Resolution Foundation
BRIEFING

In the balance

Public finances in the next parliament

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November 2014

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Summary

With the Coalition government expected to have delivered around half of its intended fiscal consolidation programme by the end of the current parliament, debates over public finances are set to loom large in the coming election campaign. To date, we have only very broad outlines of the preferred approaches of each of the main parties:[1]

» The **Conservative** party has stated that it will seek an ***overall* budget surplus by 2018-19**, thereby switching from the Coalition's focus on the cyclically-adjusted current budget. The party has also vowed to maintain investment spending as a share of GDP.

» **Labour** will instead focus on securing a ***current* budget surplus "as soon as possible"** in the next parliament, alongside committing to reducing national debt as a share of GDP.

» The **Liberal Democrats** will retain the Coalition's intention to **balance the cyclically-adjusted current budget by 2017-18**, before then switching their attention to achieving a **cyclically-adjusted balance on a budget measure that excludes some, but not all, capital spending** (specifically those elements which "enhance economic growth").

Assessing precisely what is implied by these differing approaches depends on a number of details around timings and mechanisms which have not yet been specified, and we make no attempt in this note to offer a definitive evaluation. Instead, we present indicative outcomes based on a range of reasonable interpretations of the different rules. In doing so, we make use of the OBR projections for growth, spending and receipts set out alongside Budget 2014. These figures will of course be revised at Autumn Statement 2014 (and again at Budget 2015) – not least because current estimates suggest that the previously projected tax revenues are set to significantly undershoot this year – meaning that all of our analysis will also be altered, reinforcing the need to treat our findings as indicative only.

[1] Given the lack of policy information provided to date by UKIP, we are unable to undertake any meaningful modelling of their potential approach.

What does seem relatively certain is that whoever forms the next government will oversee £8.5 billion of departmental spending cuts in 2015-16, as agreed in Spending Review 2013. If only for practical reasons, it will prove difficult for a new government formed in May 2015 to alter settlements already in place. We therefore assume throughout this note that each of the parties follows this approach and focus our attention on what happens next – in the three years from 2016-17 to 2018-19 (the end of the OBR's current forecast horizon).

The Conservative scenario we model is based on the assumption that the scale of the cuts in departmental budgets required beyond 2015-16 is reduced by the introduction of a further £12 billion cut in the welfare bill as indicated by the Chancellor in January. Even with this modification – itself very challenging – we estimate that several government departments would face real-terms budget reductions of one-half or more between 2010-11 and 2018-19. Were any of the Conservatives' proposed £7 billion in income tax cuts delivered within this period, and funded through further spending cuts (as has been suggested), the challenge would be that much greater.

With no way of judging just what "as soon as possible" might entail – it could point to a similar path to the one set out by the Coalition, or it could be slower. Given this uncertainty, we present two alternative scenarios for Labour: one in which they achieve a small (£1 billion) current budget surplus in the middle of the next parliament (which, for practical reasons[2] we take to be 2018-19) and one in which they achieve such a balance at the end of the parliament (2019-20). By excluding capital spending, both the 'Labour 18' and 'Labour 19' scenarios imply slower paces of deficit reduction than the Conservative approach. But, while that might mean smaller cuts for many government departments, it would – all else being equal – also be associated with a higher stock of debt, thereby increasing annual debt interest payments. There are always trade-offs.

[2] For ease of comparison, all of our analysis covers the three years from 2016-17. If we were to assume that Labour achieved a current budget surplus in 2017-18 – possible under its notion of "as soon as possible" – we would need to make a further assumption about the position they would take in 2018-19 because they have given no indication of what their fiscal target would be once current budget balance is secured (unlike the Conservatives and the Liberal Democrats). The precise – and inevitably wrong – position we imposed after 2017-18 would have significant implications for the overall size of consolidation required. For example, if we assumed that Labour simply maintained the same £1 billion surplus in 2018-19, then the scenario would look very similar to the one we *have* modelled for 2018-19. If we instead assumed that they went further and built a larger current budget surplus in 2018-19, then their position would shift closer to the Conservative one.

The Liberal Democrat approach implies broad adherence to the current Coalition plans through to 2017-18, followed by further consolidation in 2018-19 that – because it excludes some capital spending but not all – likely falls somewhere between the scenarios we have set out for Labour and the Conservatives. Again we present two scenarios by way of exploring different potential interpretations of this position. Our 'tighter' scenario assumes that one-quarter of capital spending is exempt from the proposed balance after 2017-18, while our 'looser' scenario assumes that borrowing is permitted against three-quarters of the total capital budget. In practice, the party could choose an approach that sits outside of these parameters.

Beyond the already planned £8.5 billion of departmental spending cuts earmarked for 2015-16, our different scenarios therefore present a range of trajectories for consolidation.

» At one end of the spectrum, our assumed **Conservative** approach implies an overall tightening in the three years from 2016-17 of £37 billion, with £12 billion coming from new cuts in the welfare budget in 2016-17 and 2017-18 and £25 billion coming from further cuts to departmental spending;

» At the other end of the spectrum our **'Labour 19' scenario** implies overall consolidation of just **£4 billion** in the three years from 2016-17, with no indication of how these savings would be balanced between departmental cuts, welfare cuts and tax rises. The higher debt interest costs associated with the additional stock of debt held under this approach are factored into the overall size of consolidation required;

» Our **'Labour 18'** scenario and our **two Liberal Democrat scenarios** imply overall consolidation that falls somewhere between these two approaches.

Also of importance to the size of the state and the distributional impact of deficit reduction is the question of *how* the parties choose to meet their consolidation targets. Prior to the 2010 election, each party specified preferences for a balance between spending cuts and tax rises. In the event, the Coalition opted for an 80:20 split and, according to Budget 2014, it remains on course to meet this target by the end of 2015-16.

Senior Liberal Democrats have indicated that they would like to stick to a similar balance after 2015-16. Based on our two scenarios, that implies the need for net tax rises (above and beyond those that have already been earmarked for funding other commitments) of between £4 billion and £6 billion. While the Conservatives appear to have explicitly ruled out any tax rises (meaning that they will need to cut spending by £37 billion), Labour have not yet made a commitment. If they were to follow the Liberal Democrat lead, our two scenarios would imply the need for net tax rises of between £1 billion and £3 billion.

Of course, all of these scenarios are highly indicative. Given the lack of details offered by each of the parties on the timing and shape of their consolidation, and given the inherent uncertainty surrounding future levels of economic growth, government revenues and other non-departmental spending, we are very clear that all of our assumed scenarios will prove themselves to be inaccurate in the fullness of time.

It is worth reflecting, for instance, on the additional 'dividend' or 'penalty' that changes in growth forecasts might provide. The divergence in government revenues that would arise over the next four years between a scenario in which receipts grew by 1 percentage point more each year than current OBR projections suggest and a scenario in which they grew by 1 percentage point less than the current projections would amount to £55 billion. Clearly the ultimate course of economic growth – and the revenue-richness of that growth – will have a significant bearing on the scale of the fiscal challenge facing the next government.

Notwithstanding this point, what the analysis in this report makes clear is that all of the potential approaches to deficit reduction that we have set out are difficult and involve unenviable trade-offs. Parties must strike a balance between cutting spending on public services or social security, raising taxes or running a deficit for longer. Alongside these decisions, they must weigh the need for protecting investment that might help generate future growth.

In order to achieve electoral credibility, each party will need to tread a careful line: on the one hand they will need to set out a clear course for deficit reduction; on the other they will need to ensure that their proposed path remains politically feasible, with consequences for public services and households that appear manageable. As yet, none of the parties have explained precisely how they will negotiate this balancing act.

Section 1

Introduction

In the aftermath of the economic collapse associated with the financial crisis of 2008, the position of the UK's public finances – in line with those across a number of advanced economies – deteriorated significantly. Dealing with the massively expanded annual deficit and stock of debt has thus been at the forefront of the Coalition government's economic thinking since its 2010 formation.

With economic recovery having proved much more elusive than the government had first hoped and then less revenue-rich once it arrived, progress towards fiscal balance has been much slower than once anticipated. While the government initially hoped to return the cyclically-adjusted current budget (CACB)[3] to surplus by the end of the parliament, the crossover point is not now forecast to arrive until 2017-18. Sizeable and persistent deficits mean the stock of national debt has more than doubled since 2007-08.

With the 2015 election fast approaching, the scale of the public finance challenge remains high on the political agenda. But it's a debate that is often hard to follow, with manifold points of contention between the parties. Not only is there the question of how quickly we should close the budget deficit, but also what mechanisms should be used – tax rises, cuts in welfare or departmental spending reductions. More fundamentally still, there is the question of quite what constitutes balance given the different definitions being used and the key underlying issue of how quickly the national debt should be reduced.

In this briefing note, we seek to aid the pre-election debate by setting out the story so far and the potential shape of things to come depending on the outcome of the next election. It is not our intention to provide definitive details of the spending cuts and tax rises that different political parties will be required to implement if they form the next government – the figures are far too uncertain[4] and the stated intentions of each party too vague to allow for any such analysis. Instead, we provide an indication of the potential trade-offs under a range of *assumed* scenarios based on our interpretation of what the sketchy details we have to date might imply in the next parliament. In doing so, we draw out the questions that each party must answer as they seek to secure electoral credibility.

We begin in **Section 2** by setting out the impacts of the 2008 financial crisis and economic downturn on the public finances, along with the Coalition government's reaction. We consider OBR projections through to 2018-19 for annual spending, receipts and borrowing, along with the impact on the stock of debt.

In **Section 3** we focus on the fiscal rules that each of the three main political parties is proposing for the next parliament.

[3] An overview of fiscal terms and an explanation of how the various elements of public spending and receipts interact is provided in the Annex.

[4] The OBR projections for 2014-15 which form part of the basis for our modelling look certain to be revised at the Autumn Statement following weaknesses in tax receipts over the first half of the year. Projections for 2015-16 and beyond are also liable to significant change.

In **Section 4** we look at the trade-offs that these tentative rules would imply for the period after the next election and the implications for public spending, while assuming all parties stick to the Spending Review 2013 plans for the first year of the next parliament (2015-16).

Section 5 then looks at how these figures might be altered by shifts in the economic backdrop, recent accounting changes and the revisions to OBR projections that will arrive alongside Autumn Statement 2014 and Budget 2015.

We offer concluding thoughts in **Section 6.**

Section 2

Downturn and fiscal consolidation: the Coalition approach

In this section we consider the size and shape of the deterioration in the UK's public finances over recent years, along with the approach taken by the Coalition government to reversing the decline. We set out the broad trajectory of deficit reduction that is in place through to 2018-19 and consider the mechanisms used by the government to achieve this.

The fiscal gap grew as tax receipts collapsed…

In reflecting on the evolution of public finances since 2007-08, the OBR has pointed out that there were "undoubtedly weaknesses in fiscal management during [the pre-crisis period], some apparent at the time and some more with the benefit of hindsight," but that it would be "hard to argue that the tax and spending policies implemented in the early- and mid-2000s were in themselves an important cause of the crisis and recession".[5]

Instead, at its heart, the sharp fiscal deterioration experienced from 2008-09 was driven by a collapse in tax revenues associated with the drop in output that accompanied the global financial crisis. While the tax-take broadly rises and falls with GDP, public spending does not. Indeed, to the extent that a weak economy automatically increases both the need for welfare support – in the form of unemployment benefits for example – and the case for other forms of fiscal stimulus, spending might be expected to rise in the immediate aftermath of a recession.

