5. Public finances: outlook and risks[1]

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Summary

- Since 2008, the official forecast for the trend level of UK economic output has been revised down significantly. This, combined with a shift in the composition of the UK economy away from more tax-rich sectors, has resulted in a worsening of the public finances. We calculate that, based on official estimates, this worsening amounts to an estimated 8.2% of national income.
- The package of tax increases and spending cuts announced since the March 2008 Budget is estimated to reduce public sector borrowing by 9.2% of national income by 2017–18: 15% from tax increases and 85% from spending cuts. By the end of 2012–13, 79% of the planned tax increases and 67% of the planned cuts to investment spending will have been implemented, while just 32% of the planned cuts to benefit spending and 21% of the cuts to day-to-day spending on public services will have been delivered.
- A significant part of the downgrade in official forecasts has come in the last two years. In response, further spending cuts have been pencilled in for after 2014–15 – the end of the current spending review period – to offset fully the increase in forecast structural borrowing: but not until 2017–18. A worse economic outlook since November 2010 has pushed up borrowing forecasts for 2014–15 by £65 billion. Mr Osborne has chosen to offset only £1 billion of this. In this sense, he is running looser fiscal policy over this parliament than he intended back in 2010.
- There is great uncertainty surrounding the evolution of the UK economy and public finances. The year after the last six general elections have seen the announcement of net tax increases averaging more than £7 billion a year. Given the current fiscal circumstances, substantial tax rises in 2015 cannot be ruled out.
- Our baseline public finance forecast shows a more than 50:50 chance that (on a like-for-like basis) borrowing this year will be higher than it was in 2011–12. Economically more important is the medium-term forecast, where our projection is similar to the OBR's, although in the next three years we assume lower underspends by Whitehall departments, and hence slightly higher spending overall.
- Under the Oxford Economics central forecast, we project that, as a result of higher trend output, the public finances would be in a stronger position by 2017–18 than forecast by the OBR. In this scenario, the fiscal consolidation plan could be reduced from 9.2% to 8.0% of national income without increasing planned borrowing. The picture would be even better under the more optimistic Oxford Economics scenario.
- On the downside, if a scenario similar to the more pessimistic Oxford Economics one were to materialise, borrowing would remain high for much longer. Public sector net debt would increase sharply to above 100% of national income, leaving the UK even less well prepared to deal with future public finance challenges such as those arising from the ageing of the population and from any future recession.

[1] The Green Budget 2013 is funded by the Nuffield Foundation

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5.1 Introduction

Since 2008, the UK has experienced a large economic shock that has not only temporarily affected our level of economic output but also changed most forecasters' views about the potential strength of the UK economy for evermore. As a result, we have experienced high levels of public borrowing in recent years and are only partway through a large planned fiscal consolidation designed to get the UK's public finances back to a more sustainable position.

In Section 5.2, we outline how the outlook for the economy and public finances has deteriorated over recent years, according to the latest official forecasts from the Office for Budget Responsibility (OBR). Section 5.3 then describes what policy measures have been announced since 2008 to deal with these problems and how these are expected to affect the overall levels of tax receipts, public spending, borrowing and debt in future.

The analysis in both Sections 5.2 and 5.3 is based on official forecasts for borrowing made since the March 2008 Budget (our pre-crisis baseline) and official estimates of the direct impact of policy measures on borrowing that have been announced since then. Within this framework, we can look at the overall development of the public finances over the last few years and how the fiscal problems and fiscal action have developed.

This analysis assumes that the official estimates of the impact of fiscal policy measures on borrowing are correct. Of course, there are uncertainties around any estimates of the impact of policy changes on economic growth and therefore on overall borrowing. It is possible that some of the weaker outlook for the economy that has occurred since 2008 has been caused by a detrimental impact of fiscal consolidation measures that is not captured in the official estimates of measures' impact. If this were the case, then both the size of the underlying problem facing the public finances that has materialised since the March 2008 Budget, and the impact that the fiscal consolidation package has had on reducing that problem, would be overstated in our calculations. Alternatively, the measures could have had a larger impact on reducing the deficit than implied by the official costings such that we understate both the size of the underlying problem and the size of the impact of fiscal consolidation – for example, if the measures have led to a bigger overall increase in labour supply than has been assumed in the costings or if monetary policy has been loosened in response and has offset any long-run impact of these measures on the UK economy.

If the official estimates of the impact of fiscal policy measures on borrowing are incorrect, this would change both the size of the apparent problem and the planned solution by the same amount. The estimated gap between the size of the problem and the measures taken would still be the correct size. However, it might nonetheless change one's view about the appropriateness of the action taken. We do not discuss this issue any further here.

What we do consider in Section 5.4 are some of the key risks surrounding the official forecast for the economy and public finances. This analysis highlights some of the factors that could lead to more or less fiscal consolidation (that is, tax and spending increases or cuts) ultimately being required to achieve the levels of borrowing that the OBR is currently forecasting in the longer term. We conclude in Section 5.5.

5.2 The disease

Prior to the financial crisis and associated recession, the March 2008 Budget forecast that, in 2012–13, government receipts would total £721 billion and public spending would be £744 billion; as a result, government borrowing was projected to be £23 billion. National income (or gross domestic product, GDP) was forecast to be £1,811 billion – implying that planned borrowing would equate to just 1.3% of national income. Therefore, at the time, it seemed that the 2008 plans would be fiscally sustainable – that is, maintaining borrowing at the level implied by the forecasts, over the medium term, would set public sector net debt on a declining path.[2]

Since 2008, we have had a huge downward shock to the economy followed by continuing downward revisions to projected levels of future national income, with the OBR now projecting 13.6% lower nominal GDP in 2012–13 than forecast in Budget 2008, as shown in Table 5.1. Lower GDP has depressed revenues – for example, from taxes on incomes, spending and profits – and increased pressure on spending, such as on working-age benefits. Combined with a lower level of GDP, these changes have led to tax receipts being reduced as a share of GDP and public spending taking up a much larger share of GDP. The importance of the lower level of GDP in explaining the higher proportion of spending in GDP is illustrated in Table 5.1, which shows that spending will be more than £40 billion less than projected – mostly as a result of discretionary spending cuts – but will still account for an additional 3.8 percentage points of GDP.

Table 5.1. Official forecasts for 2012–13: Budget 2008 and Autumn Statement 2012 compared

	HMT Budget 2008	OBR Autumn Statement 2012	Difference (£bn)	Difference (%)
£ billion				
Current receipts	721	593.8	–127.2	–17.6%
Total managed expenditure	744	702.3	–41.7	–5.6%
Public sector net borrowing	23	108.5	+85.5	+372%
National income (GDP)	1,811	1,564	–247	–13.6%
% of GDP				
Current receipts	39.8%	38.0%	n/a	–1.8ppt
Total managed expenditure	41.1%	44.9%	n/a	+3.8ppt
Public sector net borrowing	1.3%	6.9%	n/a	+5.6ppt

Note: 2012 Autumn Statement figures exclude the £28 billion of negative capital spending from Royal Mail Pension Fund.
Source: 2008 forecasts from HM Treasury, *Budget 2008*. 2012 estimates from Office for Budget Responsibility, *Economic and Fiscal Outlook: December 2012*.

In response to this much more grim outlook for the economy and the public finances, significant tax rises and spending cuts have been announced and implemented since the March 2008 Budget (as will be shown in Section 5.3). Despite this, as shown in Table 5.1, tax revenues are still forecast to be 18% lower in cash terms in 2012–13 than forecast at the time of the March 2008 Budget. Total public spending is expected to be 6% lower. Combining these changes to receipts and spending, public sector net borrowing is now

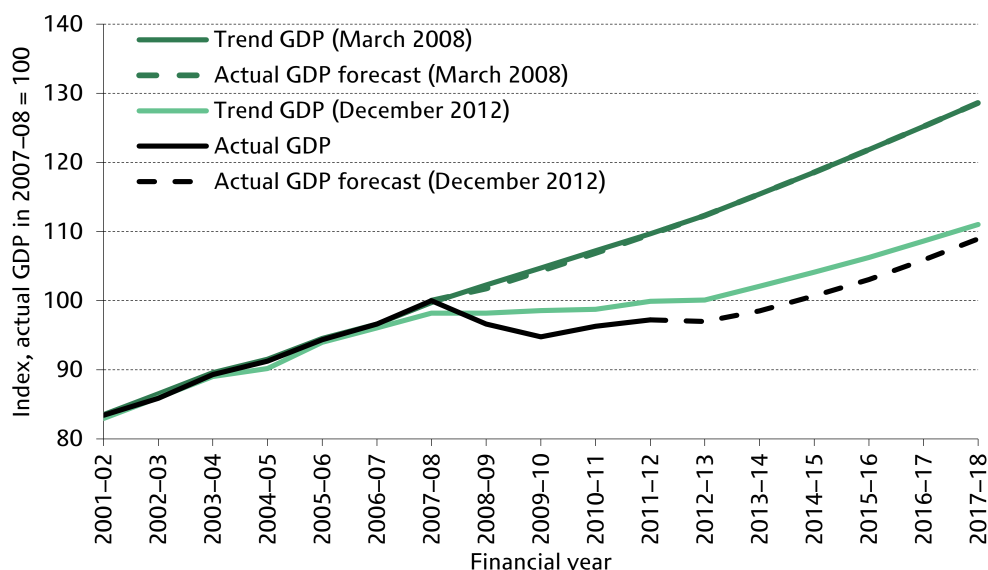
[2] Maintaining borrowing at 1.3% of national income would, under the assumption of 5% nominal growth in national income, lead to public sector net debt tending over time to 26% of national income.

forecast to be 6.9% of national income in 2012–13, which is £85 billion higher than projected at the time of the March 2008 Budget.

This increase in borrowing reflects both a temporary and a permanent problem. In this section, we briefly outline the size of the hole that has opened up in the public finances since 2008 – how this arose, what part of it is thought to be permanent, and what the outlook for borrowing and debt might have been if the current and the previous government had not announced any measures to deal with it.

Before the financial crisis and recession – at the time of the March 2008 Budget – the Treasury forecast that the UK economy would experience a short recession before returning to its trend level (that is, the level of output that can be sustained without causing inflationary pressure or rising unemployment). At that time, the Treasury's central forecast was that trend output would grow each year by 2¾% in real terms, although its forecasts for the public finances were based on a 'cautious' assumption of 2½%. The solid dark green line in Figure 5.1 shows the level of trend GDP (in real terms) and the dashed dark green line shows the level of actual GDP, as forecast by the Treasury in March 2008 – figures are expressed relative to the actual level of GDP in 2007–08, which is indexed to 100.

Figure 5.1. Forecast evolution of actual and trend national income (GDP)



Note: Historical figures for trend GDP as of December 2012 use the average of the OBR's Principal Component and Aggregate Composite methodologies for estimating the output gap.

Sources: Historical trend GDP figures as of December 2012 from chart 3.7 of T. Pybus, 'Estimating the UK's historical output gap', Office for Budget Responsibility, Working Paper 1, 2011. Historical trend GDP figures for March 2008 from HM Treasury, Public Finances Databank, December 2012. Out-turn figures for real GDP from Office for National Statistics, series ABMI. Forecasts for actual GDP as of March 2008 from HM Treasury, *Budget: March 2008*. Forecasts for actual GDP as of December 2012 from Office for Budget Responsibility, *Economic and Fiscal Outlook: December 2012*.

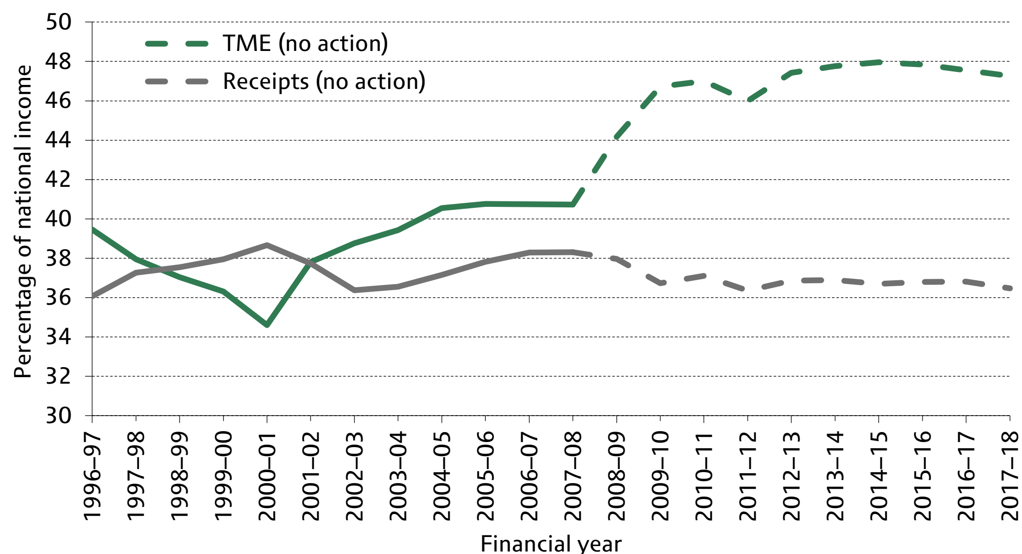
Since March 2008, the economy has of course performed a lot worse than the Treasury (and others) had been expecting and – as shown by the black line in Figure 5.1 – contracted by around 5% in real terms between 2007–08 and 2009–10. The OBR judges that little of this weak economic performance will be temporary. The latest official forecast for trend GDP, as shown by the light green line in Figure 5.1, suggests that the sustainable level of UK output will be permanently reduced by almost 14% a year – a total of £214 billion in today's terms – compared with the Treasury's projections made in March 2008. The temporary component of weakened GDP is shown by the gap between the black line and the pale green line. That the dashed black line remains below the pale

green line until 2017–18 illustrates the OBR's forecast that the UK economy will not return to its (permanently lower) trend level until at least 2017–18.

