

The crisis, the consolidation and Britain's public finances

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St Catharine's College, Cambridge, 30 April 2014

Outline

- **The Budget 2008 forecast**
- **What happened instead**
- **Impact on receipts and spending**
- **Balancing the budget: will it happen and how?**

The outlook in March 2008

- **Financial crisis underway, but impact on economy and public finances still expected to be modest**
- **“Because of the changes made by this Government to entrench stability and increase the flexibility and resilience of our economy, I am able to report that the British economy will continue to grow through this year and beyond.”**

(Alistair Darling, 2008 Budget speech)

- **Outside forecasters only a bit more pessimistic**

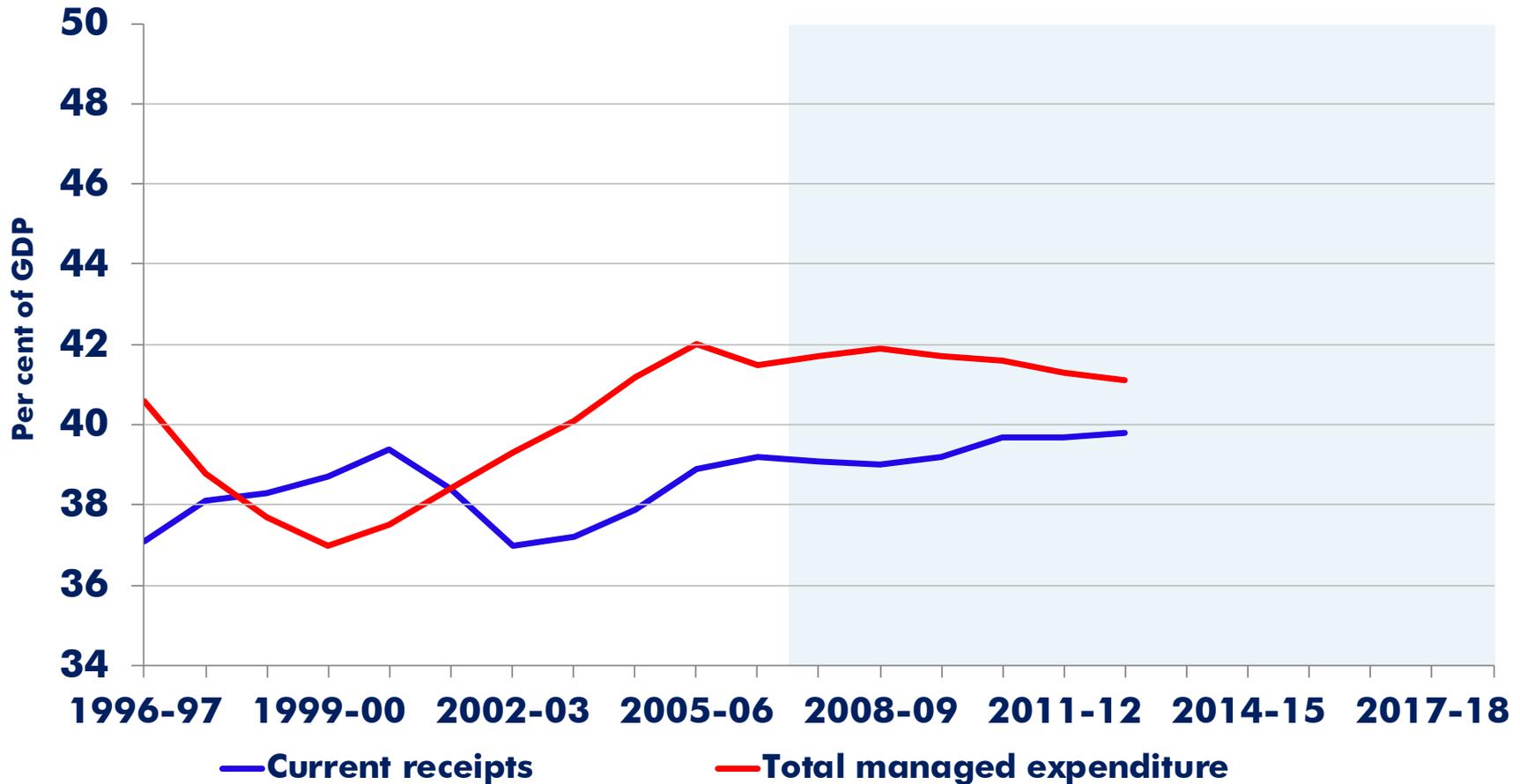
March 2008 GDP growth forecasts

Cumulative real GDP growth forecast for calendar years 2008 and 2009



Public sector net borrowing

Budget 2008



Benign fiscal outlook reflected...

- **Real GDP growth dipping to 1³/₄% in 2008, then rising to 2¹/₂%**
- **Nominal GDP growth steady at 4³/₄ – 5¹/₂% a year**
- **Potential GDP growth steady at 2³/₄% a year (2¹/₂% assumed)**
- **Financial sector profits recovering after brief disruption**
- **Equity prices rising with money GDP**
- **House prices flat in 2008, then growing with earnings**
- **Housing transactions remaining at pre-crisis levels**
- **CPI inflation stable at 2% from second half of 2009 onwards**
- **Real earnings growth stable at around 2%**
- **Little movement in Gilt rates**

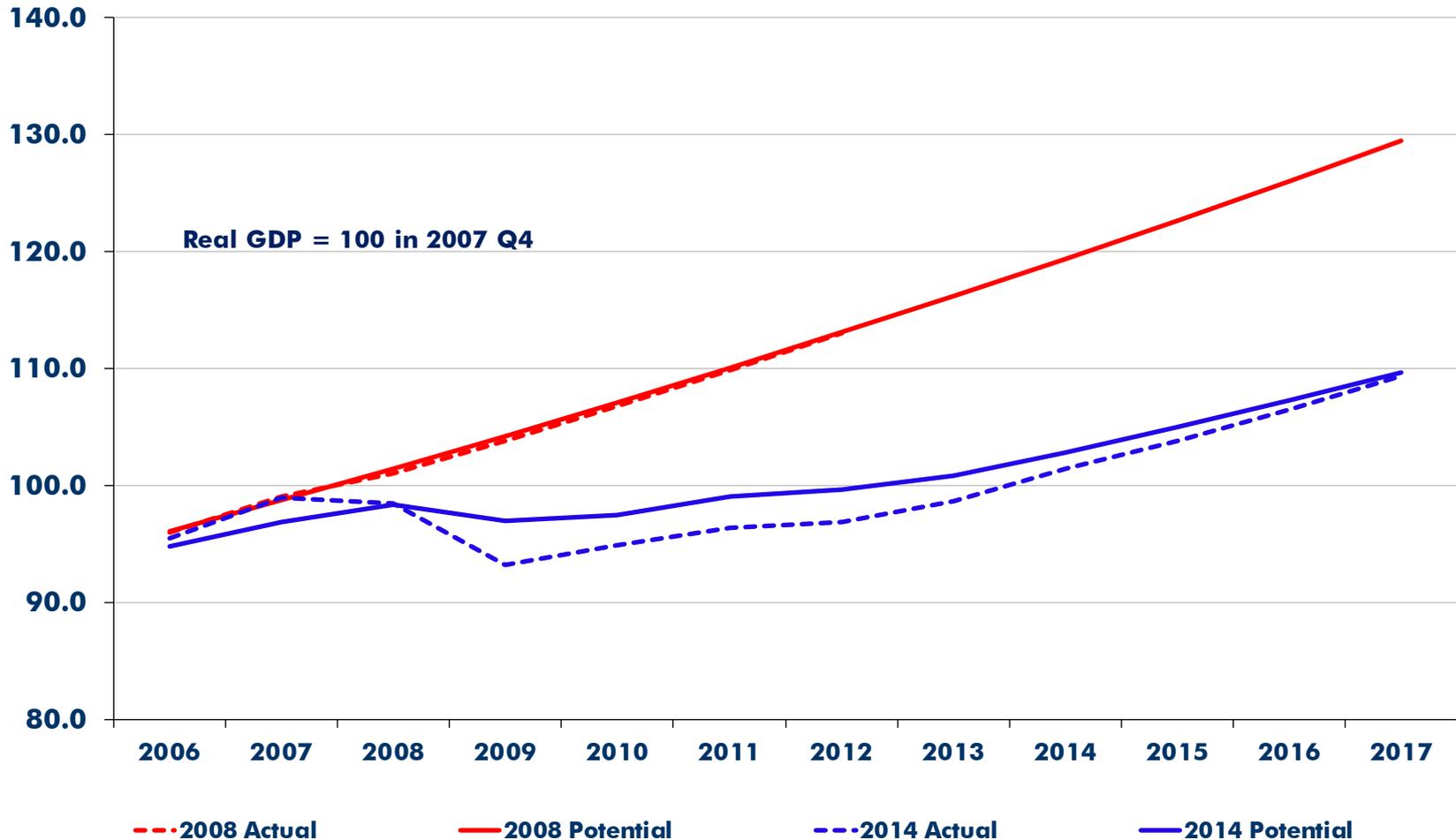
But instead...

<i>Change from 07-08 to 12-13</i>	Budget 08	Outturn
Real GDP	+13.8%	-2.6%
Nominal GDP	+30.4%	+7.9%
Nominal wages and salaries	+30.2%	+8.7%
Nominal consumer spending	+29.1%	+12.5%
Nominal financial profits	+53.8%	+7.1%
Nominal non-financial profits	+28.7%	+3.4%

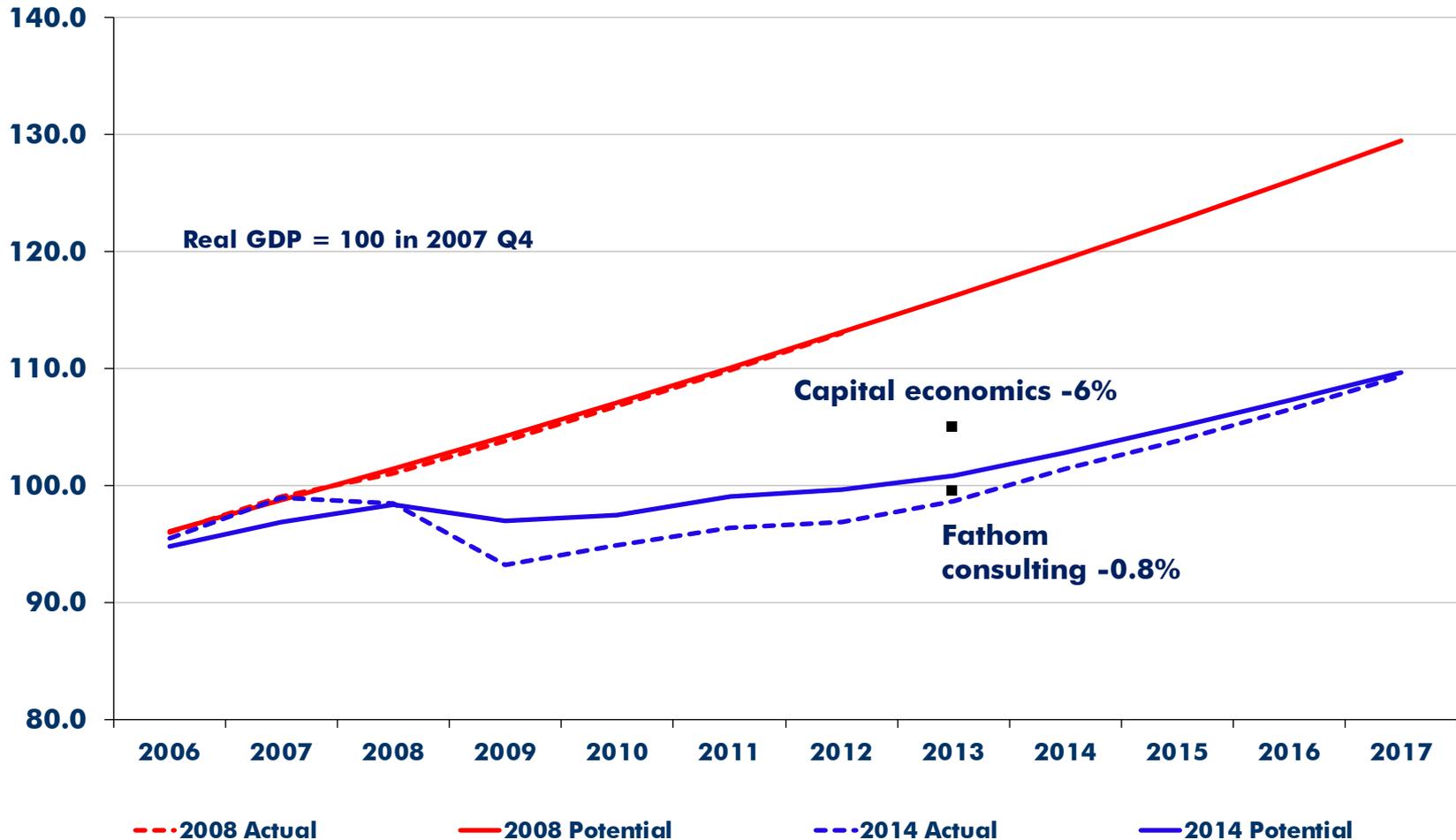
But instead...