Figure 1 highlights the extent to which the trajectories of spending and receipts diverged between 2007-08 and 2009-10. In real terms, total managed expenditure (TME) – which includes all spending by central and local government and by public corporations – increased from around £670 billion to £726 billion, while government receipts fell from £626 billion to £557 billion.[6] As a result, the gap between annual spending and receipts – as measured by Public Sector Net Borrowing (PSNB) – rose from £43 billion in 2007-08 to £170 billion just two years later.[7]

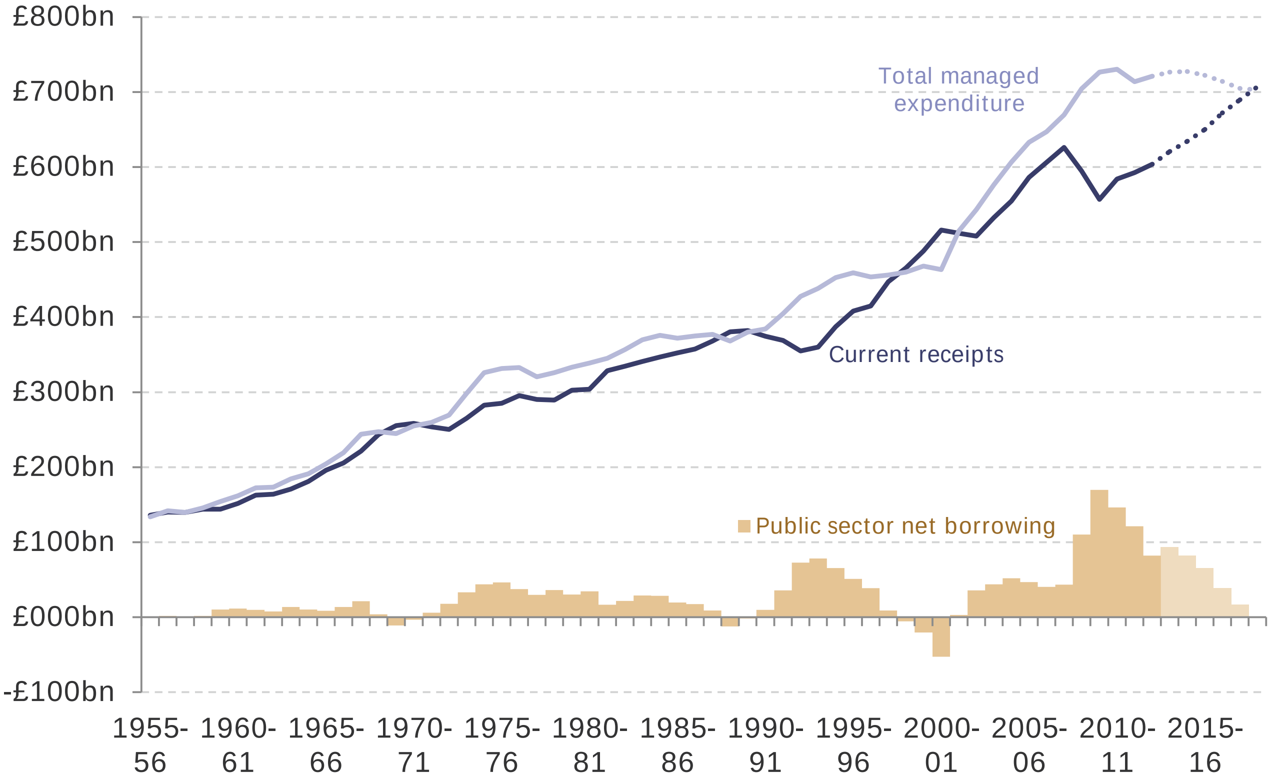
[5] J Riley & R Chote, *Crisis and Consolidation in the Public Finances*, OBR, September 2014

[6] All cash figures in this briefing note are real-terms 2013-14 prices, adjusted using the GDP deflator, unless otherwise stated. As noted in Section 5, all figures have been subject to revision following the recent accounting changes associated with the implementation of the European System of Accounts (ESA) 2010. Because OBR projections are not due to be updated to this new accounting basis until Autumn Statement 2014, we retain the old accounting practice throughout this note.

[7] The PSNB figures reported in this note exclude the effects of the one-off transfer of Royal Mail pension assets in 2013-14 (treated as negative capital expenditure of £28bn in the National Accounts). They also exclude flows associated with the Asset Purchase Facility (APF) which are projected to be positive (capital grants in the National Accounts) in the years to 2016-17 (thereby reducing PSNB) and offsettingly negative from 2017-18 to 2022-23 (thereby increasing PSNB).

Figure 1:
Public finances overview under existing Coalition plans: 1955-56 to 2018-19

Public spending, receipts & borrowing (2013-14 prices)



Source: RF analysis of ONS & OBR

Notes: PSNB and TME figures exclude the effects of the transfer of the Royal Mail Pension Fund and flows from the Asset Purchase Facility (APF).

Although PSNB has since fallen from its peak, in the last year for which outturn data is available (2012-13) it still stood at £117 billion, or 7.4 per cent of national income. As a result of this sustained period of unusually high annual borrowing, Public Sector Net Debt (PSND) – the stock of national debt – has more than doubled since 2007-08. From £613 billion before the downturn, it reached £1.2 trillion in 2012-13, equivalent to 74 per cent of national income.[8]

The Coalition reacted by reducing spending as a share of GDP...

Faced with such a spike in debt, the Coalition government has implemented a programme of 'fiscal consolidation' designed to restore the annual budget to balance and – over time – reduce the stock of debt as a share of GDP. As Figure 1 shows, that plan has involved holding overall spending broadly constant in real terms from 2011 onwards, while allowing a recovering economy

[8] Excluding financial sector interventions.

to generate growing tax revenues, thereby closing the gap that opened up at the start of the downturn.[9]

Measured as a share of national output, this trajectory means that spending is set to fall from a peak of 47 per cent of GDP in 2009-10 to just 38 per cent by 2018-19. This is lower than at any time since 2001-02 (when the budget was last in surplus). In contrast, receipts are due to remain broadly flat at around 38 per cent of GDP.

With its primary focus being on the cyclically-adjusted current budget…

The primary focus of the Coalition has not, however, been on the gap between TME and receipts, but rather on the current budget; that is, the difference between *non-investment* spending and receipts. Whereas PSNB peaked at £170 billion in 2009-10, the current budget deficit stood at £118 billion in the same year.

More specifically, the government has targeted the cyclically-adjusted current budget (CACB). This adjustment attempts to account for the state of the economy in order to give a better idea of the underlying, structural deficit. This measure peaked in 2009-10, amounting to around £84 billion according to the latest estimates from the Office for Budget Responsibility (OBR).

The CACB sits at the heart of the Coalition's main fiscal target:

» The 'fiscal mandate' calls for a forecast balance (or surplus) in the CACB by the end of the rolling five-year forecast horizon.

Additionally, the Coalition has introduced a secondary aim focused on the stock of debt:

» The 'supplementary target' stipulates that PSND should be falling as a share of national income in 2015-16.

While the focus on cyclical-adjustment and a rolling five-year target ensures that the government 'looks through' temporary economic effects and therefore does not attempt to over-compensate for the deterioration in public finances, calculation of the figure rests on an estimation of the size of the output gap (the economy's distance from its potential) that is extremely difficult to get right and highly contested.

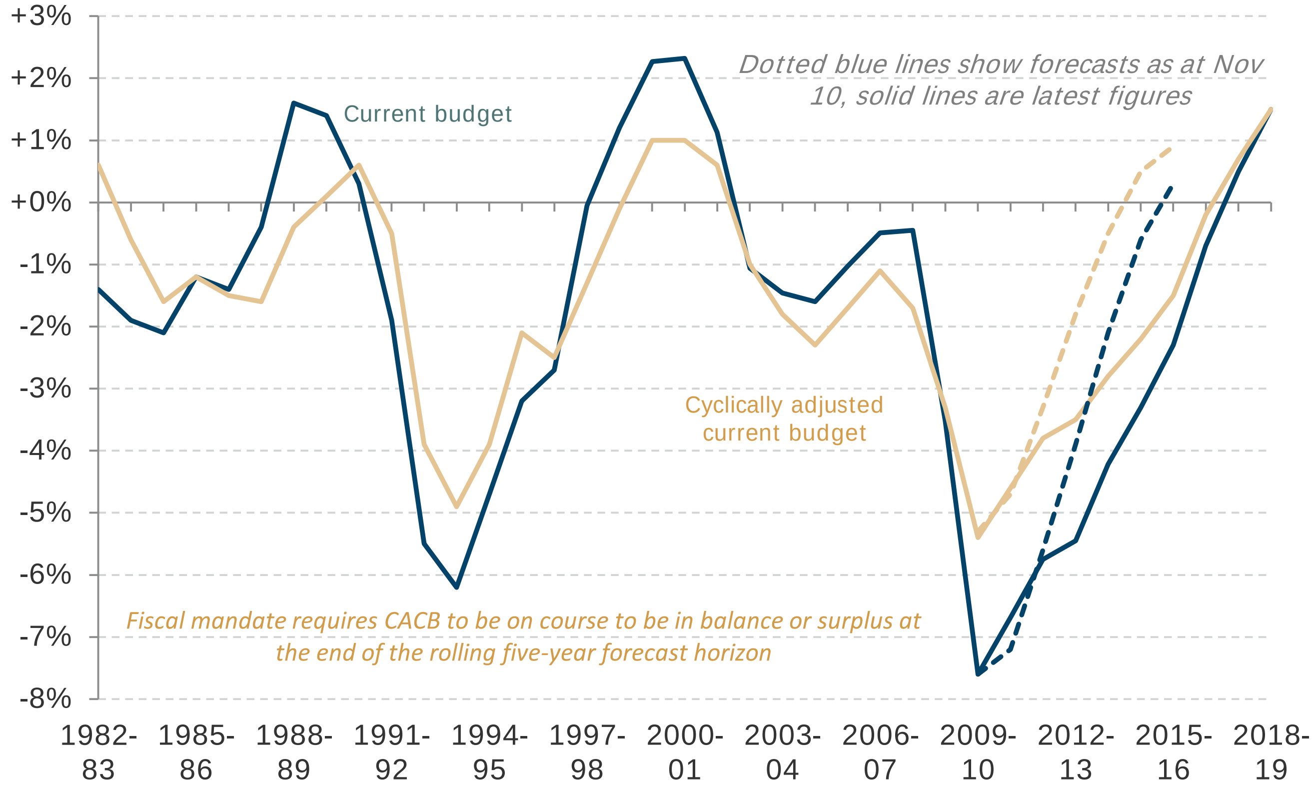
Which is currently projected to reach surplus by 2017-18…

The anticipated closing of the output gap by 2017-18 – though clearly still subject to considerable uncertainty – means that the current budget and the CACB will be broadly in line by the end of the forecast period. As Figure 2 shows, both measures are expected to return to surplus in 2017-18. As a result, the Coalition is considered to be on course to meet its fiscal mandate.

[9] Revenues associated with discretionary tax measures introduced by the Coalition have been offset by tax cuts such as the increase in the personal allowance. To the extent that tax measures *have* played a (minor) role in the overall consolidation, they relate to policy changes introduced by the previous Labour government.

Figure 2:
Outturn and projections for the current budget under existing Coalition plans: 1982-83 to 2018-19

Current budget surplus as a share of GDP



Source: RF analysis of ONS & OBR

Notes: Figures from 2014-15 onwards are OBR estimates/projections.

It is worth noting however, that the crossover point has moved outwards over time, highlighting the fact that being *on course* to meet a rolling target – which the Coalition has consistently been – does not necessarily translate into achieving balance within the specified timeframe.

Nevertheless, with the economic uncertainty that characterised the immediate post-crisis period abating somewhat over the past two years, we might feel more confident in these latest projections. The case for greater confidence reflects the fact that the primary reason previous ambitions were missed was the disappointing performance of tax receipts – determined largely by the unexpectedly slow return of economic growth. In contrast, government spending has been cut further than was expected in 2010.

Against this however, there is a new concern that the link between economic growth and tax revenues has been weaker than expected in recent months. Employment growth has been strong, but wage growth has been low. This, combined with Coalition tax reforms, mean that economic growth has not translated into rising tax revenues in the way that had previously been anticipated.[10]

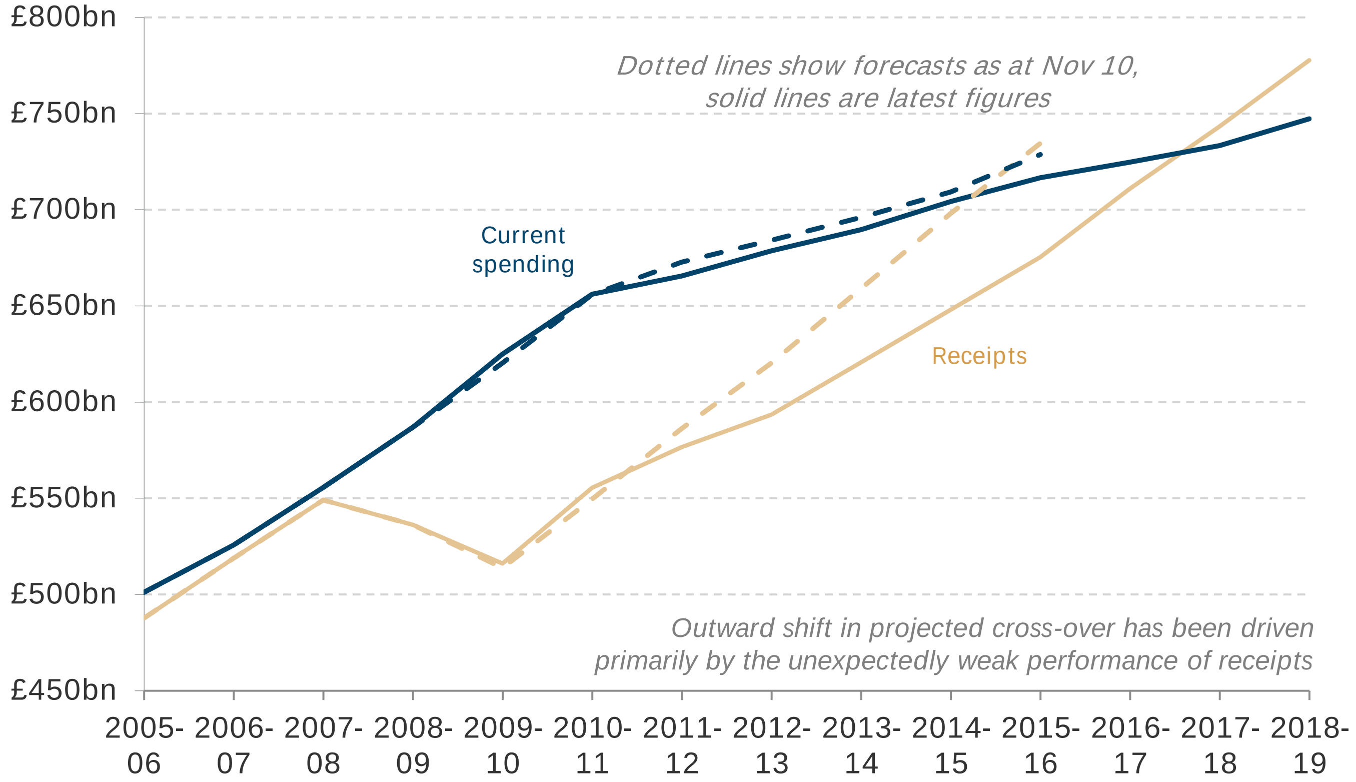
Figure 3 sets out how the OBR's projections have changed since 2010. In its November 2010 outlook, the OBR projected that nominal government receipts of £735 billion would overtake

[10] See for example, C Giles, "Weak oil and tax revenues weigh on public finances, data show", *Financial Times*, 21 November 2014

current spending of £729 billion in 2015-16. In its March 2014 data, it projected that spending would in fact be slightly lower – at £717 billion – in 2015-16, but that the receipts brought into government would amount to just £675 billion – some £60 billion lower than previously

Figure 3:
Revenue and spending outturns and projections under existing Coalition plans: 2005-06 to 2018-19

Tax receipts and government spending (nominal)



Source: RF analysis of ONS & OBR

Notes: TME figures exclude the effects of the transfer of the Royal Main Pension Fund and flows from the Asset Purchase Facility (APF). Figures from 2014-15 onwards are OBR estimates/projections.

anticipated. The crossover point is thus pushed outward to 2017-18.

