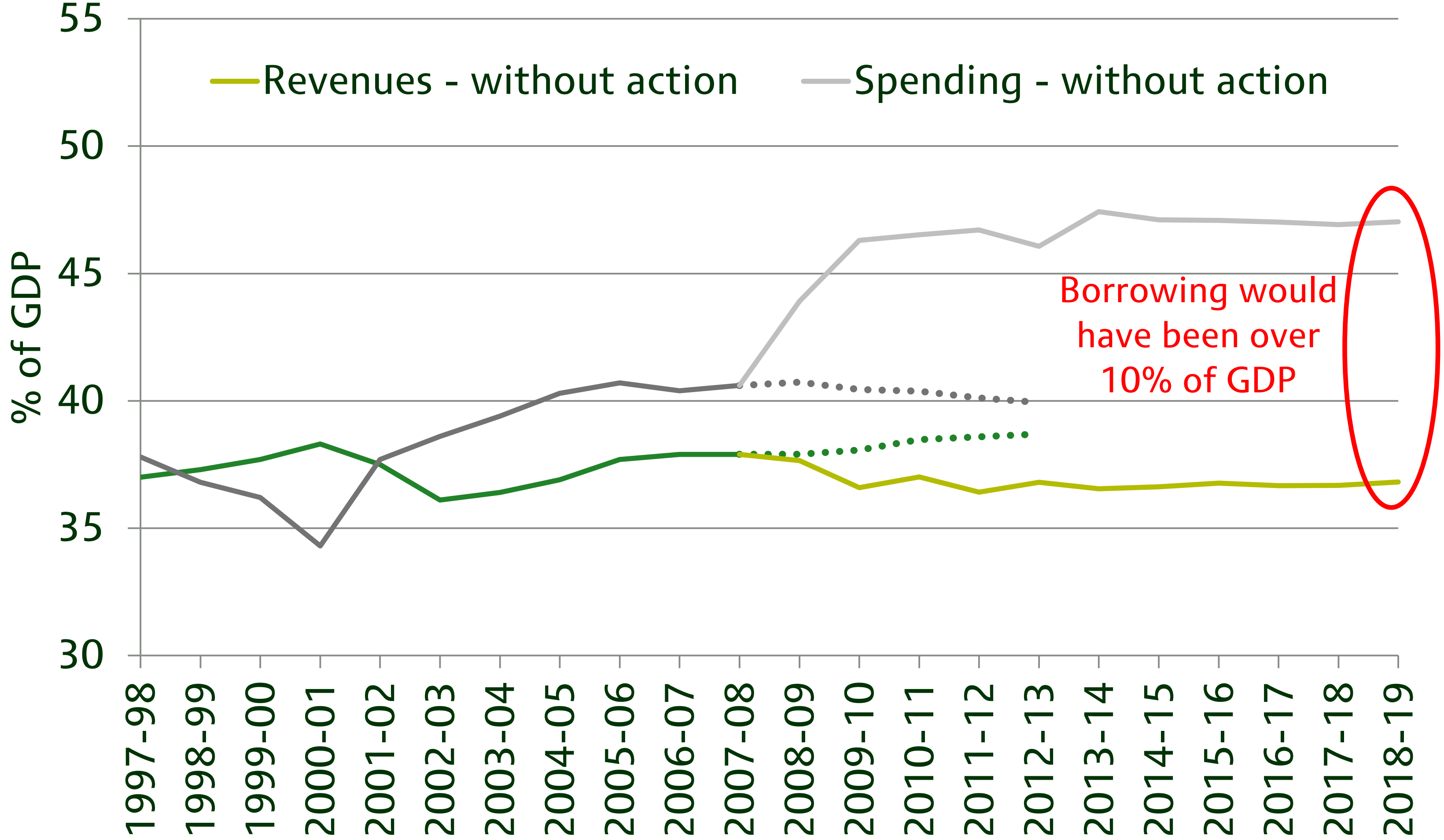
Effect of the crisis on UK's public finances

- Level of trend GDP now forecast to be permanently lower than previously expected
- Tax revenues fell as GDP fell in cash/real terms
  - Small fall as % of GDP due to fiscal drag and compositional changes
  - Falls in housing prices and transactions reduced stamp duty revenues
  - Falls in stock prices reduced capital taxes and associated with lower bonus payments
  - Financial sector contraction reduced corporation tax revenues
- Around half of spending set in advance in cash terms and upward pressure on cyclical spending during recession
  - Spending increased a lot as % of GDP
  - Policy default would have been for spending to remain high as % GDP without "action"

Institute for Fiscal Studies

Spending and revenues, without action

Public sector receipts and total managed expenditure, 1997 to 2018

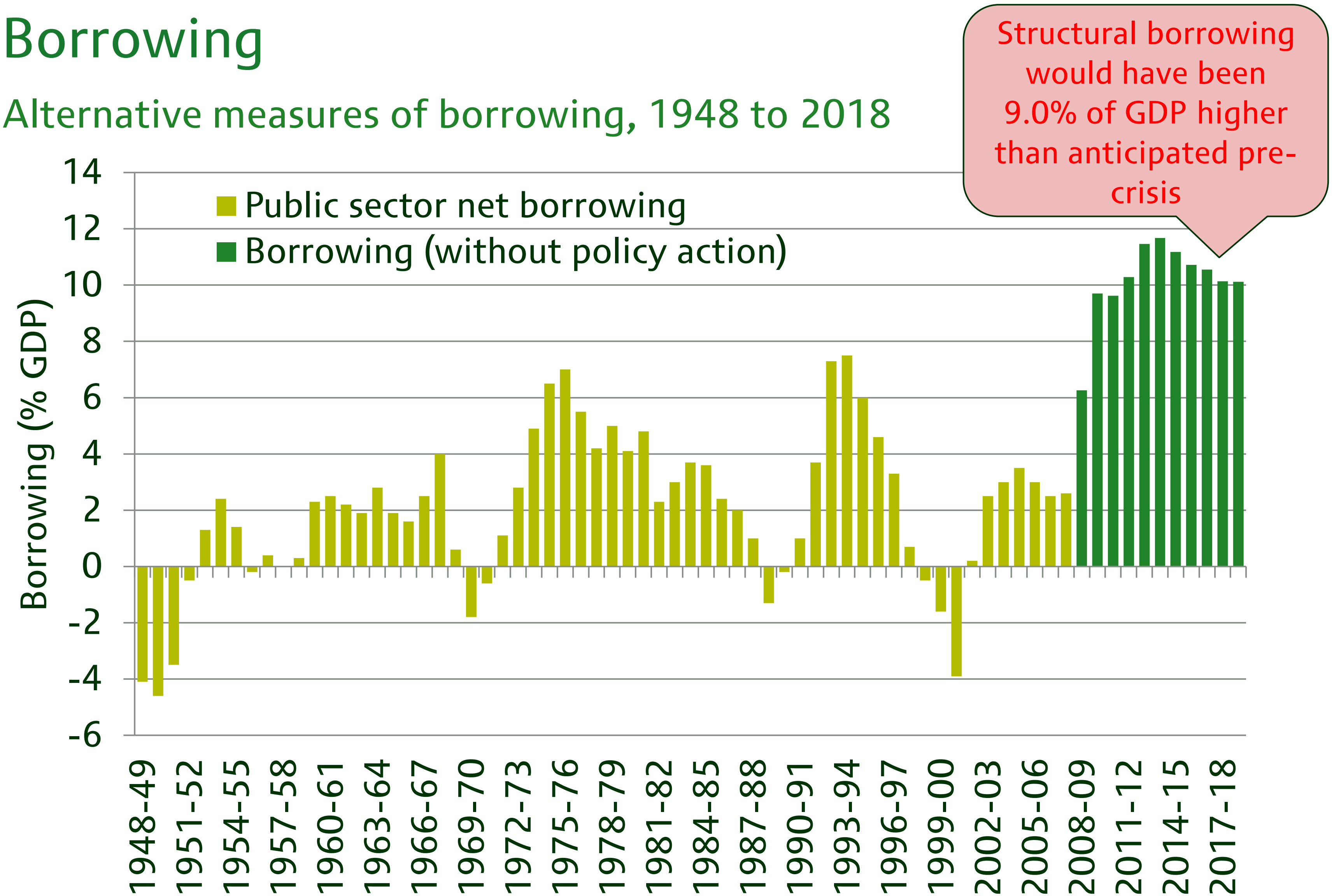


Source: Office for Budget Responsibility's public finances databank and authors' calculations.

Institute for Fiscal Studies

Borrowing

Alternative measures of borrowing, 1948 to 2018



Source: Office for Budget Responsibility's public finances databank and authors' calculations.