<i>Change from 07-08 to 12-13</i>	Budget 08	Outturn
Employment	+720k	+294k
Unemployment	+235k	+754k
Consumer prices index	+11.2%	+17.5%
Retail prices index	+15.6%	+17.4%
Equity prices	+15.3%	-4.7%
House prices	+19.7%	-2.3%
Housing transactions	+10.7%	-36.5%
Sterling oil prices	+£11	+£34
10-year gilt yields	-0.1 ppt	-3.0 ppt

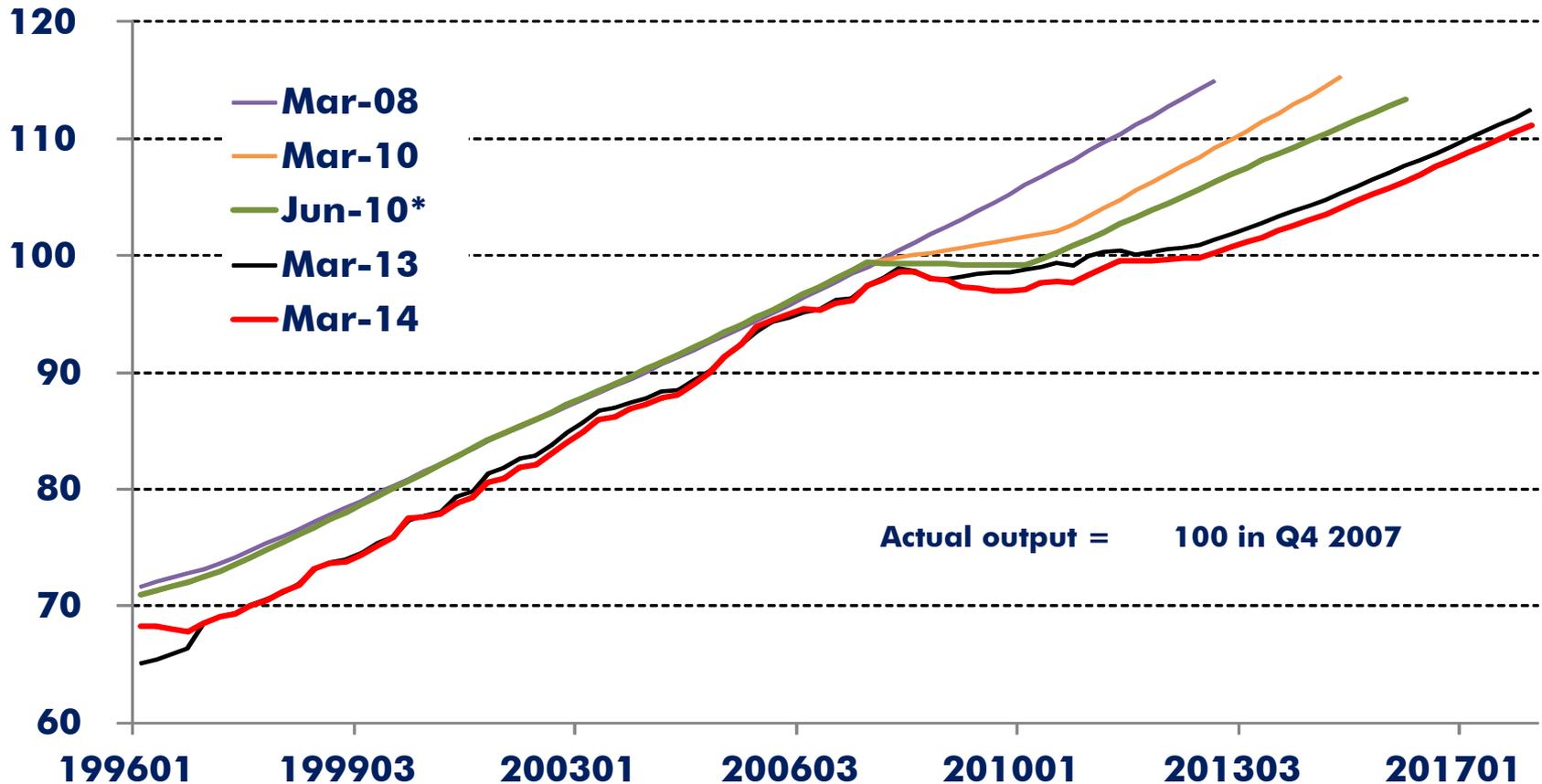
Actual and potential GDP



Actual and potential GDP



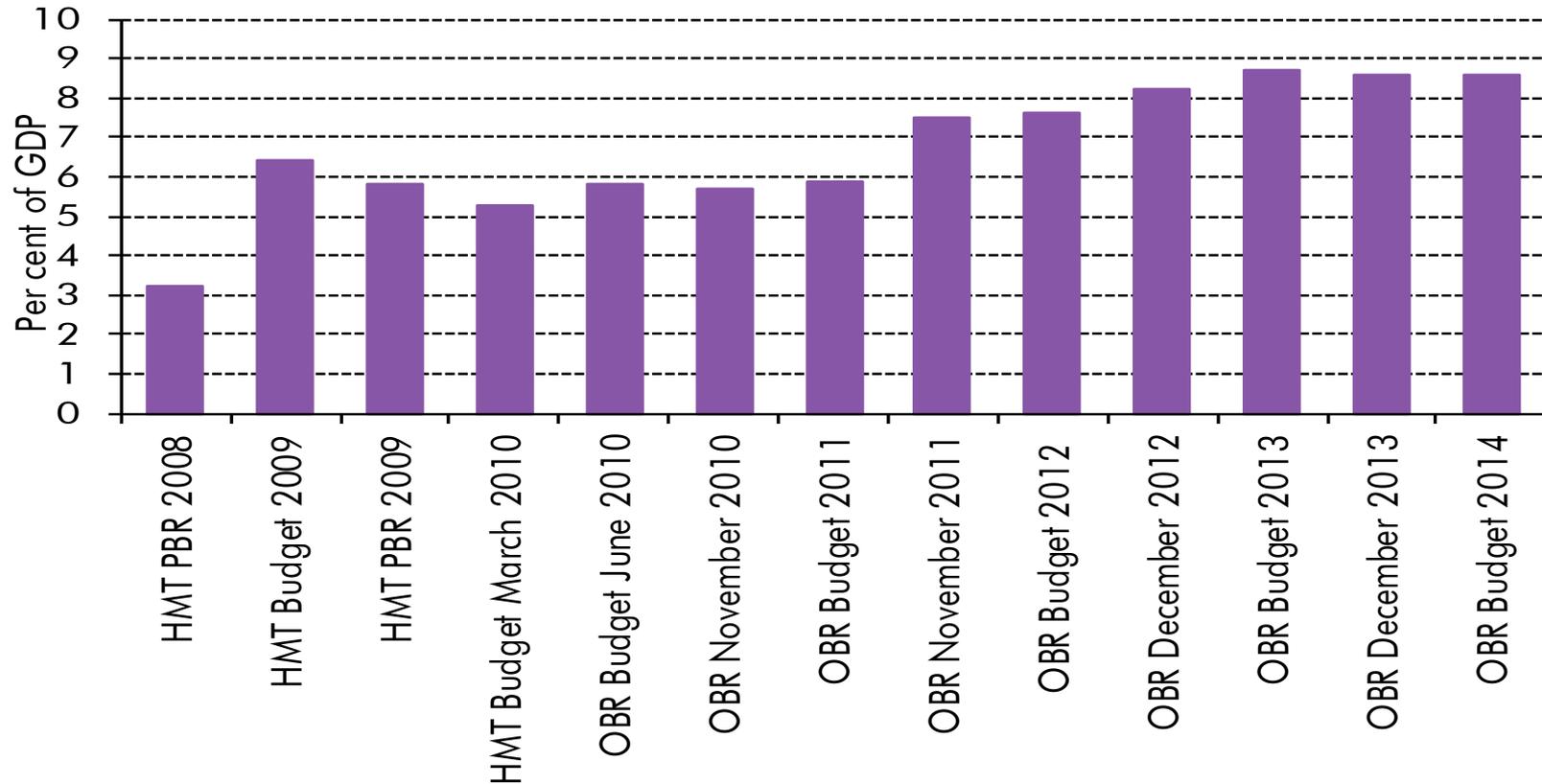
Forecasts of potential GDP



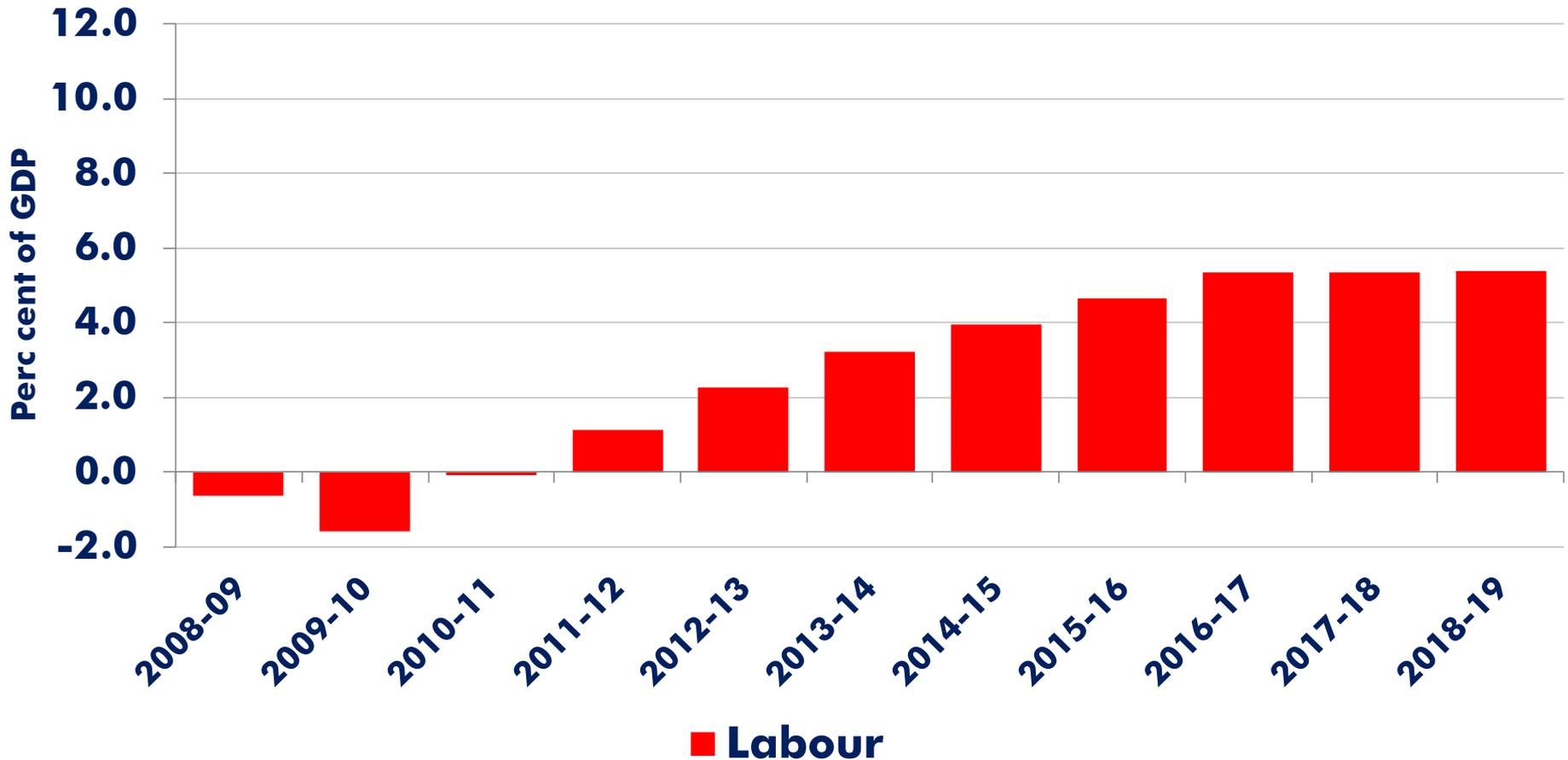
*In June 2010 the OBR had not produced a historical potential output series

The 'hole' in the public finances

Deterioration in medium-term structural budget balance relative to March 2008 Budget forecast