Corresponding to an overall budget surplus by 2018-19…

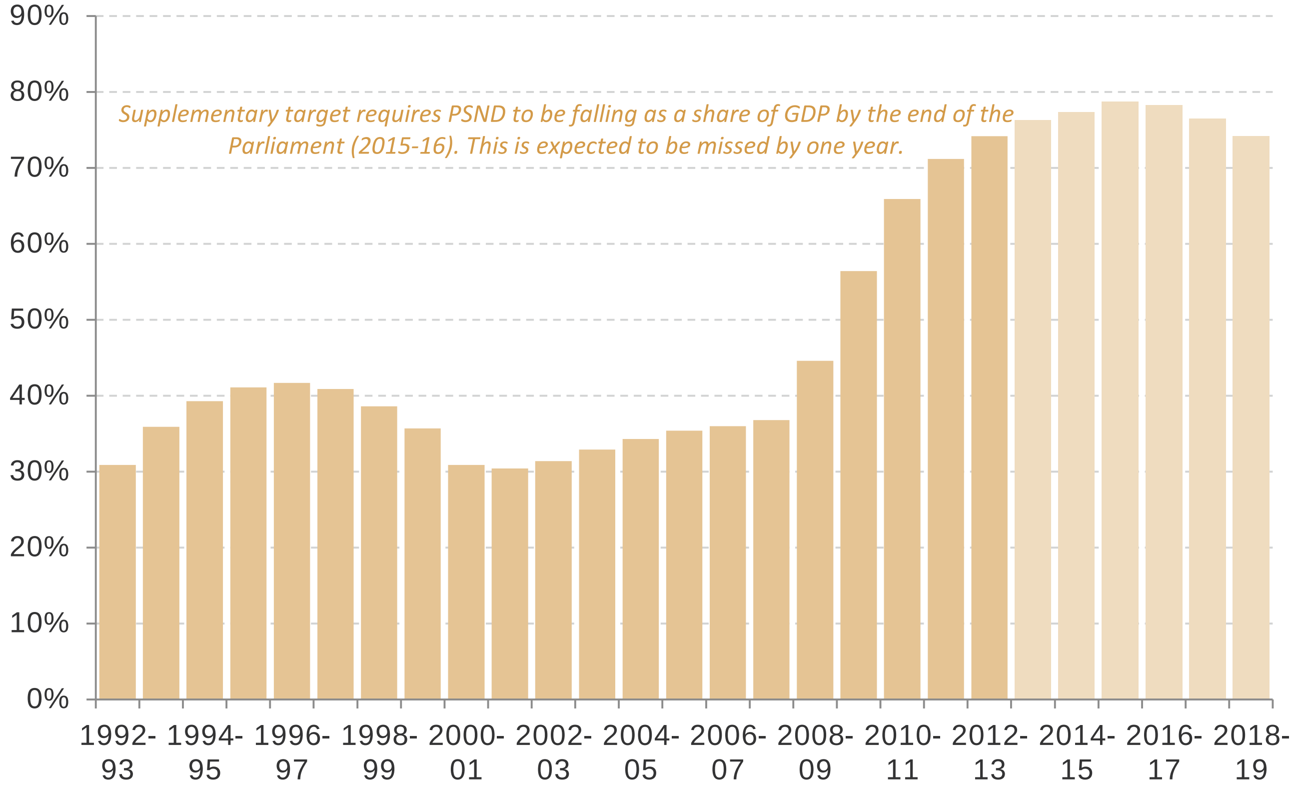
The surplus on the CACB is projected to stand at £13 billion in 2017-18, rising to £28 billion by the end of the forecast horizon in 2018-19. Removing the cyclical-adjustment leaves surpluses of £9 billion and £28 billion[11] in the same periods, with the 2018-19 position translating into an *overall* surplus (that is, including net investment spending) of £1 billion.

The Coalition's supplementary target – that PSND should be falling as a share of national income by 2015-16 – is currently projected to be missed by one year, as Figure 4 shows, with PSND peaking at 78.7 per cent in 2015-16 and falling for the first time since 2001-02 (to 78.3 per cent) in 2016-17.

[11] This is marginally lower than the CACB position due to the near-removal of the output gap by 2018-19.

Figure 4:
Public sector net debt outturn and projection under existing Coalition plans: 1992-93 to 2018-19

Public sector net debt as a share of GDP



Source: RF analysis of ONS & OBR

But the shape of consolidation after 2015-16 is yet to be defined…

In attempting to meet its fiscal rules, the Coalition has implemented a combination of:

- tax measures;
- cuts to Departmental Expenditure Limits (DEL) – which covers relatively predictable areas of expenditure by government departments; and
- cuts to Annually Managed Expenditure (AME) – which covers more demand-led areas of spending such as welfare and debt interest, and which is therefore harder to control than DEL.

Policies related to taxes and welfare can be amended with each semi-annual financial statement (Budget and Autumn Statement). In contrast, broad DEL trajectories are set at (typically) multi-year spending reviews. Spending Review 2010 set departmental budgets for each year from 2011-12 to 2014-15, while Spending Review 2013 established planned expenditure for 2015-16.

With around £37 billion of spending cuts or tax increases required over three years…

While no such details have yet been set out for the period beyond 2015-16, the Coalition has proposed a course for *overall* spending (TME) (through to 2018-19). Separately, the OBR projects likely AME expenditure on the basis of what is known about future government policy and expectations of future economic performance. By taking these AME estimates away from the government's plan for TME, the OBR is able to derive a level of DEL cuts beyond 2015-16.

Such an approach suggests that, beyond the planned £8.5 billion reduction in DEL in 2015-16 set out by Spending Review 2013, the existing deficit reduction trajectory set out by the Coalition would require a further £37 billion DEL cuts in the three years to 2018-19.

Which can't all be achieved by further cuts in departmental budgets…

In practice however, the magnitude of DEL cuts required would be likely to be reduced by the introduction of policies designed instead to generate savings from AME or raise new revenue from taxation.

This is particularly the case given that, with each additional cut, maintaining the pre-existing pace of DEL reductions becomes harder to achieve. By the end of 2015-16, total DEL is set to have fallen by around 11 per cent since 2010-11. However, the ringfencing of some budgets[12] and differing approaches to current and capital spending within departments means that the pain has been shared very unevenly, with some departments facing budgets that will have shrunk by between one-quarter and one-half.

As such, applying all of the £37 billion fiscal tightening implied by current Coalition policies beyond 2015-16 to DEL would rest on delivering highly implausible looking cuts in some departments – particularly if protection was again provided for health, schools and aid. In those circumstances, 2018-19 budgets would be cut relative to 2010-11 by two-fifths in Defence and BIS, by half in the Home Office and by two-thirds in the FCO. Correcting for population growth would make the impact on public services appear starker still.

Indicating the need for alternative consolidation approaches…

In practice therefore, if it remained in power we would expect the Coalition to propose alternative means of achieving the required consolidation that reduced the burden on DEL. Yet, while the Liberal Democrats have pointed to potential tax rises and the Conservatives have indicated a preference for more welfare cuts that could reduce the size of DEL cuts required beyond 2015-16, there is no agreed approach at this stage.

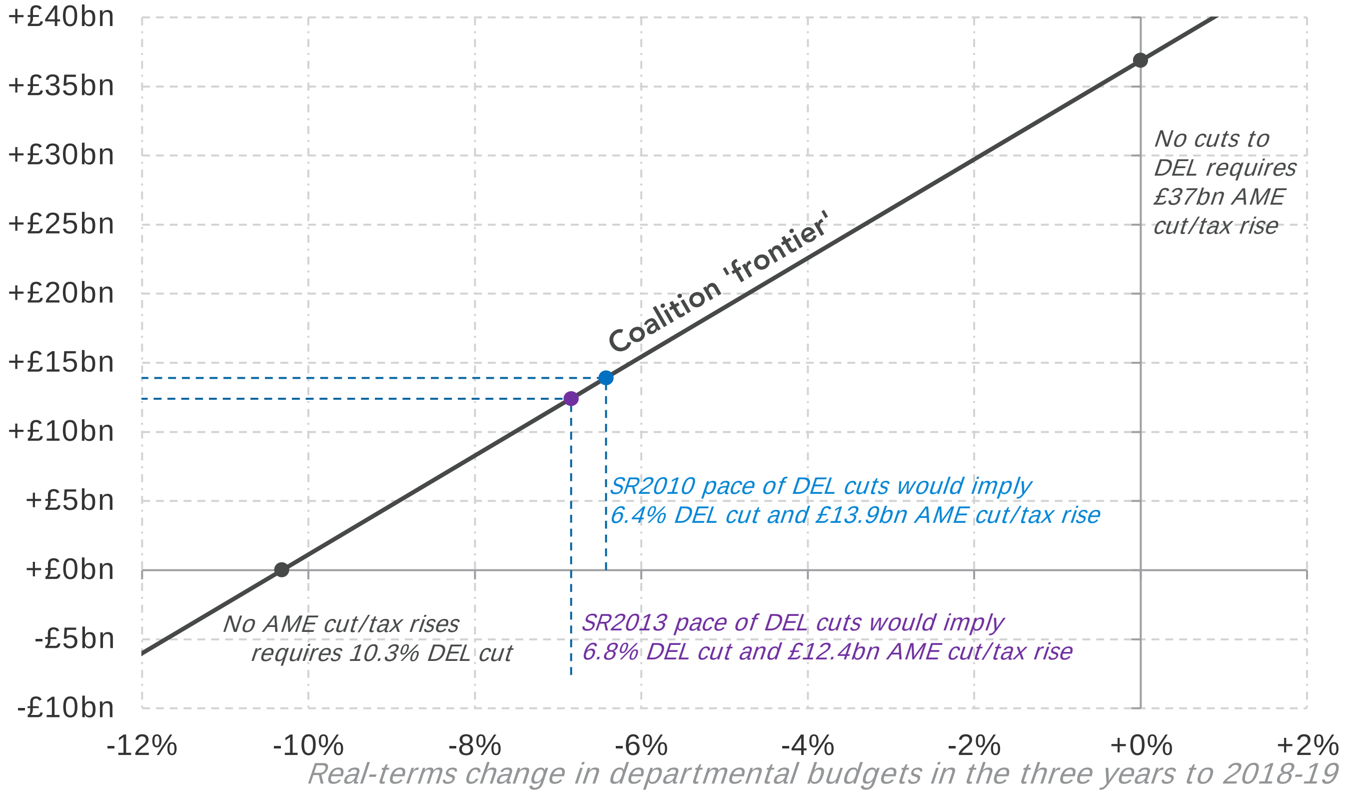
Any number of combinations might be considered. Figure 5 sets out the full range of trade-offs (or 'frontier') implied by the existing Coalition approach in broad terms in the three years after 2015-16. It shows that, in the absence of any change in tax or benefit policy a future government would need to deliver an additional 10.3 per cent cut in departmental budgets. At the other extreme, these DEL reductions could be avoided altogether if the government raised the £37 billion from some combination of welfare cuts or new tax receipts.

[12] In particular, Spending Review 2010 specified protection for spending on schools, health and overseas development aid (ODA). Similar – though slightly less generous – protections were included in Spending Review 2013. As a result, real-terms growth in the NHS budget of 4.9 per cent between 2010-11 and 2015-16 is set to contrast with cuts of 16.7 per cent in Defence, 25 per cent in the Home Office, 37 per cent in the DWP, and 50 per cent in the FCO.

For comparison, we present the particular combination that would arise if the Coalition opted for the same average annual reductions in DEL as in either the Spending Review 2010 period (2011-12 to 2014-15) or the Spending Review 2013 one (2015-16). If cutting in line with Spending Review 2010, total real-terms DEL cuts over the three-year period following 2015-16 would amount to 6.4 per cent, meaning that a further £13.9 billion would need to be found from some combination of cuts in AME and increases in receipts in order to complete the £37 billion consolidation. If following the pattern intended for 2015-16 instead, DEL cuts over the three-year period would be a little higher, at 6.8 per cent. This would imply additional AME cuts or tax rises of around £12.4 billion.