Effect of the crisis on UK's public finances

- Level of trend GDP now forecast to be permanently lower than previously expected
- Tax revenues fell as GDP fell in cash/real terms
  - Small fall as % of GDP due to fiscal drag and compositional changes
- Around half of spending set in advance in cash terms and upward pressure on cyclical spending during recession
  - Spending increased a lot as % of GDP
  - Policy default would have been for spending to remain high as % GDP without "action"
- Without "action"
  - Borrowing would have remained above 10% of GDP
  - Unsustainable fiscal position

Fiscal policy response to the crisis (1)

- Two new fiscal targets adopted in May 2010
  - **Fiscal mandate:** cyclically-adjusted current budget must be forecast to be in balance or surplus at the end of the rolling five-year forecast horizon
    - Currently being met
  - **Supplementary target:** debt must be falling as a share of GDP between 2014–15 and 2015–16
    - Currently on course to be missed

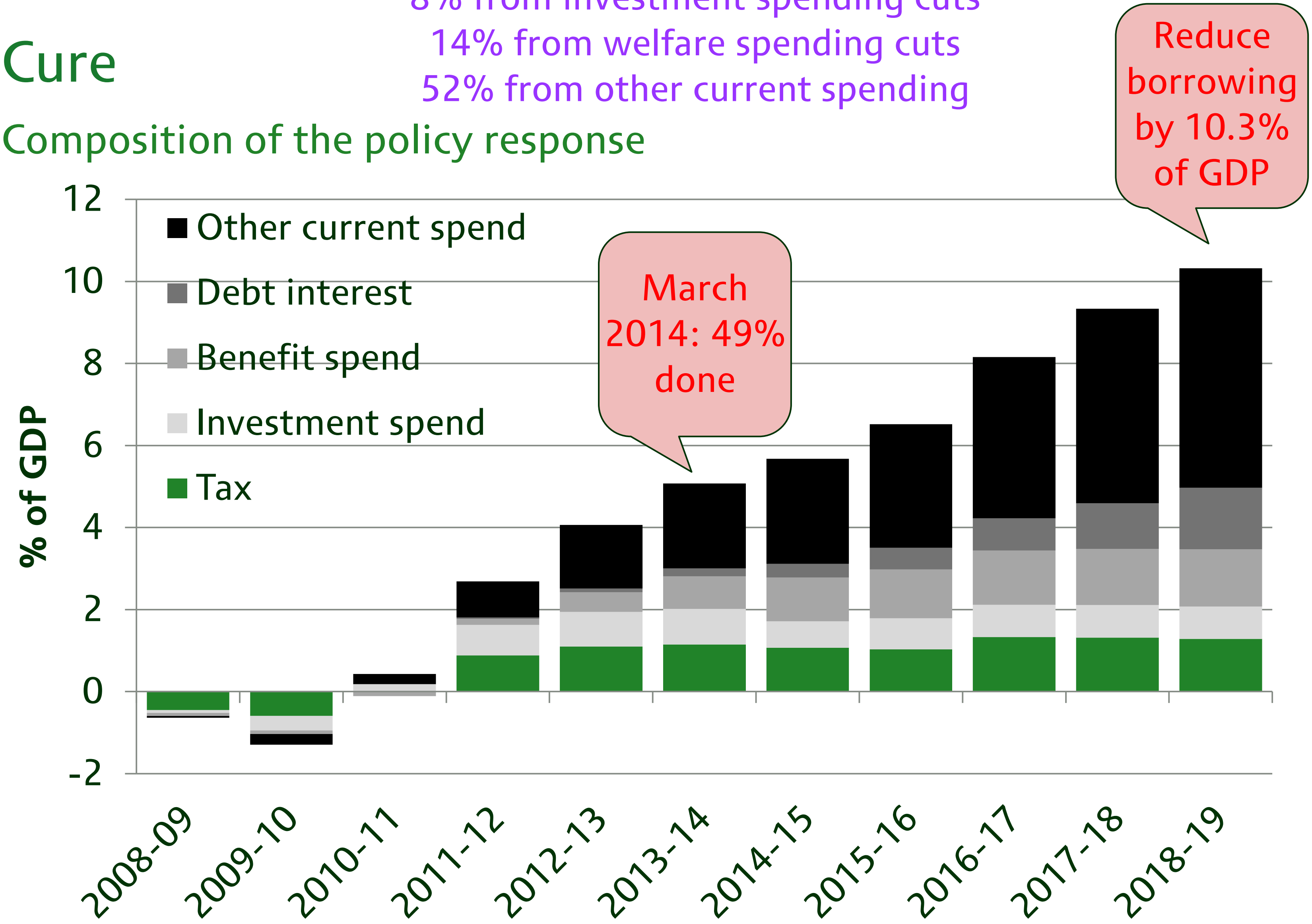
Fiscal policy response to the crisis (2)

- The "no policy change" baseline
  - Tax and benefit rates/thresholds uprated as set out in legislation (mainly RPI-indexed)
    - Include pre-announced policy changes
  - Public service spending growth
    - Pre-announced cash plans up to 2010–11
    - 1.8% a year real terms growth from 2011–12 to 2014–15 (pencilled into March 2008 Budget)
    - Grows in line with GDP thereafter
- Short-term fiscal stimulus followed by fiscal tightening
  - Stimulus in 2008–09 and 2009–10
  - Stimulus reversed and tax rises/spending cuts started in April 2010
  - Tax rises largely complete by April 2014
  - Spending cuts to continue to March 2019

Cure

Composition of the policy response

12% from tax rises
8% from investment spending cuts
14% from welfare spending cuts
52% from other current spending

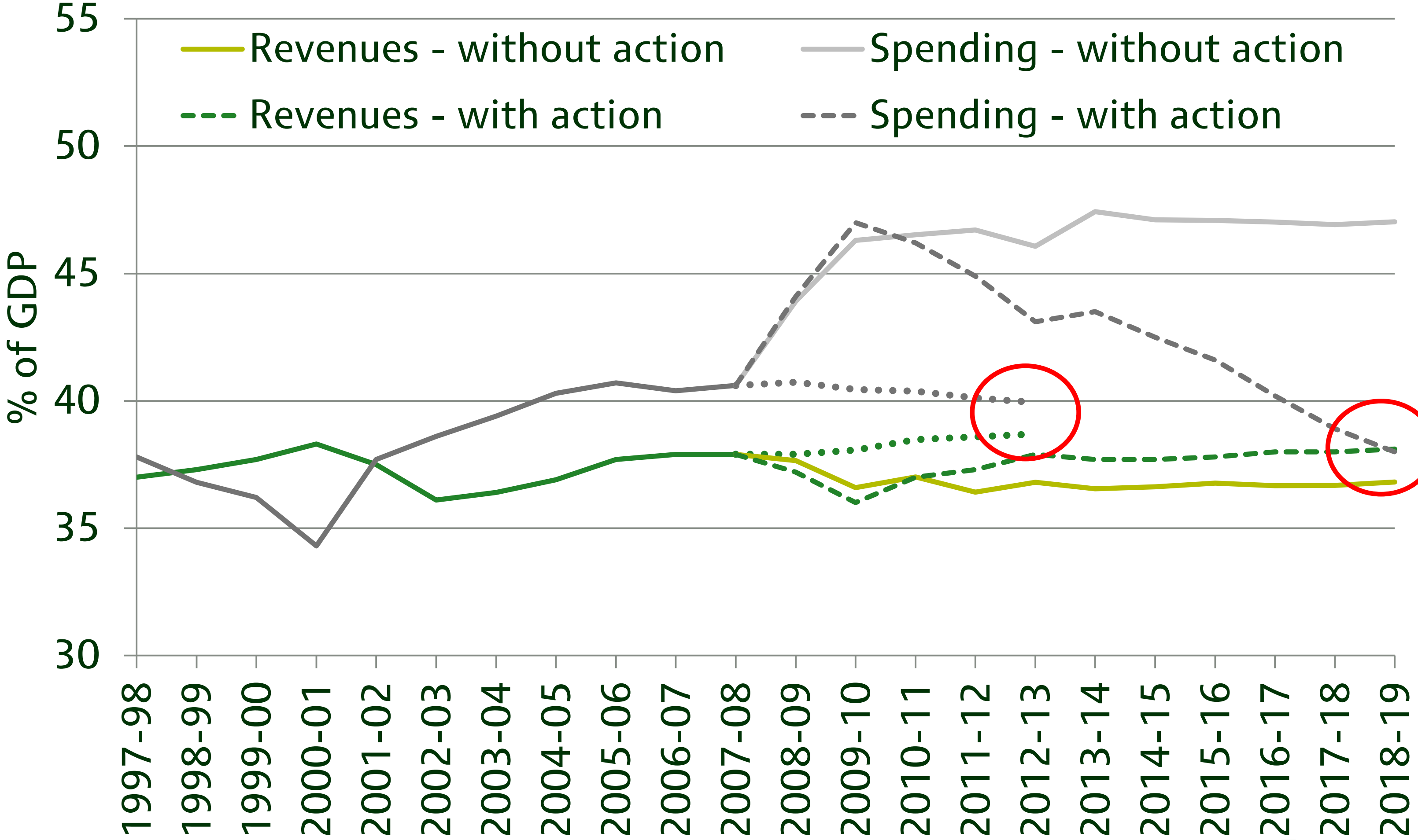


Source: Authors' calculations based on HM Treasury and Office for Budget Responsibility figures.

