The Public finances

Paul Johnson

Presentation to David Hume Institute
March 10 2015
GDP just above 2008 peak
(GDP per capita still below peak and economy at least 15% smaller than expected)
Strong, consumer-led, expansion in prospect

UK: Contributions to GDP growth

%pts

-1.0  -0.5  0.0  0.5  1.0  1.5  2.0  2.5  3.0  3.5  4.0


- Consumer spending
- Govt. consumption
- Investment
- Inventories
- Net trade

Source: Oxford Economics
In context of strengthening world economy

**World: GDP forecasts**

<table>
<thead>
<tr>
<th>Country</th>
<th>2014</th>
<th>2015</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>2.4</td>
<td>3.3</td>
</tr>
<tr>
<td>Eurozone</td>
<td>0.9</td>
<td>1.5</td>
</tr>
<tr>
<td>Japan</td>
<td>0.9</td>
<td>1.8</td>
</tr>
<tr>
<td>China</td>
<td>6.8</td>
<td>6.1</td>
</tr>
<tr>
<td>World</td>
<td>2.9</td>
<td>3.1</td>
</tr>
</tbody>
</table>

Source: Oxford Economics
Household incomes since 2007-08

Real household income (2007–08 = 100)

- Age 22–30
- Age 31–59
- Age 60 and over

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Real weekly median earnings by age group

Real earnings indexed to 100 in 2008

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Underlying weakness in the public finances and the fiscal response

Yellow line shows the estimated underlying increase in structural borrowing since March 2008.
Notes and sources: see Figures 1.3 to 1.6 of The IFS Green Budget: February 2015.
The December 2014 plan: international comparison

• Comparison of IMF forecasts for structural borrowing in 32 advanced economies shows that the UK is forecast to have:
  – the 4\textsuperscript{th} largest structural borrowing at the peak during the crisis
  – implemented the 7\textsuperscript{th} largest consolidation up to 2015
  – (essentially) the 2\textsuperscript{nd} largest structural borrowing in 2015
  – the largest planned fiscal consolidation between 2015 and 2019
  – the 18\textsuperscript{th} largest (or 15\textsuperscript{th} smallest) structural deficit in 2019
Public sector debt high by recent historical standards

% of national income

Financial year

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

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Public sector debt high by recent historical standards

Debt hasn’t exceeded 80% of national income since 1967–68

But was higher from:
- 1830–31 to 1869–70
- 1916–17 to 1967–68

Notes and sources: see Figure 5.2 of The IFS Green Budget: February 2015.
Debt: the parties’ plans

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

• Implied cuts are large
  – 2009–10 to 2014–15 already represents largest period of consecutive cuts to public service spending per head since Second World War

• Additional pressures in next parliament
  – easiest cuts presumably done first
  – public sector wage restraint harder when private sector wages growing
  – public service pensions to cost public sector employers £4.7 billion per year more due to recent revaluation and increased employer NICs

• Longer-term pressure: growing and ageing population
  – even with optimistic assumptions over health spending, projected to add 3.9% of national income to spending over next fifty years
Real terms DEL cuts since 2010-11: original and latest plans

-10.6
-8.8
-6.8
-5.6
-4.6
-3.6
-2.6
-1.6
0

Real terms cut since 2010-11 (%)

DEL

Notes and sources: see Table 7.2 of The IFS Green Budget: February 2015.
Real terms DEL cuts since 2010-11: original and latest plans

<table>
<thead>
<tr>
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<th>DEL</th>
<th>Resource DEL</th>
<th>Capital DEL</th>
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<tr>
<td>Original plans, original inflation (to 2014-15)</td>
<td>-8.8</td>
<td>-8.6</td>
<td>-9.5</td>
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<tr>
<td>Original plans, actual inflation (to 2014-15)</td>
<td>-10.6</td>
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<td></td>
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<tr>
<td>Outturns and latest plans, actual inflation (to 2014-15)</td>
<td>-9.5</td>
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<tr>
<td>Latest plans to 2015-16</td>
<td>-30</td>
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Notes and sources: see Table 7.2 of *The IFS Green Budget: February 2015*. © Institute for Fiscal Studies
Real terms DEL cuts since 2010-11: original and latest plans

- DEL: -10.6%
- Resource DEL: -9.5%
- Capital DEL: -8.3%
- Latest plans to 2015-16: -25.9%

Notes and sources: see Table 7.2 of The IFS Green Budget: February 2015.
Real terms DEL cuts since 2010-11: original and latest plans

-10.6
-25.9
-24.4
-6.4
8.6
9.5
8.3
6.4
25.9
24.4
25.9

grey: Original plans, original inflation (to 2014-15)
black: Original plans, actual inflation (to 2014-15)
green: Outturns and latest plans, actual inflation (to 2014-15)
yellow: Latest plans to 2015-16

Notes and sources: see Table 7.2 of The IFS Green Budget: February 2015.
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Notes and sources: see Table 7.2 of The IFS Green Budget: February 2015.
Social security spending: 1997–98 to 2015–16

£billion, 2015–16 prices

Notes and sources: see Figure 9.1 in Green Budget document
Social security spending: 1997–98 to 2015–16

£billion, 2015–16 prices

Notes and sources: see Figure 9.1 in Green Budget document
Public spending in context

Notes and sources: see Figure 7.1 of The IFS Green Budget: February 2015.
Public services spending in context

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

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Parties’ fiscal rules

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

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Notes and sources: £ billion figures in 2015-16 prices. See Table 7.7 of *The IFS Green Budget: February 2015.*
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*Given parties’ fiscal rules and stated intentions:*

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Given parties’ fiscal rules and stated intentions:

- Conservatives

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Risks in forecasts for receipts

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

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

• General elections
  – with notable exception of spring 1992, pre-election budgets appear relatively restrained
Policy risk: downside risks risk for revenues

• Forecasts assume rates of fuel duties indexed in line with the (discredited) RPI
  – recent history suggests this won’t happen: 5-year cash freeze would cost £4.1bn in 2019–20, CPI-indexation would cost £1.8bn

• Income tax personal allowance and higher-rate threshold CPI uprated
  – we estimate 5.1 million higher-rate taxpayers in 2015–16, fiscal drag increases this by 1.2 million in 2020–21 and by 2.8 million in 2025–26

• Some thresholds frozen in cash terms
  – £100k and £150k income tax thresholds
  – £50k and £60k child benefit takeaway thresholds:
    • we estimate 1.2m families lose some/all child benefit in 2015–16
    • fiscal drag would result in 50% increase by 2020–21
    • and a more than doubling by 2025–26
In conclusion

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