Figure 5:
Potential DEL and AME trade-offs between 2015-16 and 2018-19 under existing Coalition plans

Value of welfare cuts/tax rises in the three years to 2018-19 (2013-14 prices)



Source: RF analysis of ONS & OBR

Notes: From 2013-14 there is a definitional shift from DEL to AME. Chart is adjusted to remove this effect.

The Coalition partners – and Labour – will of course have their own preferences for trade-offs between DEL, AME and tax. They also have differing opinions about the timing (and definition) of deficit reduction itself. Although still somewhat vague, the broad pre-election policy intentions set out by the main political parties point towards the alternatives on offer. We consider them in turn in the next section.

i Why not £25 billion?

Over recent weeks there has been debate and some confusion about the scale of consolidation still to come in the next parliament. A figure of £25 billion has been used by both the Chancellor and the Prime Minister for instance, with confusion arising for two key reasons.

First, the time period. The £25 billion only applies to 2016-17 and 2017-18, thereby excluding the further tightening that would be needed in 2018-19 to stick to the Coalition's existing plans for deficit reduction.

Secondly, and more fundamentally, there is a definitional problem. The £25 billion relates to the real-terms reduction in *total* spending (excluding debt interest) projected to occur between 2015-16 and 2017-18. It fails to account for the fact that some areas of spending – in relation to the state pension for example, where demographic factors are at play – are projected to rise, meaning that achieving the stated reduction in total spending requires additional *discretionary* spending cuts.

By looking at the full three year period after 2015-16 covered by the OBR's existing forecasts, and by focusing on the discretionary spending cuts required to meet the given total spending envelope, we estimate that adherence to the Coalition's existing deficit reduction plans would require £37 billion of policy action.

Section 3

Alternatives beyond 2015-16: assumed party scenarios

In this section, we set out and discuss the broad fiscal plans articulated in varying levels of detail by each of the three main political parties for the period beyond 2015. We consider the implications of these differing approaches in Section 4.

The Conservatives say they will focus on absolute surplus, alongside further cuts to welfare…

While the Coalition's fiscal mandate relates to the cyclically-adjusted current budget (CACB), George Osborne announced in September 2013 that a 2015 Conservative government would aim to achieve an absolute surplus in the next parliament. The Prime Minister has said that the plan is to achieve the absolute surplus target in 2018.[13] This matches the existing Coalition projection of a £1 billion overall surplus in 2018-19.

In addition, the Chancellor intends to establish a rule designed to keep investment steady as a proportion of GDP:

> *We also want to go on investing in the essential infrastructure of our country – the roads and railways and science and communications that are the backbone of the future economy. So we should commit, alongside running a surplus and capping welfare, to grow our capital spending at least in line with our national income.*[14]

Osborne has suggested that a Conservative government would not raise taxes further to close the deficit, stating to the Treasury Select Committee that "further consolidation after the year 2015-16 is built into the tables as a spending reduction – a spending consolidation. I am clear that tax increases are not required to achieve this, and that this can be achieved with spending reductions".[15]

He has stated that an additional £12 billion of welfare cuts would be found over the first two years of the next parliament. To date, he has specified where £3 billion of this will come from (namely the freeze in working-age benefits in 2016-17 and 2017-18).[16]

The Conservatives also propose £7.2 billion of income tax cuts by 2020 – raising the personal allowance to £12,500 and raising the higher rate threshold to £50,000. It has not been made clear how this would be paid for, though the indication is that it would be via additional spending cuts. However, there is no timetable for delivering these tax cuts within the parliament. They might for instance be delivered in 2019-20 or 2020-21, rather than the years analysed in this report. For that reason, we do not model the implications of these tax cuts in Section 4. It is worth noting

[13] Conservative Party Conference Speech by the Prime Minister, 1 October 2014

[14] Conservative Party Conference Speech by the Chancellor of the Exchequer, 30 September 2013

[15] Oral evidence before the Treasury Committee, q241, 11 July 2013

[16] Conservative Party Conference Speech by the Chancellor of the Exchequer, 29 September 2014

however that, were they delivered earlier – in part or in full – the squeeze on departmental and welfare spending that we present would be *even tighter* and even harder to deliver.

While Labour say they will concentrate on the current budget…

While the Conservatives propose to balance the overall budget, Ed Balls announced in January 2014 that Labour would aim to get the *current* budget into surplus in the next parliament, thereby excluding net investment. Alongside this, he declared that a future Labour government would aim to reduce debt as a proportion of GDP within the parliament:

> *I am today announcing a binding fiscal commitment. The next Labour government will balance the books and deliver a surplus on the current budget and falling national debt in the next parliament… We will get the current budget into surplus as soon as possible in the next parliament. How fast we can go will depend on the state of the economy and public finances we inherit.*[17]

There is no mention of whether this is the cyclically-adjusted current budget or not. The absence of any reference to such adjustment would appear to make it more likely that it relates to the non-adjusted position, however. In any case, with the output gap projected to be approaching zero by 2018-19, this distinction is perhaps of reduced significance for the years under consideration here.

While in line with the Coalition's existing focus on the current budget, Labour's position represents a clear difference from the Conservatives' new stance. Capital spending is currently projected to amount to somewhere in the region of £25-£30 billion a year over the course of the next parliament, and so this is the extra sum that Labour could ultimately spend on day-to-day public services or on AME each year relative to Conservative plans if they chose to (they might not). Obviously, Labour could choose to increase the capital budget beyond this without impacting on their current budget target, though they would eventually find themselves constrained by their commitment to reduce debt as a share of GDP.

Of course, a key question is what year constitutes "as soon as possible"? The choice of target year makes a very significant difference to public finance outcomes. Unlike the Conservatives and the Liberal Democrats (see below), Labour have made no statement about what path they would follow once the current budget had been returned to balance. Given the uncertainties surrounding the Labour plans, we contrast two 'assumed' scenarios in Section 4.

Labour have also announced that they would increase real spending on the NHS by £2.5 billion (for context, the Stephens report on the NHS argues that an £8 billion increase is needed by 2020).[18] However, they suggest that this will have no direct bearing on their deficit targets because it will be matched by £2.5 billion in tax increases. As with the £7 billion Conservative tax cut proposals, we do not include this £2.5 billion figure in our modelling in Section 4, other than when setting out implied real-terms changes in departmental budgets.

The Liberal Democrats focus on a budget that excludes *some* elements of capital, alongside some tax increases

The Liberal Democrats' medium-term fiscal policy is to balance the cyclically-adjusted current budget (CACB) by 2017-18. That is consistent with the existing Coalition approach, which is

[17] Labour Press Release, "Ed Balls announces binding fiscal commitment that the next Labour government will deliver a current budget surplus", 24 January 2014

[18] NHS England, *Five Year Forward View*, October 2014

projected to deliver a surplus of £13.4 billion on this measure at that point. Indeed, we assume the Liberal Democrat emphasis on 'balance' rather than 'surplus' corresponds to a slight loosening relative to the current trajectory.

Beyond 2017-18, the party wants to balance an 'overall' budget but, unlike the Conservatives, this pledge relates to a cyclically-adjusted measure and excludes some elements of capital spending. In short, the Liberal Democrat position sits somewhere between the Conservatives (balance including all capital) and Labour (balance excluding all capital). There is also a commitment to reduce debt as a share of national income:

> *The Liberal Democrat objective is to eradicate the structural current budget deficit by 2017-18 and have debt falling as a percentage of GDP…*
>
> *Once we have balanced the books, we will ensure that overall public spending grows again in line with the economy… We will follow two new fiscal rules. Our first fiscal rule is that, from 2017-18, debt must fall as a proportion of our national income every year – except during a recession – so it reaches sustainable levels around the middle of the next decade…*
>
> *Our second fiscal rule is that over the economic cycle we will balance the overall budget, with one significant exception to enable us to invest in the things that will help our economy grow. Provided the debt rule is met, the government will be able to borrow for capital spending that enhances economic growth or financial stability… In our spending review we will set out long-term plans for capital expenditure, and ensure that investment in infrastructure, including housing, continues to rise both in absolute terms and as a share of the economy.*[19]

In contrast to the Conservatives, Nick Clegg has argued that deficit reduction after 2015-16 would be achieved "not just through further spending cuts" but through tax increases too, such as the proposed Mansion Tax.[20] However, it is worth noting that any gains from new tax policies would need to be offset against the party's pledge for tax cuts – in the form of further increases in the income tax personal allowance (a policy that is expected to cost in excess of £5 billion[21], with the first increase in 2016-17[22]) and potentially a rise in the National Insurance threshold.

While they share a policy on the personal allowance with the Conservatives, the Liberal Democrats also intend to increase NHS spending, as Labour does. They have proposed £1 billion of extra spending for 2016-17 and beyond, but, as in Labour's case, it is argued that this will be funded through new taxation and so does not directly affect the deficit targets (and is similarly excluded from our modelling).[23]

In considering the implications of the Liberal Democrat approach beyond 2017-18, much will depend on how fast they would want to reduce the national debt and, above all, which capital spending is classed as "productive" and which is not (and who decides). We discuss two possible scenarios in the next section.

[19] Liberal Democrats, *Pre-Manifesto 2014: A Stronger Economy and a Fairer Society*, p15

[20] *ibid.*

[21] G Kelly, "Why the Liberal Democrats' £12,500 tax allowance promise is a smaller pledge than it sounds", *New Statesman*, 11 March 2014

[22] "Liberal Democrats will raise tax-free allowance in the first year of the next Parliament", libdems.org.uk

[23] They have also proposed that up to £1.5 billion be added to the NHS budget in 2015-16.

Section 4

Implications of alternative fiscal plans beyond 2015-16

Having set out the broad position taken by each party in Section 3, we look next at the potential implications of each approach and consider what they might mean for departmental allocations and for welfare spending.

It is important that all of these findings are treated with caution, both because of the inherent uncertainty in such calculations and because it is generally unclear precisely what course of action each party would take – we are making a number of assumptions here. Instead, the various scenarios set out below can be considered to be our interpretation of what existing party statements might imply for the pace and shape of fiscal tightening.

In all instances we assume no dynamic effects. That is, we take GDP trajectories as given (in line with the OBR projections from March 2014, which are of course subject to change) and assume that these are unaltered by any change in the nature of deficit reduction. Similarly, we assume no changes in yields on government bonds as a result of any change in the timing of debt reduction. Again, both assumptions might reasonably be challenged.

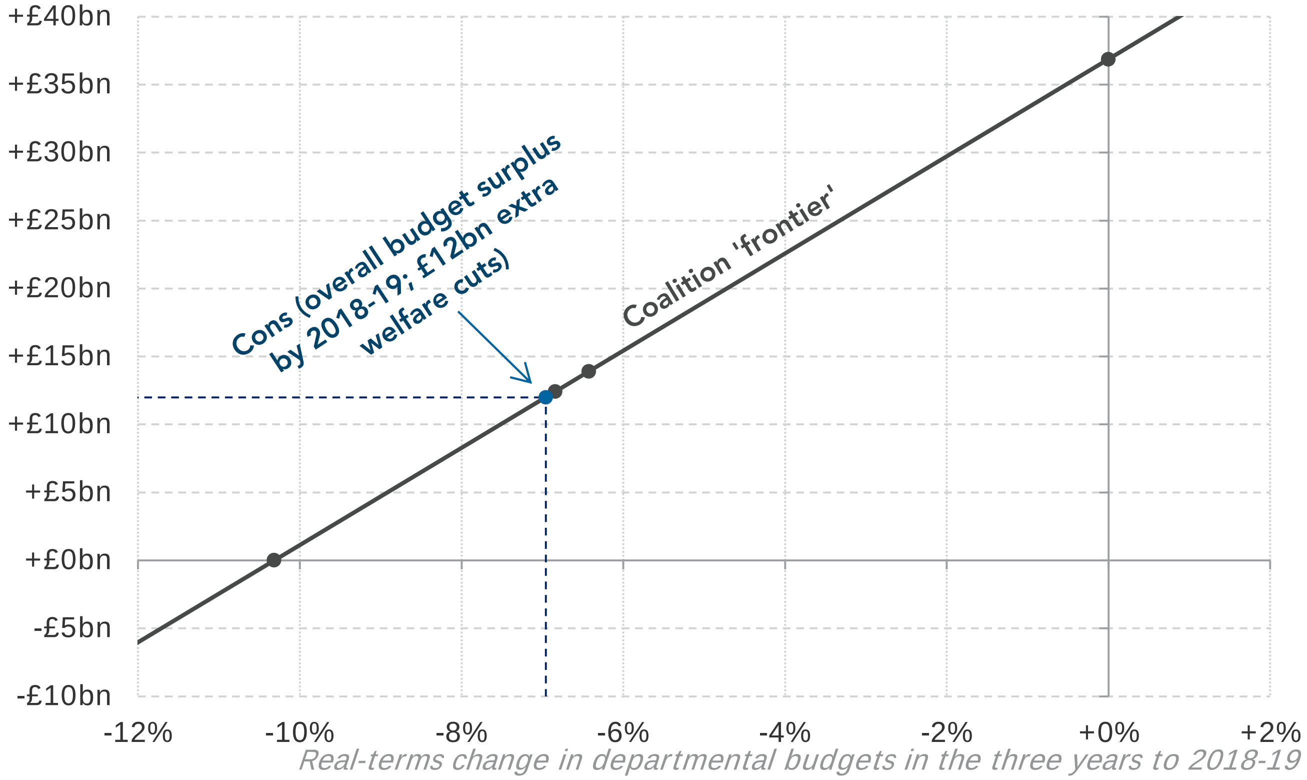
Our 'assumed' Conservative scenario implies a broad continuation of the pace of departmental budget cuts…

Referring back to the range of possible combinations of DEL cuts, AME cuts or tax rises set out in Figure 5, the Conservative pledge to secure £12 billion of additional welfare cuts in the next parliament (which we assume take effect in 2016-17 and 2017-18) implies that the remaining tightening in DEL required in the three years after 2015-16 falls from £37 billion to £25 billion.[24] As Figure 6 on the next page shows, that would produce an overall pace of DEL cuts that was very slightly faster than those planned for 2015-16, amounting to 7 per cent over the period.