Now aiming for tighter fiscal position than planned pre-crisis

Spending and revenues, with action

Public sector receipts and total managed expenditure, 1997 to 2018

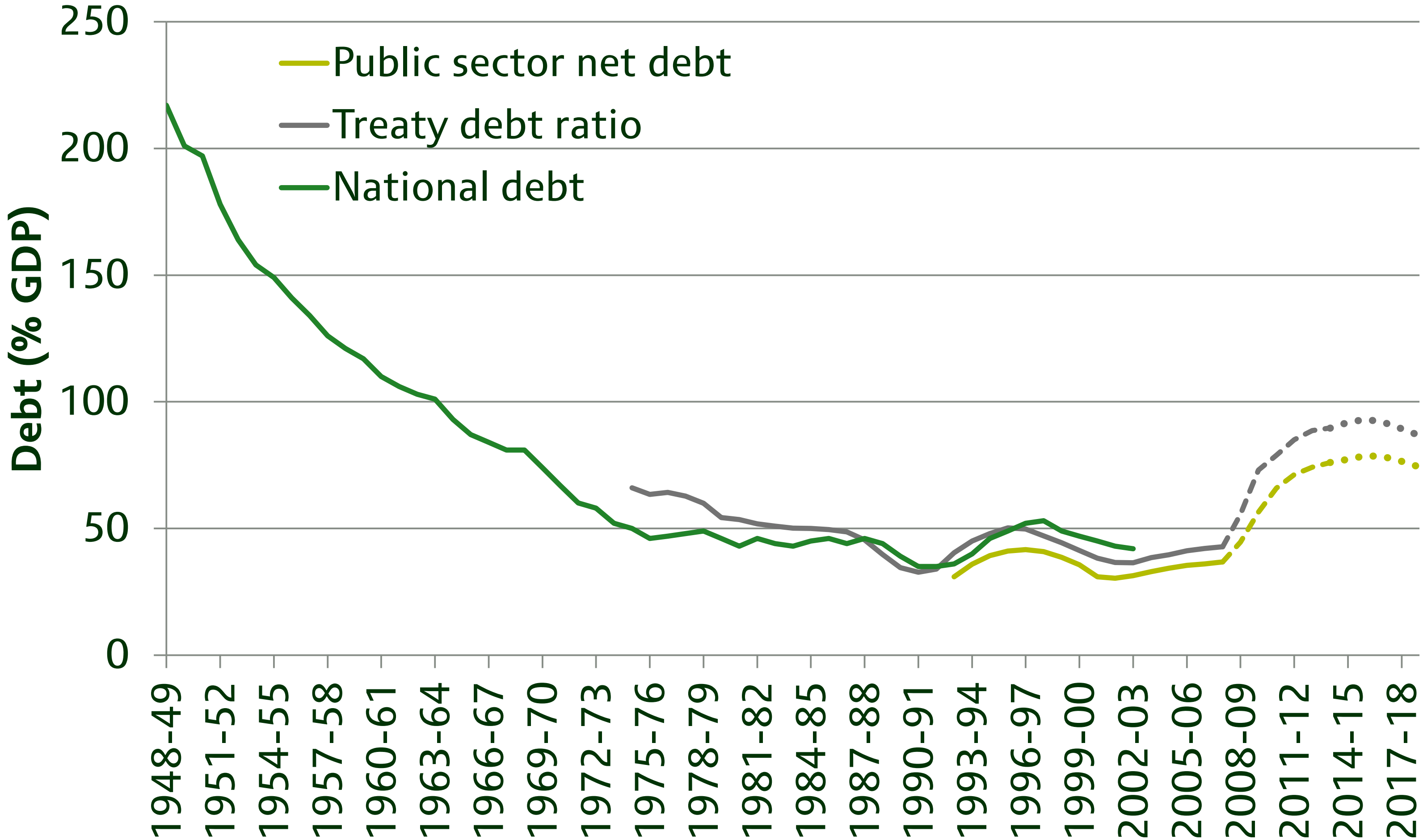


Source: Office for Budget Responsibility's public finances databank and authors' calculations.

Institute for Fiscal Studies

Debt forecast to peak in 2015–16

Alternative measures of debt, 1948 to 2018



Source: Office for Budget Responsibility's public finances databank.

Institute for Fiscal Studies

Aside: Fiscal institutions after the crisis

- Office for Budget Responsibility (OBR) created in May 2010
  - Independent fiscal council: accountable to Parliament, not the government
  - Produces fiscal and economic forecasts based on announced policy
  - Tasked with assessing compliance with the new fiscal targets
- OBR has significantly increased the transparency and credibility of official fiscal and economic forecasts

Aside: Monetary policy response

- Bank of England significantly loosened monetary policy
  - Interest rates: cut from 5.75% in July 2007 to 0.5% by March 2009
  - Central bank asset purchases started in March 2009 at £75bn, rising to £375bn by July 2012
- Sterling devalued significantly
  - By 25% against trade-weighted basket of currencies

Specific measures

- Deep cuts to spending on some areas of public services

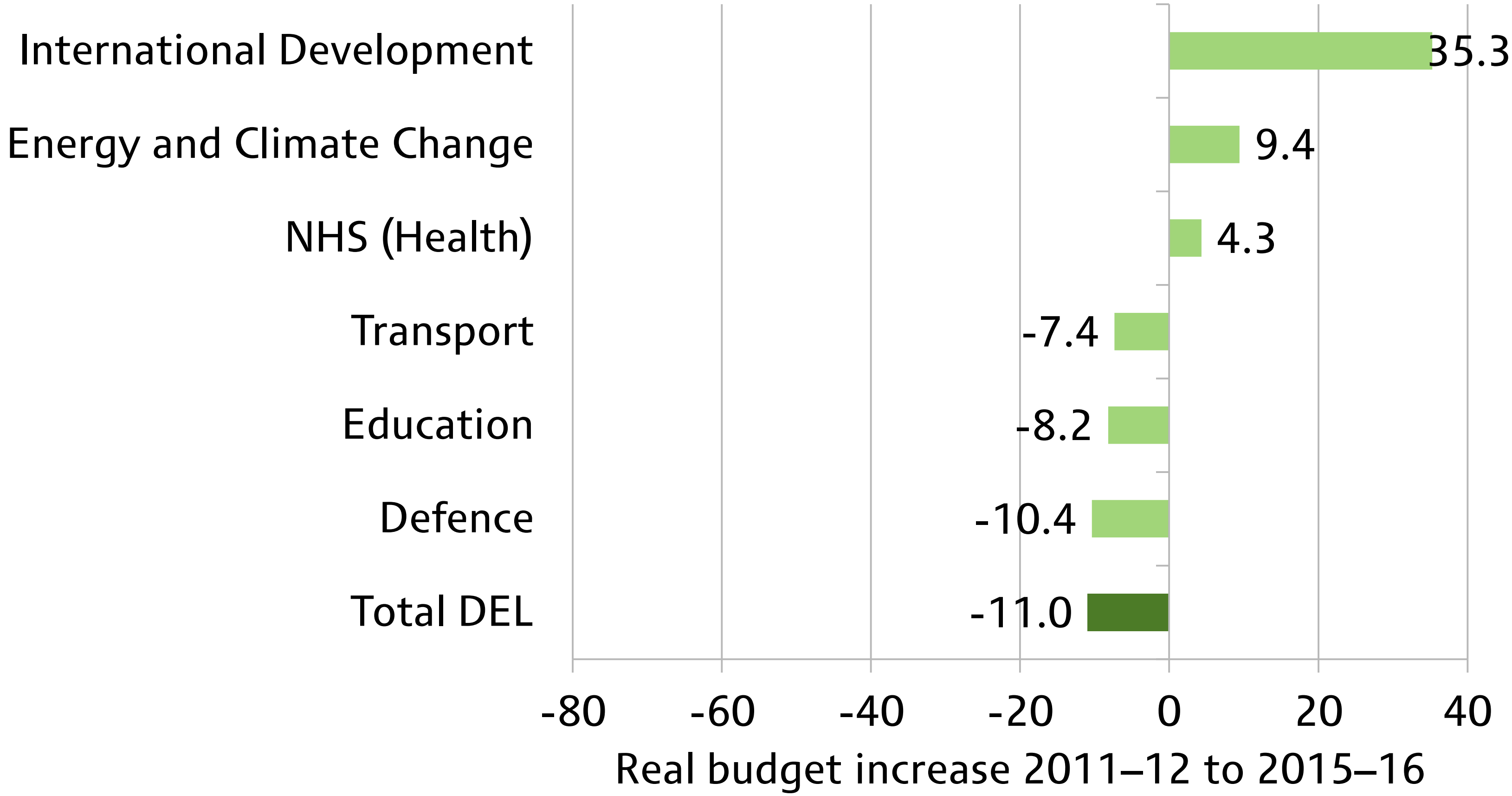
Planned cuts to public spending

Between 2010–11 and 2018–19 and after economy-wide inflation

- Total spending cuts of 4.4%
- But
  - debt interest spending rising
  - social security spending, particularly on pensioners, rising
  - other non-departmental spending such as on PAYG spending public service pensions and UK contribution to the EU budget rising
- Departmental spending on public services cut by 19.9%