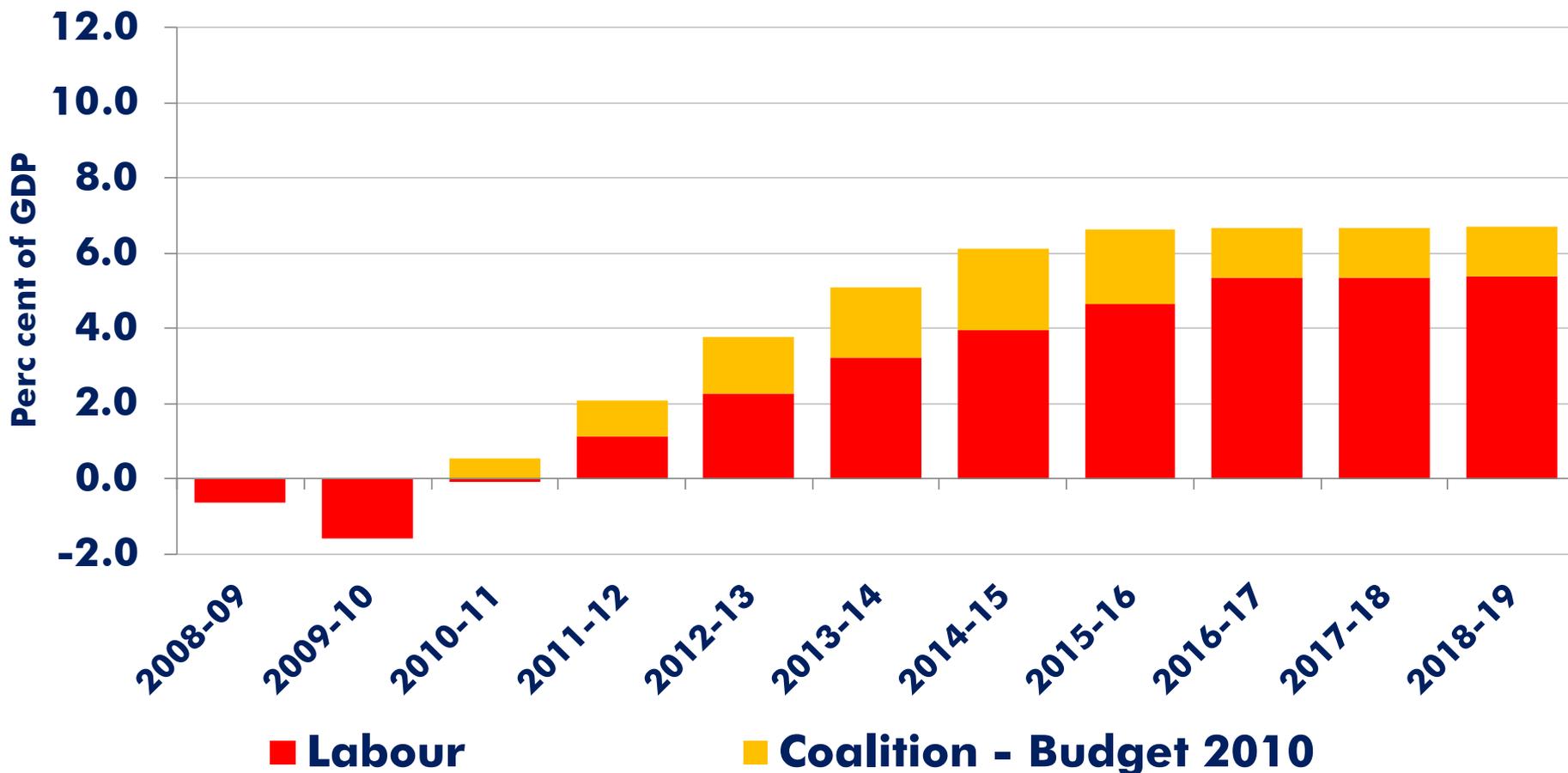
Policy measures post Budget 08



Source: Institute for Fiscal Studies

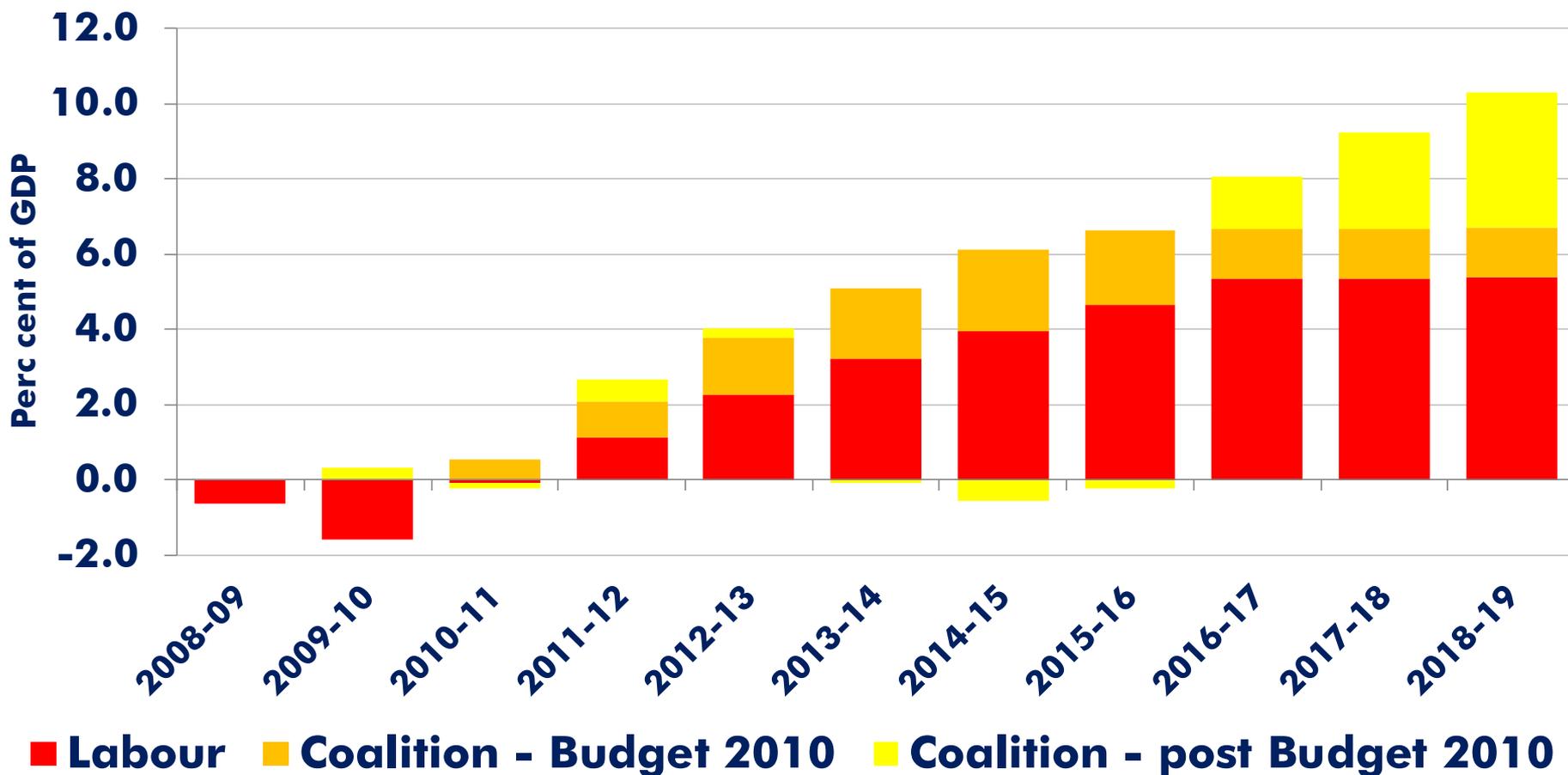
Office for
**Budget
Responsibility**

Policy measures post Budget 08



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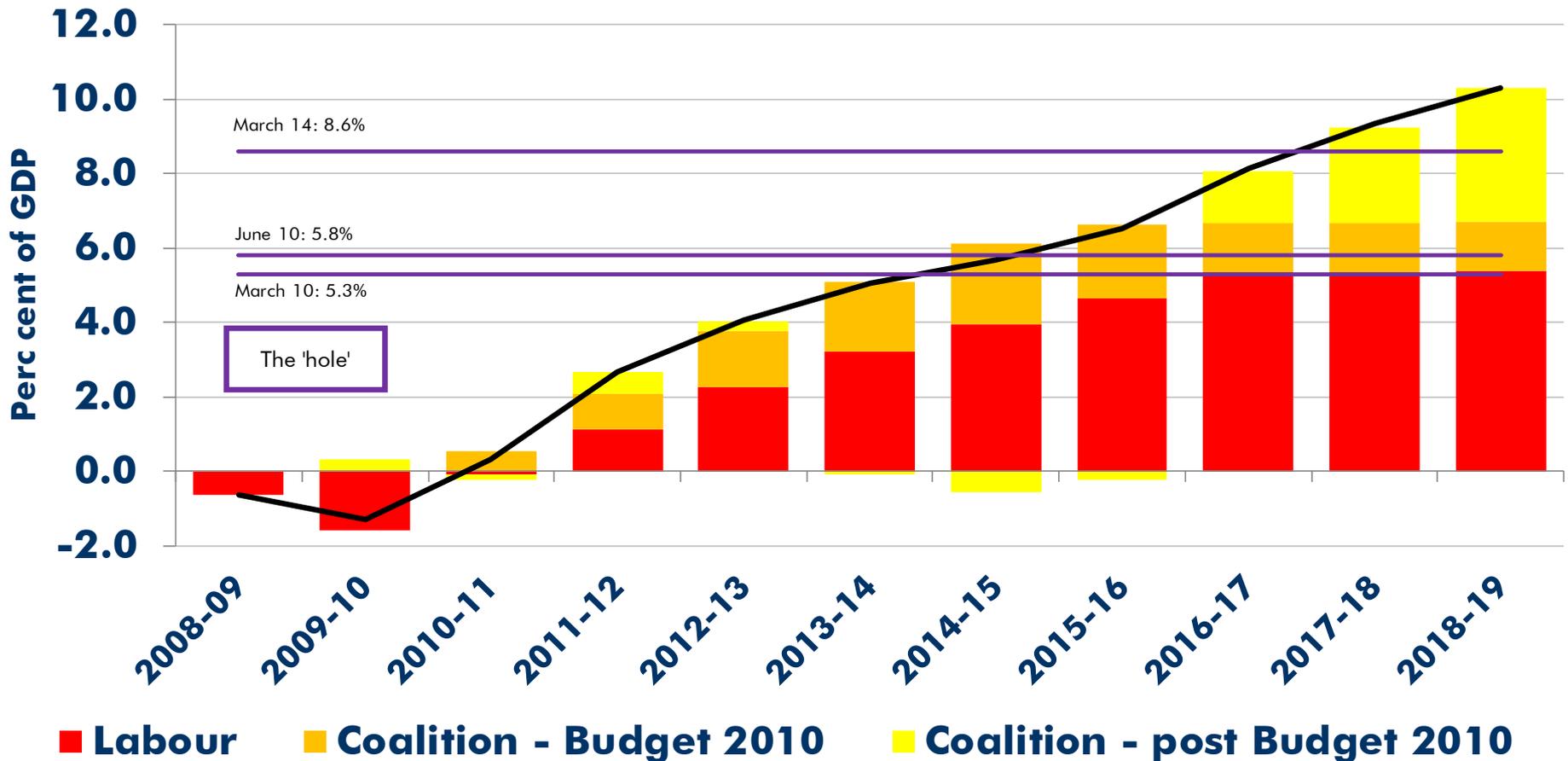
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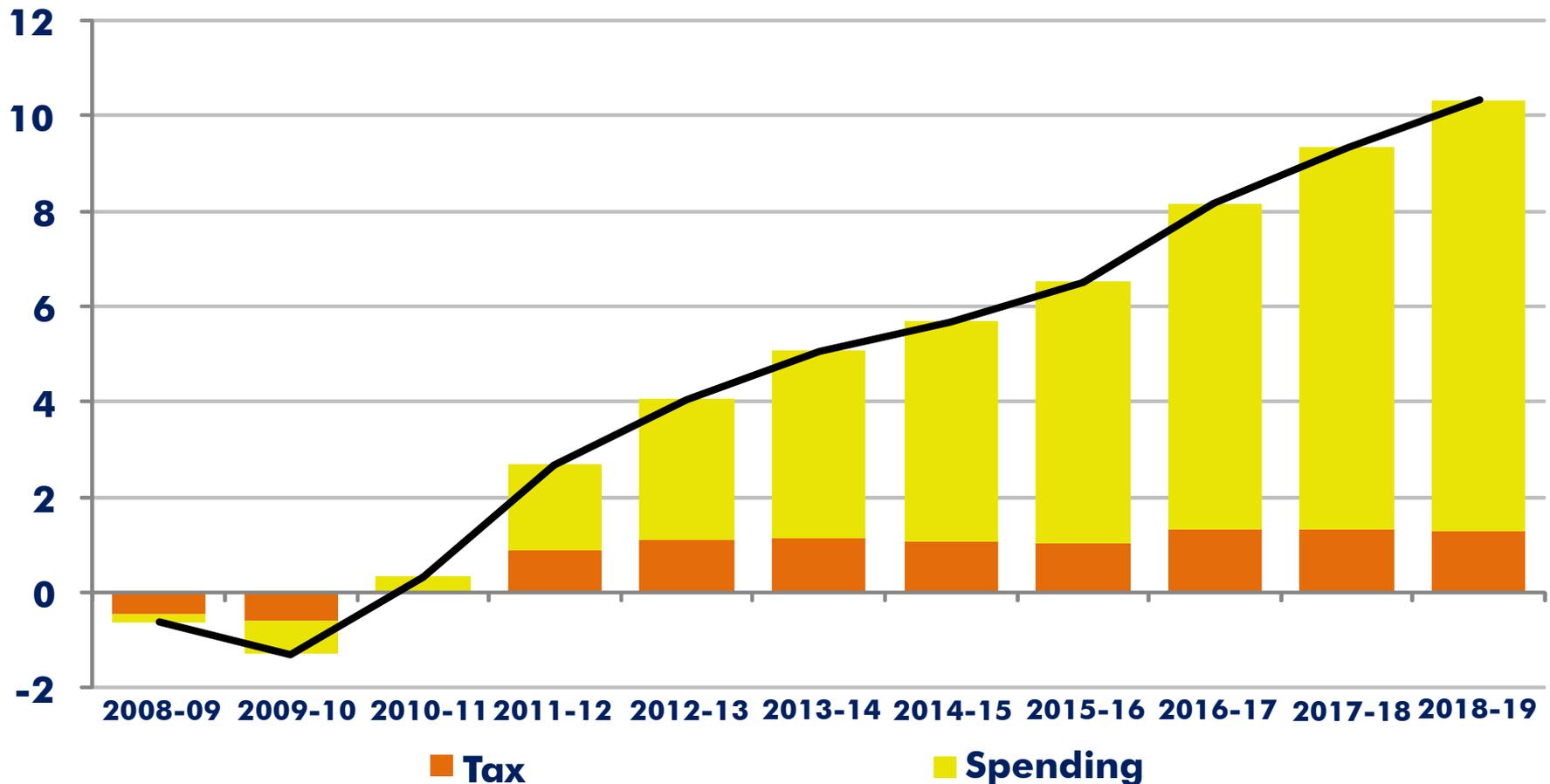


