Public finances: risks on tax, bigger risks on spending?

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The planned consolidation

Notes and sources: see Figure 1.2 of *The IFS Green Budget: February 2014*. 

We are here 4.7% (46%) done 

10.1% tightening planned
Bringing tax and spend back to pre-crisis levels

Notes and sources: see Figure 1.1 of The IFS Green Budget: February 2014.
Illustrative projections for debt

Notes and sources: see Figure 1.4 of The IFS Green Budget: February 2014.
How might the public finances differ under Labour?

• “The next Labour government will balance the books and deliver a surplus on the current budget and falling national debt in the next Parliament”
  – “How fast we can go will depend on the state of the economy and public finances we inherit”

• Coalition planning £26 billion current budget surplus in 2018–19

• Labour could cut taxes and/or increase day-to-day spending by up to £26 billion and meet their pledge in 2018–19
  – Could also spend more on investment

• Current budget surplus less constraining than budget surplus
  – Labour government might aim to over-achieve
  – Trade off between benefits of higher spending/lower tax and cost of debt falling less rapidly
Plenty of risks still remain

• Current forecasts are for a positive medium term picture
  – Borrowing: surplus forecast for 2018–19
  – Debt: on a declining path from 2015–16

• But plenty of risks still remain...

• Don’t know for sure how large a consolidation is required
• Uncertainty around recovery in tax revenues
• Probably biggest uncertainty is whether planned cuts to public service spending can/will be implemented
  – Only 37% of planned cuts to day-to-day spending on public services done so far
How large a fiscal consolidation is required?

• Independent forecasters disagree on the size of the ‘output gap’
  – ‘Output gap’ = difference between level of national income and potential/trend level of national income; amount of spare capacity

• Matters because it determines the division of borrowing into:
  – Cyclical: Caused by economy being below potential and will disappear as the economy recovers
  – Structural: Will not just disappear as the economy recovers

• If output gap is larger than OBR currently forecast:
  – → economy is further below trend
  – → more of borrowing is cyclical
  – → more of borrowing will disappear automatically
  – → smaller consolidation required
How large a fiscal consolidation is required?

Figures illustrate tightening required for structural borrowing in 2018–19 to be forecast to be the same as was forecast for the medium term in Budget 2008 (1.2% of national income) – i.e. to offset all of the permanent increase in structural borrowing arising from the financial crisis.

Notes and sources: see Table 2.1 of The IFS Green Budget: February 2014.
Risks to future tax revenues

Policy risk?

- Little future increase in revenues forecast to come from tax increases that have yet to be implemented
  - NICs increase (£4.9 billion): relatively little risk
  - Anti-avoidance policies (around £2 billion): more uncertain
- Implemented policies may raise less than expected...
  - E.g. Bank levy rate has needed to be increased in every Budget and Autumn Statement under coalition (will now be more than twice that originally intended in 2014) to raise the originally planned revenue
- Future policy action might reduce revenues...
  - E.g. OBR forecasts assume that fuel duty rates will increase in line with inflation, but coalition to date has never done this. Freezing fuel duty rates until after 2018–19 would cost £4.2 billion
Risks to future tax revenues

Other risks?

• Increase in receipts 2013–14 to 2018–19 driven by increases in income tax and capital taxes
  – (capital taxes = capital gains tax, inheritance tax and stamp duties)
• Are forecasts for these too optimistic?
  – Forecast profiles are not out of line with the profile of these receipts seen after the 1990s recession
Risks to future tax revenues
Changing composition of revenues?

- Highest proportion of net taxes and NICs from capital taxes since at least 1978
- Increasingly coming from a relatively small number of high income people
  - Top 1% contributed:
    - 11% in 1979
    - 21.3% in 1999-2000
    - 27.5% in 2011-12

Notes and sources: see Table 2.5 of The IFS Green Budget: February 2014.
Planned cuts to spending

2010–11 to 2018–19:
Total spending: −3.8% (−£28.3bn)
Debt interest: +46.9% (+£22.5bn)
Non-debt interest: −7.4% (−£50.8bn)

Notes and sources: see Figure 2.6 and Table 2.3 of The IFS Green Budget: February 2014.