Whitehall departments: ‘winners’

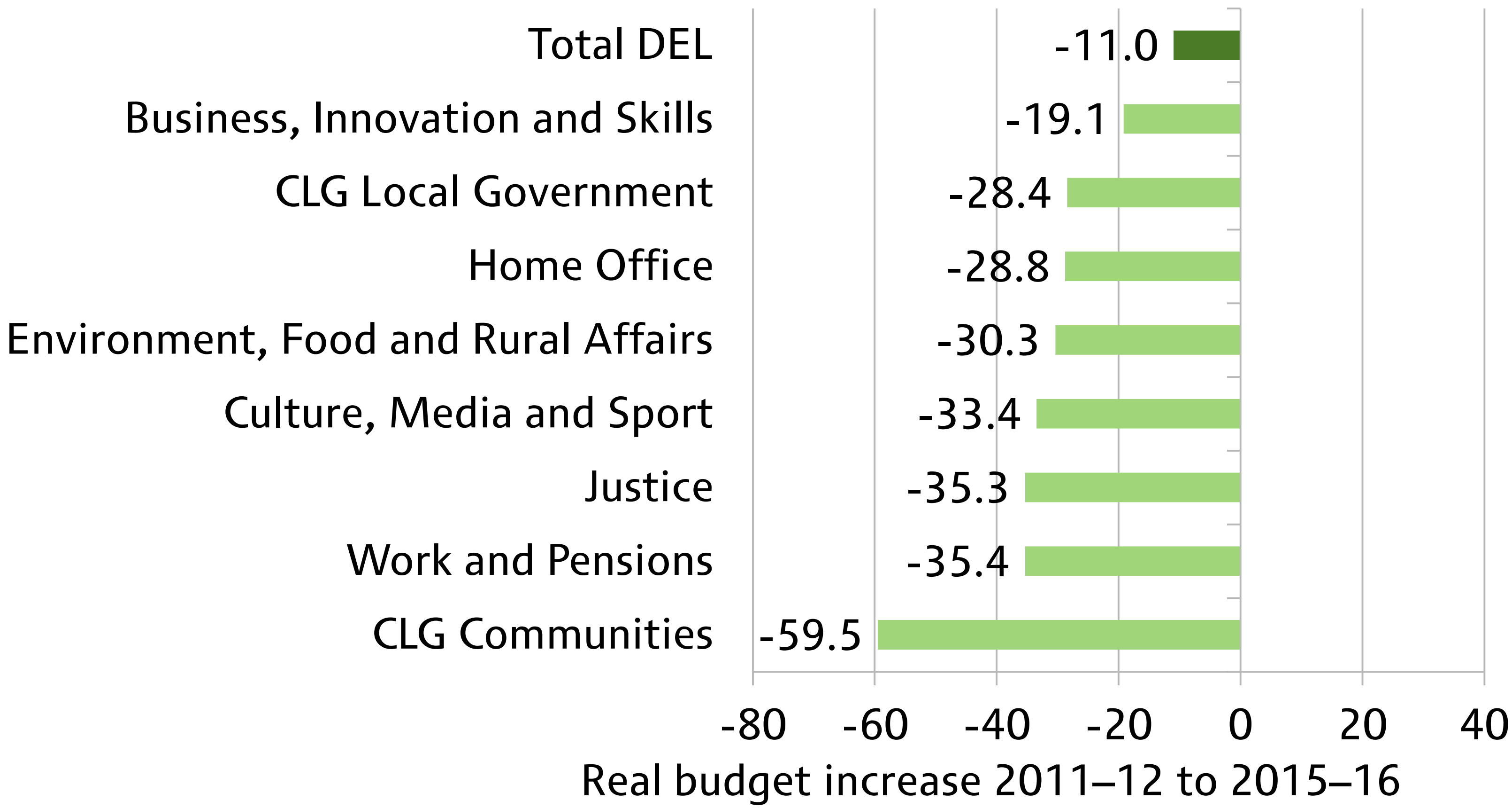
Departmental budget in 2015–16 compared to 2010–11, after economy-wide inflation



Note: Figures show cumulative change in total DEL after economy-wide inflation. Adjusted for consistency, including for business rate retention policy, movement of cost of operations into the special reserve, financial transactions associated with ‘Right to Buy’ policy, and the Green Investment Bank.

Whitehall departments: ‘losers’

Departmental budget in 2015–16 compared to 2010–11, after economy-wide inflation



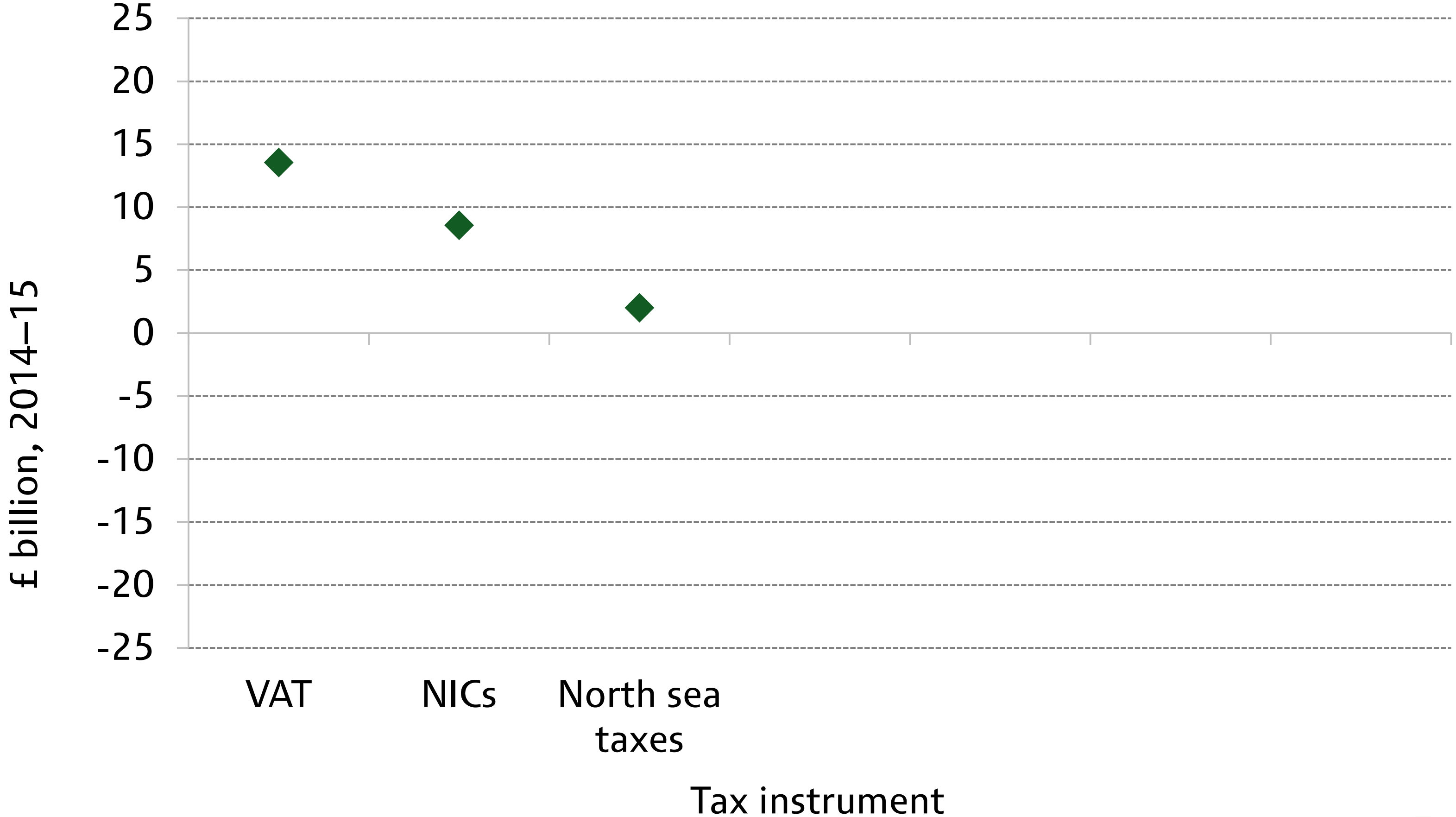
Note: Figures show cumulative change in total DEL after economy-wide inflation. Adjusted for consistency, including for business rate retention policy, movement of cost of operations into the special reserve, financial transactions associated with ‘Right to Buy’ policy, and the Green Investment Bank.