NB: Measures include re-costing of previously implemented measures, notably 50p income tax rate

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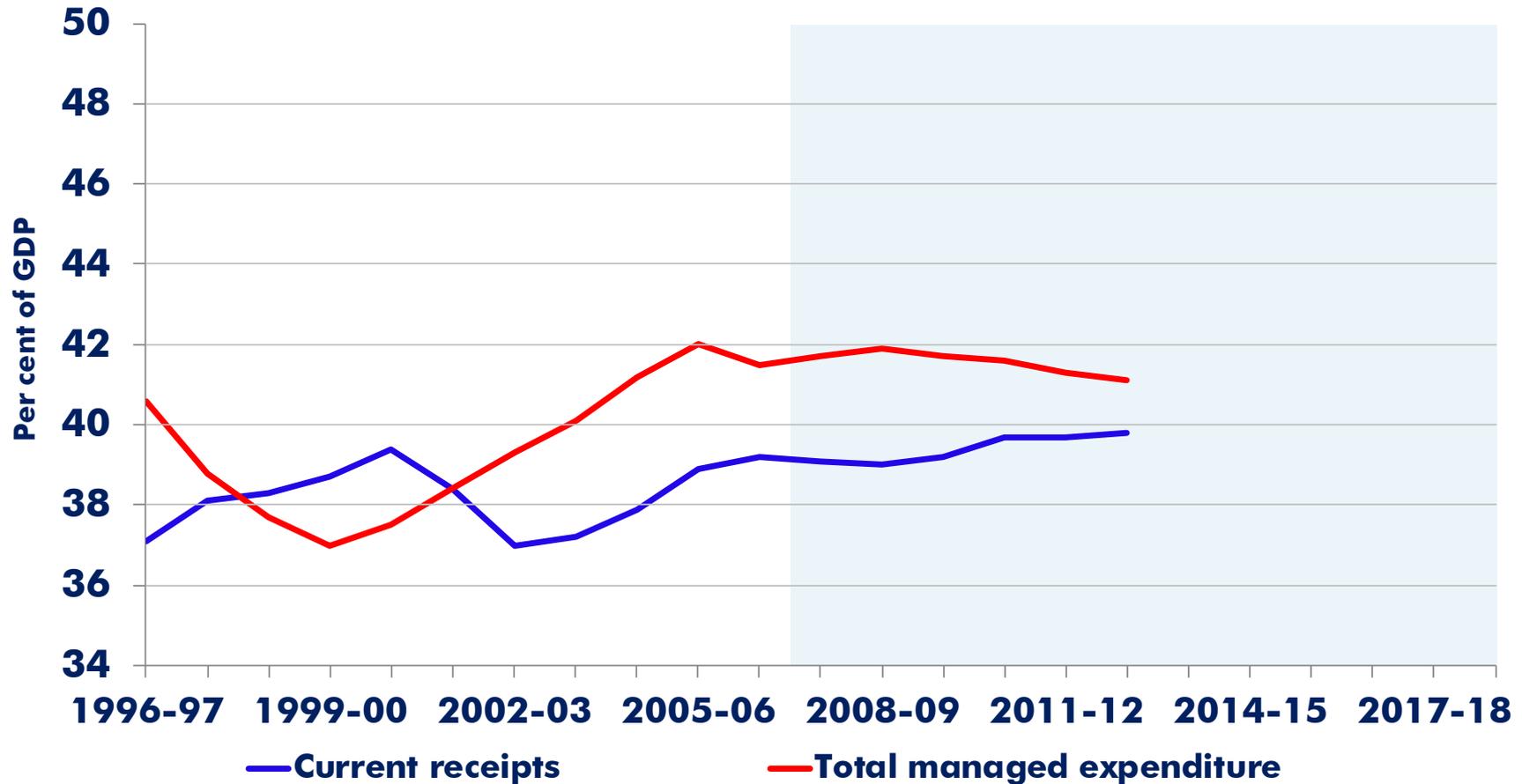


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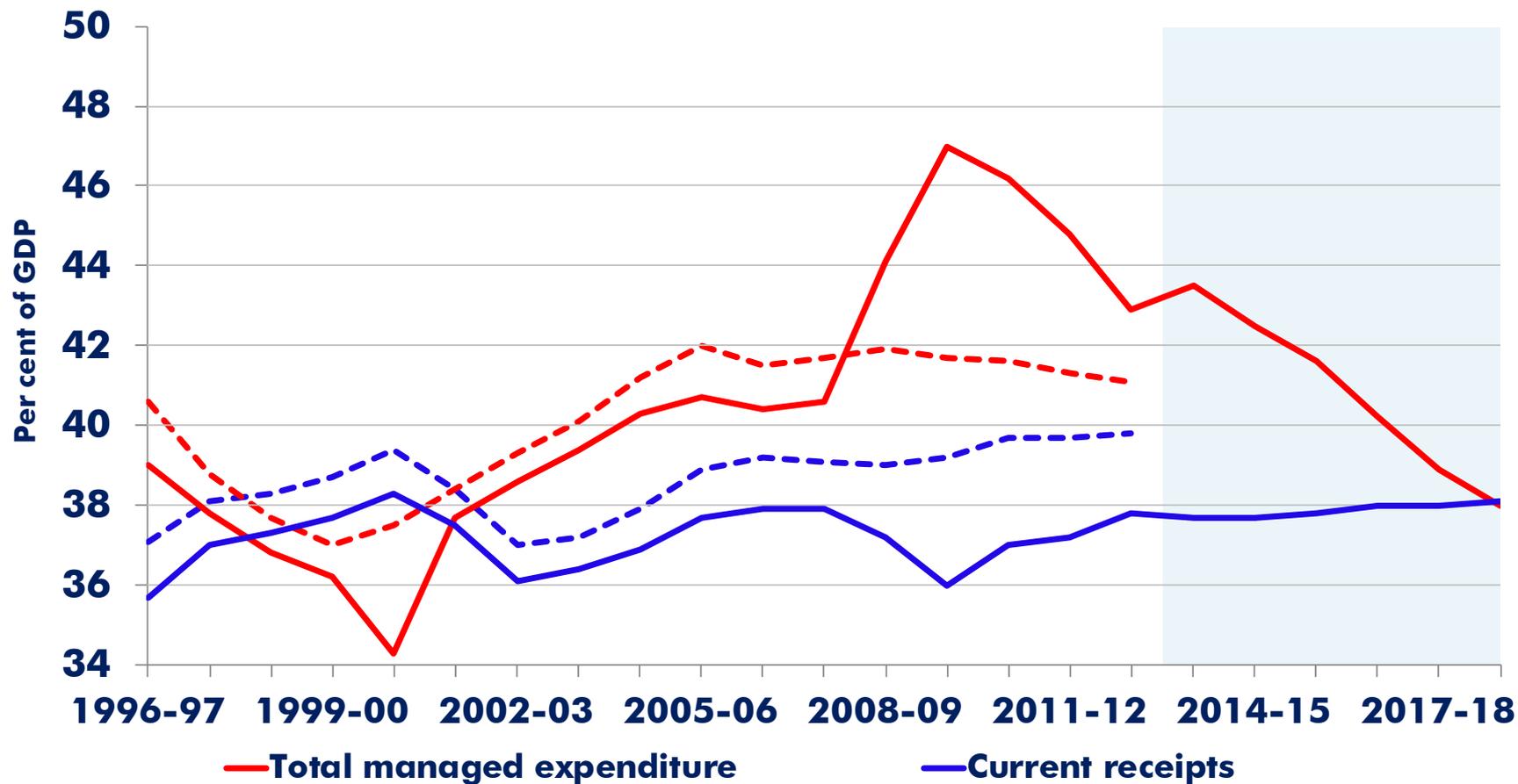
Public sector net borrowing