Tax receipts have been depressed as a share of national income as the crisis has had a disproportionately negative effect on relatively tax-rich activities – such as the profits of the financial sector. Spending as a share of national income has increased sharply. This is not only because of upwards pressure on spending arising from the recession but also because, prior to the crisis, plans for public service spending had already been set out in cash terms for 2008–09, 2009–10 and 2010–11. The latter means that the disappointing out-turn for national income has led to much higher spending on public services as a share of national income than intended pre-crisis.

The out-turns for public sector receipts and spending from 1996–97 to 2007–08 are shown in Figure 5.2. Also shown are projections for receipts and spending from 2008–09 onwards, after stripping out the estimated direct impact on the public finances of measures announced since the March 2008 Budget. This shows that, in 2007–08, the difference between spending and receipts (that is, the level of borrowing) was 2.4% of national income. In the absence of policy action, receipts would have fallen slightly as a share of national income while spending would have increased dramatically, so that by 2017–18 the difference would still have been 10.8% of national income.

Figure 5.2. Revenues and spending – without policy action

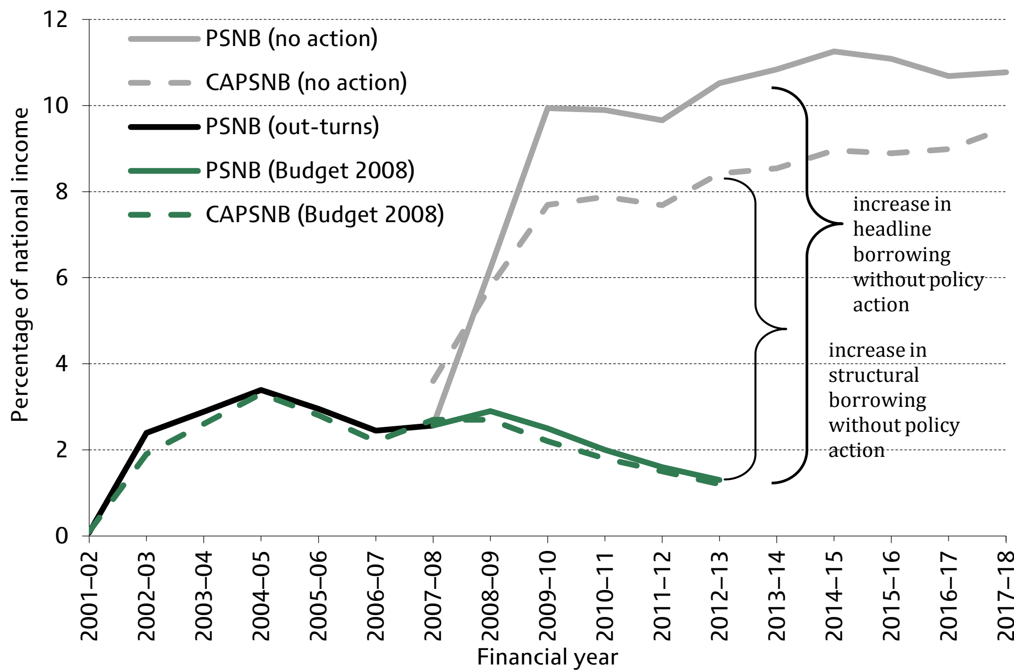


Notes: 'No action' ignores the direct impact of all fiscal policy measures that have been announced in Budgets, Pre-Budget Reports, Spending Reviews and Autumn Statements since Budget 2008. TME figures exclude the £28 billion of negative capital spending from Royal Mail Pension Fund in 2012–13.
Source: Out-turn figures for revenues and spending are from HM Treasury, Public Finances Databank, December 2012. Authors' calculations using all HM Treasury Budgets, Pre-Budget Reports and Autumn Statements between March 2008 and December 2012 (up to the March 2010 Budget available at http://www.hm-treasury.gov.uk/budget_archive.htm; June 2010 Budget onwards available at http://www.hm-treasury.gov.uk/budget.htm; Autumn Statements available at http://www.hm-treasury.gov.uk/as2012_index.htm) and all OBR Economic and Fiscal Outlooks between June 2010 and December 2012 (all available at http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-december-2012/).

Official forecasts in March 2008 suggested that headline borrowing would fall from 2.6% of national income in 2007–08 to 1.3% by 2012–13 (shown by the solid green line in Figure 5.3). Cyclically-adjusted borrowing (shown by the dotted green line in Figure 5.3) was forecast to fall to 1.2% of national income in 2012–13. However, the subsequent deterioration of the public finances meant that, as shown by the solid grey line, with no policy action, headline borrowing would instead have increased by 8.0% of national

income, to 10.5% (that is, the same as the gap between revenues and spending presented in Figure 5.2).

Figure 5.3. Public sector net borrowing – without policy action



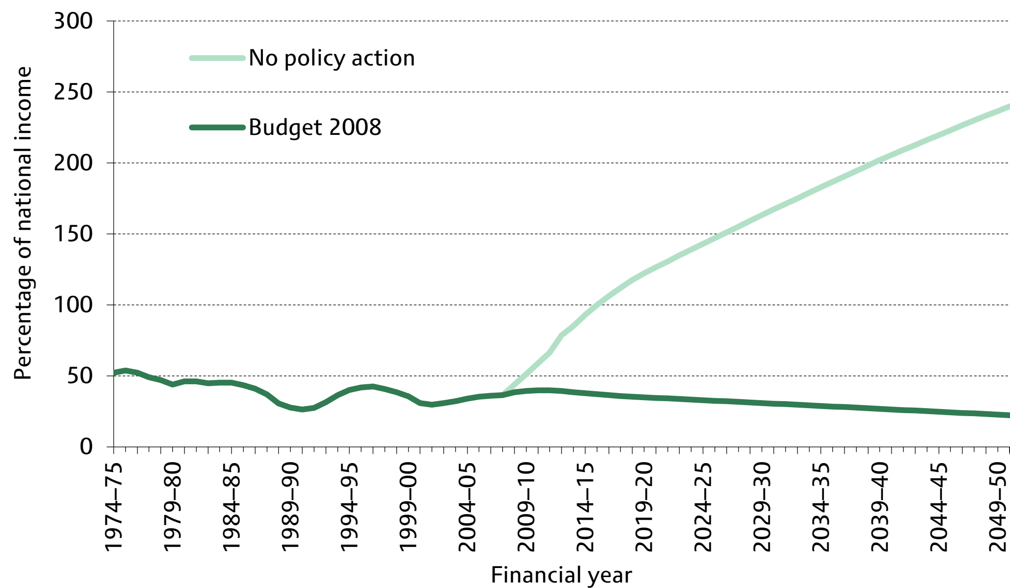
Notes: CAPSNB denotes cyclically-adjusted PSNB. Figures for cyclically-adjusted PSNB from December 2012 use the average of the OBR's Principal Component and Aggregate Composite methodologies for estimating the output gap. 'No action' ignores the direct impact of all fiscal policy measures that have been implemented since Budget 2008. December 2012 borrowing figures exclude the £28 billion of negative capital spending from Royal Mail Pension Fund in 2012–13.
Source: Out-turn figures for PSNB from Office for National Statistics, series J5II. Forecasts for PSNB from HM Treasury, *Budget 2008*, HC 388 and Office for Budget Responsibility, *Economic and Fiscal Outlook: December 2012*. December 2012 historical CAPSNB are authors' calculations using data from T. Pybus, 'Estimating the UK's historical output gap', Office for Budget Responsibility, Working Paper 1, 2011. Forecasts for CAPSNB (December 2012) from Office for Budget Responsibility, *Economic and Fiscal Outlook: December 2012*. Out-turn figures for CAPSNB (Budget 2008) from HM Treasury, Public Finances Databank, March 2008.

For an economy such as the UK, borrowing at this level could not be sustained on an ongoing basis. The appropriate policy response will depend on whether the high deficit is a temporary problem that will disappear once the economy recovers, or a permanent, structural problem, requiring discretionary tax rises and/or spending cuts at some point.[3] The estimated increase in the permanent component of borrowing is shown by comparing, in Figure 5.3, the lines for cyclically-adjusted borrowing as forecast in 2008 (the dotted dark green line) and as realised, excluding the effects of policy action since 2008 (the dotted grey line). Making this comparison, one can see that without any policy response, headline borrowing would have been 9.2% of national income higher in 2012–13 than projected at the time of the March 2008 Budget. Of this, 7.2 percentage points is thought to reflect an increase in structural borrowing. Structural borrowing in 2012–13 is estimated to have increased from 1.2% to 8.4% of national income. This means that around three-quarters of the deterioration in the public finances that has occurred since 2008 is thought to reflect new permanent weakness in the outlook for borrowing and

[3] Of course, even once one has decided what the overall size of the medium-term policy response should be – which will depend on whether the problems are cyclical or structural – important decisions need to be made about exactly what measures to choose, when they should be announced and when they should be implemented.

one-quarter is thought to reflect a temporary problem that should self-correct as the economy recovers.

Figure 5.4. Debt forecasts – without policy action



Notes: Forecasts for debt levels assume that the economy returns to its trend level in 2019–20 and that thereafter non-debt-interest spending and revenues remain constant as a share of national income, while inflation is assumed to run at 2% a year and real growth in national income at 2.3% a year until 2020–21, then rising to 2.4% between 2021–22 and 2040–41 and 2.5% thereafter. Average nominal interest rates are assumed to remain at 3.9% (the level forecast in the December 2012 Economic and Fiscal Outlook for the end of the OBR's forecast horizon, 2017–18). 'No policy action' ignores the direct impact of all fiscal policy measures that have been implemented since Budget 2008.
Source: Authors' calculations using results set out in T. Helgadottir, G. Chamberlin, P. Dhami, S. Farrington and J. Robins, *Cyclically adjusting the public finances*, OBR Working Paper No. 3, 2012 (http://budgetresponsibility.independent.gov.uk/wordpress/docs/Working-paper-No3.pdf), Office for Budget Responsibility, *Fiscal Sustainability Report: July 2012* (http://budgetresponsibility.independent.gov.uk/fiscal-sustainability-report-july-2012/) (in particular, table 3.4) and the forecasts for borrowing, net investment and the output gap from Office for Budget Responsibility, *Economic and Fiscal Outlook: December 2012* (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-december-2012/).

The implication of this permanent increase in public sector net borrowing for the path of public sector net debt is shown in Figure 5.4. Prior to the crisis, the then Chancellor Alistair Darling forecast in his March 2008 Budget that public sector net debt would rise to close to, but not exceed, 40% of national income. The projections implied that, over the longer term, debt would decline as a share of national income.[4] Had no plan to increase taxes and/or cut spending been announced since March 2008, it is clear that the public finances would have been in an unsustainable position: public sector net debt would have been set to increase remorselessly over the next forty years. Doubtless, financial markets would at some point have forced action on the UK government.

[4] This long-term forecast assumes that policy would adjust to hold the level of planned receipts and non-debt-interest spending constant as a share of national income. This means, for example (and as discussed in Section 5.4), that changes to taxes and spending would be made to offset the impact of an ageing population and of declining North Sea oil and gas production on the public finances.

Box 5.1. Measuring the size, composition and timing of the post-crisis fiscal consolidation

To measure the size of the consolidation, and how swiftly it is progressing, requires a starting point and a counterfactual – what would have happened in the absence of policy change.

To quantify new tax and benefit changes, we take the official estimates of the impact of these policy changes. These costings start from existing government policy, including the assumption that tax and benefit thresholds are uprated each year as set out in legislation. We simply take those estimates of the effects of changes as the size of that component of the consolidation.