[24] This is only coincidentally equal to the rounded £25 billion of supposedly required cuts referred to by the Chancellor – see Box 1.

Figure 6:
Potential DEL and AME trade-offs between 2015-16 and 2018-19 under assumed Conservative scenario

Value of welfare cuts/tax rises in the three years to 2018-19 (2013-14 prices)



Source: RF analysis of ONS & OBR

Notes: Conservative scenario: based on assumption that Coalition trajectory is followed, producing an overall surplus in 2018-19, but with an additional £12bn of welfare (AME) cuts in 2016-17 and 2017-18.

But with an increased emphasis on day-to-day departmental spending…

Alongside reducing the pace of departmental cuts relative to a world in which no further AME cuts are introduced, the Conservative pledge to maintain investment as a share of GDP is likely to affect the balance between current and capital expenditure.

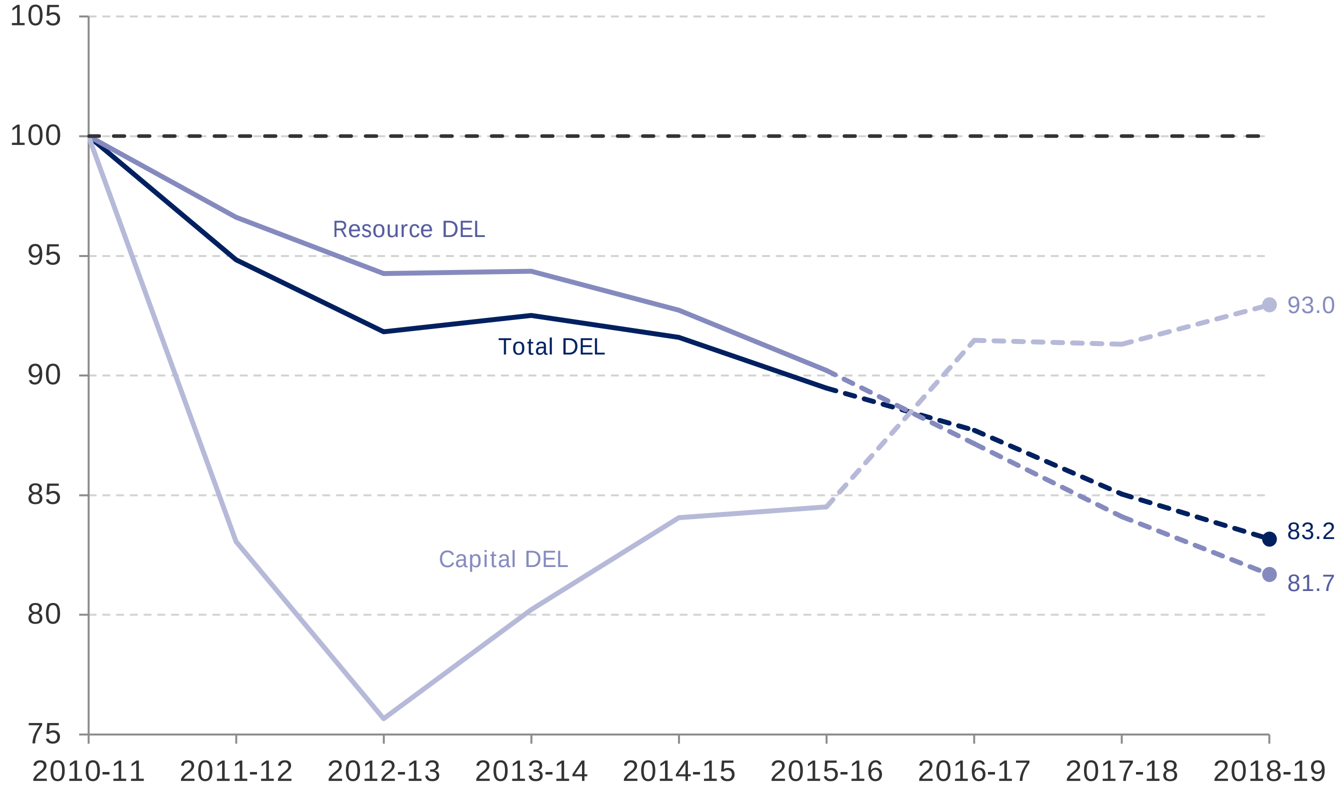
Under existing Coalition plans, net investment excluding Royal Mail and Asset Purchase Facility transfers is set to stand at 1.5 per cent of GDP in 2015-16 (down from 1.6 per cent in 2014-15 and 2.2 per cent before the downturn) before falling to 1.4 per cent in 2017-18 and 2018-19. If we assume that the Conservative proposal involves taking the 2015-16 level of investment spending as its benchmark, then maintaining it at 1.5 per cent of GDP would require annual capital spending to be boosted by around £2 billion by 2018-19. This would need to be offset by reductions in day-to-day spending on public services (resource DEL, or RDEL) in order to maintain the trajectory for the overall budget.

That will change the distribution of cuts between departments…

Figure 7 sets out potential trajectories for RDEL, capital DEL (CDEL) and total DEL under this assumed Conservative scenario. It shows that total DEL would be 17 per cent lower in real terms at the end of the period than in 2010-11. RDEL is reduced by 18 per cent and CDEL by 7 per cent.

Figure 7:
Resource and capital DEL outturn and projection under assumed Conservative scenario: 2010-11 to 2018-19

DEL spending in real terms: 2010-11 = 100



Source: RF analysis of ONS & OBR

Notes: See notes to Figure 6. In addition, there is a transfer from RDEL to CDEL to ensure that investment spending is held constant as a share of GDP. From 2013-14 there is a definitional shift from DEL to AME. Chart is adjusted to remove this effect.

But the overall magnitude of cuts will remain highly significant…

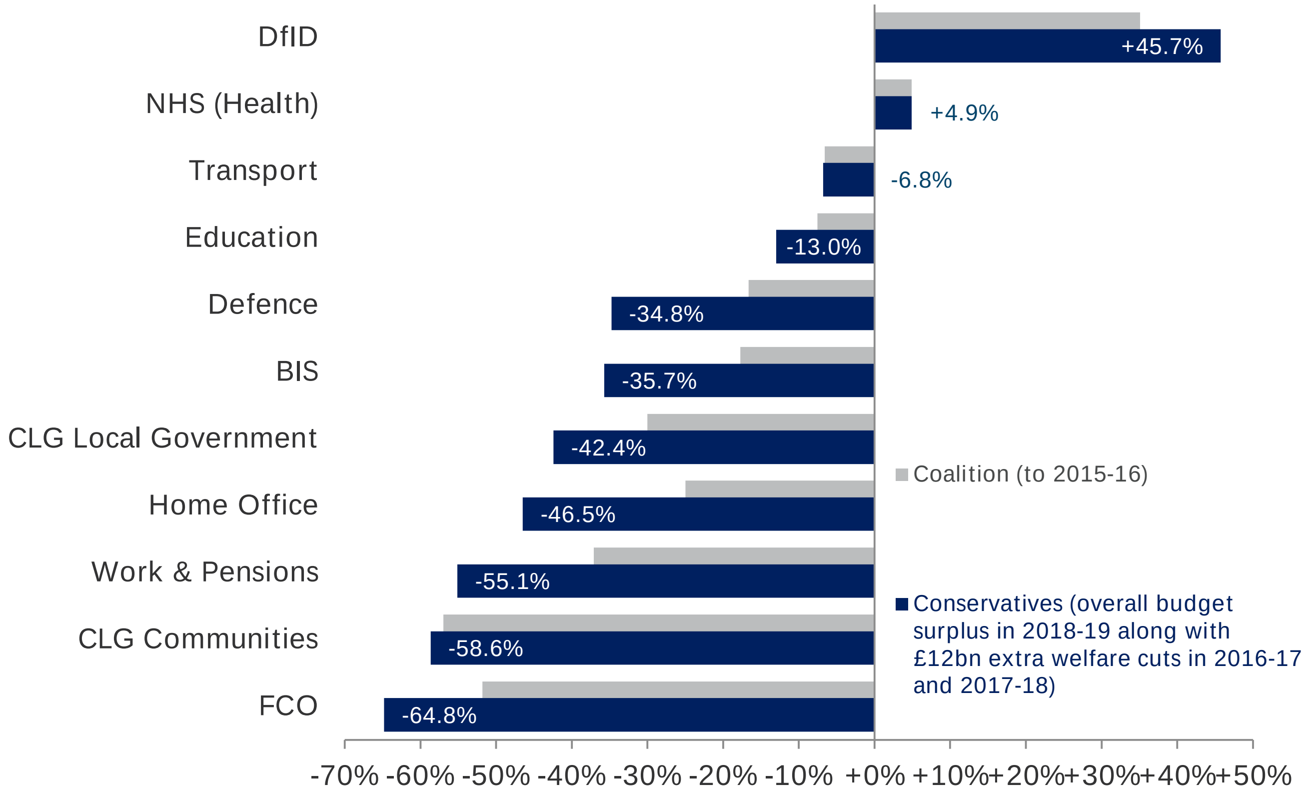
Despite an additional £12 billion of welfare cuts, our assumed Conservative scenario would still imply a sizeable cumulative impact on departmental budgets over the full period of fiscal consolidation.

In Figure 8 we incorporate the Conservative pledge to continue to protect health spending in real terms after 2015-16, and assume that the protection given to schools and aid in 2015-16 also remains in place in the following three years, with the required RDEL and CDEL cuts being shared equally across non-ringfenced areas.

As noted in Section 2, because the protected departments have become an ever-larger share of total departmental spending since the start of the programme of fiscal consolidation, this assumed Conservative approach – while only increasing the overall pace of cuts introduced in Spending Review 2013 slightly – actually results in acceleration in budget reductions among non-protected departments. As such, Figure 8 shows that cumulative cuts between 2010-11 and 2018-19 would amount to one-third in Defence, close to one-half in the Home Office and approaching two-thirds in the FCO.

Figure 8:
Potential DEL outcomes in selected departments under assumed Conservative scenario: 2010-11 to 2018-19

Cumulative real terms change in DEL 2010-11 to 2018-19



Source: RF analysis of ONS & OBR

Notes: See notes to Figure 6. Cut in the FCO budget is over-stated slightly because of transfer of BBC World Service from FCO to the BBC licence fee from April 2014. The impact is thought to be relatively small, however. The Conservative figures are affected by our assumption that capital spending is maintained at 1.5 per cent of GDP in line with its stated commitment, resulting in an increase in CDEL relative to current projections. This has the effect of modifying the overall cuts faced by departments with large capital components and amplifying the cuts faced by others.

Which sit alongside a challenging target on welfare

It is also worth reflecting that cutting a further £12 billion from AME after 2015-16 – presumably from within the welfare cap – would be extremely challenging. This would be equivalent to over 10 per cent of spending within the cap, and similar to the total cost of Child Benefit or Disability Living Allowance (eventually Personal Independence Payments), or half of the Housing Benefit budget. The Chancellor has proposed freezing working-age benefits for an additional two years (2016-17 and 2017-18), raising £3 billion, but this is of course only a quarter of what is needed under this plan.

The pace of reduction under our 'assumed' Labour scenarios rests on the target year in place…

As noted above, existing Coalition plans are forecast to deliver a current budget surplus of £9 billion in 2017-18 and £28 billion in 2018-19 (resulting in an overall budget surplus of £1 billion). Simply by assuming that the current budget surplus targeted by a future Labour government could fall as low as £1 billion, we can envisage the scale of tightening set out in Figure 5 being reduced (that is, the 'frontier' line that sets out the range of trade-offs under the current approach would shift to the right).

Cutting a further £12 billion from AME after 2015-16 – presumably from within the welfare cap – would be extremely challenging

With no way of knowing at what point Labour will seek to achieve current budget balance, we consider two possible approaches below: one in which they produce a small surplus of £1 billion somewhere in the middle of the parliament (2018-19) and one in which they produce the same surplus at the end of the parliament (2019-20).