Specific measures

- Deep cuts to spending on some areas of public services
- Very large tax increases partially offset by some large tax cuts

Decomposing the net tax increases

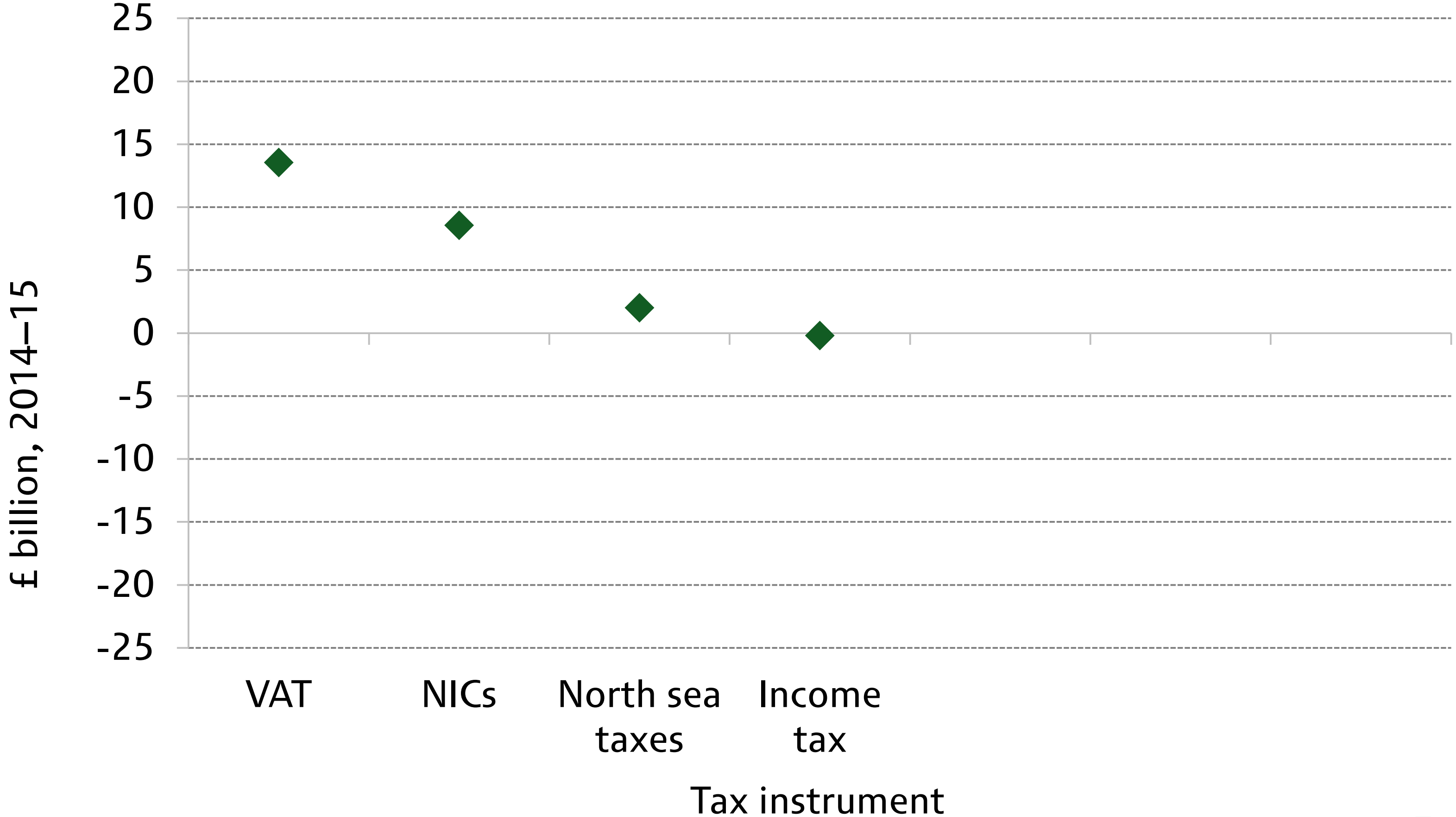
Measures since Budget 2008 estimated to be a £24 billion net takeaway



Source: Authors' calculations using data from the Office for Budget Responsibility. Estimates for impact in 2018–19 expressed in 2014–15 terms by deflating by nominal GDP growth.

Decomposing the net tax increases

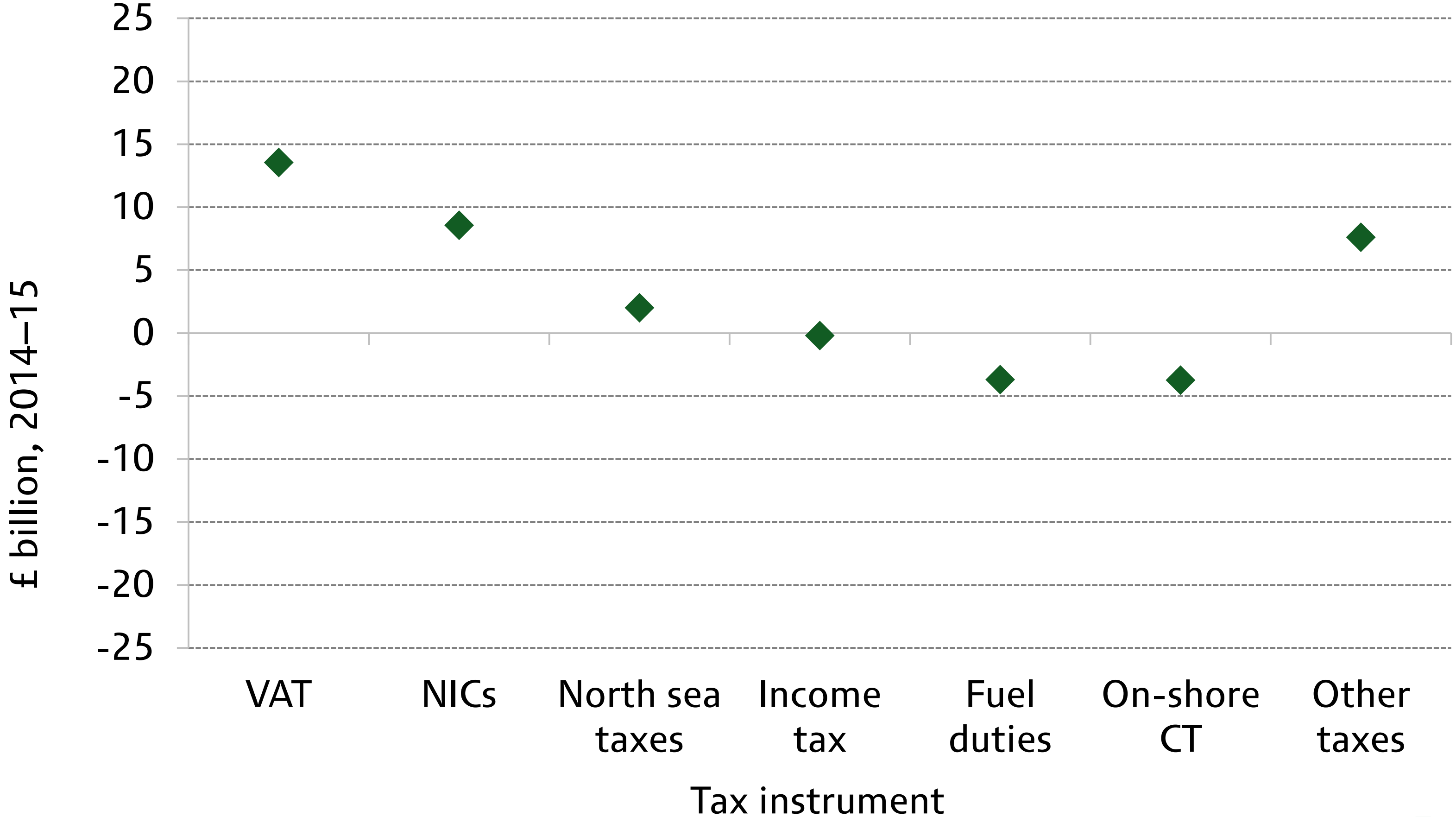
Measures since Budget 2008 estimated to be a £24 billion net takeaway



Source: Authors' calculations using data from the Office for Budget Responsibility. Estimates for impact in 2018–19 expressed in 2014–15 terms by deflating by nominal GDP growth.