Defining a baseline for spending on public services is more difficult. We take the plans set out in the March 2008 Budget. At that point, the then government had set out plans for overall spending beyond 2010–11 (the end of the then current spending review period) alongside some small medium-term tax increases. The spending plans were for a real-terms increase in current spending, with investment held constant as a share of national income; this implied that overall spending would fall as a share of national income. Extending this same growth assumption up to 2014–15 – the last year for which the last Labour government published official forecasts – provides a baseline for these years. We compare actual and planned levels of spending up to the end of 2014–15 with this baseline. To the extent that real spending is less than this baseline, this is part of the consolidation.

Beyond 2014–15, we have no spending plans from the previous government. There are perhaps two obvious counterfactuals we could take. One would involve an assumption that, had the crisis not happened, real-terms spending would have stayed constant. This seems to us an entirely unrealistic baseline; this would have implied the size of the state shrinking and the deficit falling indefinitely. Much more plausible is an assumption that spending would have risen in line with national income; certainly no period since the Second World War has seen a sustained cut to public spending as a share of national income. So, from 2014–15, we take as our baseline for total spending that it grows in line with GDP.

Using this methodology, baseline non-investment spending is assumed to grow more quickly beyond 2014–15 than before. Therefore, cuts to this element of spending in later years will tend to look relatively large compared with the counterfactual. That is one reason why, on this methodology, we find that a large proportion of cuts to non-investment are still to come. (In other circumstances, one might wish to consider instead how much of the total planned real-terms decline in some components of public spending has been delivered. This type of calculation, which we present in Chapter 6, yields a different answer.)

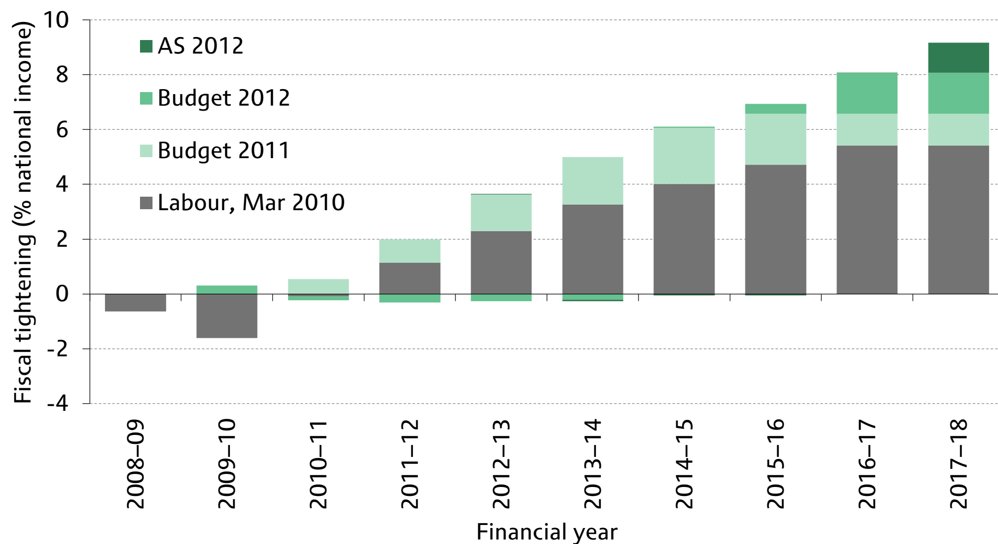
5.3 The cure

In response to the worsening outlook for the economy, the last Labour government implemented a temporary fiscal stimulus package in order to try to limit the length and depth of the recession. The direct impact of this was to increase government borrowing by lowering taxes and increasing spending in 2008–09 and 2009–10. After that, the Labour government planned to restore the public finances to health by implementing a fiscal consolidation package; this fiscal consolidation package was amended and extended by the coalition government. This section discusses the overall size and timing of the planned measures and how these have changed over the last two years in response to a worsening outlook for the economy and public borrowing. To calculate the impact of the announced measures on public borrowing, we use the official estimates of the effect of changes to tax and spending on borrowing. Further details can be found in Box 5.1. As mentioned in the introduction, if these estimates are wrong, both the size of the apparent problem that we calculate has emerged and the size of the impact of the consolidation announced would be changed by the same amount. However, we focus on the official estimates here for simplicity.

Size and timing of the fiscal consolidation: changes over time

In March 2010, our calculations based on official forecasts suggest that – at that time – cyclically-adjusted public borrowing was thought to have increased by 5.3% of national income (or £83 billion in today's terms) as a result of the financial crisis and recession; this is shown later, in Figure 5.6. The Labour government had announced plans to

Figure 5.5. Planned timing and composition of fiscal consolidation: changes over time



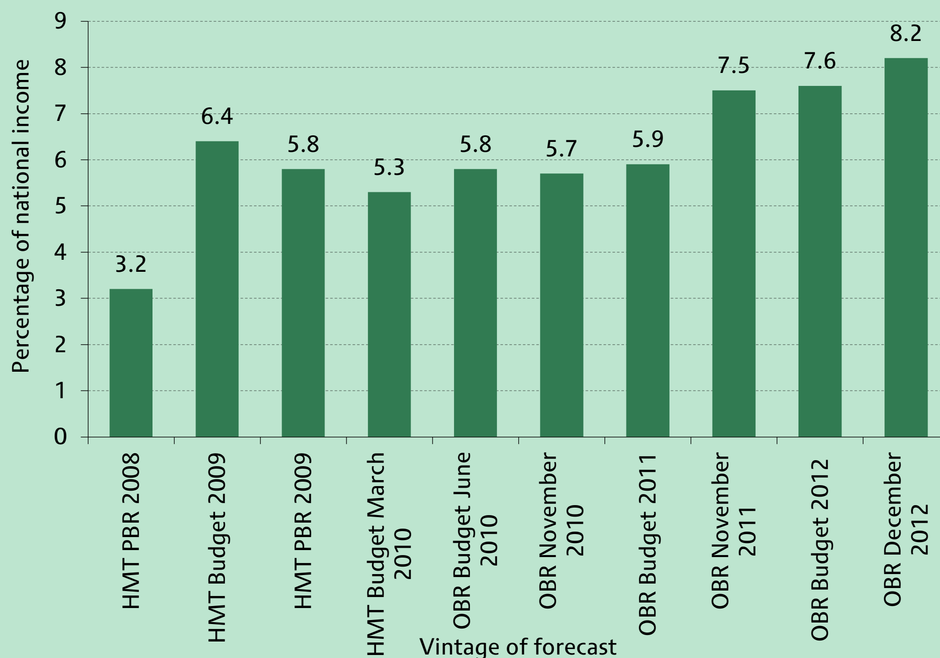
Note: Bars show the planned fiscal tightening (reduction in government borrowing) for each year, decomposed by when the measures were announced or were recosted.
Source: Authors' calculations using all HM Treasury Budgets, Pre-Budget Reports and Autumn Statements between March 2008 and March 2012 (up to the March 2010 Budget available at http://www.hm-treasury.gov.uk/budget_archive.htm; June 2010 Budget onwards available at http://www.hm-treasury.gov.uk/budget.htm; Autumn Statements available from http://www.hm-treasury.gov.uk/as2012_index.htm) and all OBR Economic and Fiscal Outlooks between June 2010 and December 2012 (all available at http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-december-2012/).

Box 5.2. An uncertain diagnosis

Following 2007–08, it became clear that both the economy and the public finances were much weaker than previously thought. The forecasts in the November 2008 Pre-Budget Report, produced in the immediate aftermath of the demise of Lehman Brothers, implied that the permanent deterioration in the outlook for the public finances was 3.2% of national income. Our calculations suggest that this estimate doubled in the March 2009 Budget to 6.4% of national income before falling to just below 6% of national income in the Pre-Budget Report of 2009, where it remained relatively stable right through to the OBR forecast produced alongside the March 2011 Budget.

Since then, the estimated size of the structural deterioration in the UK's public finances has been revised up twice: first in the Autumn Statement of 2011, when the OBR forecasts suggested a revision of 1.6% of national income since the previous budget (from a deterioration of 5.9% to 7.5% of national income); and second, one year later in the Autumn Statement of 2012, when our estimates suggest that the OBR's forecasts implied that underlying borrowing had increased by a further 0.6% of national income (from 7.6% of national income in the 2012 Budget to 8.2%).

Figure 5.6. The changing size of the problem: estimated increase in medium-term cyclically-adjusted borrowing (excluding policy response) since March 2008



Sources: Authors' calculations using all HM Treasury Budgets and Pre-Budgets between November 2008 and March 2010 (available at http://www.hm-treasury.gov.uk/budget_archive.htm) and all OBR Economic and Fiscal Outlooks between June 2010 and December 2012 (available at http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-december-2012/).

increase taxes and cut spending by 5.4% of national income by 2016–17 (as shown in Figure 5.5) – slightly more than was then thought to be required to fill the hole that had opened up.

On taking office, the new coalition government accelerated and increased the size of the planned fiscal consolidation package. As of the March 2011 Budget, this new package of measures (shown in Figure 5.5) was projected to be sufficient to repair the damage done to the public finances (which we estimate, again based on official figures, was thought to be 5.9% of national income at that time; see Figure 5.6) by 2014–15. There was then set to be a further fiscal tightening in 2015–16, which would have reduced the deficit further.

However, since then, the outlook for the UK economy and the public finances has deteriorated even further (as described in Box 5.2). In response to this, the coalition government has significantly revised its plans for tax increases and spending cuts on two more occasions.

In November 2011, our calculations based on the OBR's revised forecasts suggest that the hole in the public finances had increased from 5.9% of national income to 7.5% (Figure 5.6). Mr Osborne, in his November 2011 Autumn Statement, chose to allow borrowing to rise in the short term but to offset the rise in borrowing in the next parliament by increasing the size of the spending cuts planned for 2015–16 and 2016–17. (This is shown by the 'Budget 2012' bars in Figure 5.5.)

In his December 2012 Autumn Statement, Mr Osborne responded to a further worsening in the outlook for the public finances in a similar way. Borrowing was allowed to increase over the course of this parliament and a further year of spending cuts was pencilled in for the next parliament (2017–18). (This is shown by the 'AS 2012' bars in Figure 5.5.)

The revisions to the official forecasts for government borrowing in the 2011 and 2012 Autumn Statements, combined with the fact that Mr Osborne has chosen not to offset these with policy measures until after 2015–16, means that official projections for borrowing have been revised up substantially. Table 5.2 compares the forecasts for public sector net borrowing in the November 2010 Autumn Statement (i.e. before the significant downgrades to the outlook for the UK public finances made by the OBR) with the latest official forecasts in the December 2012 Autumn Statement.

At the time of the November 2010 Autumn Statement, the OBR forecast that borrowing would fall from £148.5 billion to £35 billion in 2014–15. The latest forecasts (adjusted in a way that is described in the note to Table 5.2) are for it to fall only to £99 billion in 2014–15. Official estimates suggest that policy measures announced since the end of 2010 will reduce borrowing by only £1 billion in that year – in other words, in the absence of these measures, borrowing would have been projected to be £100 billion. Therefore, of the £65 billion increase in borrowing forecast for 2014–15 that has emerged since the 2010 Autumn Statement, Mr Osborne has chosen to offset with policy action only £1 billion by that year. In this respect, he is running very much looser fiscal policy than he intended back in 2010.

Beyond 2014–15, the announced policy response has been larger. By 2017–18, the additional fiscal consolidation pencilled in by Mr Osborne is estimated to reduce borrowing by £53 billion in that year. As a result, borrowing is forecast to be £31 billion in 2017–18. This is still higher than that implied by the November 2010 Autumn

Statement.[5] Therefore, the Chancellor by 2017–18 has chosen to offset the majority, but not all, of the deterioration in the outlook for the public finances that has been seen over the last two years. A possible justification for this is that the OBR expects the additional borrowing that Mr Osborne has chosen not to offset with policy measures to be cyclical rather than structural. In both November 2010 and December 2012, the OBR estimated that the Chancellor was aiming for cyclically-adjusted net borrowing of 0.3% of national income at the end of each forecast horizon (2015–16 and 2017–18, respectively).

Figure 5.7 in Box 5.3 shows how forecasts for public sector net borrowing have evolved over time. It reveals that the deterioration in the outlook for the public finances seen since 2010 means that, despite the additional austerity measures implemented by this government, headline borrowing is projected to be higher from 2012–13 onwards than it was at the time of Alistair Darling's March 2010 Budget.