Labour could of course choose to move quicker (say, 2017-18). However, given that they have provided no indication of what fiscal position they would seek once they achieve their stated aim of balance (unlike the Conservatives and the Liberal Democrats), we have no way of knowing what fiscal position a current budget balance in 2017-18 would translate into in 2018-19. This creates practical difficulties for us because we focus on the three years after 2015-16 throughout this report, so as to provide like-for-like comparisons between the different scenarios. In order to maintain this focus, we are faced with a choice between modelling a scenario in which Labour achieves balance in 2017-18 (only possible if we introduce another – inevitably wrong – assumption about their post-balance position in 2018-19[25]) and taking 'mid-parliament' to equate to 2018-19. We have opted for the latter.[26]

Figure 9 sets out both scenarios – 'Labour 18' and 'Labour 19' – and compares them with the original Coalition 'frontier' and our assumed Conservative scenario.[27] In each instance, the trade-offs are those that would exist in the three years between 2015-16 and 2018-19.

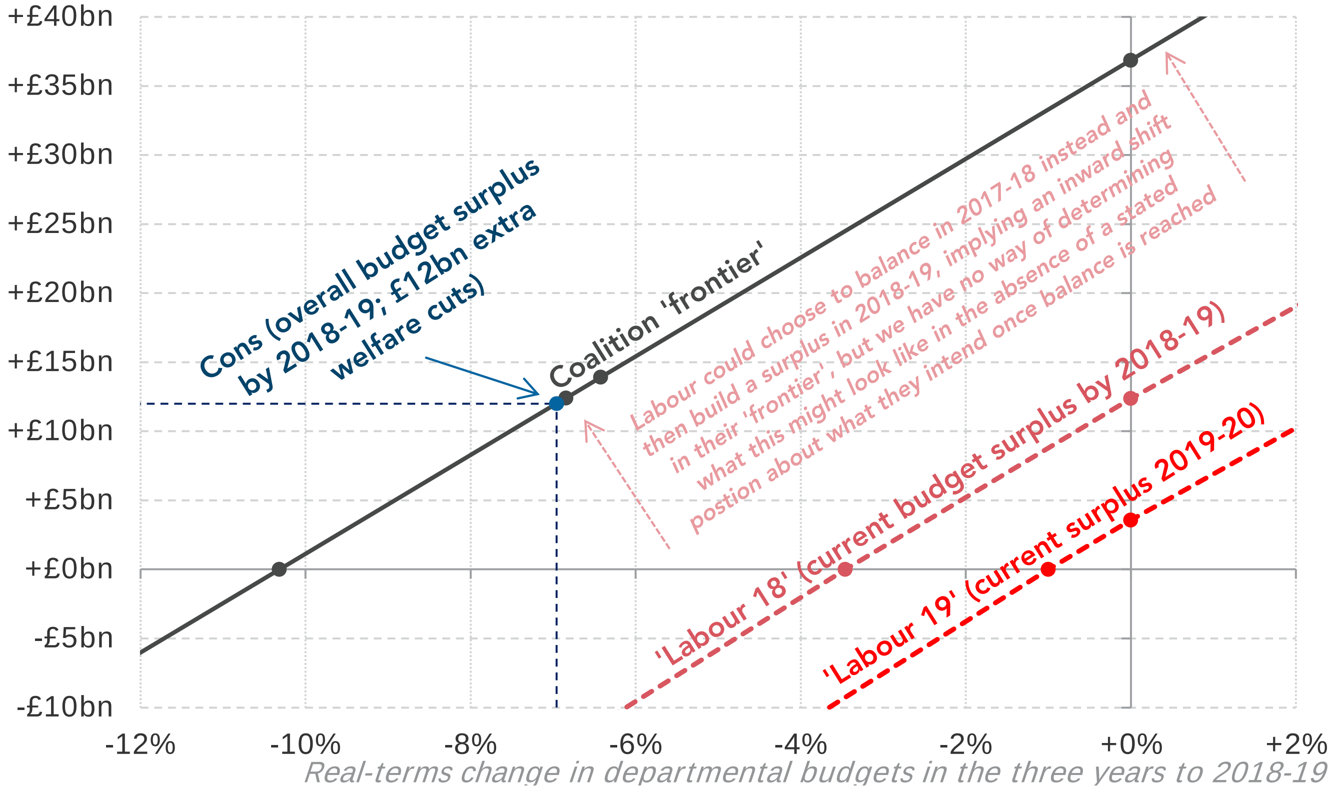
[25] Note, if – for example – we assumed that Labour simply chose to continue to produce a £1 billion current budget surplus after 2017-18, we would effectively end up with the same outcome as is shown under the scenario in which they first achieve balance in 2018-19.

[26] Of course if Labour *were* to target 2017-18, it would simply move the scale of tightening required closer to those recorded in our Conservative and Liberal Democrat scenarios.

[27] Each of these scenarios is consistent with Labour's stated aim of reducing PSND as a share of GDP over the course of the next parliament.

Figure 9:
Potential DEL and AME trade-offs between 2015-16 and 2018-19 under assumed Labour and Conservative scenarios

Value of welfare cuts/tax rises in the three years to 2018-19 (2013-14 prices)



Source: RF analysis of ONS & OBR

Notes: Conservative scenario: based on assumption that Coalition trajectory is followed, producing an overall surplus in 2018-19, but with an additional £12bn of welfare (AME) cuts in 2016-17 and 2017-18. Labour scenarios: based on assumption that a current budget surplus of £1bn is targeted in each of the two years specified ('Labour 18' and 'Labour 19'). Assume steady reductions in spending in each year between 2015-16 and the target year.

But the focus on the current budget means the Labour scenarios appear somewhat looser than the Conservative approach…

Under the 'Labour 18' scenario, a new set of trade-offs is established in Figure 9. That is, unlike the Conservative scenario which sits on the Coalition 'frontier', the 'Labour 18' scenario implies a smaller overall scale of fiscal tightening. Under the 'Labour 19' scenario, in which a current budget surplus is delivered in 2019-20, the scale of the overall fiscal challenge is reduced still more significantly – resulting in a further rightward shift in the 'frontier' of possible trade-offs.

While both Labour scenarios reduce the scale of consolidation required, it should be noted that they also result in higher levels of debt relative to the Conservative approach, with implications for debt interest payments (see p25). These payments are factored into the modelling set out in Figure 9 above.

Meeting the 'Labour 18' target via DEL cuts alone would require a cumulative reduction over the three years after 2015-16 of 3.5 per cent. This would still imply a slower pace of DEL cuts than the one set out in our assumed Conservative scenario. Additionally, Labour would have the option of reducing the required pace of DEL cuts still further by introducing new AME cuts or tax rises.

Alternatively, if it chose not to cut departmental spending at all, it would need to find £12.5 billion in savings or revenues from elsewhere.

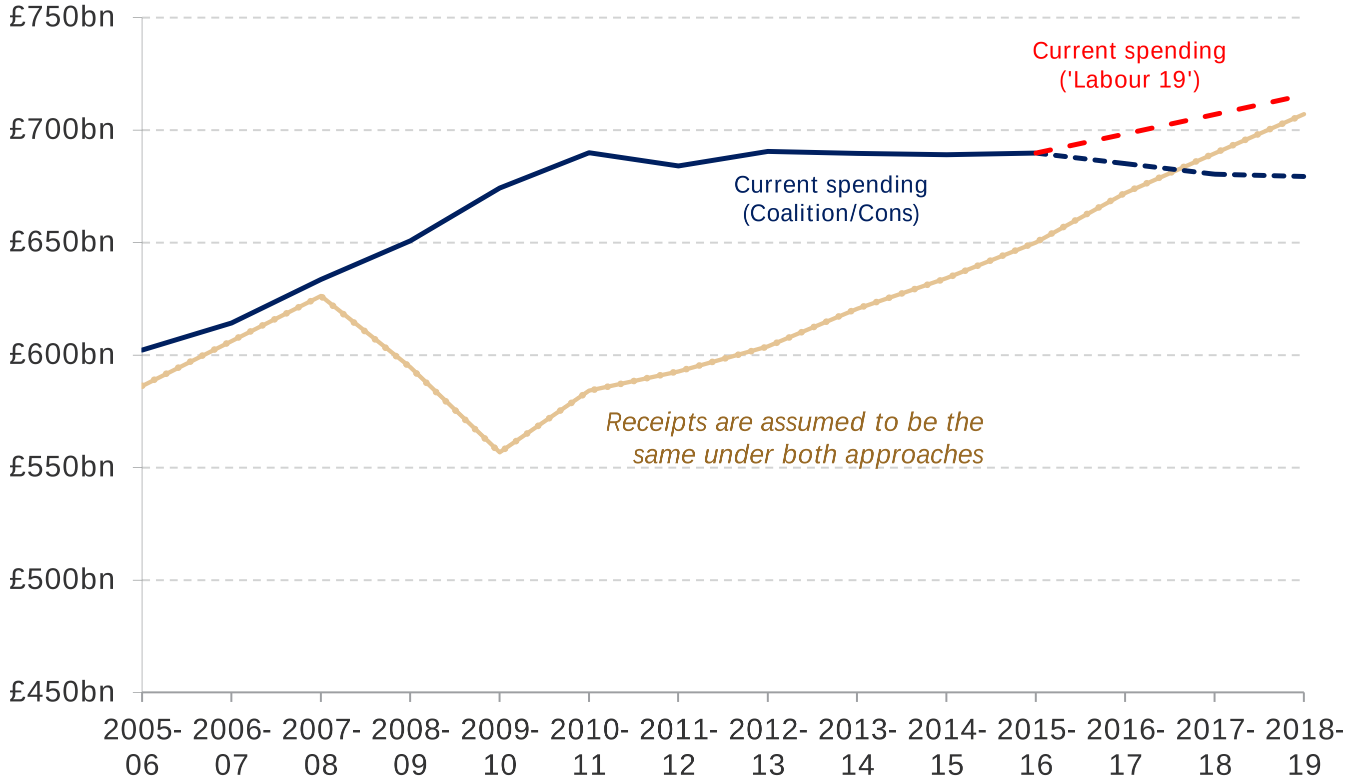
Turning to the 'Labour 19' scenario – the 'loosest' of all the scenarios we consider in this paper – we see that a Labour government would need just £4 billion of further consolidation in the three years after 2015-16 to meet its deficit reduction target, equivalent to a 1 per cent cumulative reduction in DEL.

This will strike some as a surprising finding, but it is a product of the fact that the existing Coalition plans already imply a sizeable current budget surplus in 2018-19, allied with the assumption that Labour's less ambitious target is shifted one year further out, to 2019-20.

To be clear, this is not the same as relying on the output gap closing in order to reduce the size of the deficit: by 2018-19 it is assumed that the output gap is already close to zero, meaning that there is very little scope for 'catch-up' deficit reduction. Instead, it relies on the fact that holding DEL flat in real terms (that is, no 'cuts') implies a reduction in spending relative to GDP, while receipts maintain (or slightly increase) their share of national income.

Figure 10:
Contribution of spending and revenue changes to deficit reduction under 'Labour 19' scenario and Conservative scenario

Tax receipts and government spending (2013-14 prices)



Source: RF analysis of ONS & OBR

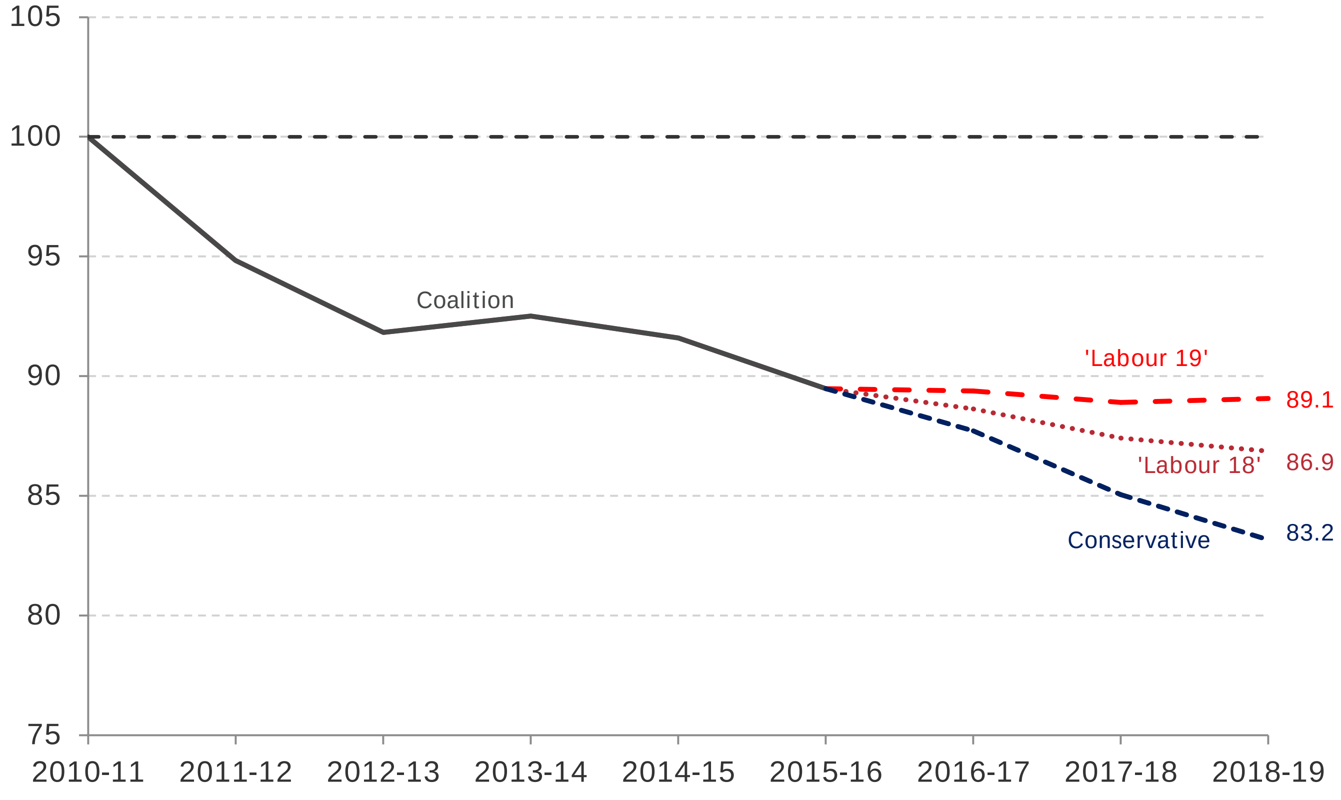
Notes: 'Labour 19' scenario: based on assumption that they stick to the 2015-16 plans of the Coalition and then target a £1 billion current budget surplus in 2019-20. Does not include £2.5 billion extra NHS spending commitment or offsetting tax rises. Conservative scenario: based on assumption that Coalition trajectory is followed, producing an overall surplus in 2018-19, but with an additional £12bn of welfare (AME) cuts in 2016-17 and 2017-18. Does not include £7 billion tax cuts promised for some point in the next parliament.