Budget 2008



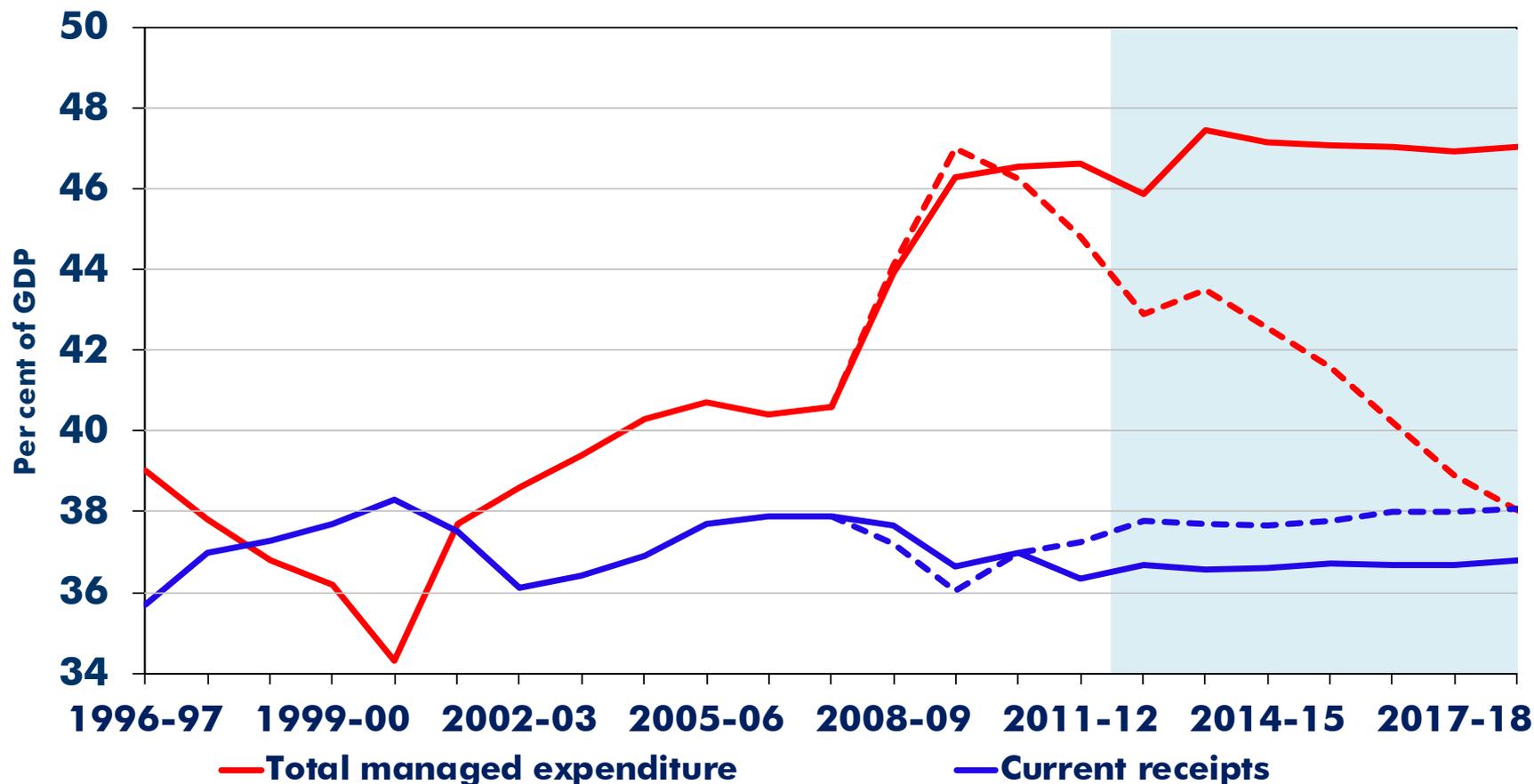
Public spending and receipts

Budget 2008 and March 2014 forecasts

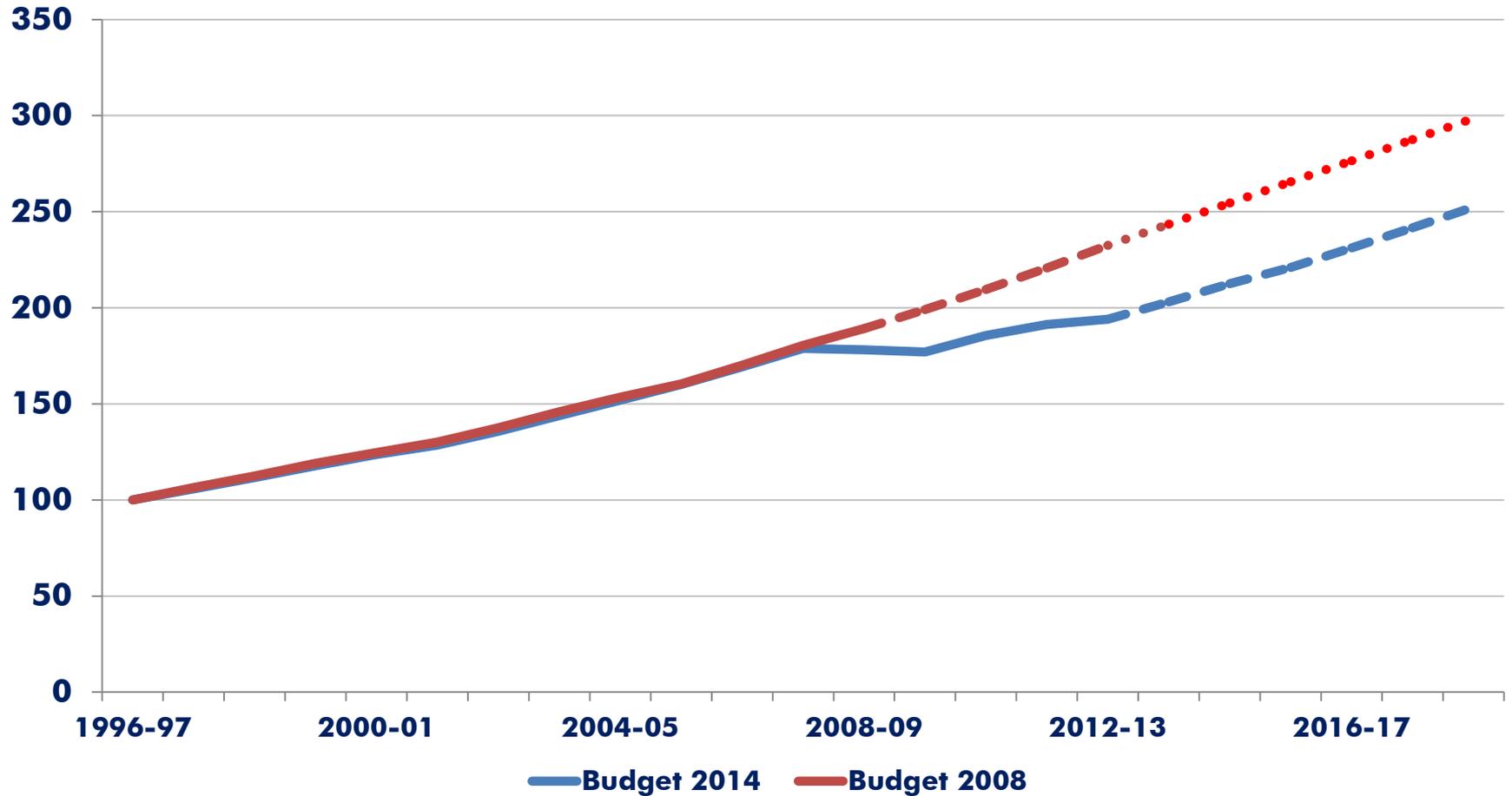


Public spending and receipts

March 2014 forecast: including and excluding post Budget 2008 measures

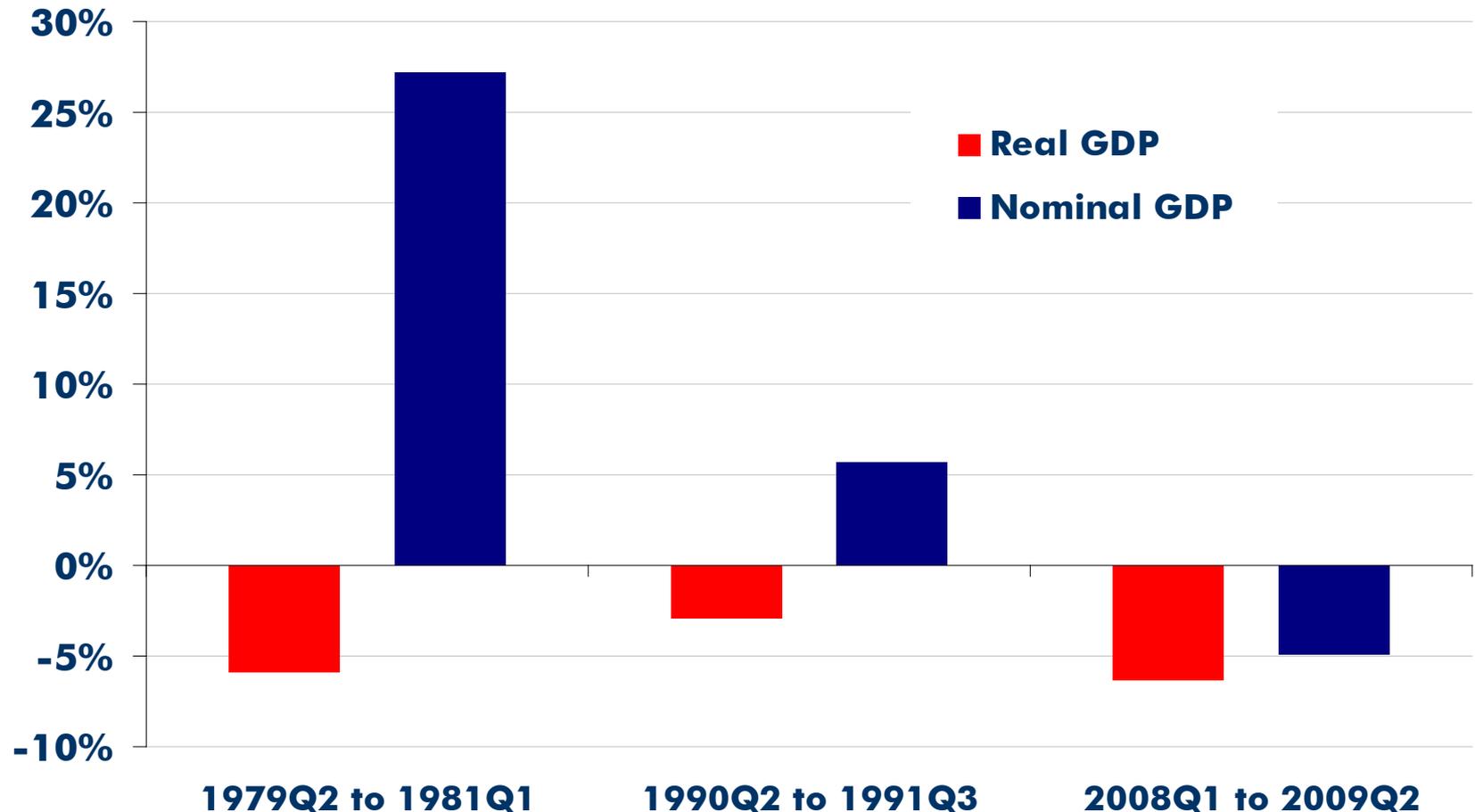


Nominal GDP permanently lower



NGDP fell in this recession

Changes over period of peak to trough fall in real GDP



Nominal GDP since 2008 in the G7



■ Real GDP growth ■ GDP deflator growth ◆ Nominal GDP growth

Spending or receipts problem?

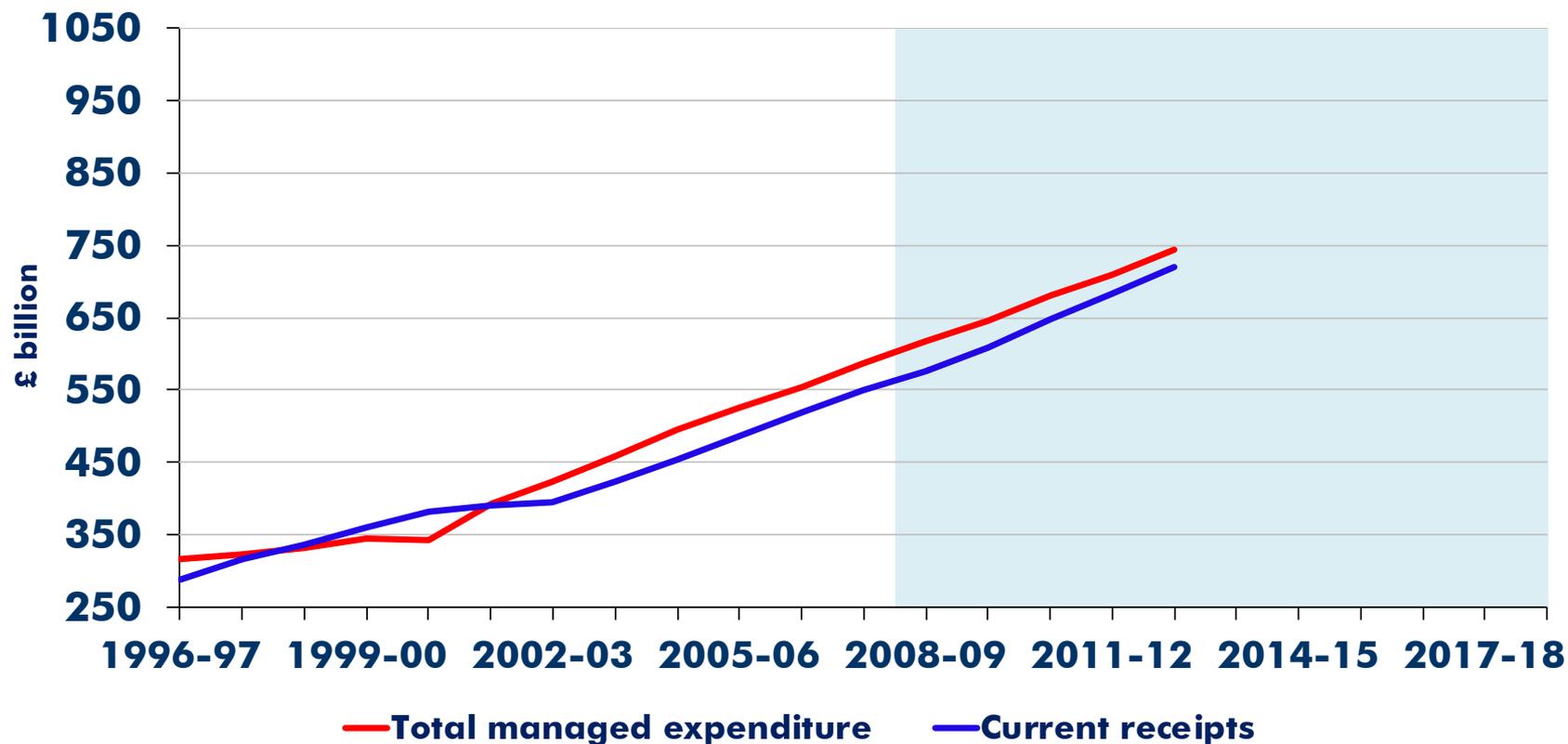
<i>2009-10: error relative to Budget 2008 forecast</i>	Cash	% Nominal GDP*
Receipts	-£96bn	-2.3%
Spending	+£25bn	+6.7%

*excluding revisions to 2007-08 NGDP)

- **Nominal GDP fell 1.2% from 2007-08 to 2009-10, compared to the Budget 2008 forecast of a 10% rise**