Table 5.2. How borrowing forecasts changed between November 2010 and December 2012 (£ billion unless otherwise stated)

	2010–11	2011–12	2012–13	2013–14	2014–15	2015–16	2016–17	2017–18
PSNB, Autumn Statement, November 2010								
£bn	**148.5**	**117**	**91**	**60**	**35**	**18**	n/a	n/a
Underlying change	–6.8	4.4	27.6	50.2	65.1	71.5	n/a	n/a
Borrowing forecast, with no measures after 2010 Autumn Statement								
£bn	**141.7**	**121.4**	**118.6**	**110.2**	**100.1**	**89.5**	**86.7**	**83.3**
Extra policies	0.0	0.0	1.7	1.9	–1.1	–7.5	–30.0	–52.6
PSNB, Autumn Statement, December 2012								
Adjusted £bn	**141.7**	**121.4**	**120.3**	**112.1**	**99.0**	**82.0**	**56.7**	**30.7**
Unadjusted £bn	*141.7*	*121.4*	*80.5*	*99*	*88*	*73*	*49*	*31*

Notes: Adjusted PSNB figures exclude the £28 billion of negative capital spending from Royal Mail Pension Fund in 2012–13, as well as the effects of reclassifying Northern Rock Asset Management, Bradford & Bingley, and financial transactions relating to the Asset Purchase Facility on the public balance sheet.
Sources: November 2010 and December 2012 OBR Economic and Fiscal Outlooks, available at http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-december-2012/. Measures based on authors' calculations using all HM Treasury Budgets and Autumn Statements between November 2010 and December 2012, available at http://www.hm-treasury.gov.uk/budget.htm). Latest out-turns for PSNB from ONS series J5II.

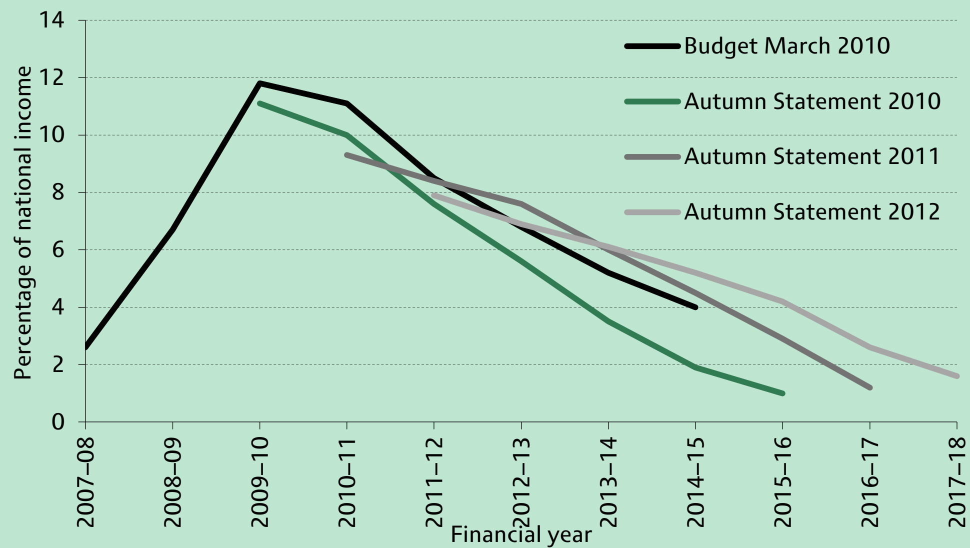
[5] As shown in Table 5.2, the November 2010 Autumn Statement forecast borrowing of £18 billion in 2015–16 (the last year of the forecast horizon at the time). With no planned loosening of fiscal policy beyond this, borrowing would have been projected to be lower than the £31 billion of borrowing now forecast by the OBR.

Box 5.3. Changes to official borrowing forecasts

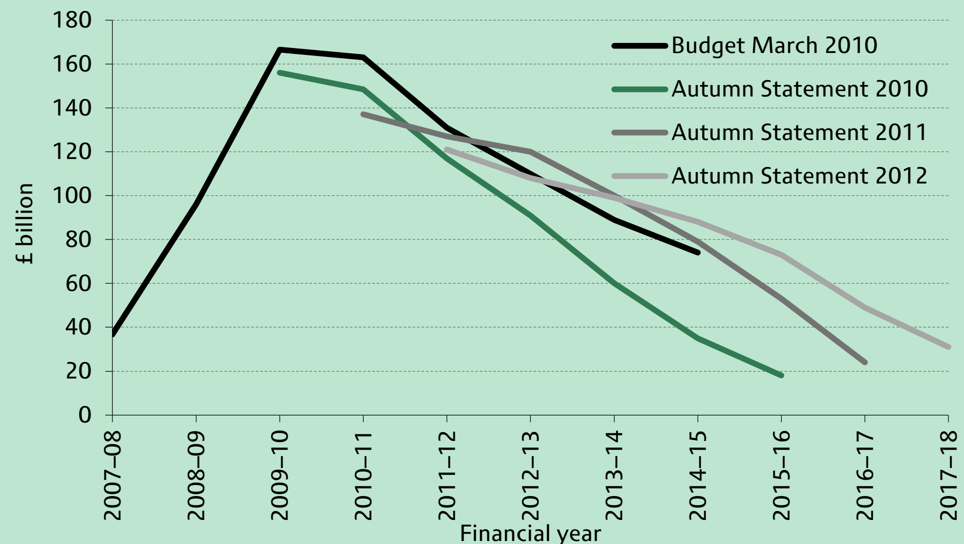
A number of factors have contributed to changing official forecasts for borrowing over the last few years. First, as described in Box 5.2, the estimated size of the permanent damage done to the UK's public finances by the crisis and recession has increased since late 2010. Second, there has also been additional temporary weakness in the UK economy – above that which the Treasury had forecast in March 2010. Third, new policy measures have been announced over the last few years, which affect the amount of tax raised and the level of public spending. These factors have led to official borrowing forecasts being revised over recent years. Figure 5.7 shows official forecasts for borrowing as a share of national income from the March 2010 Budget to the 2012 Autumn Statement.

Figure 5.7. Different vintages of forecasts for public sector net borrowing

a. Percentage of national income



b. £ billion



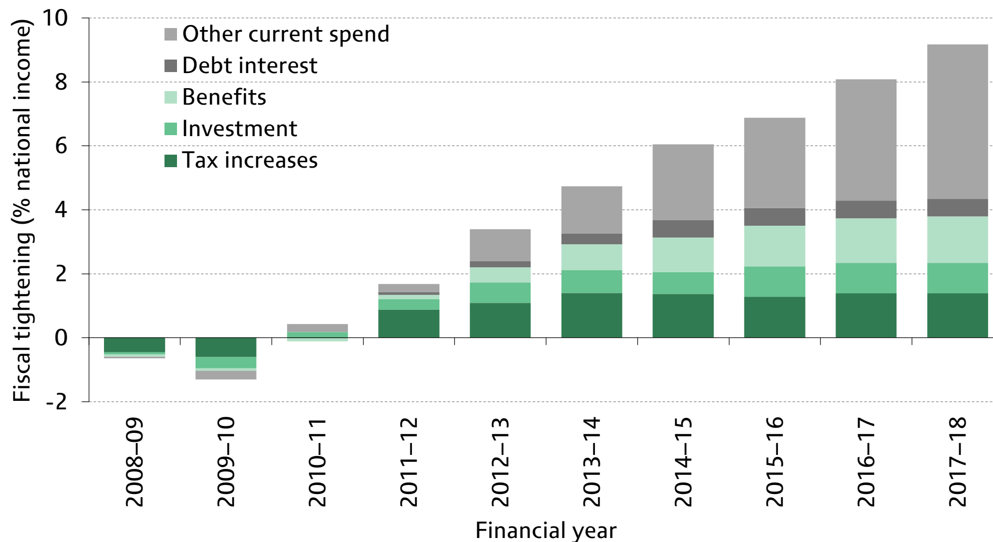
Note: December 2012 borrowing figures exclude the £28 billion of negative capital spending from Royal Mail Pension Fund.

Source: Out-turn figures for 2007–08 from HM Treasury, Public Finances Databank, December 2012. Budget March 2010 (available at http://www.hm-treasury.gov.uk/budget_archive.htm) and OBR Economic and Fiscal Outlooks between June 2010 and December 2012 (all available at http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-december-2012/).

Composition of the fiscal consolidation and progress to date

The current period of fiscal consolidation began in 2010–11, when the Labour government's fiscal stimulus package was withdrawn and the incoming coalition government implemented some in-year spending cuts and some immediate increases in indirect taxes (including increasing the main rate of VAT to 20% from January 2011). Additional spending cuts and tax increases are due to be implemented each year through to 2017–18. Taken together, the measures announced since the March 2008 Budget are expected to reduce public borrowing by 9.2% of national income (or £144 billion) by 2017–18 (as was shown in Figure 5.5). The overall magnitude, timing and composition of the fiscal 'cure' is shown in Figure 5.8.

Figure 5.8. Timing and composition of the fiscal remedy



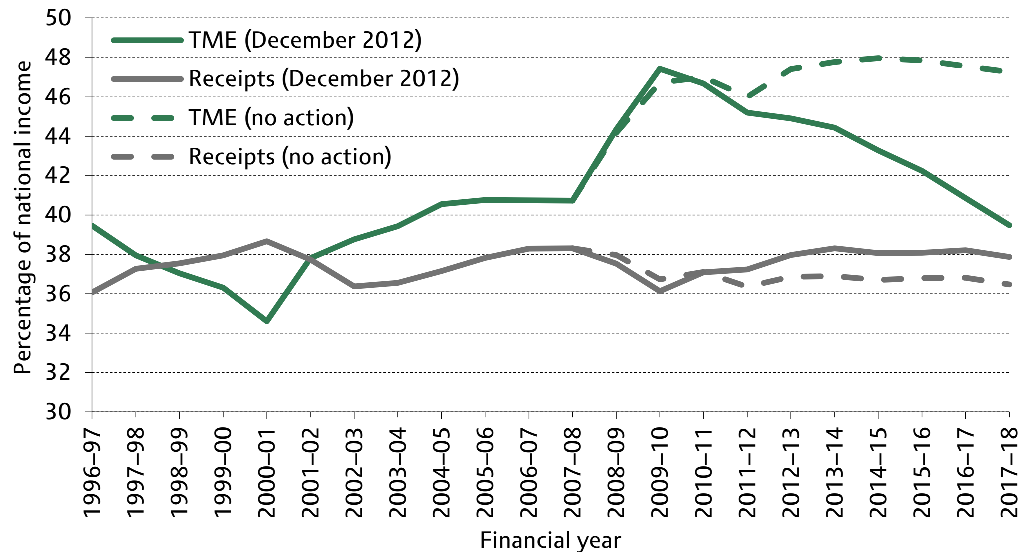
Notes: Bars represent the planned fiscal tightening (reduction in government borrowing), decomposed into tax increases and spending cuts, with the spending cuts further subdivided into benefit cuts, other current spending cuts and investment spending cuts.
Source: Authors' calculations using all HM Treasury Budgets, Pre-Budget Reports and Autumn Statements between March 2008 and December 2012 (up to the March 2010 Budget available at http://www.hm-treasury.gov.uk/budget_archive.htm; June 2010 Budget onwards available at http://www.hm-treasury.gov.uk/budget.htm; Autumn Statements available from http://www.hm-treasury.gov.uk/as2012_index.htm) and all OBR Economic and Fiscal Outlooks between June 2010 and December 2012 (all available at http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-december-2012/).

The current financial year is forecast to see a relatively large fiscal tightening from discretionary policy changes (1.7% of national income). By the end of this year, almost two-fifths (37%) of the total fiscal consolidation is planned to have been done, with the remainder coming over the following five years. Within this, the tax rises and investment spending cuts have been relatively front-loaded while the benefit cuts and the cuts to day-to-day spending on public services have been relatively back-loaded. Therefore, although the fiscal consolidation is ultimately expected to consist of 15% tax increase and 85% spending cuts, 32% of the measures implemented so far have come from tax rises and 68% from spending cuts. The estimates in Figure 5.8 imply that by the end of 2012–13, 79% of the net tax rises but just 30% of the spending cuts announced since the March 2008 Budget will have been implemented. Within these spending cuts, 67% of the planned cut to investment spending will have happened, whereas just 32% of the benefit cuts and 21% of the cuts to day-to-day spending on public services will have been felt. Box 5.1 gives more details on how these estimates were calculated. Details of how the personal tax and benefit changes have been distributed across households can be found

in Chapter 7, while the allocation of public service cuts across different services can be found in Chapter 6.

The fiscal consolidation measures announced since March 2008 have drastically altered the path for tax revenues and spending compared with what would have occurred since the crisis in the absence of policy response. This is shown in Figure 5.9. Although spending still significantly outstrips revenues this year, this gap is smaller than it would have been without government action over the last five years.

Figure 5.9. Revenues and spending – with and without policy action



Notes: As Figure 5.2.
Source: As Figure 5.2.