Decomposing the net tax increases

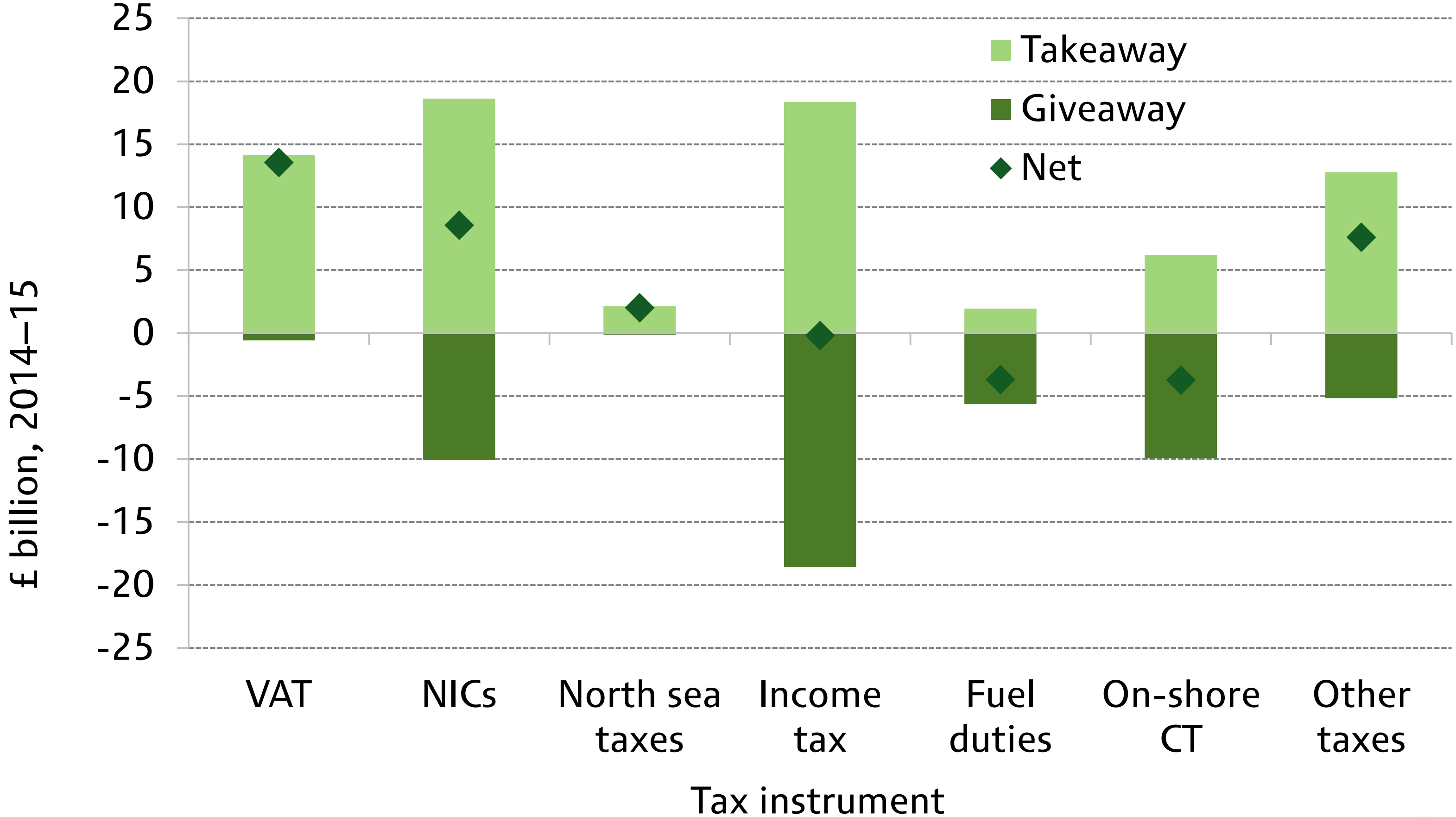
Measures since Budget 2008 estimated to be a £24 billion net takeaway



Source: Authors' calculations using data from the Office for Budget Responsibility. Estimates for impact in 2018–19 expressed in 2014–15 terms by deflating by nominal GDP growth.

Decomposing the net tax increases

Measures since Budget 2008 estimated to be a £24 billion net takeaway arising from an £74 billion takeaway and a £50 billion giveaway from 483 measures



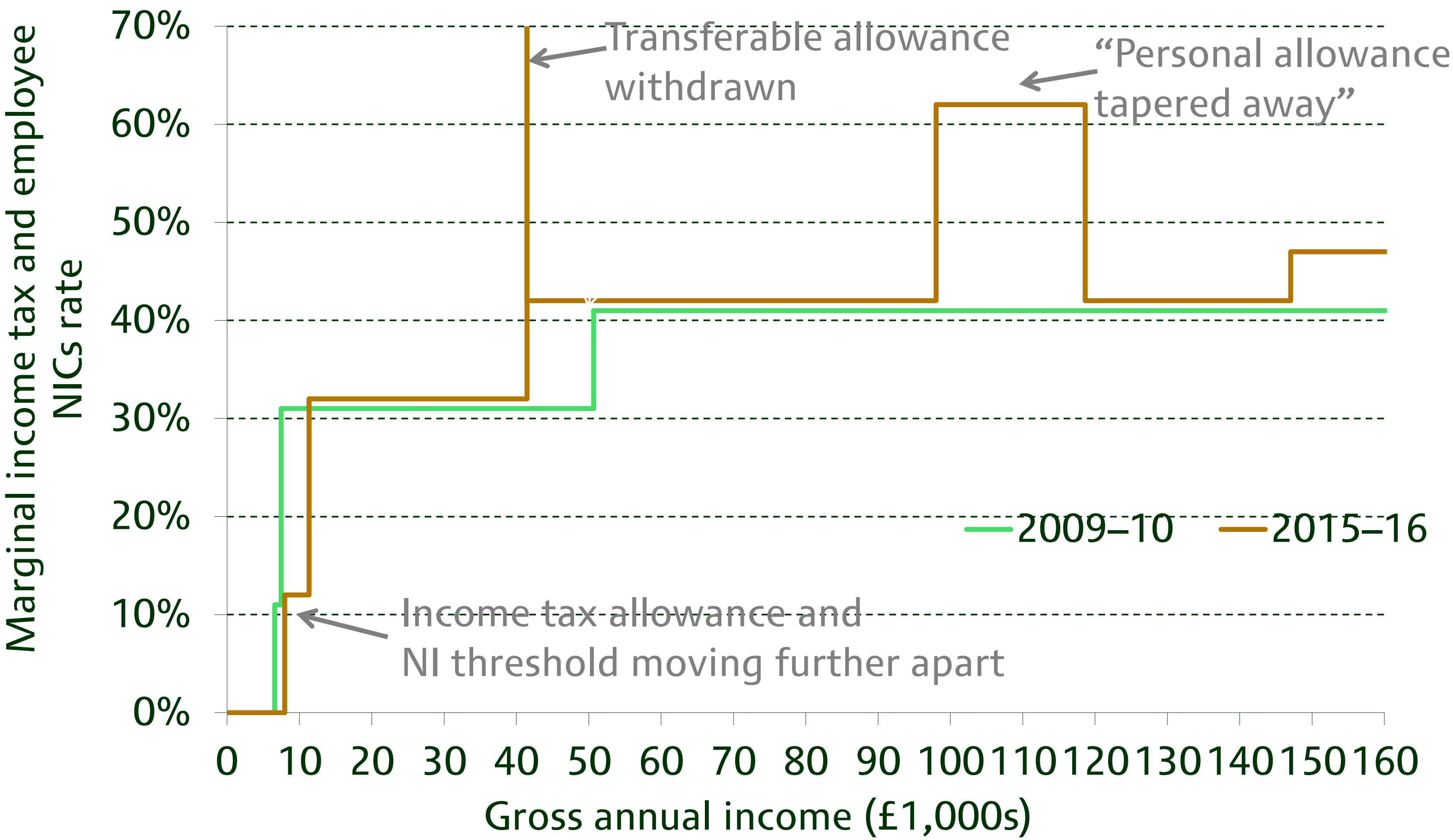
Source: Authors' calculations using data from the Office for Budget Responsibility. Estimates for impact in 2018–19 expressed in 2014–15 terms by deflating by nominal GDP growth.

Changes to the tax system (1/2)

- Increasing rates of NICs and main rate of VAT not particularly bad ways to raise large sums of money
  - VAT increase is in part a windfall tax on those with savings so, if thought to be one-off, could be efficient
  - but UK VAT base very narrow: increase in main rate increases distortions for both producers and consumers
  - both weaken work incentives
- Cutting main rate of corporation tax and getting rid of low profit rate is a good way to cut taxes
- Recent reforms have made direct personal tax schedule less coherent
  - many have been taken out of income tax at considerable cost, but over one million low earners who don't pay income tax still pay National Insurance
  - system of pensions tax relief for those on high incomes has been made less efficient, more complicated and, arguably, unfair

Institute for Fiscal Studies

Personal tax schedule



Note: 2015–16 system assumes married to a non-income tax paying partner.