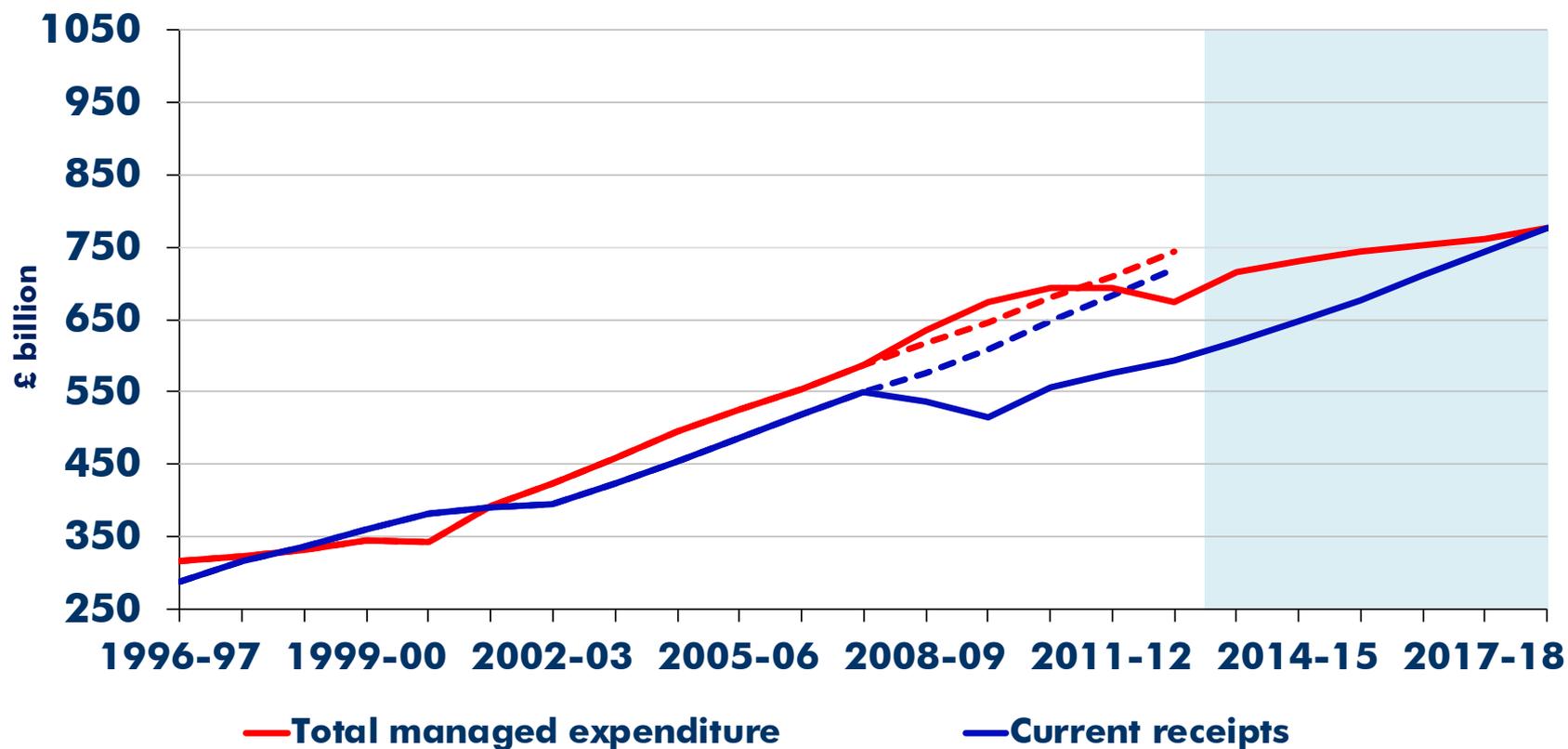
Public spending and receipts

Budget 2008



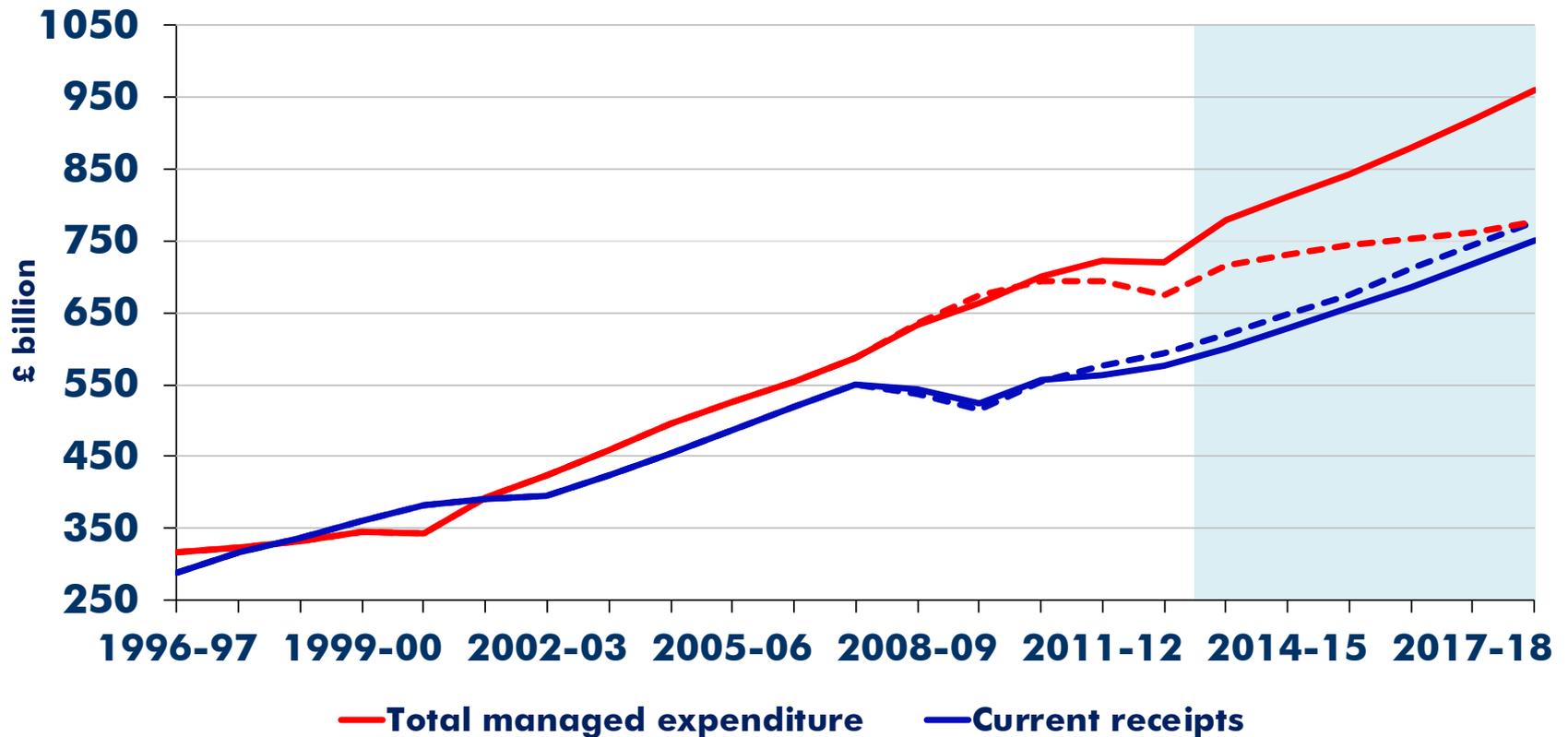
Public spending and receipts

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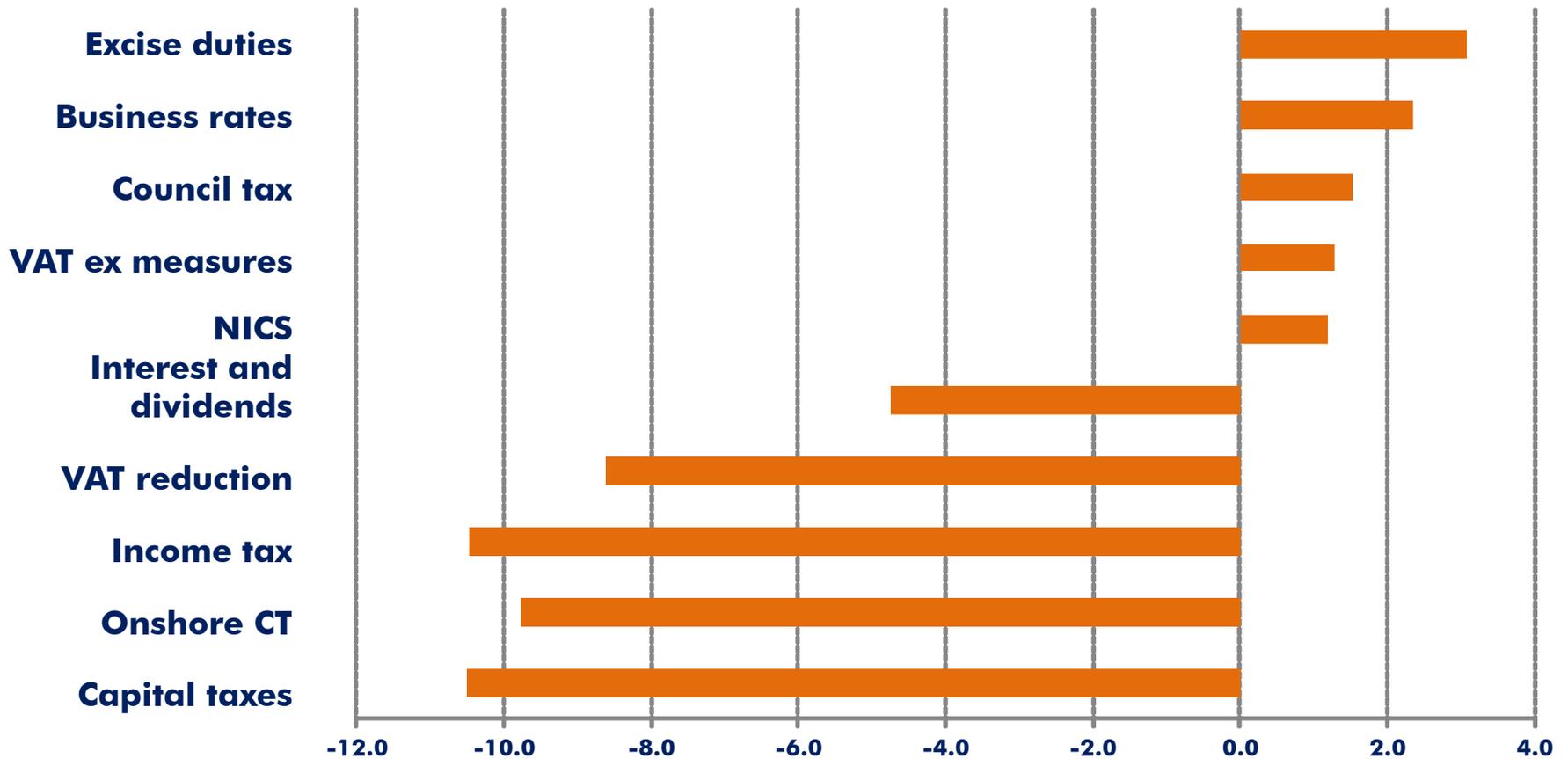
Public spending and receipts

Budget 2014 forecast: including and excluding post Budget 2008 measures



Receipts during the crisis

Change in receipts between 2007-08 and 2009-10 (£bn)



Why did receipts fall 07-08 to 09-10?

- **By a lot in cash terms:**
 - Lower nominal GDP (including lower nominal labour income, consumer spending and profits)
- **But also somewhat as a share of NGDP:**
 - Profits tend to be super-cyclical
 - Negative fiscal drag, thanks to weak earnings growth and stubborn consumer inflation
 - Disproportionate hit to revenue-rich financial sector
 - Asset prices and transactions weak relative to NGDP
 - Discretionary VAT cut

The fall and rise in receipts

Change in share of GDP	Crisis (09-10 v 07-08)	Consolidation (18-19 v 09-10)
Income tax and NICs		
VAT		
Onshore corporation tax		
UK oil and gas		
Capital taxes		
Fuel and excise duties		
Business rates and council tax		
Interest and dividends		
Other		
Total	-1.9	+2.0
<i>Memo: policy measures</i>		
<i>Memo: financial sector</i>		

The fall and rise in receipts

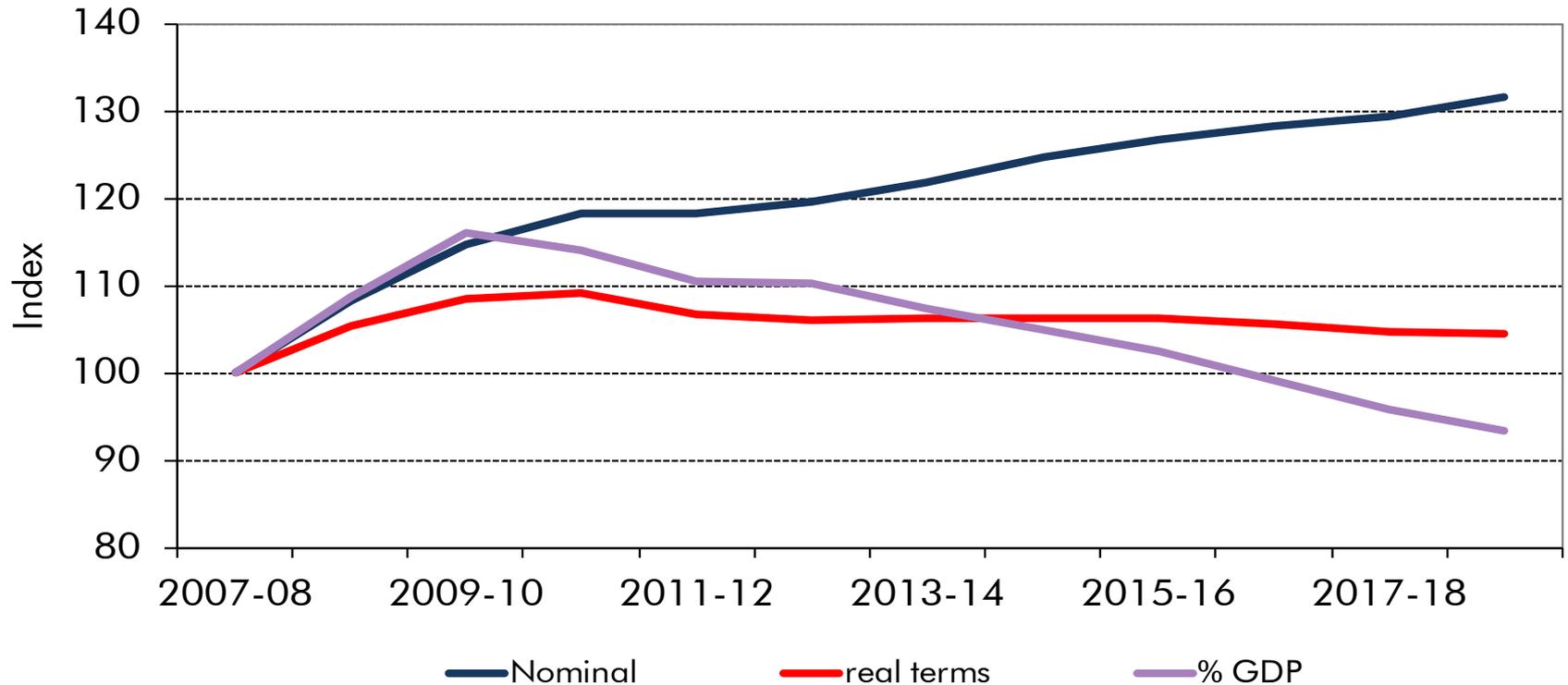
Change in share of GDP	Crisis (09-10 v 07-08)	Consolidation (18-19 v 09-10)
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Capital taxes		
Fuel and excise duties		
Business rates and council tax		
Interest and dividends		
Other		
Total	-1.9	+2.0
<i>Memo: policy measures</i>	-0.7	+2.3
<i>Memo: financial sector</i>	-0.5	+0.1

The fall and rise in receipts

Change in share of GDP	Crisis (09-10 v 07-08)	Consolidation (18-19 v 09-10)
Income tax and NICs	-0.5	+0.2
VAT	-0.4	+1.1
Onshore corporation tax	-0.7	-0.0
UK oil and gas	-0.1	-0.3
Capital taxes	-0.7	+0.9
Fuel and excise duties	+0.2	-0.5
Business rates and council tax	+0.3	-0.4
Interest and dividends	-0.3	+0.5
Other	+0.2	+0.5
Total	-1.9	+2.0
<i>Memo: policy measures</i>	-0.7	+2.3
<i>Memo: financial sector</i>	-0.5	+0.1

Public spending: rising or falling?