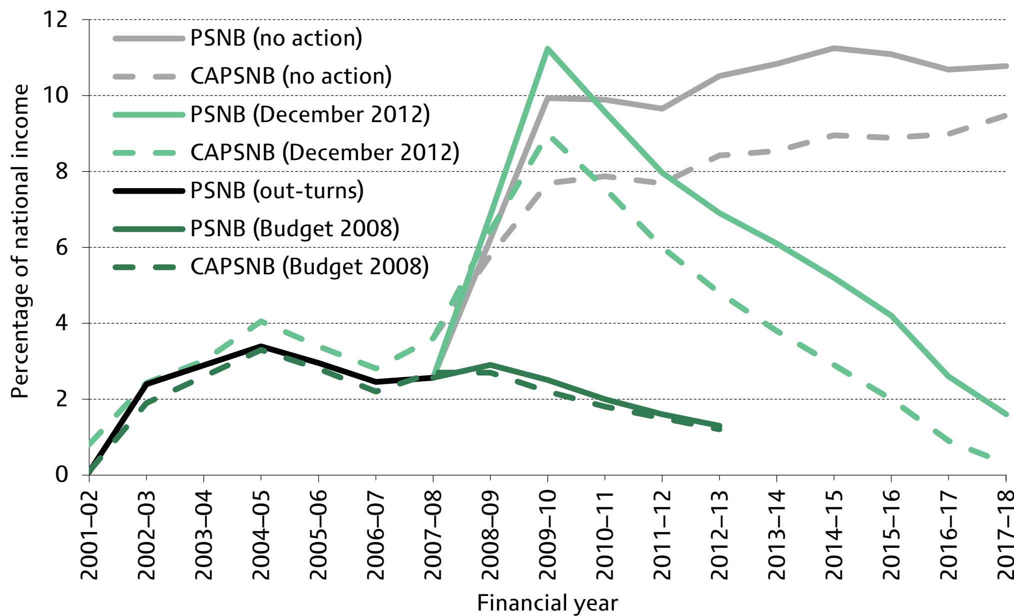
The fact that the majority of the fiscal consolidation is due to come from spending cuts rather than tax rises might be considered appropriate if the objective is to put public spending and tax receipts approximately back to their pre-crisis levels as a share of national income: certainly the sharp increase in public spending as a share of national income that occurred between 2007 and 2010 was not the intention of the Labour government when it held the October 2007 Comprehensive Spending Review (nor that of the then opposition Conservative Party when it signed up to those spending totals). The current plans imply public spending being the same share of national income in 2017–18 as it was in 2003–04 (and the same level in real terms as it was in 2008–09), while tax receipts would be slightly below the level they were at on the eve of the crisis in 2007–08.

By 2017–18, the planned fiscal cure (at 9.2% of national income, shown in Figure 5.8) is estimated to be somewhat above the estimated 8.2% of national income underlying deterioration in the outlook for the UK public finances that has been seen since March 2008 (shown in Figure 5.6). Therefore, the government's current plans imply that structural borrowing will be slightly lower in the medium term than it was projected to be in the March 2008 Budget. Indeed, the latest forecasts suggest that cyclically-adjusted PSNB will decline by 2017–18 to the lowest level seen since the height of the dot com bubble in 2001–02 (Figure 5.10).

This reduction in borrowing is sufficient to return public sector net debt to a sustainable path. Assuming that the cyclically-adjusted primary balance remains constant beyond

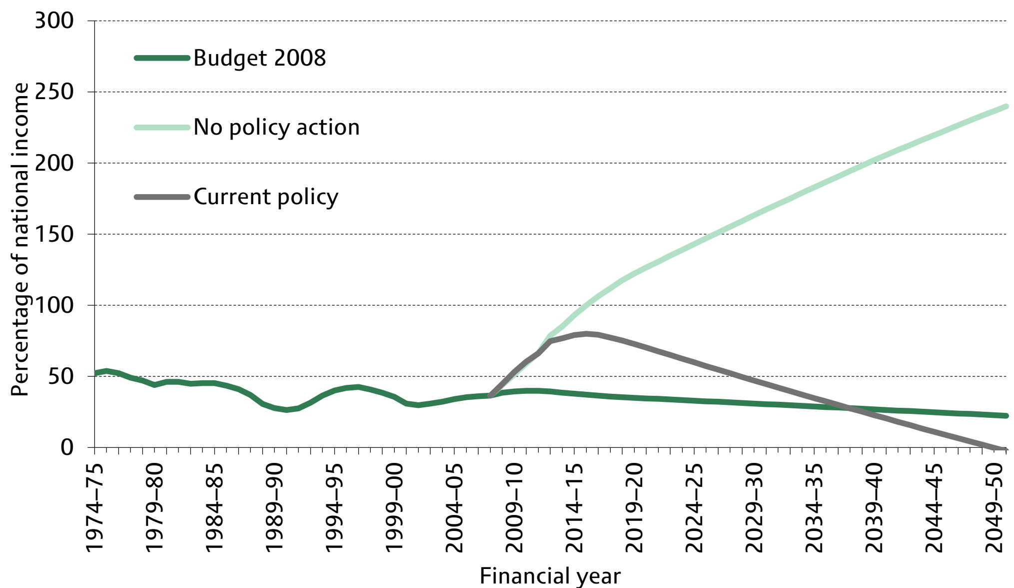
2018–19,[6] public sector net debt would peak at just below 80% of national income in 2015–16 and then decline thereafter. However, it would still not be projected to return to pre-crisis levels (of below 40% of national income) until 2032–33. (Figure 5.11.)

Figure 5.10. Public sector net borrowing – with and without policy action



Notes: As Figure 5.3.
Source: As Figure 5.3.

Figure 5.11. Debt forecasts – with and without policy action



Notes: As for Figure 5.4.
Sources: As for Figure 5.4.

[6] As mentioned above, this assumption requires, in particular, that the impact on the public finances of factors such as the costs of an ageing population and the likely erosion of revenues from fuel duties are offset with changes to taxes or spending rather than changes in borrowing.

5.4 Risks to the public finances

Short-term risk: borrowing in 2012–13

One immediate risk to the Chancellor's fiscal plans is that borrowing this year will overshoot the latest official forecast from the OBR. Data that have become available since the OBR published its latest forecast in December 2012 lead us to believe that borrowing this year will be somewhat higher than the OBR forecasts. Specifically, the IFS baseline forecast is that borrowing in 2012–13 will overshoot the OBR's December 2012 forecast by £4.9 billion, as shown in Table 5.3. A number of factors contribute to this judgement. (Much more detailed information on the IFS public finance forecasts can be found in Appendix A.)

Table 5.3. Comparisons of forecasts for government borrowing, 2012–13

£ billion	OBR March 2012	OBR December 2012	Green Budget February 2013	Difference between Green Budget forecast and:	
				March	December
Current receipts	591.5	593.8	590.5	–1.0	–3.3
Current expenditure[a]	686.8	682.9	684.5	–2.3	1.6
Surplus on current budget	–95.3	–89.1	–94.0	1.3	–4.9
Net investment	–3.4	–8.5	–8.5	–5.1	0.0
Total managed expenditure	683.4	674.3	676.0	–7.4	1.6
Public sector net borrowing	91.9	80.5	85.5	–6.4	4.9

a. In line with the National Accounts, depreciation has been included as current expenditure.
Note: Public sector net investment, total managed expenditure and public sector net borrowing are all reduced by the £28 billion of negative capital spending from Royal Mail Pension Fund.
Source: Authors' calculations. Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2012 and *Economic and Fiscal Outlook*, December 2012 (both available at http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-december-2012/).

In December 2012, the OBR revised up its forecast for revenues this year (from £591.5 billion to £593.8 billion). However, this reflected the addition of some new income streams (in particular, from the Bank of England's Asset Purchase Facility) more than offsetting a downwards revision to underlying tax revenues. In the light of further data that have become available since the OBR made its forecast, we judge that receipts will be a further £3.3 billion lower in 2012–13 than the OBR forecast.[7] In particular, we have a more pessimistic forecast for revenues from income tax, VAT and corporation tax, somewhat offset by more optimistic forecasts for revenues from NICs, stamp duties and excise duties.

In December 2012, the OBR also revised down its forecast for public sector current spending by £3.9 billion, which included an estimate that central government departments would underspend their allocated budgets by £4.5 billion. This forecast requires central government spending on the delivery and administration of public

[7] For example, as the OBR acknowledged in its commentary on the public finance figures for December that were published on 22 January, 'VAT receipts since we produced the December EFO forecast have not shown the expected increase in growth rates' (http://budgetresponsibility.independent.gov.uk/pubs/Jan-2013-PSF-Commentary-1.pdf).

services to grow by just 1.1% over the last five months of this year, compared with the same period last year (while growth averaged 1.5% over the first seven months of the year). The data that have become available since the OBR forecast was published show that growth in central government current spending on the delivery and administration of public services has picked up.[8] Our baseline forecast is, therefore, for current spending to be £1.6 billion higher in 2012–13 than the OBR forecasts. In other words, we assume that central government departments will underspend on the day-to-day delivery of public services by £2.9 billion, rather than the £4.5 billion assumed by the OBR. In all other areas, we assume that the OBR is correct in its forecast for spending.

Taken together, the IFS baseline forecast is therefore for the current budget deficit (that is, the difference between receipts and non-investment spending) to be £94.0 billion in 2012–13, which is £4.9 billion higher than the OBR's forecast of £89.1 billion. Because the IFS baseline forecast is for the same level of public sector net investment spending as the OBR forecasts, borrowing (that is, the gap between revenues and total spending, including investment) is also projected to be £4.9 billion higher than the OBR's forecast, at £85.5 billion.

Headline borrowing of £85.5 billion would be lower than the £121.4 billion of borrowing in 2011–12. However, the 2012–13 figure includes the impact of the nationalisation of the Royal Mail Pension Plan assets and the Chancellor's decision to transfer the Asset Purchase Facility from the Bank of England to the Treasury – both of which depress borrowing in 2012–13 but do not strengthen the public finances over the long run. Stripping out these effects, the IFS baseline forecast is that (on a like-for-like basis) borrowing would rise from £121.4 billion in 2011–12 to £125.4 billion in 2012–13 (or from 7.9% to 8.0% of national income).

While this disagreement between our forecast and the OBR's forecast for borrowing this year (of £4.9 billion) might sound large, it is well within the bounds of normal uncertainty surrounding official in-year forecasts for public sector net borrowing. With data from the final three months of the financial year still to come and much uncertainty remaining, it is still possible that borrowing could ultimately rise or fall in nominal terms between last year and this year. Furthermore, while cash borrowing rising year-on-year might be politically sensitive, fundamentally – regardless of whether there is a small fall (as forecast by the OBR in December) or a small rise (as our baseline forecast suggests) – borrowing is likely to be substantively unchanged between last year and this year. Far more important for determining fiscal policy is the medium- and longer-term outlook for borrowing and debt.

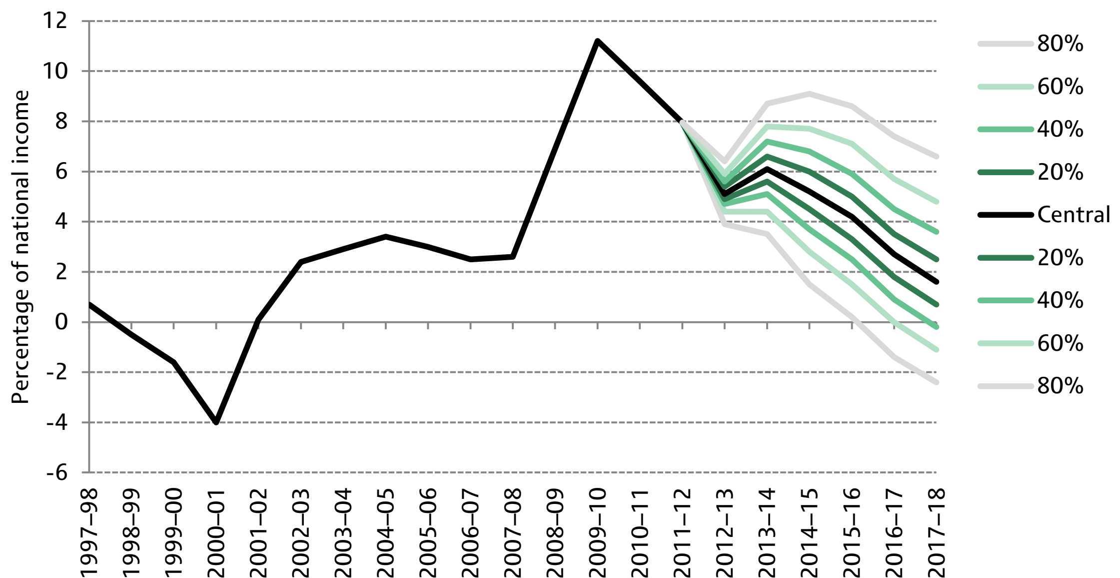
Medium-term risks

One way of thinking about how certain we might be about the latest official forecasts for borrowing is to examine how accurate they have been in the past. Previous IFS Green Budgets have used the errors made in previous official fiscal forecasts to present a 'fan chart' around our central forecasts for borrowing. From its inception, the OBR has chosen to present its forecasts in the same way. This method of quantifying uncertainty relies on three key assumptions: first, that the central forecast is as likely to be an underestimate as it is to be an overestimate; second, that the latest forecasts are likely to be as (in)accurate as previous Pre-Budget Report forecasts made by HM Treasury; and third, that there are no further new policy announcements.