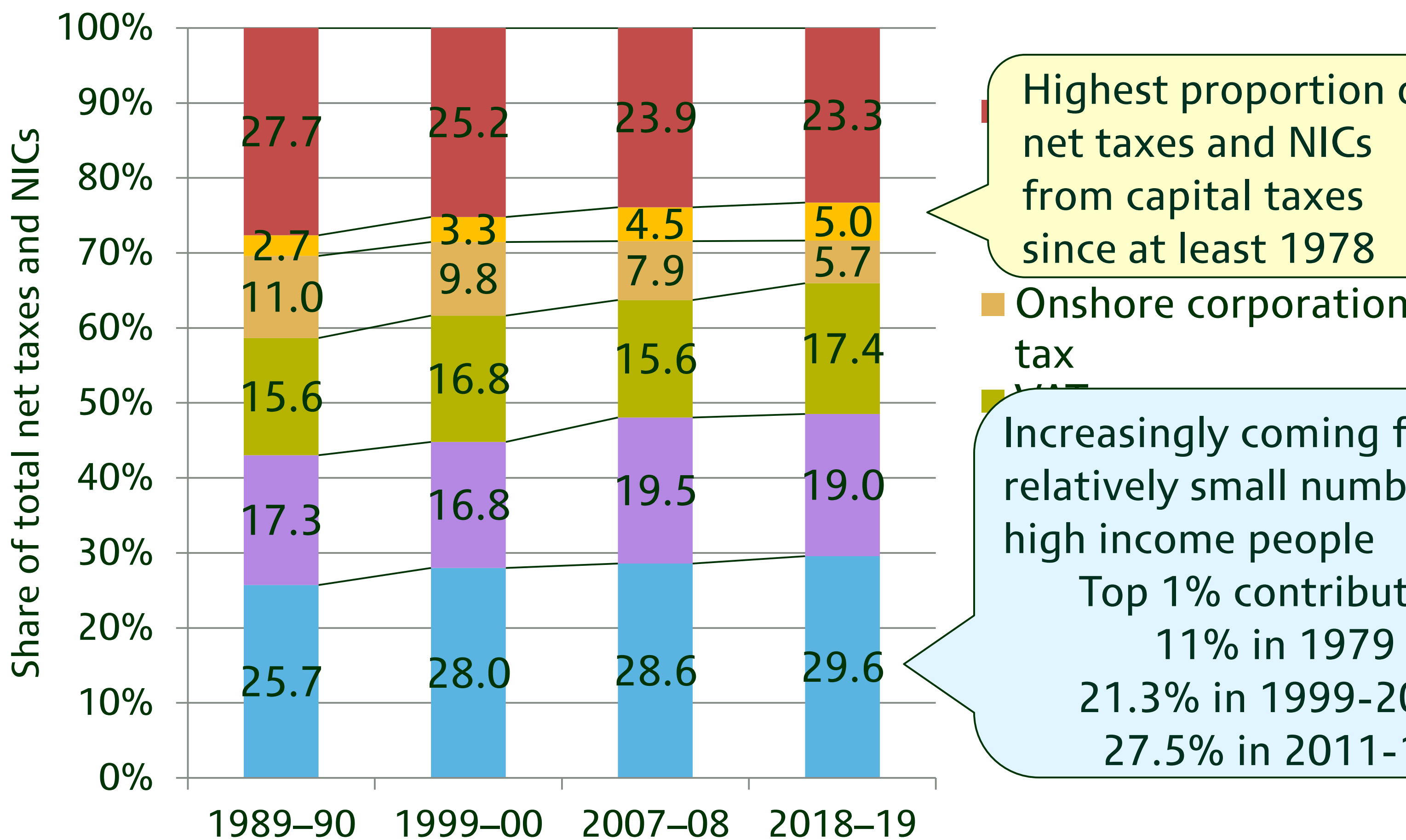
Institute for Fiscal Studies

Changes to the tax system (2/2)

- Housing taxation shifted from council tax towards stamp duty
  - bad as stamp duty strong contender for the UK's worst tax
  - lack of reform of council tax: still regressive with respect to property values and, in England, based on 1991 values
- Rates of fuel duties have been cut substantially without a long-run strategy
  - currently 58p/l and falling in real terms
  - motor vehicles becoming more efficient and congestion worsening
  - every year the Chancellor cancels the next planned increase

Institute for Fiscal Studies

Changing composition of revenues



Highest proportion of net taxes and NICs from capital taxes since at least 1978

Increasingly coming from a relatively small number of high income people

Top 1% contributed:

11% in 1979

21.3% in 1999-2000

27.5% in 2011-12

Source: Crawford, Keynes and Emmerson (2014).

Specific measures

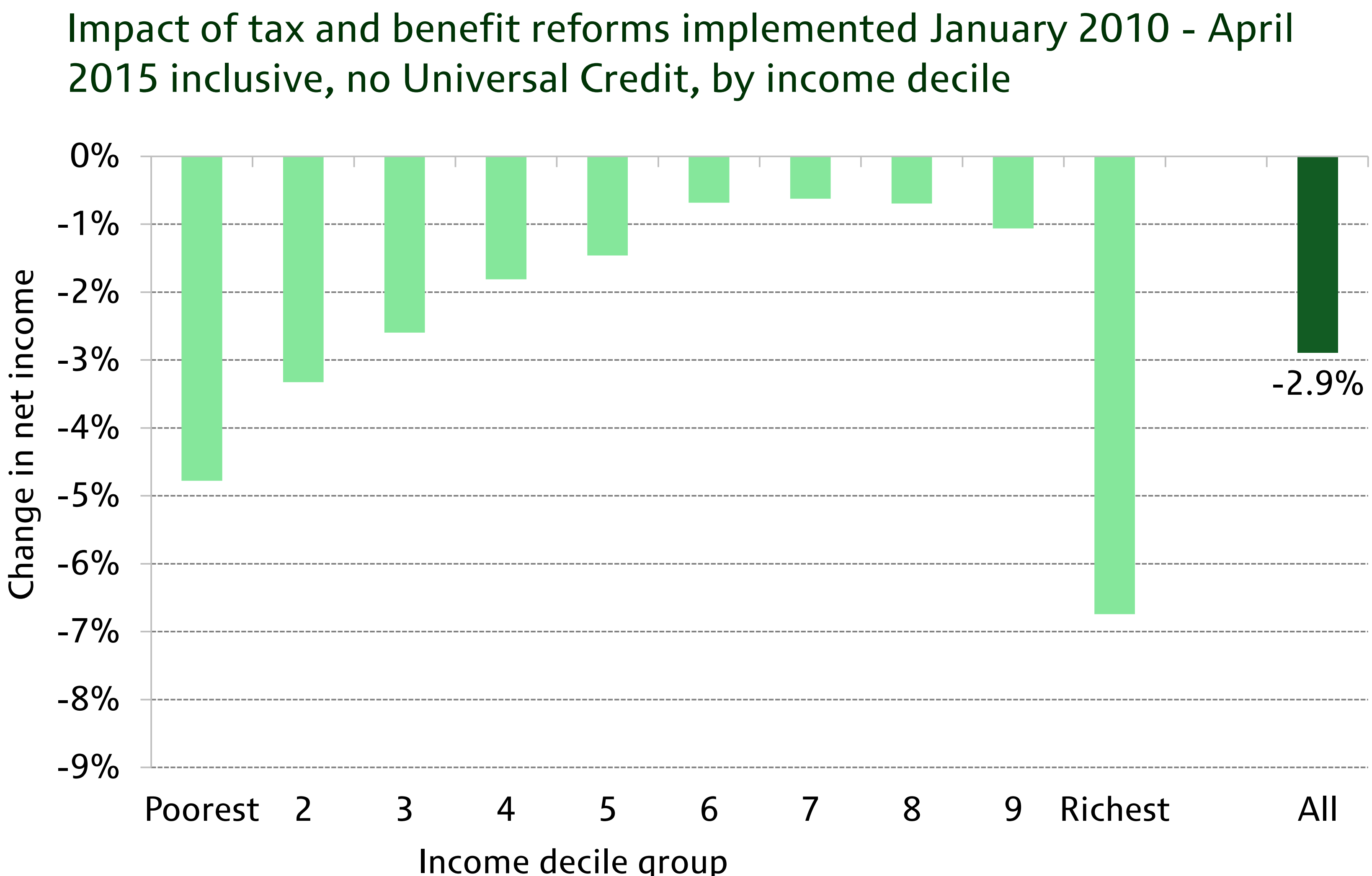
- Deep cuts to spending on some areas of public services
- Very large tax increases partially offset by some large tax cuts
- Large cuts to benefit spending focussed on working age individuals

Institute for Fiscal Studies

Changes to the benefit system

- Pensioner benefits largely protected from cuts
  - most working age benefits now indexed less generously, pensioner benefits indexed more generously
  - cuts to housing benefit and disability benefits don't apply to pensioners (and they are little affected by cuts to child-related benefits)
- Cuts to health-related benefits involve attempt to restrict benefits to least healthy through more stringent, more frequent, testing
- Increase in the earliest age at which individuals can receive a state pension has been brought forward and further increases mooted
  - coherent response to the public finance challenge of rising longevity
- Work incentives, on average, strengthened by benefit reforms

Cure: all in this together?