Total managed expenditure, 2007-08=100



Public spending during the crisis

2009-10 versus 2007-08	Nominal % change		Change in share of GDP	
	Budget 08	Outturn	Budget 08	Outturn
Total spending, <i>of which</i>	+10.2%	+14.7%		
Public services/admin (current + capital DEL)				
Social security and tax credits				
Central government debt interest				

Public spending during the crisis

2009-10 versus 2007-08	Nominal % change		Change in share of GDP	
	Budget 08	Outturn	Budget 08	Outturn
Total spending, <i>of which</i>	+10.2%	+14.7%		
Public services/admin (current + capital DEL)	+9.8%	+13.0%		
Social security and tax credits	+11.6%	+19.6%		
Central government debt interest	+1.3%	+1.0%		

Why did nominal spending rise more quickly than expected?

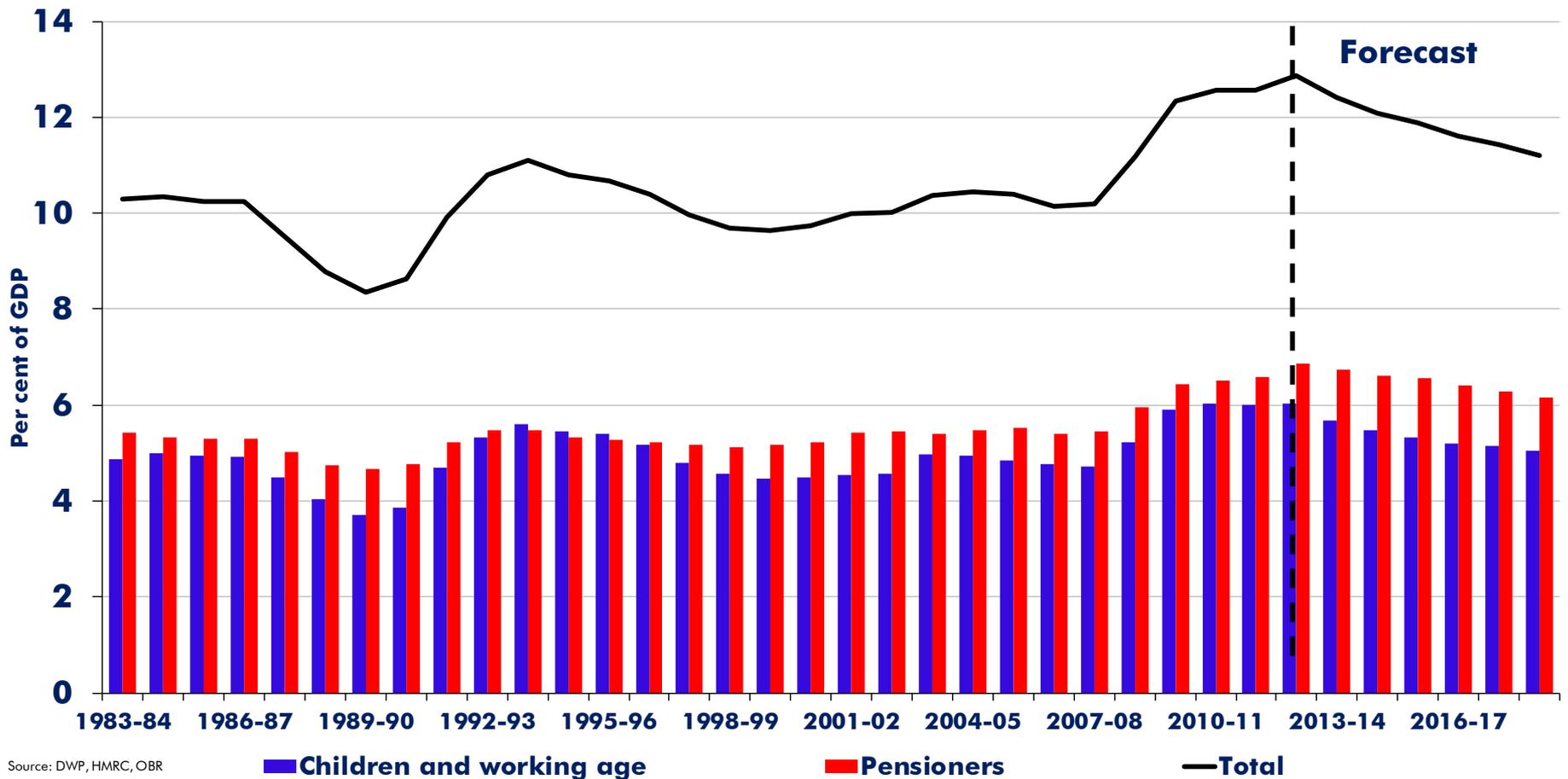
- Public services: underspend in 07-08 plus stimulus spending
- Welfare: unemployment higher than expected
- Debt interest: more borrowing but lower borrowing costs

Public spending during the crisis

2009-10 versus 2007-08	Nominal % change		Change in share of GDP	
	Budget 08	Outturn	Budget 08	Outturn
Total spending, of which	+10.2%	+14.7%	0	+6.5
Public services/admin (current + capital DEL)	+9.8%	+13.0%	-0.1	+3.2
Social security and tax credits	+11.6%	+19.6%	+0.1	+2.4
Central government debt interest	+1.3%	+1.0%	-0.2	0

- Nominal spending and GDP were both expected to rise by c.10% in Budget 2008, leaving spending/GDP unchanged
- But nominal spending rose by around 15% while nominal GDP fell by 1.2%, so spending jumped sharply as a share of GDP

Welfare spending



Drivers of welfare spending

Caseloads compared with Budget 2008 forecasts

Thousands	2007-08	2008-09	2009-10	2010-11
State pension	0	-18	-18	-33
Housing benefit	21	165	557	833
JSA	66	270	636	440
DLA/PIP	15	24	40	33

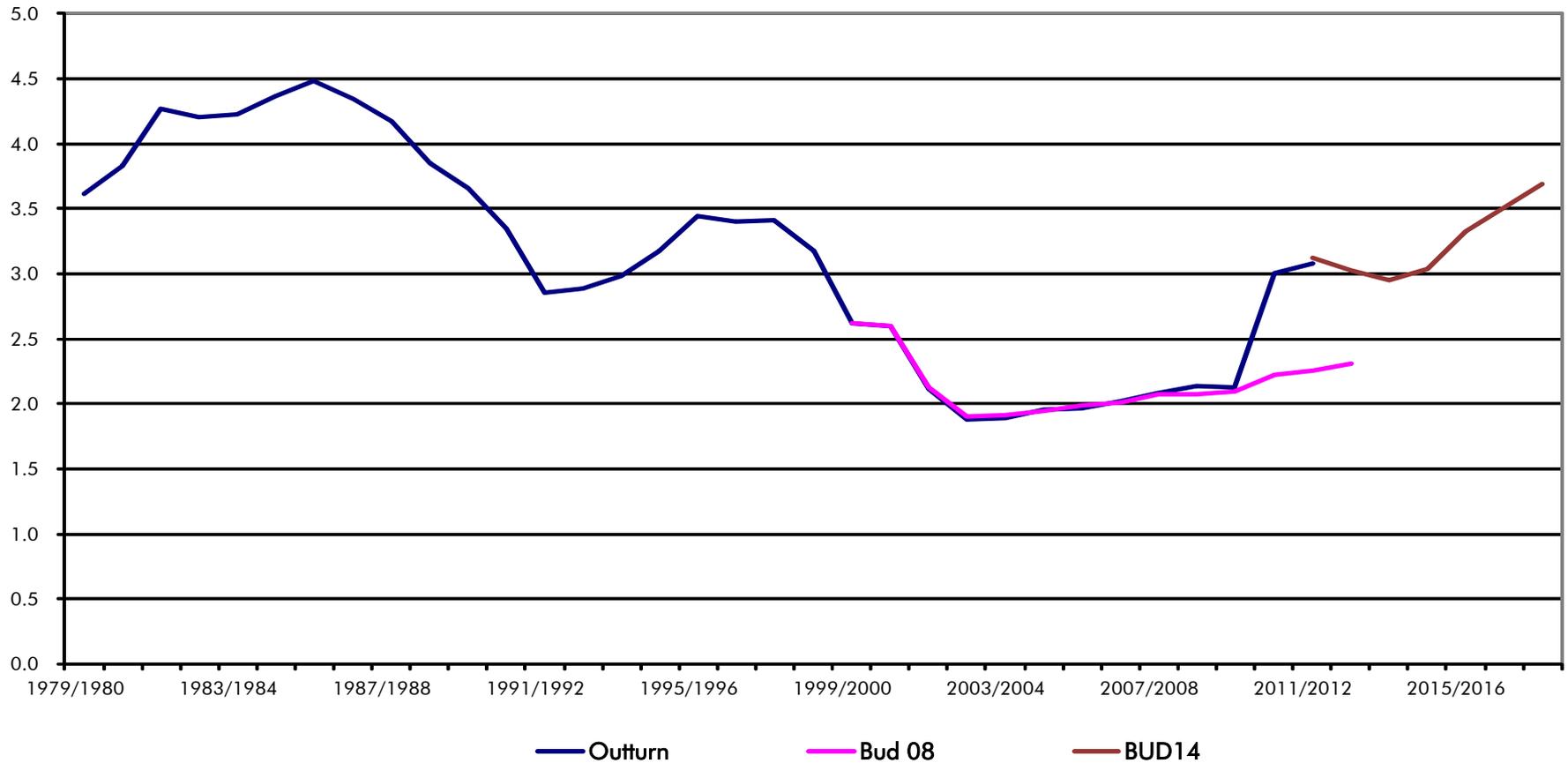
Drivers of welfare spending

Inflation, earnings and nominal GDP per capita (% change)

Per cent	2008-09	2009-10	2010-11	2011-12	2012-13	Total change between 2008-09 and 2012-13
RPI inflation	3.9	5.0	-1.4	4.6	5.6	18.8
ROSSI inflation	2.3	6.3	1.8	4.8	6.8	23.9
CPI inflation	1.8	5.2	1.1	3.1	5.2	17.4
Average earnings growth	0.6	3.0	1.0	2.7	1.0	8.5
Growth in nominal GDP per 16+ person	-1.2	-1.4	4.1	2.4	0.7	4.5

Prior to 2011-12, means-tested benefits were generally uprated with ROSSI and other benefits with RPI (in 2010-11 these were uprated by +1.5% rather than -1.4%). The baseline assumption since 2011-12 has been to uprate most benefits with CPI.

Debt interest: rising from low base

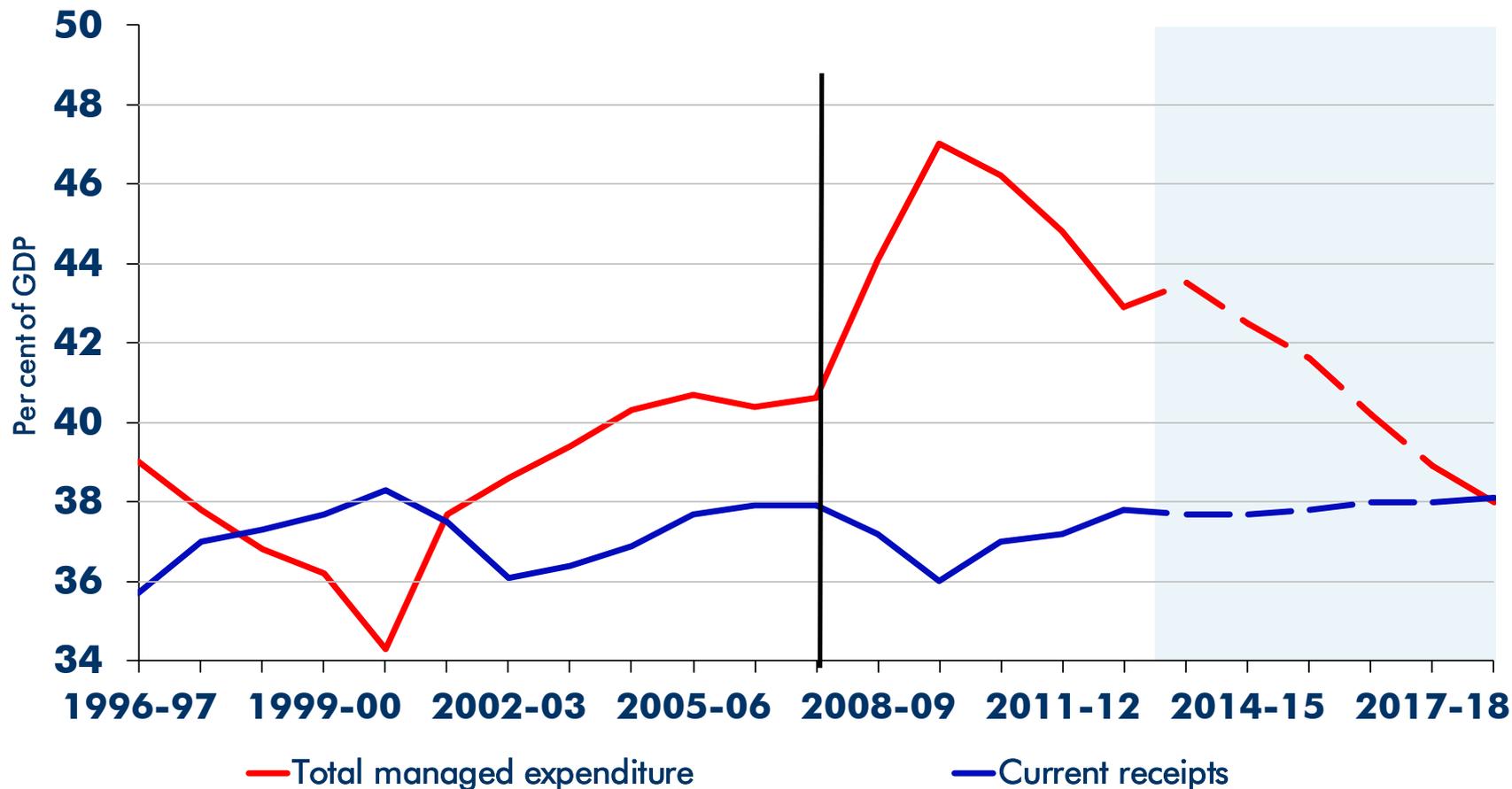


Debt stock and debt interest

	2007-08	2012-13	2018-19
Budget 2008			
Cash PSND	535.6	731.2	-
Average interest rate	4.7	4.6	-
Debt interest	29.9	36.3	-
Budget 2014			
Cash PSND	537.8	1185.2	1548.1
Average interest rate	4.7	1.8	4.0
Debt interest	30.2	47.6	75.2