Cutting DEL by just 1 per cent in real-terms under the 'Labour 19' scenario would imply an overall increase in current expenditure of 3.7 per cent (accounted for by real-terms increases in AME). The latest OBR projections suggest that real GDP will grow by 7.9 per cent between 2015-16 and 2018-19, while government receipts will increase by 8.8 per cent.[28] As Figure 10 on the previous page shows therefore, spending growth would be easily outpaced by the increase in receipts, meaning that the gap between the two would still narrow, albeit less rapidly than under the Conservative scenario.[29]

Resulting in potentially slower DEL reductions…

Figure 11:
DEL outturn and projection under assumed Labour and Conservative scenarios: 2010-11 to 2018-19

DEL spending in real terms: 2010-11 = 100



Source: RF analysis of ONS & OBR

Notes: See notes to Figure 10. From 2013-14 there is a definitional shift from DEL to AME. Chart is adjusted to remove this effect. Unlike Figure 10, the Labour DEL totals include the £2.5 billion pledged for additional NHS spending (set to be funded from taxation) from 2017-18.

[28] Growth in receipts is forecast to outpace GDP growth in part due to the return of fiscal drag once real-terms wage growth resumes and in part due to gains in capital taxes. Changes in pension withdrawals measures and voluntary NICs which are also expected to boost receipts in the short-term, before increasing costs in the long-term.

[29] To be clear then, in the 'Labour 19' scenario, we assume that the current budget deficit stands at £8.6 billion in 2018-19, but that no additional consolidation is required in 2019-20 to meet the target of balance in that year. This is because government revenues are assumed to grow alongside GDP in 2019-20, whereas total spending would grow by less than GDP (but by more than the GDP deflator). Thus a small real-terms increase in DEL would be consistent with closing the current budget deficit. As a result, all of the tightening required over the course of the parliament under the 'Labour 19' scenario is captured within Figure 9.

In the absence of any information about where on the various 'frontiers' we have established, Labour would choose to position itself – that is, how much of the overall fiscal tightening it would seek to achieve via DEL cuts and how much via AME cuts or tax rises – we have no way of knowing quite what the implications of each scenario would be on departmental budgets.

In Figure 11 we present the extreme case – that in which all of the required consolidation falls on DEL. It shows that the two Labour scenarios imply cumulative cuts in total DEL between 2010-11 and 2018-19 that range between 11 per cent (under the 'Labour 19' approach) and 13 per cent (under the 'Labour 18' scenario).

Of course in practice we might expect a future Labour government to offset DEL reductions with tax rises or AME cuts. But, in the absence of any sense of their preferred balance, we show the extreme case here by way of illustration.

Lowering the level of departmental budget cuts recorded by 2018-19…

Figure 12:
Potential DEL outcomes in selected departments under assumed Conservative and Labour scenarios: 2010-11 to 2018-19

Cumulative real terms change in DEL 2010-11 to 2018-19

Source: RF analysis of ONS & OBR

Notes: See notes to Figure 10. Cut in the FCO budget is over-stated slightly because of transfer of BBC World Service from FCO to the BBC licence fee from April 2014. The impact is thought to be relatively small, however. Includes extra Labour NHS spending (set to be funded from taxation) from 2017-18, and assumes that all of the tightening required under the Labour scenarios is delivered via DEL cuts (rather than AME cuts or tax rises). The Conservative figures are affected by our assumption that capital spending is maintained at 1.5 per cent of GDP in line with its stated commitment, resulting in an increase in CDEL relative to current projections. This has the effect of modifying the overall cuts faced by departments with large capital components and amplifying the cuts faced by others.

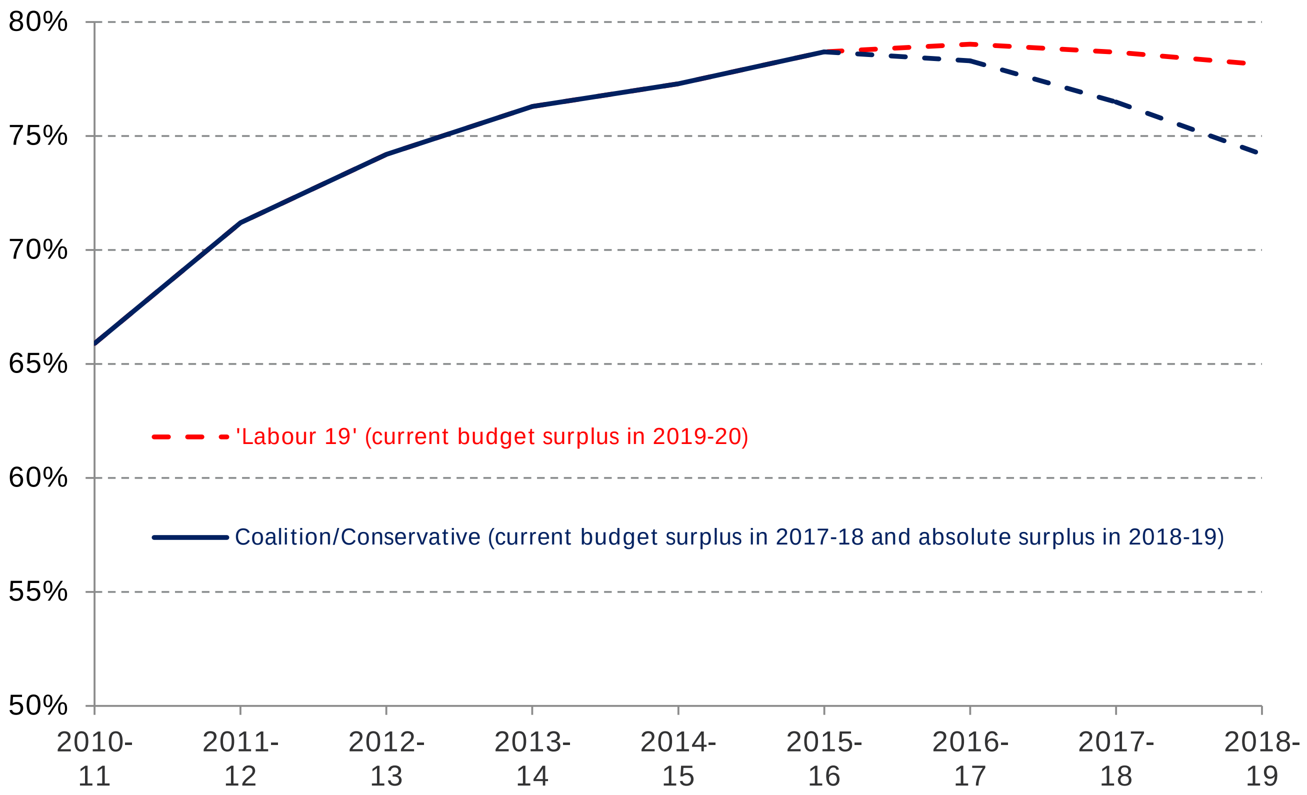
This range of DEL outcomes can be applied to individual department budgets. Figure 12 compares the 'Labour 18' and 'Labour 19' scenarios with the assumed Conservative one.

Even in the absence of any new AME cuts or tax rises, both Labour scenarios produce smaller reductions in budgets than our assumed Conservative approach.[30] Under the 'Labour 19' scenario, the required cuts are generally much reduced, with the Defence budget falling by one-fifth rather than one-third, for example. This outcome reflects the fact that this approach involves a much gentler path for DEL – with the slower deficit reduction meaning that more of the work is done by growth in receipts (as shown in Figure 10). Even taking this approach though, we still find reductions of more than half in Communities and in the FCO (although much of this is already in place by 2015-16).

But slower deficit reduction translates to a slower pace of debt reduction…

Figure 13:
Potential PSND outcomes under assumed Conservative and 'Labour 19' scenarios: 2010-11 to 2018-19

Public sector net debt as a share of GDP



Sources: RF analysis of ONS & OBR

Notes: See notes to Figure 10

[30] Outcomes would also differ because we make an assumption in the Conservative scenario that funds are diverted from RDEL to CDEL in order to meet the Conservative pledge to maintain investment spending as a share of GDP. This has the effect of concentrating DEL cuts on those departments in which CDEL accounts for a relatively low share of the overall budget.

The dynamic effects of variations in the pace of deficit reduction on economic growth are unclear. Given the inherent uncertainty surrounding potential fiscal multipliers, particularly in a world in which the economy is at or near its potential, and the likelihood that interest rates will by then have risen from their current historic low (meaning that any unwanted slowdown in economic growth associated with deficit reduction could be partially offset by a loosening of monetary policy), we make no attempt to account for them, assuming instead no dynamic effects in this exercise.

Clearly, however, we would expect slower deficit reduction to result in a higher stock of debt. While both the assumed Labour scenarios would meet the party's stated aim of reducing debt within the parliament,[31] they are also likely to imply higher levels of PSND than that experienced under the assumed Conservative approach (which is identical to the existing Coalition trajectory). Taking the 'Labour 19' Labour approach as one end of the spectrum, Figure 13 shows that there appears to be relatively little difference in the short-term. However if, after meeting its aim of surplus on the current budget, Labour continued to hold a looser fiscal position than the Conservatives, then the trajectory of debt would begin to look very different. It very much depends on the medium-term fiscal stance which extends beyond the years considered here.

Even in the short-term, these higher debt levels have implications for debt interest payments. By 2018-19, the higher stock of debt implied by the 'Labour 19' scenario would result in around £3 billion extra in debt interest costs in real-terms.[32] These additional AME costs are included in our modelling, with the higher debt trajectory therefore eating into the additional funds that Labour would have at its disposal for DEL relative to the Conservatives. Clearly if Labour instead chose to pursue a tighter path of deficit reduction, these effects would be reduced or removed entirely.[33]

Although difficult to model, the Liberal Democrat approach is likely to come in somewhere between the Conservative and Labour scenarios...

The uncertainties surrounding which bits of capital would be in or out of scope of the post-2017-18 Liberal Democrat deficit target (after balancing the structural current budget), along with questions over quite when a surplus by this measure would be targeted, are too great to allow for detailed modelling at this stage. However, we look at two scenarios: one in which 'balance' is achieved in 2018-19 with just 25 per cent of capital spending excluded (closer to the Conservative's target – which excludes no investment), and one in which 75 per cent is excluded (closer to the Labour scenarios – which exclude all net investment).

The difference between the two Liberal Democrat scenarios amounts to around £13 billion per year (total consolidation of £31 billion in the 'tighter' scenario and £18 billion in the 'looser' one.

Meaning a wide range of fiscal choices at the election...

With the addition of these Liberal Democrat scenarios, the full range of fiscal policies and trade-offs under each of our assumed approaches is shown in Figure 14.

[31] At the extreme, the 'Labour 19' scenario results in PSND falling for the first time in 2017-18.