[8] Source: Office for National Statistics & HM Treasury, *Public Sector Finances, December 2012*, http://www.ons.gov.uk/ons/rel/psa/public-sector-finances/december-2012/index.html.

The OBR's latest forecasts for public sector net borrowing are shown in fan-chart style in Figure 5.12. Its central forecast is that borrowing will fall to 1.6% of national income in 2017–18. But the figure shows that, under the assumptions described above, there is an 80% chance – on the OBR's central forecast – that public sector net borrowing in 2017–18 will be between a deficit of 6.6% of national income and a surplus of 2.4% of national income, with the narrower bands corresponding to ranges with lower likelihoods of occurring. In other words, there is a 10% chance that there will be a surplus of more than 2.4% of national income and a 10% chance that borrowing will exceed 6.6% of national income.

Figure 5.12. Probabilities of public sector net borrowing outcomes



Source: Chart 4.6 of Office for Budget Responsibility, *Economic and Fiscal Outlook: December 2012* (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-december-2012/).

This highlights the importance of considering not only the OBR's central forecast for the public finances (or indeed anyone else's, including our own) but also the risks around that forecast. This subsection discusses a number of these risks. The first set of risks concerns the possibility that the government may not implement the fiscal consolidation plans as currently set out. A possible downside risk for borrowing is that the government is unable to impose such harsh spending cuts as currently planned in the run-up to the next election. A possible upside risk for borrowing is the possibility that an incoming government after the next general election would choose to increase taxes more than is currently planned, as many new governments have done in recent decades.

The second set of risks concerns the outlook for the economy. On the upside for borrowing, the trend level of the UK economy could be higher than the OBR currently thinks – implying more scope for cyclical recovery – and/or tax receipts could, for other reasons, grow more quickly than the OBR expects (for example, because growth could be more heavily concentrated in highly-taxed sectors of the economy). On the downside for borrowing, the trend level of the UK economy could be lower than the OBR currently thinks and/or tax receipts could, for other reasons, recover less quickly than the OBR expects. We explore the risks to the public finances arising from uncertainty about the outlook for the size and structure of the UK economy by presenting forecasts for the UK's public finances under four alternative sets of macroeconomic assumptions – the OBR's December 2012 forecast, the Oxford Economics central forecast, a more optimistic OE

scenario and a more pessimistic OE scenario. The three OE scenarios are described in more detail in Chapters 1 and 2.

Implementing the planned fiscal consolidation

One major risk to the public finances is that the government may not be able to deliver the ambitious fiscal consolidation plans that it has announced. The UK has not (at least since the Second World War) experienced a spending squeeze of the size or duration that is currently planned and, as shown in last year's Green Budget, prior to the current crisis perhaps the only relevant example of such deep cuts being delivered elsewhere in recent decades is Ireland in the late 1980s.[9] Chapter 6 discusses in detail the challenges facing the government in delivering this spending squeeze.

The tax increases that have been announced are much smaller than the spending cuts and most of them have already been implemented (as shown in Figure 5.8), so there is perhaps less risk that these will be reversed. As we get closer to the next election, with the electorate having suffered through five years of austerity and a long period in which, on average, household incomes have been squeezed, there is a possibility that politicians could be tempted to announce some pre-election tax cuts – as the Conservative government did in 1992 – in order to attempt to win over some voters. Figure 5.13 examines how common a phenomenon this has been before other recent UK elections; parliamentary terms are marked by the shaded areas. Over the 28 years since 1985, there has been an average net discretionary tax increase announced each year of £1.3 billion (in 2012–13 terms). But, in the 12 months before elections, governments have tended to announce tax giveaways – amounting on average to £2.2 billion a year in 2012–13 terms. If the current government were to follow this precedent, the public finance position could be weakened in the run-up to the next election.

However, much more striking in Figure 5.13 than the pre-election tax giveaways are the post-election tax increases. In the 12 months following the last six general elections, newly-elected governments have tended to announce tax rises – averaging £7.5 billion a year in the long run. Given the continuing pressures on the public finances, it might not be surprising if the next election were also to be followed by some substantial tax increases.

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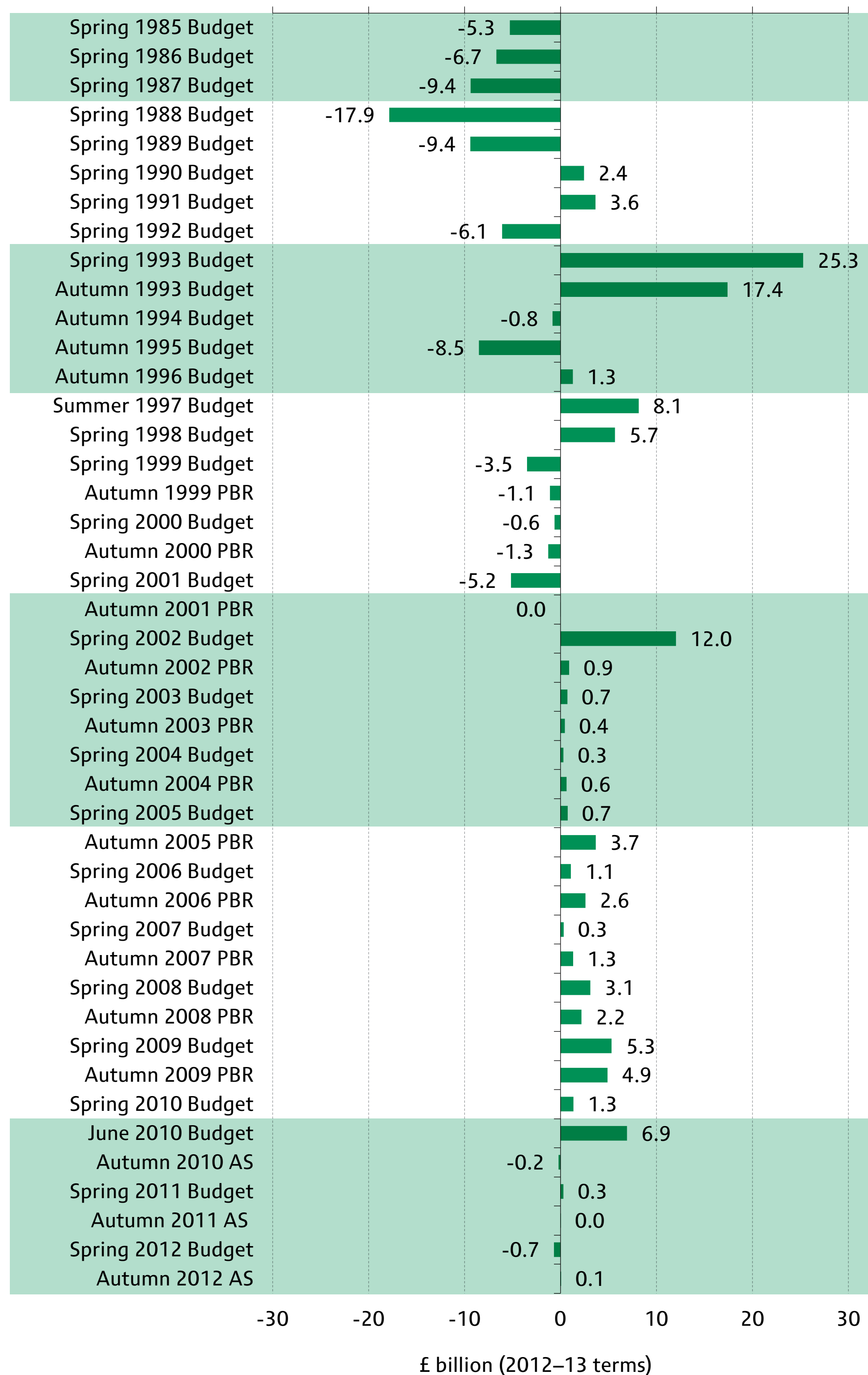
[9] See table 3.5 of R. Crawford, C. Emmerson and G. Tetlow, 'Fiscal repair: painful but necessary', in C. Emmerson, P. Johnson and H. Miller (eds), *The IFS Green Budget: February 2012* (http://www.ifs.org.uk/budgets/gb2012/12chap3.pdf).

Figure 5.13. Long-run takeaway from discretionary tax measures



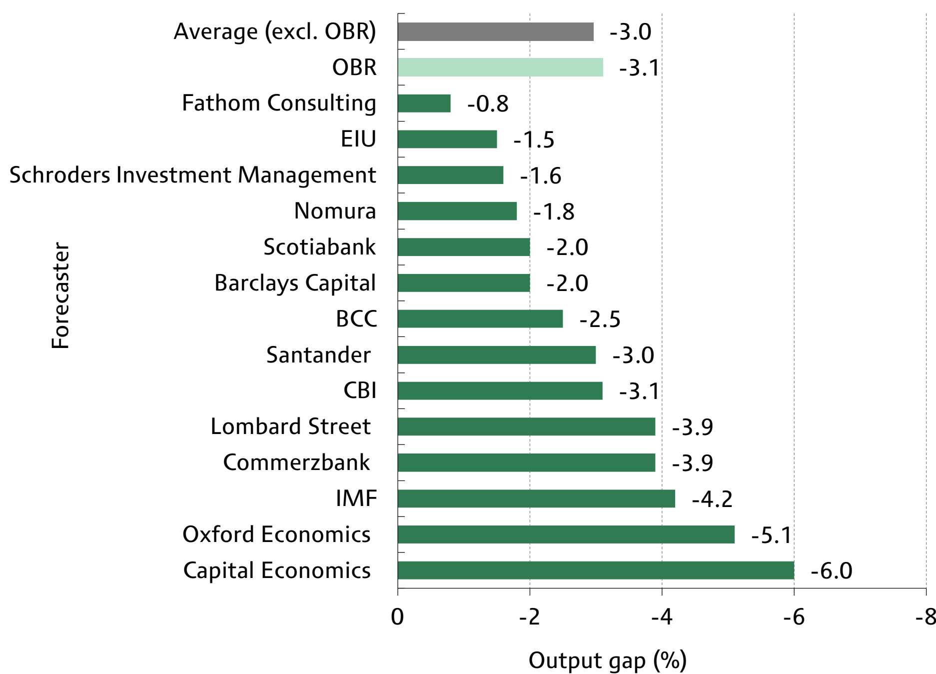
Sources: Authors' calculations using all HM Treasury Budgets, Pre-Budget Reports and Autumn Statements between March 1985 and December 2012 (from the March 1998 Budget up to the March 2010 Budget available at http://www.hm-treasury.gov.uk/budget_archive.htm; June 2010 Budget onwards available at http://www.hm-treasury.gov.uk/budget.htm; Autumn Statements available at http://www.hm-treasury.gov.uk/as2012_index.htm) and all OBR Economic and Fiscal Outlooks between June 2010 and December 2012 (all available at http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-december-2012/).

How much scope is there for economic recovery?

How much active fiscal consolidation (in the form of permanent spending cuts and tax increases) will actually be required to get the public finances back to a sustainable position depends in large part on how much 'spare capacity' there is in the economy. This is measured by the output gap – a concept that defines the difference between the trend and actual levels of GDP. A larger output gap implies that borrowing will fall by more as the economy bounces back.

However, it is difficult enough to measure how much output an economy is actually producing, and even more difficult to measure how much it *could* be producing. The OBR and several other institutions publish estimates of the output gap, but there is no consensus on the best approach to take and there is substantial variation between estimates of past, current and future output gaps. (As Box 5.2 sets out, the official estimate of the damage done to the public finances by the financial crisis and recession has changed significantly over the last four years, and this has largely been driven by changes to the official estimate of the trend level of GDP.)

Figure 5.14. Alternative estimates of the output gap in 2012



Source: HM Treasury, 'Forecasts for the UK economy: a comparison of independent forecasts', January 2013 (http://www.hm-treasury.gov.uk/forecasts).