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Planned cuts to spending

2010–11 to 2018–19:
- Non-debt interest: −7.4% (−£50.8bn)
- Social security: +8.5% (+£17.0bn)
- Public services: −13.8% (−£67.8bn)

Notes and sources: see Figure 2.6 and Table 2.3 of The IFS Green Budget: February 2014.
Planned cuts to spending

2010–11 to 2018–19:
- Public services: $-13.8\%$ (−£67.8bn)
- Departmental: $-20.4\%$ (−£82.3bn)
- Other non-dept.: $+16.8\%$ (+£14.6bn)

Public service spend
Departmental
Other non-departmental spend

£ billion (2013-14 prices)

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Notes and sources: see Figure 2.6 and Table 2.3 of The IFS Green Budget: February 2014.
Departmental spending cuts not set in stone

- Departmental spending beyond 2015–16 not explicitly planned
  - Equals planned total spending less OBR forecasts for social security and other non-departmental spending
  - $\Rightarrow$ Changes in these will have implications for departmental spend
- New “welfare cap” could reduce unanticipated increases in social security spending
- Government could choose to cut social security further
  - £12 billion would reduce departmental spending cuts between 2015–16 and 2018–19 to the same rate as over 2010–11 to 2015–16
  - Cut of 17.1% between 2010–11 and 2018–19 (‘unprotected’: –31.2%)
  - £12 billion equivalent to 6% of all social security spending, 11% of non-pension spending, or 13% of spending on non-pensioners
Are these cuts deliverable?
A reason to think yes...

• Government departments have (more than) delivered the budget cuts required in 2011–12 and 2012–13
  – Likely that political cost of over-spending means that departments treat their budgets as a cap rather than a target

• ⇒ Suggests mechanism is there: departments look like they can deliver the spending cuts if they are required to...
  – (though this will get harder!)
Are these cuts deliverable? A reason to think no...

- But would a future government want to stick to these plans once the associated fall in service provision and/or quality becomes more apparent?
- Large cuts to public service spending still to come
  - These are likely to get harder/more painful to deliver
- The above figures also understate the squeeze on spending
  - Additional spending commitments
  - Demographic pressures
Additional spending commitments

- Some policies cost (more) money beyond 2015–16
  - Increased employer NICs in the public sector => £3.3 billion
  - Dilnot reform to social care funding => £1.0 billion
  - Tax-free childcare scheme => £0.4 billion

- Autumn Statement 2013 announced spending policies but provided no additional funds beyond 2015-16
  - Extension of free school meals (£0.8 billion)
  - Abolishing HE student number cap (£0.7 billion by 2018-19)

- Need to be funded from within departmental spending => increases the pressure on other areas

- Adds up to £6.2 billion (around 2% of departmental spending)
Demographic pressures

- Population increasing which increases demand for public services
  - ONS projects population will grow by 5.6% (3.5 million) between 2010 and 2018
- Public service spending forecast to fall by average 1.7% per year 2010–11 to 2018–19 but spending per person to fall by 2.4%
- Population also ageing which puts particular pressure on public services used more by older people
  - ONS projects population aged 65 and over will grow by 20.0% (2.0 million) between 2010 and 2018
- For example: Real freeze in NHS spending between 2010–11 and 2018–19 would actually be a 9.1% cut in real age-adjusted NHS spending per person
  - NHS may be ‘protected’ but still considerable squeeze
The bottom line:

- Public service spending reduced to the share of national income seen at the end of the 1990s (technically: lowest since at least 1948)

Will this be acceptable to voters or will higher taxes, lower social security spending or higher borrowing be preferred?
Summary (1/2)

• Four years through a nine year fiscal consolidation
  – 4.7% out of the planned 10.1% tightening done by end 2013–14
• If the rest is implemented, and if forecasts prove correct, then government will be running a surplus in 2018–19
• But plenty of risks (positive and negative) still remain
• Increasingly reliant on a few high income individuals for a large proportion of tax revenue
  – In 2011–12 top 1% of income tax contributors (300,000 individuals) contributed 27.5% of income tax receipts (=7.5% of all revenues)
• Government probably going to freeze fuel duties again in future
  – Freezing duties until after 2018–19 would cost £4.2 billion
Implementation of planned cuts to spending is very uncertain

‘Unprotected’ depts could be cut by 31.2% between 2010–11 and 2018–19 even if £12 billion further cut to social security spending

Government still announcing additional spending priorities
  – Increases the pressure on budgets by around £6 billion (2%)

Demographic pressures mean increasing demand for services
  – Eg. Real freeze in NHS spending would actually be a 9.1% real cut in age-adjusted NHS spending per person

Will people be happy with lower service provision/quality?
  – Or would higher taxes or borrowing be preferred?

On a brighter note, the fiscal consolidation required may still turn out to be smaller than currently estimated