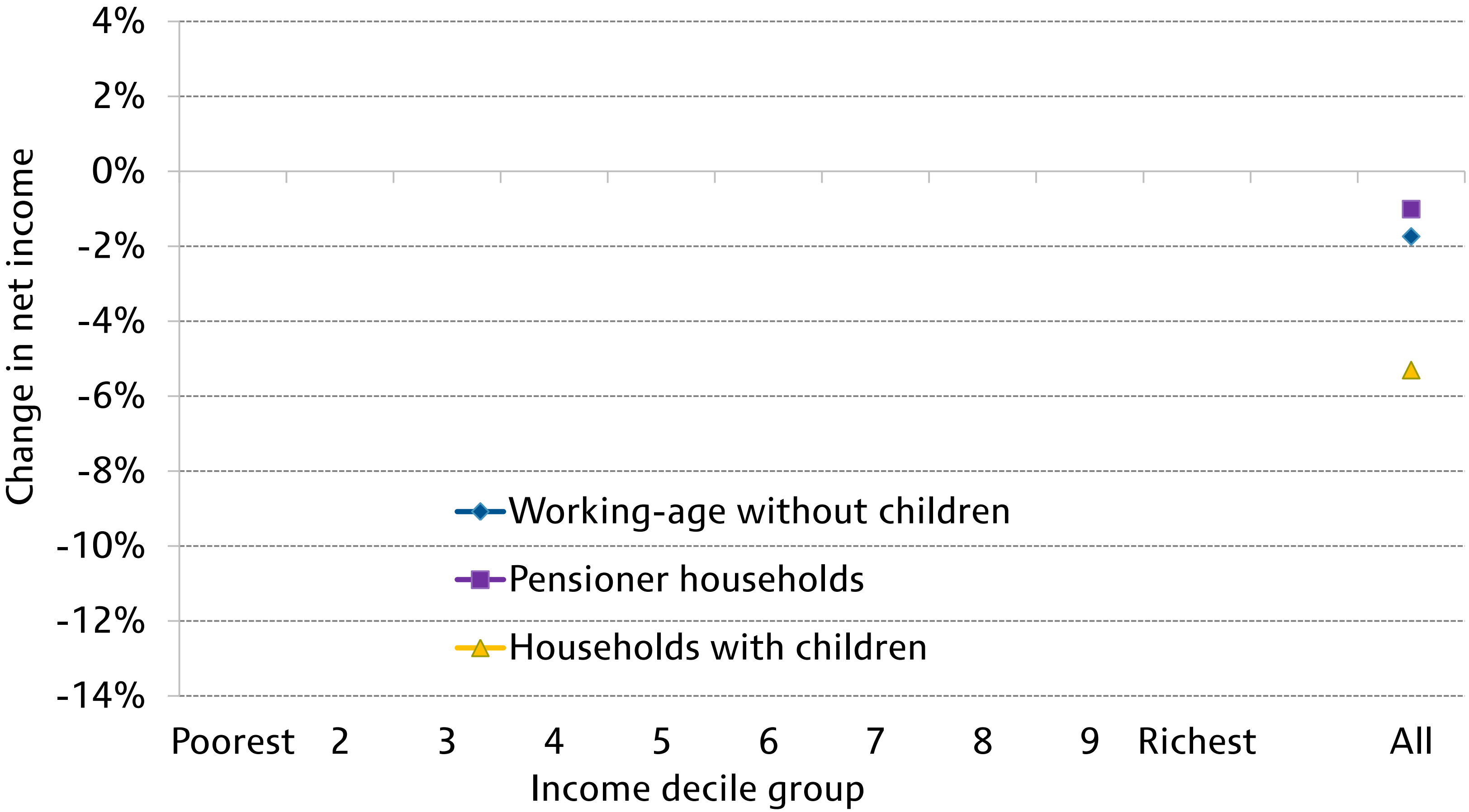


Note: Assumes full take-up of means-tested benefits and tax credits.
Source: Phillips (2014).

Institute for Fiscal Studies

Cure: all in this together?

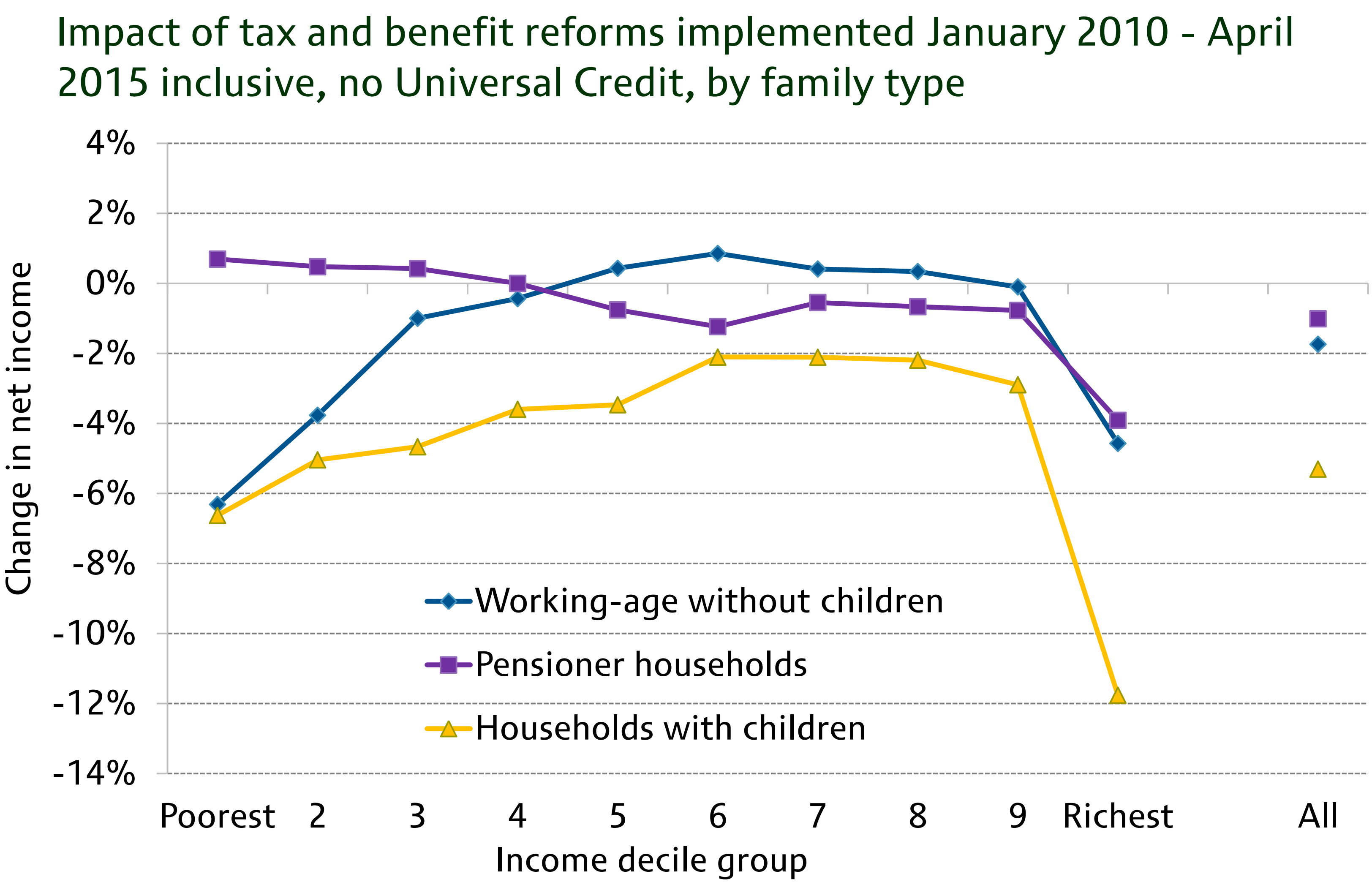
Impact of tax and benefit reforms implemented January 2010 - April 2015 inclusive, no Universal Credit, by family type



Note: Assumes full take-up of means-tested benefits and tax credits.
Source: Phillips (2014).

Institute for Fiscal Studies

Cure: all in this together?



Note: Assumes full take-up of means-tested benefits and tax credits.
Source: Phillips (2014).

Institute for Fiscal Studies

Effect on work incentives

- Fall in real earnings between 2010 and 2015 would have led to a significant, though not enormous, weakening of work incentives
- Tax & benefit reforms have an ambiguous impact on work incentives
  - strengthened by: cuts to (some) out-of-work benefits and, for most earners, increases in tax allowances
  - weakened by: increases in tax rates, increases to (some) out-of-work benefits and, for higher earners, cut to tax thresholds
  - complicated effects of cuts to in-work support
- Adam and Browne (2013) find that, on average, the reforms strengthen incentives to be in work and more than offset effects of falling real earnings
  - strengthened less for those with children than those without
- Benefit cuts primarily responsible for that average strengthening
  - but not dramatic given scale of cuts, partly because of nature of tax credit reforms

Conclusions

- Pre-crisis
  - planned to reduce structural borrowing from 2.7% to 1.2% of GDP
- Trend GDP now expected to be substantially lower
- Without action, structural borrowing would have risen by 9% of GDP
- 9-year fiscal consolidation plan
  - 10.3% of GDP
  - 88% from spending cuts
- Deep cuts to spending on some areas of public services
  - share of budget going on NHS continues to grow
- Very large tax increases partially offset by some large tax cuts
  - some changes have improved operation of tax system, but many have worsened it
- Large cuts to benefit spending focussed on working age individuals
  - on average strengthen work incentives

UK public finances and the financial crisis

Carl Emmerson and Gemma Tetlow

Presentation given at workshop on "European public finances through the financial crisis", ZEW Centre for European Economic Research, Mannheim, Germany, 11 June 2014.