In December 2012, the OBR estimated that in 2012 the UK economy was operating 3.1% below its trend level. This is just above the average of the latest estimates by other independent forecasters (2.9%), as shown in Figure 5.14. However, among the other independent forecasters, there is a large range of estimates for the size of the output gap in 2012 – spanning from –0.8% to –6.0%.

The OBR's latest forecast is for headline borrowing of 5.1% of national income this financial year – of which 3.0 percentage points is thought to be structural and 2.1 percentage points is thought to be purely cyclical. It is possible to quantify the potential impact of different output gap estimates on the level of borrowing (and thus decompose headline borrowing into the part that is structural and the part that is cyclical) using estimates of how the UK public finances have varied over the ups-and-downs of previous economic cycles. For example, if Fathom Consulting is correct and the output gap is 2.3

percentage points smaller than the OBR estimates, the structural deficit would be estimated currently to be around 1.6% of national income larger.[10] Were the OBR to adopt this estimate of the output gap, and leave its assumed growth in trend output unchanged, the government would need to find approximately another £25 billion of tax increases or spending cuts to expect to reach the same cyclically-adjusted borrowing level that it is targeting for 2017–18. At the other extreme, if Capital Economics is correct that the output gap is actually 2.9 percentage points larger than the OBR estimate, this would suggest that the structural deficit was currently around 2.0% of national income smaller than the OBR thinks. Were the OBR to adopt this estimate of the output gap, and leave its assumed growth in trend output unchanged, approximately £32 billion less would be needed in the way of tax increases and spending cuts than is currently planned.

This gives an idea of the range of uncertainty surrounding estimates of how large the UK's structural borrowing currently is – and thus what active policy response might be required to return borrowing to more sustainable levels, such as the level that Mr Osborne is aiming for. However, the simple rule-of-thumb calculations we have just set out assume that the current period of weak economic performance has the same relationship with government borrowing as that seen in previous economic recessions and booms. If the recent recession or the coming recovery is different from past experience (or if the responsiveness of the tax and benefit system to the economic cycle has changed – for example, due to policy reforms or to changes in individual behaviour over the cycle), then the scope for receipts to bounce back and for spending to fall as the economy recovers may be different. Therefore, in the next subsection, we take a more detailed look at how different views of the current and future state of the economy affect our view of the fiscal position by presenting bottom-up forecasts for the UK's public finances under four alternative scenarios for the macroeconomy.

What will happen to borrowing as output recovers?

The last subsection has shown that the health of the public finances is crucially determined by the potential level of output in the economy and that that is quite uncertain. What also matters is the strength of the public finances for any given level of output. This will depend on the composition of output, how this interacts with the tax and benefit system, and what the government chooses to spend on the provision of public services. This subsection uses the IFS model of the public finances to project their strength under different scenarios for the future size and composition of (actual and potential) output in the UK.

We start by examining the path of the public finances under the assumption that the economy evolves as the OBR projects. This baseline forecast highlights areas in which we take a different view from the OBR on how tax receipts and spending will evolve given the same underlying economic forecast. These differences are important and understanding where the forecasts differ is especially so. However, it is important to stress that the differences are relatively small in the context of the overall fiscal situation. There is nothing in our fiscal forecasts, given the OBR's macroeconomic forecasts, that would lead us to take a qualitatively different view of the scale of the fiscal challenge.

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[10] This figure is calculated by multiplying the difference in the output gap estimate by the OBR's estimate for how the output gap affects borrowing levels; the OBR estimates that a 1 percentage point increase in the output gap reduces structural borrowing as a share of national income by 0.7 percentage points. Source: T. Helgadottir, G. Chamberlin, P. Dhami, S. Farrington and J. Robins, 'Cyclically adjusting the public finances', OBR Working Paper No. 3, 2012 (http://budgetresponsibility.independent.gov.uk/wordpress/docs/Working-paper-No3.pdf).

Much bigger differences in the outlook for the public finances would arise if we took a different macroeconomic forecast. Here we consider three alternative sets of public finance forecasts based on different macroeconomic scenarios. The first set assumes the UK economy performs as projected under the Oxford Economics central scenario. In this case, headline growth over the next five years is very similar to that projected by the OBR but the composition of this growth is different (for example, oil and equity prices are higher while property price growth and economy-wide inflation are lower) and the trend level of output is considerably higher than the OBR assumes. To examine some potential upside risks, the second case we examine is the more optimistic Oxford Economics scenario. In this scenario, business investment picks up more quickly and both headline growth and the level of potential output are higher than under the OE central scenario. Finally, we look at the more pessimistic Oxford Economics scenario. In that scenario, both headline growth and the potential level of output in the UK are severely depressed relative to the OE central scenario. More details of the three Oxford Economics scenarios can be found in Chapters 1 and 2. Much more detailed information on the IFS public finance forecasts under all of these scenarios can be found in Appendix A.

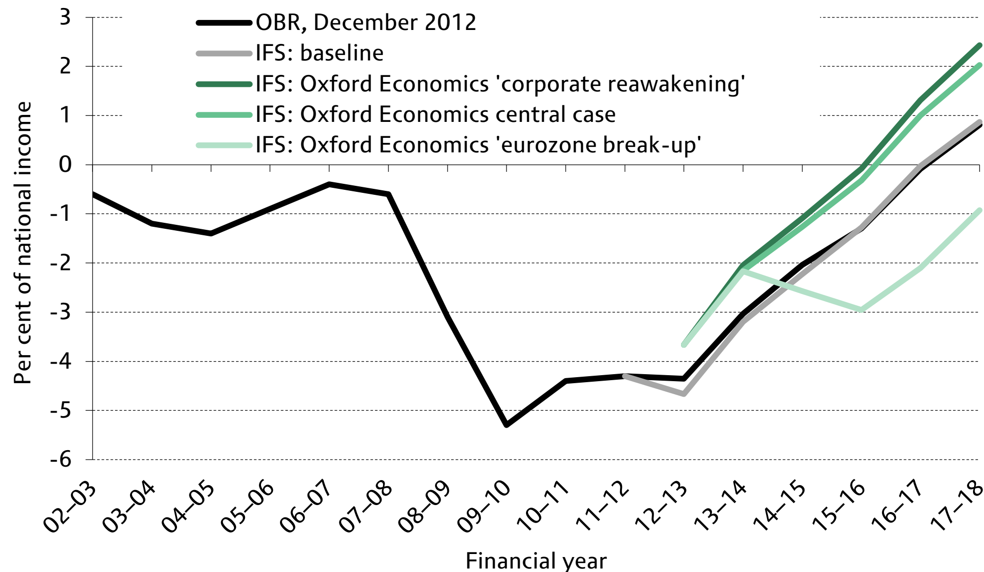
IFS baseline forecast

The IFS baseline forecast is for similar growth in total receipts to that in the OBR forecast. This is perhaps not terribly surprising given that we are basing our revenue forecast on the same underlying economic projections. Details of differences in the projections for individual taxes can be found in Appendix A (in particular in Figure A.2). However, our baseline forecast for spending differs more significantly. In particular, we believe that there is a significant risk that Whitehall departments do not underspend their budgets in 2013–14 and 2014–15 to the extent that the OBR factored into its latest forecast. Therefore, whereas the OBR assumed in its December 2012 forecast that Whitehall departments will underspend their budget allocations by £3.5 billion in 2013–14 and £3.0 billion in 2014–15, we assume that departments will actually spend all of their allocations. This is in line with the assumption we have made in previous IFS Green Budgets – and, indeed, in line with the assumption underpinning the official public finance forecasts made for years beyond the current financial year by the OBR (and, under the previous Labour government, by the Treasury) prior to Autumn Statement 2012. While there have often been underspends in recent years, these could become less common as the spending cuts become much deeper. We – like the OBR – are attempting to forecast the strength of the public finances under current policy (i.e. we are not trying to anticipate the net fiscal impact of possible future announcements of changes to taxation or spending). Given that government policy is – presumably – for Whitehall departments to spend the funds that have been allocated to them, it seems appropriate to us to assume that these funds will be spent in future years. In 2015–16 and beyond, this difference in assumption does not affect the level of spending in our baseline forecast.[11]

By 2017–18, there is little difference between the headline fiscal aggregates forecast under the IFS baseline and the OBR's latest forecast. The Chancellor would still meet his fiscal mandate (as shown in Figure 5.15) and be on course to miss his supplementary

[11] Government policy is that, after economy-wide inflation, total public spending should be cut at the same rate in real terms between 2014–15 and 2017–18 as over the period from 2010–11 to 2014–15, *ignoring the impact of any assumed underspend in 2014–15*.

Figure 5.15. Cyclically-adjusted current budget balance forecasts



Note: Figures shown exclude the impact of reclassifying on the public balance sheet Northern Rock Asset Management and Bradford & Bingley, as well as the financial transactions relating to the Asset Purchase Facility.
Source: Authors' calculations. Oxford Economics. Tables 4.4, 4.17, 4.26, 4.32 and 5.1 and box 4.1 of OBR, *Economic and Fiscal Outlook*, December 2012, Cm 8481 (http://cdn.budgetresponsibility.independent.gov.uk/December-2012-Economic-and-fiscal-outlook23423423.pdf).

target (see Figure 5.16). For more discussion of the Chancellor's fiscal targets, see Chapter 4.

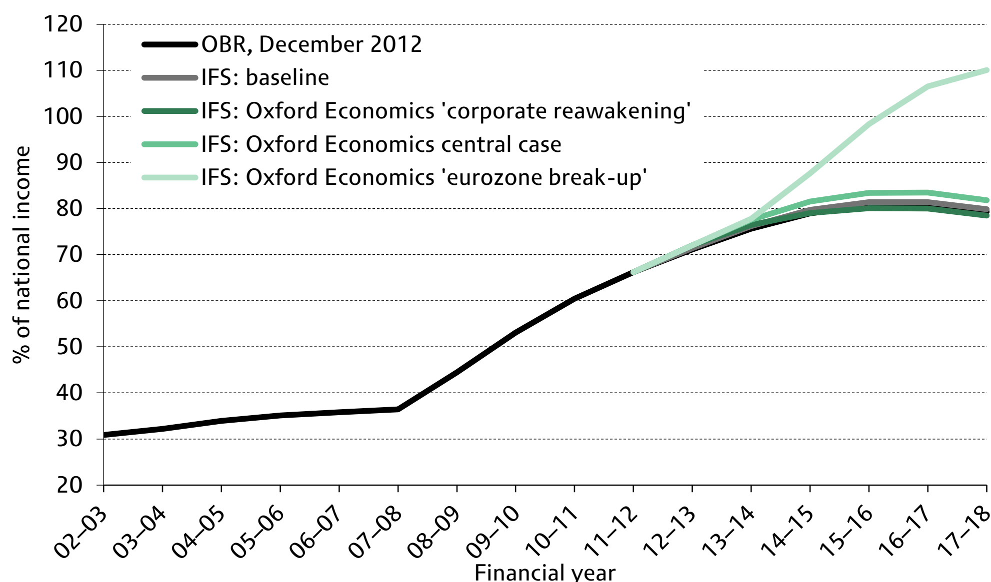
Oxford Economics central case

Under the Oxford Economics central scenario, the IFS forecast is again for the headline fiscal aggregates in 2017–18 to be similar to the OBR's latest forecast. However, under this scenario, trend output is higher than the OBR estimates and therefore there is more spare capacity in the UK economy throughout the forecast horizon. This means that, whereas under the OBR's forecast the headline current budget deficit of 0.4% of national income in 2017–18 translates into a cyclically-adjusted surplus of 0.9%, our forecast headline deficit of 0.2% of national income under the Oxford Economics central scenario translates into a much larger cyclically-adjusted surplus of 2.1% of national income.[12] Therefore, we judge that the underlying health of the public finances would be significantly better under the Oxford Economics central scenario than under the OBR's scenario. If the economy and public finances were to follow the path suggested by the Oxford Economics central scenario (and our forecasts for the public finances on that basis), Mr Osborne could reduce the total planned fiscal consolidation from 9.2% of national income to 8.0% of national income by 2017–18 and still leave cyclically-adjusted borrowing the same as projected by the OBR in the December 2012 Autumn Statement – and, therefore, still comply with his fiscal mandate with the same margin as suggested by the OBR's latest forecast. This 1.2% of national income difference is equivalent to £19 billion in today's terms.

[12] The figures for the cyclically-adjusted current budget surplus presented in Figure 5.15 have (unlike those cited in the text and those in the tables in Appendix A) been adjusted to strip out the effect of the reclassification of the Bank of England's Asset Purchase Facility, Bradford & Bingley and Northern Rock Asset Management on the public balance sheet. See Chapter 4 for a longer discussion of these changes and why we argue that the Chancellor's fiscal targets should continue to be judged on a basis that excludes these reclassifications, as shown in Figure 5.15.