Public spending and receipts

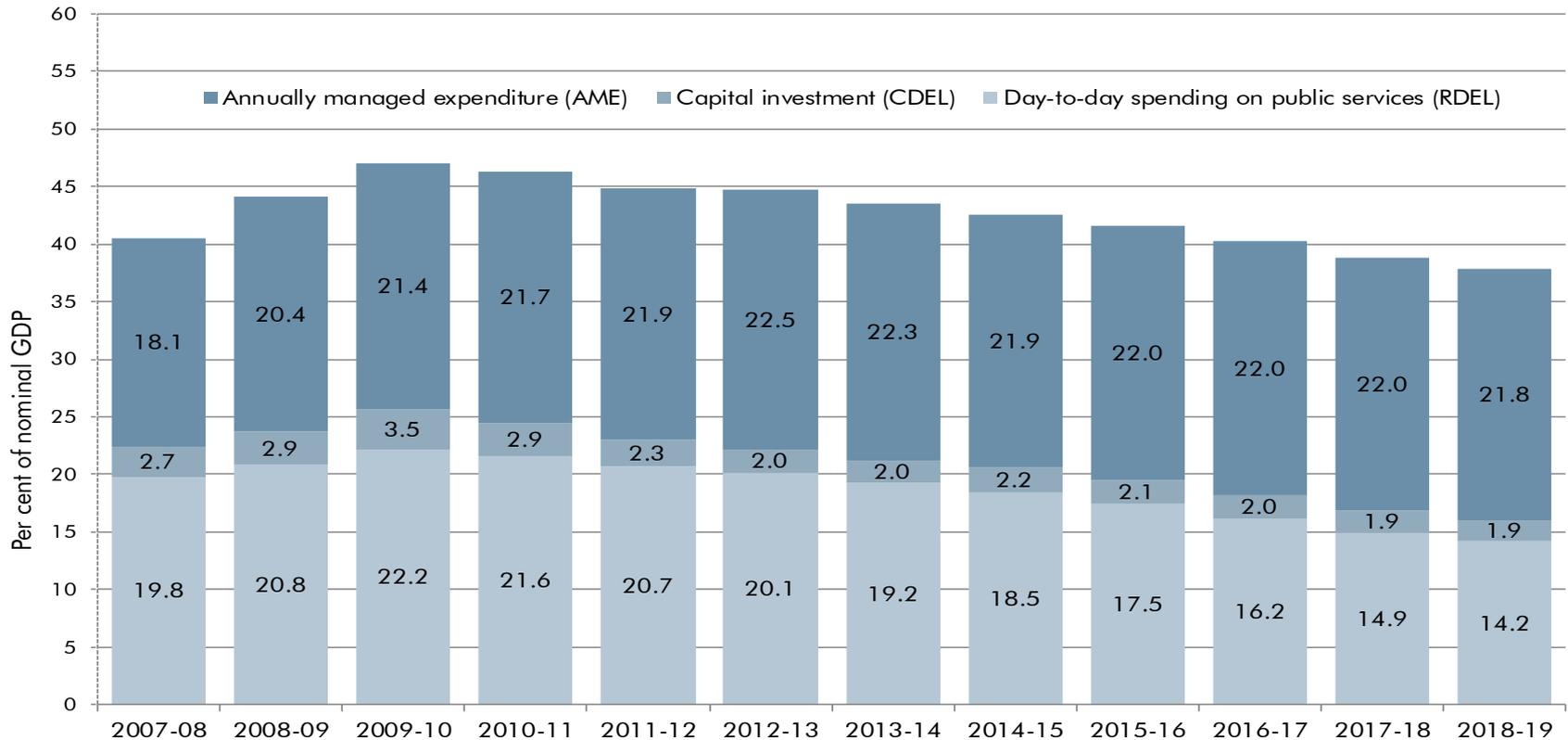
Budget 2008 and March 2014 forecasts



Squaring the circle

Change in share of GDP	2007-08	2018-19	Change
PSNB	2.6	-0.2	-2.8
Welfare	10.2	11.2	1.0
Debt Interest	2.1	3.7	1.6
Other AME	5.8	6.9	1.1
Receipts	37.9	38.1	0.1
Departmental spending	22.5	16.1	-6.4
<i>of which: capital</i>	<i>2.7</i>	<i>1.9</i>	<i>-0.7</i>
<i>of which: resource</i>	<i>19.8</i>	<i>14.2</i>	<i>-5.7</i>

The squeeze on public spending

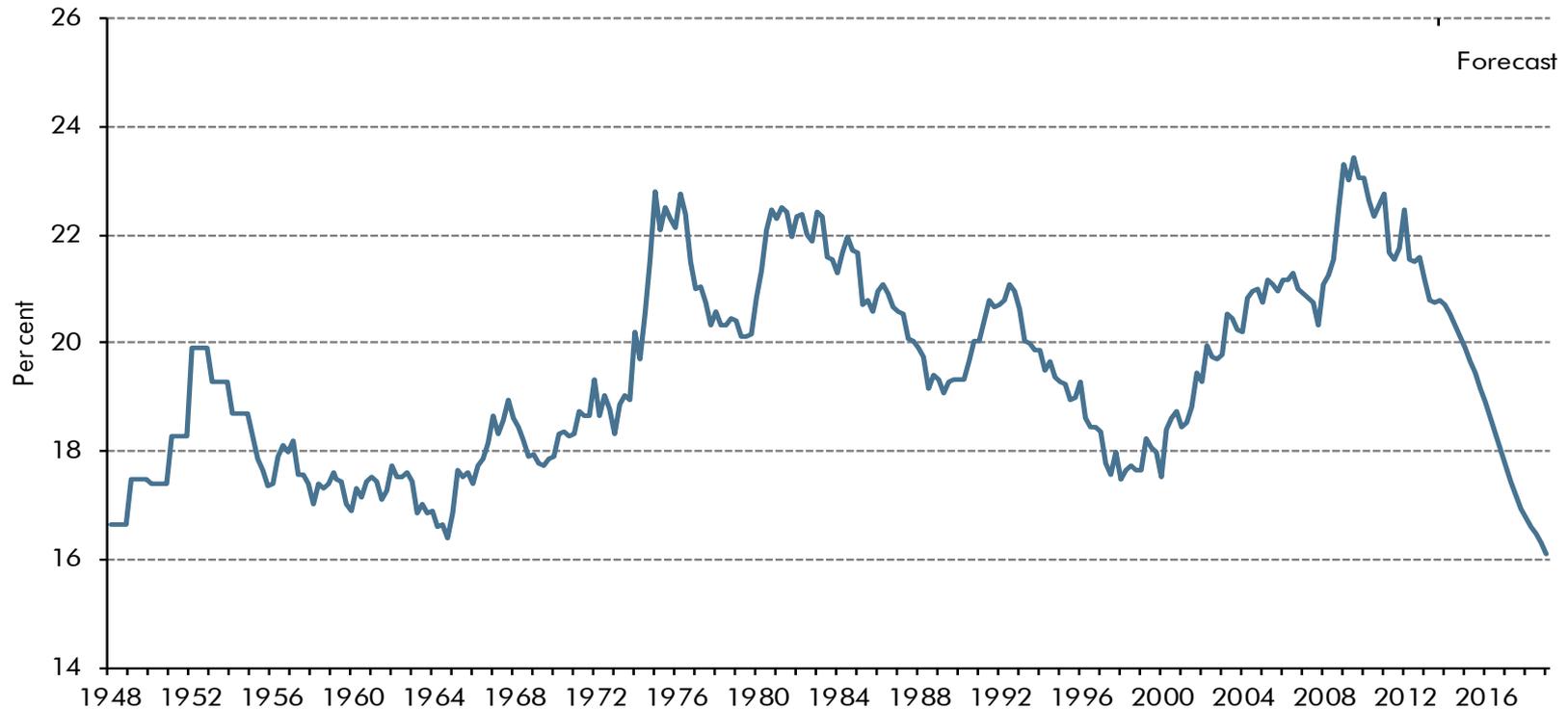


Source: OBR, HMT

Memo: AME includes Single Use Military Equipment

The squeeze on public spending

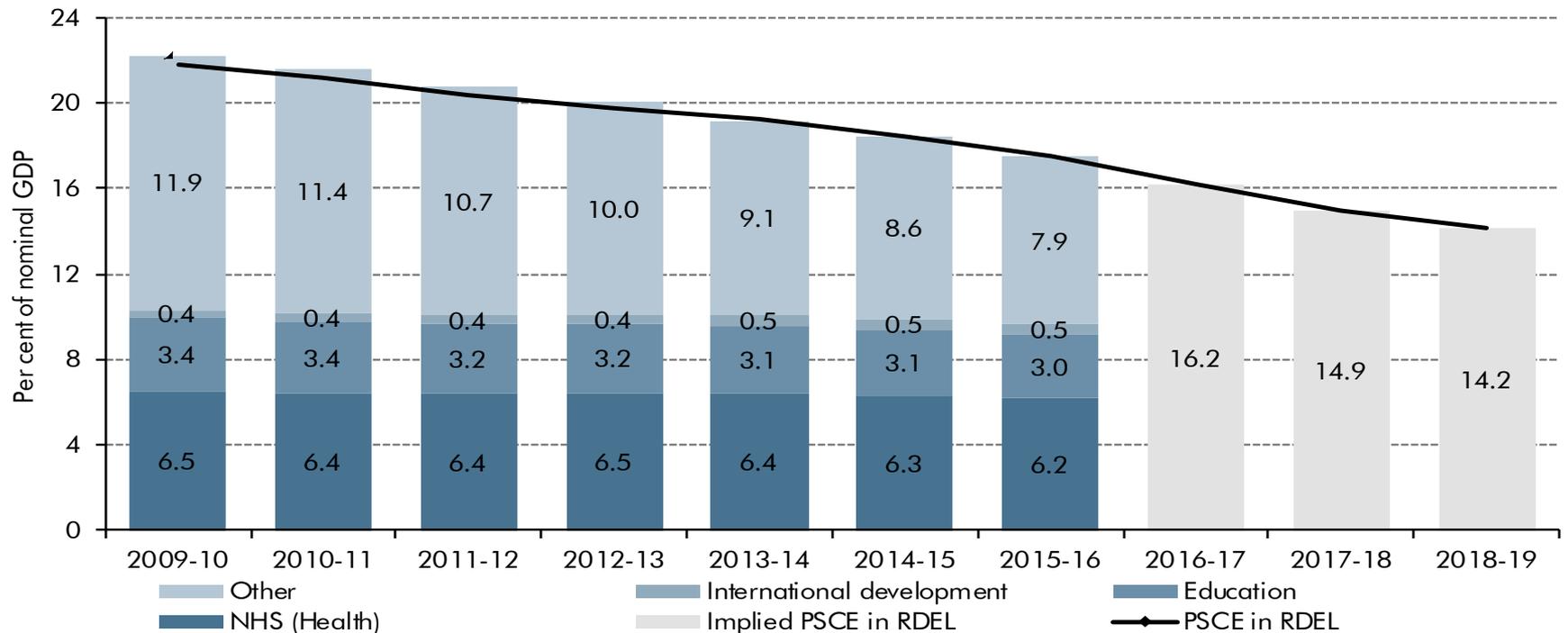
Government consumption of goods and services as a share of GDP



Source: ONS, OBR

The squeeze on public spending

Current Spending on public services and administration



Plans for RDEL excluding depreciation upto 2015-16. Beyond 2015-16 based on implied PSCE in RDEL calculated from the Government assumption for TME. Other includes unallocated amounts.

Source: HM Treasury Budget 2014, HM Treasury Public Expenditure Statistical Analyses, July 2013

Conclusion: will this happen?

- **Lots of uncertainties**

- Macro forecast and fiscal forecast
- Assessment of potential and 'hole' in public finances

- **Policy choices**

- We have to forecast on basis of Coalition policy, but
- Conservatives want more welfare cuts
- Labour see less need for balanced budget
- Lib Dems: more borrowing and tax?