However, even though the underlying health of the public finances is significantly better under the Oxford Economics central case than under the OBR's forecast, we forecast that there would nonetheless be a slightly higher level of total borrowing over the next few years – largely driven, as in our baseline forecast, by higher spending by central government departments than the OBR assumes. Therefore, we forecast that public sector net debt would peak at 82.7% of national income in 2015–16 (2.8 percentage points above the peak level forecast by the OBR) before falling to 79.7% of national income in 2017–18.[13] Under this scenario, as under the OBR's forecast and our baseline one, the Chancellor would be on course to miss his supplementary fiscal target. This is shown in Figure 5.16.

Figure 5.16. Public sector net debt forecasts



Note: As Figure 5.15.
Source: As Figure 5.15.

Oxford Economics optimistic case: 'corporate reawakening'

Under the more optimistic Oxford Economics scenario, stronger economic growth – in particular in employment, consumer spending and real earnings – means that we forecast the public finances would recover more quickly. We forecast that public sector net borrowing would fall to just 0.7% of national income in 2017–18 (compared with the OBR's forecast of 1.6% and our baseline forecast of 1.5%). Part of the faster growth in this scenario represents a more rapid recovery from recession and is, therefore, only a cyclical improvement. But part represents stronger growth in trend output. As a result, the cyclically-adjusted position is also stronger than under any of the other scenarios we consider. Under this scenario, the Chancellor would still be on course to miss his supplementary fiscal target, as we forecast that net debt would rise between 2014–15 and 2015–16 (as shown in Figure 5.16). However, he could reduce his planned fiscal consolidation by 1.6% of national income (or £25 billion in today's terms) and still meet his fiscal mandate with the same margin as forecast by the OBR in December 2012. Oxford Economics places a 15% chance on a scenario similar to this occurring.

[13] The figures for public sector net debt presented in Figure 5.16 have (unlike those cited in the text and those in the tables in Appendix A) been adjusted to strip out the effect of the reclassification of the Bank of England's Asset Purchase Facility, Bradford & Bingley and Northern Rock Asset Management on the public balance sheet. See Chapter 4 for a longer discussion of these changes and why we argue that the Chancellor's fiscal targets should continue to be judged on a basis that excludes these reclassifications, as shown in Figure 5.16.

Oxford Economics pessimistic case: 'eurozone break-up'

Under the more pessimistic Oxford Economics scenario, we forecast that the health of the UK public finances through to 2017–18 would be much worse. Another deep recession in 2014–15 and 2015–16 (driven in this scenario by six countries leaving the eurozone by the end of 2014), with a decline in employment and much lower growth in corporate profits than forecast under the other scenarios, is projected to lead to public sector net borrowing rising to 9.1% of national income in 2015–16. This would leave the Chancellor on course to breach his supplementary target and, depending on when such a scenario emerged, potentially in breach of his fiscal mandate. More fundamentally, we estimate that a scenario similar to this would send public sector net debt above 100% of national income. This would leave the UK even less well prepared to deal with future public finance challenges, such as any arising from the ageing of the population (discussed later) or from future recessions. Oxford Economics places a 15% chance on a scenario similar to this occurring.

Summary of different scenarios of the public finances

These alternative scenarios for the public finances highlight some of the risks surrounding the latest official forecasts and the government's fiscal consolidation plans. The upside risks that are elucidated by these scenarios are as follows:

- Oxford Economics central estimate is that the trend level of output is higher than the OBR currently estimates. This suggests there could be greater scope for tax receipts to grow and spending to fall as the economy bounces back.
- Our forecast for the public finances under the more optimistic Oxford Economics scenario shows how the public finances could recover more quickly if a more optimistic picture for the UK economy than the OBR expects materialises over the next five years.

If these upside risks materialised, some of the currently-planned fiscal consolidation could be reversed while still meeting the Chancellor's fiscal mandate with the same margin as forecast by the OBR in December 2012. Our public finance forecast suggests that under the Oxford Economics central scenario the planned fiscal consolidation could be reduced from 9.2% of national income to 8.0% of national income (a reduction of £19 billion in today's terms), whereas were OE's more optimistic scenario to emerge it could be reduced to 7.6% of national income (or by £25 billion in today's terms).

Conversely, the downside risks that are highlighted by these scenarios are the following:

- Our forecast is that central government departments will not underspend their allocated budgets in the next three years by as large a margin as the OBR forecast in December 2012. As a result of this, we expect central government spending (and hence borrowing) to be higher than forecast by the OBR.
- Our forecast for the public finances under the more pessimistic Oxford Economics scenario shows how the public finances could deteriorate further and then take even longer to recover if a more pessimistic picture for the UK economy materialises over the next five years.

Part of these downside risks are purely temporary and so would not require an additional permanent tightening of fiscal policy – although even a temporarily weaker outlook for the public finances would push the debt level up and this increase could be quite sharp, as suggested by the more pessimistic Oxford Economics scenario, which would see public sector net debt projected to exceed 100% of national income in 2016–17. In addition, part of the weaker economic performance under this scenario is forecast to be permanent

and would thus eventually require a further permanent tightening of fiscal policy to return borrowing in the longer run to the levels implied by the latest OBR forecast.

The next challenge: pressures of an ageing population

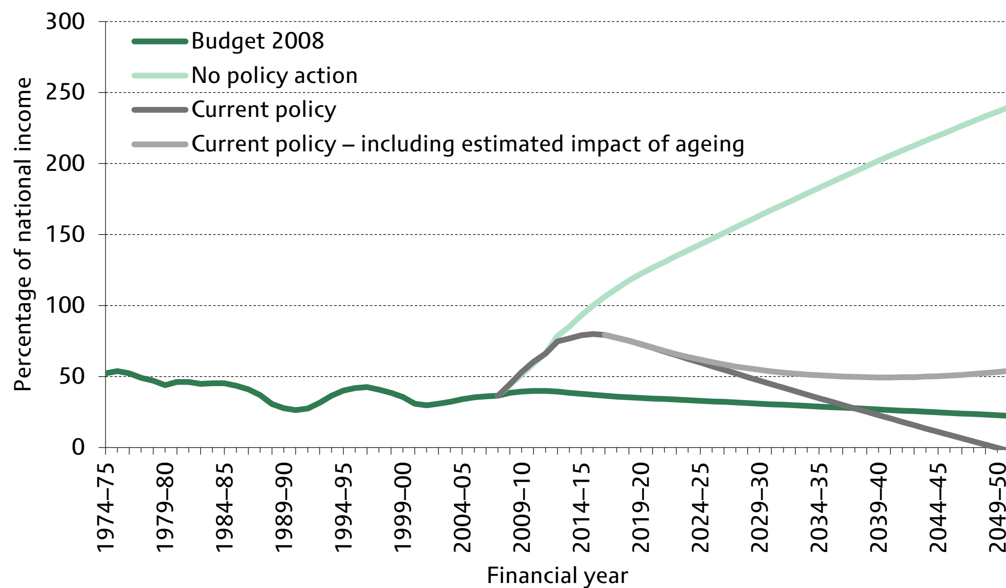
Even if the public finances evolve as the OBR expects up to 2017–18, further policy changes may still be required to keep the public finances on a sustainable path in the longer term. This is because there are a number of further known challenges for the public finances over the next few decades:

- The depletion of North Sea oil and gas reserves will lead to an important revenue stream drying up (see Chapter 10 for a discussion of the taxation of North Sea oil and gas).
- A shift to more efficient motor vehicles – which is necessary if the UK is to meet its targets to decarbonise – will erode revenues from both vehicle excise duty (VED) and fuel duties.
- As a result both of individuals living longer and of fluctuations in historic birth rates, the UK population is ageing. Under current policies, this is projected by the OBR to lead to an increase in public spending as a share of national income, as higher spending on the NHS, long-term care and state pensions outweighs the forecast decline in spending on areas such as education and public service pensions.

The first two of these imply that adjustments need to be made to offset these declining tax revenues. For example, other taxes could be increased to try to keep the overall tax burden unchanged. (The demise of revenues from VED and fuel duties strengthens further the argument for comprehensive road pricing and hopefully makes such a reform more politically feasible.) The costs of an ageing population will, arguably, require harder choices, as either a larger tax burden or cuts to spending (either in areas where it is increasing as a share of national income as the population ages or in areas where it is, or both) will be required if borrowing is to be kept constant.

If fiscal policy were to adjust fully to the public finance cost of the ageing of the population – with tax rises or spending cuts sufficient to offset completely the additional costs of an ageing population – public sector net debt would be on course to decline over time and to fall back to pre-crisis levels of 40% of national income by around 2032–33, as was shown in Figure 5.11 and is repeated in Figure 5.17. However, if instead neither taxes nor spending adjust to deal with the costs of an ageing population and thus borrowing is simply allowed to rise, public sector net debt would be on course to fall to around 50% of national income but then gradually to increase again. To avert this, and to keep us on the 'current policy' path, would not be painless: the estimates in the OBR's July 2012 Fiscal Sustainability Report suggest that a combination of tax rises and spending cuts worth a total of 4.2% of national income, or £65 billion in today's terms, would be required. The single-tier pension proposals set out in a recent DWP White Paper proposed a reform to state pensions that DWP estimates could reduce long-run spending on state pensions by

Figure 5.17. Public sector net debt – alternative scenarios



Notes: As for Figure 5.4. 'Including estimated impact of ageing' uses the OBR's latest forecasts for changes in age-related spending between 2017–18 and 2050–51 from tables 3.6 and 3.10 of Office for Budget Responsibility, *Fiscal Sustainability Report: July 2012* (http://budgetresponsibility.independent.gov.uk/fiscal-sustainability-report-july-2012/).
Source: As for Figure 5.4.

0.4% of national income (which is not included in Figure 5.17); this would go about a tenth of the way to offsetting the pressures of an ageing population on public spending.[14]

5.5 Conclusions

Since 2008, the UK has experienced a large economic shock that has not only temporarily affected our level of economic output but also changed most forecasters' views about the potential strength of the UK economy for evermore. As a result, we have experienced high levels of public borrowing in recent years and are only partway through a large planned fiscal consolidation designed to get the UK's public finances back to a more sustainable position. The fiscal consolidation plans include a substantial squeeze on public service spending over a seven-year period, the majority of which is yet to materialise and is set to continue well into the next parliament. One key risk to the public finances, therefore, is that this or the next government proves unable or unwilling to cut public spending as sharply as currently planned. The difficult choices implied by the planned cuts to public service spending are discussed in more detail in Chapter 6.

There is also a risk to the public finances that net tax cuts are implemented in coming Budgets. While recent history suggests that, on average, small net tax cuts have been announced in the Budgets preceding general elections, a more striking pattern is the tendency for net tax rises to be announced in the 12 months following a general election.

There are also a number of other uncertainties surrounding the outlook for the UK's public finances. The economy and public finances could turn out better or (as recent years have demonstrated) worse than the OBR currently expects.

[14] Department for Work and Pensions, *The Single-Tier Pension: A Simple Foundation for Saving*, Cm 8528, 2013 (http://www.dwp.gov.uk/docs/single-tier-pension.pdf).

On the upside, the trend level of UK economic output could be higher than the OBR currently estimates; the OBR's estimate of spare capacity in the UK economy is roughly in the middle of other independent forecasts. If spare capacity is actually greater than the OBR thinks, there would be more scope for tax revenues to grow and spending to fall as the economy bounces back over the coming years. This upside risk is demonstrated by our public finance forecast under the Oxford Economics central scenario, which suggests that structural borrowing would be 1.2% of national income (or £19 billion in today's terms) lower in the medium term than the OBR's latest forecast. Were the OBR to adopt such a scenario, Mr Osborne could reduce his planned fiscal consolidation package from 9.2% of national income to 8.0% of national income and still expect to reduce the structural deficit as his plans currently imply.

One obvious downside is that the trend level of economic output could be lower than the OBR estimates. That is certainly the view of a number of forecasters. If the currently least optimistic independent forecaster (Fathom Consulting) is correct and the output gap is 2.3 percentage points smaller than the OBR estimates, the structural deficit would be estimated currently to be around 1.6% of national income larger. Were the OBR to adopt this estimate of the output gap, and leave its assumed growth in trend output unchanged, the government would need to find approximately another £25 billion of tax increases or spending cuts to expect to reach the same cyclically-adjusted borrowing level that it is targeting for 2017–18.

In addition, there could be further adverse shocks to the UK economy – for example, driven by changes in the global economy. This could lead to substantially higher borrowing in the medium term than currently expected. Our forecast under the more pessimistic Oxford Economics scenario is that headline borrowing would still be at 7.4% of national income in 2017–18 and that public sector net debt would climb sharply to above 100% of national income. This would represent a further considerable worsening in the outlook for public sector net debt since 2008 and would leave the UK even less well prepared to deal with future public finance challenges such as those arising from the ageing of the population and those arising from any future recession.