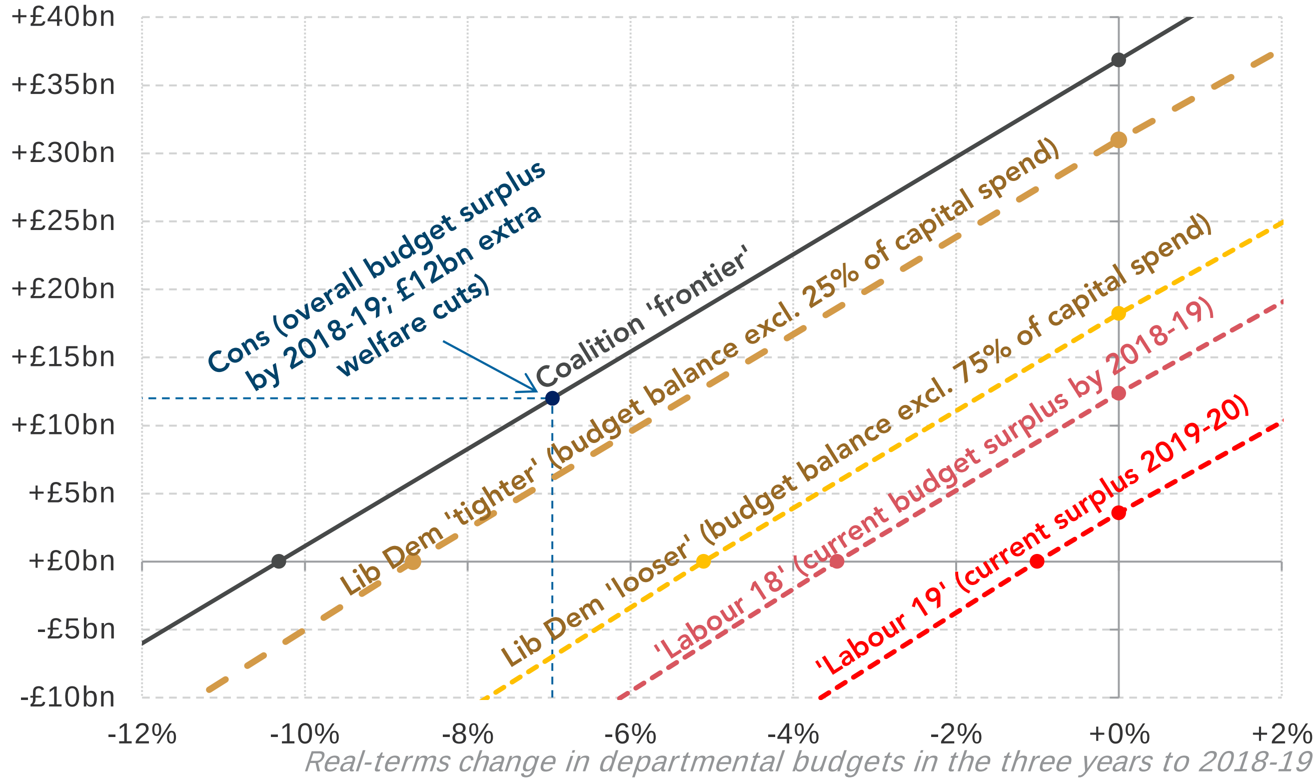
[32] This figure is calculated by applying OBR projections for the yields on new debt issuance in each year from 2016-17 to the additional new debt that would need to be funded under the Labour approach relative to the Coalition/Conservative one.

[33] Alongside the direct effect of raising the required debt issuance in any given year, some would argue that slower deficit (and therefore debt) reduction trajectories might also have the potential to increase the yield demanded by investors, thereby raising debt interest payments still further. Others would be sceptical that it would make much difference. There is – as with the issue of fiscal multipliers – too much uncertainty over quite how the market would react to consider such impacts in this note.

Figure 14:

Potential DEL and AME trade-offs between 2015-16 and 2018-19 under assumed Liberal Democrat, Labour and Conservative scenarios

Value of welfare cuts/tax rises in the three years to 2018-19 (2013-14 prices)



Notes: Conservative scenario: based on assumption that Coalition trajectory is followed, producing an overall surplus in 2018-19, but with an additional £12bn of welfare (AME) cuts in 2016-17 and 2017-18. Labour scenarios: based on assumption that a current budget surplus of £1bn is targeted in each of the two years specified ('Labour 18' and 'Labour 19'). Assume steady reductions in spending in each year between 2015-16 and the target year. They could choose to balance in 2017-18 instead and then build a surplus in 2018-19, implying an inward shift in their 'frontier', but we have no way of determining what this might look like in the absence of a stated position about what they intend once balance is reached. Liberal Democrat scenarios: based on assumption that Coalition trajectory is followed to 2017-18, before achieving a budget balance in 2018-19 that excludes either 25 per cent ('tighter') or 75 per cent ('looser') of all capital spending.

Source: RF analysis of ONS & OBR

To recap, our five scenarios imply consolidation in the three years between 2016-17 and 2017-18 (on top of the £8.5 billion already earmarked for 2015-16) in the range of £4 billion to £37 billion.

- The assumed **Conservative scenario** produces a current budget surplus in 2017-18 and an overall budget surplus in 2018-19. It implies total consolidation of **£37 billion** beyond 2015-16, split between a £12 billion reduction in the welfare bill and a further £25 billion cut in departmental spending (equivalent to a 7 per cent cumulative reduction over the three years);
- Our **Liberal Democrat 'tighter' approach** results in a current budget balance in 2017-18 and an 'overall' balance (excluding one-quarter of the capital budget) in 2018-19. It implies total consolidation of **£31 billion** beyond 2015-16. This is equivalent to a cumulative reduction in DEL of 8.7 per cent in the absence of any cuts in AME or tax rises, though in practice the party has indicated that it *would* introduce an unspecified degree of such measures;
- The **Liberal Democrat 'looser' approach** also produces a current budget balance in 2017-18, but this time the 'overall' balance in 2018-19 excludes three-quarters of the capital budget. In this instance, the total required amounts to £18 billion beyond 2015-16, equivalent to a three year DEL reduction of 5.1 per cent;

- Our **'Labour 18' approach** results in a small current budget surplus in 2018-19, implying total DEL cuts of around £13 billion beyond 2015-16 in the absence of any reductions in AME or tax rises. That would be equivalent to a cumulative DEL cut of 3.5 per cent over three years; and
- The loosest of our scenarios – as described in the **'Labour 19' approach** – generates a small current budget surplus at the end of the parliament, in 2019-20. In this instance, the required consolidation in the three years from 2016-17 amounts to just £4 billion, equivalent to a 1 per cent reduction in DEL. No additional consolidation would be required in 2019-20 itself.

While none of the parties have yet set out precisely how they intend to meet their fiscal targets, they have each proposed *some* spending cuts and/or tax increases for the years after 2015-16. Yet in many cases they have also committed these to funding tax cuts and/or spending increases elsewhere. In each instance then, our figures exclude any net tax cuts (such as raising the personal allowance) or spending increases (such as real terms increases for the NHS) proposed by the parties. Such policies will require their own *additional* consolidation over and above that set out here.

And important trade-offs to be made between tax increases and spending cuts

As well as the broad pace and definition of deficit reduction, there are crucial trade-offs to be made in terms of the balance between spending cuts and tax rises. Such trade-offs can – for better or for worse – be formulated as explicit rules.

In 2010, the Coalition stated its intention to achieve fiscal consolidation via a combination of 80 per cent expenditure reduction and 20 per cent revenue increases. The actual balance achieved by the Coalition has shifted over the course of the parliament. Tax increases accounted for a larger share in the early years, reflecting the fact that most of the impact in this area can be traced back to policies introduced by the previous Labour government. Additional tax increases announced by the Coalition (including the rise in VAT) have been significantly offset by tax cuts elsewhere (including the increase in the personal tax allowance). [34] But, according to Budget 2014, the Coalition is on track to deliver its 80:20 target for the total package of consolidation up to and including 2015-16.[35]

The 80:20 (4 to 1) ratio adopted by the Coalition reflected the preference argued for by the Conservatives before the 2010 election (David Cameron described it as "the gold standard"[36]), and contrasts with a Liberal Democrat proposal at the time of 71:29 (2 1/2 to 1) and a Labour preference for 67:33 (2 to 1).[37] Clearly, these ratios may no longer reflect the positions of the three parties. Indeed, it is important to emphasise that in approaching the post-2015-16 period of consolidation, the Conservatives appear to have explicitly ruled out further tax increases, while Labour are yet to express any preference for a given balance. The Liberal Democrats – or, more specifically, Nick Clegg and Danny Alexander – have, however, indicated that they would favour continuing the Coalition's 80:20 ratio.[38]

For completeness, and simply by way of illustration, we set out in Table 1 the implications under each of our five scenarios of seeking to secure a balance of future consolidation (i.e.

[34] *Budget 2014*, Table 1.2

[35] *ibid.*

[36] David Cameron, *BBC Radio 4 Today programme*, 27 May 2010

[37] IFS, *Election Briefing 2010 Summary*

[38] "Alexander slaps down Cable over tax plan," *Politics Home*, 8 October 2014

post-2015-16)[39] that matches in turn each of the three targets discussed prior to 2010.

Table 1: Balance of net spending cuts/tax increases required in the three years from 2016-17 to achieve selected ratios for future consolidation

Total consolidation	Conservative £37bn		Lib Dem 'tighter' £31bn		Lib Dem 'looser' £19bn		'Labour 18' £13bn		'Labour 19' £4bn	
	Spending cuts	Tax rises	Spending cuts	Tax rises	Spending cuts	Tax rises	Spending cuts	Tax rises	Spending cuts	Tax rises
Ratio:										
4 to 1	£30bn /	£7bn	£25bn /	£6bn	£15bn /	£4bn	£10bn /	£3bn	£3bn /	£1bn
2½ to 1	£27bn /	£11bn	£22bn /	£9bn	£13bn /	£5bn	£9bn /	£4bn	£3bn /	£1bn
2 to 1	£25bn /	£12bn	£21bn /	£10bn	£12bn /	£6bn	£8bn /	£4bn	£3bn /	£1bn

Source: Resolution Foundation analysis using OBR projections

Notes: Figures may not sum due to rounding. Any new tax cuts (e.g. income tax) or spending increases (e.g. NHS) would require further consolidation. Extra borrowing relative to existing plans incurs extra debt interest. Conservative scenario: Current budget surplus of £9 billion in 2017-18, absolute surplus of £1 billion in 2018-19. Labour scenarios: based on assumption that a current budget surplus of £1bn is targeted in each of the two years specified ('Labour 18' and 'Labour 19'). Assume steady reductions in spending in each year between 2015-16 and the target year. Liberal Democrat scenarios: based on assumption that Coalition trajectory is followed to 2017-18, before achieving a budget balance in 2018-19 that excludes either 25 per cent ('tighter') or 75 per cent ('looser') of all capital spending.

The table shows that the apparent Liberal Democrat preference for 80:20 would entail £15 billion to £25 billion of spending cuts and £4 billon to £6 billion of net tax increases depending on the scenario in question. Again, by way of illustration, the lower of these tax requirements would be roughly equivalent to an increase in the basic rate of income tax to 21p; the higher might be financed by raising both the basic and higher rates of income tax by 1p. A 1 percentage point increase in the standard VAT rate would deliver a tax gain roughly in the middle of these two figures.[40]

If Labour were to opt for either our 'Labour 18' or 'Labour 19' scenarios, and were to express a preference for a 4 to 1 ratio, then this would imply net tax increases of between £1 billion (1p on the higher rate of income tax) and £3 billion (increasing all VAT rates by half of a percentage point). Alternatively, if it were to revive its pre-2010 preference for 2 to 1, then the scenarios we have set out would imply net tax increases of between £1 billion and £4 billion. Likewise, if the Conservatives reverted to their 4 to 1 approach (admittedly unlikely given the Chancellor's clear statement on tax), then they would need to find £7 billion in new tax revenues (over and above the £7 billion of tax cuts they have proposed in the next parliament). This is equivalent to a 1.5 percentage point rise in the standard rate of VAT or an almost 2p increase in the basic rate of income tax. But, to repeat, all of this is purely hypothetical (particularly in relation to Labour and the Conservatives).

Whatever the economic justification, if any, for a chosen split between tax rises and spending cuts, and whether or not they are made explicit by each party, the chosen balance will be an important factor in determining the size of the state at the end of fiscal consolidation as well as the distributional impact of deficit reduction.

[39] Were the intention instead to deliver the chosen ratio for the whole of the post-financial crisis consolidation period then the balances shown in Table 1 would need to be altered. This is clearly true in relation to the 2 to 1 and 2½ to 1 ratios, because extra work would be required to reverse the prevailing 4 to 1 ratio. It might, however, also be true where the aim is to maintain an overall consolidation balance of 4 to 1. This is because the impact of existing Coalition tax and spending changes might be expected to become more weighted towards spending cuts over time. For example, pension reforms have boosted tax revenue in the short-term – contributing to the 4 to 1 figure for 2015-16 – but will reduce it in the long-run.

[40] HMRC, *Direct effects of illustrative tax changes*

Section 5

The importance of growth and a revenue-rich recovery

The modelling in this report is based primarily on OBR projections from March 2014 – the latest available. These figures will inevitably change, with significant implications for the task of fiscal consolidation facing the next government.

First, the UK has just moved to a new set of national accounting standards.[41] While altering little on the ground, these have changed a wide range of economic figures. We expect the Autumn Statement and new OBR figures to make use of the new standards and not be comparable with previous figures, including those in this report. The depth of the recession, the level of national debt, the deficit and the size of the state as a proportion of the economy are among those figures that will change.

Secondly, since the last OBR release in March, economic growth and employment have performed better than expected, but wages and tax receipts have disappointed. OBR estimates for 2014-15 will therefore be subject to significant revision and there may be implications for medium-term projections too. A key judgement is whether these changes will lead to a reduction in the output gap, which would increase the proportion of net borrowing that is classed as structural.

Thirdly, even the revised OBR figures will be wrong – for the simple reason that all economic projections are – and will be revised again at Budget 2015 and beyond. Whatever the merits of the parties' deficit targets and spending plans – be they rigid or vague – the level of economic growth, and particularly growth that feeds through to tax receipts, will play a huge role in determining the severity of consolidation in the next parliament.

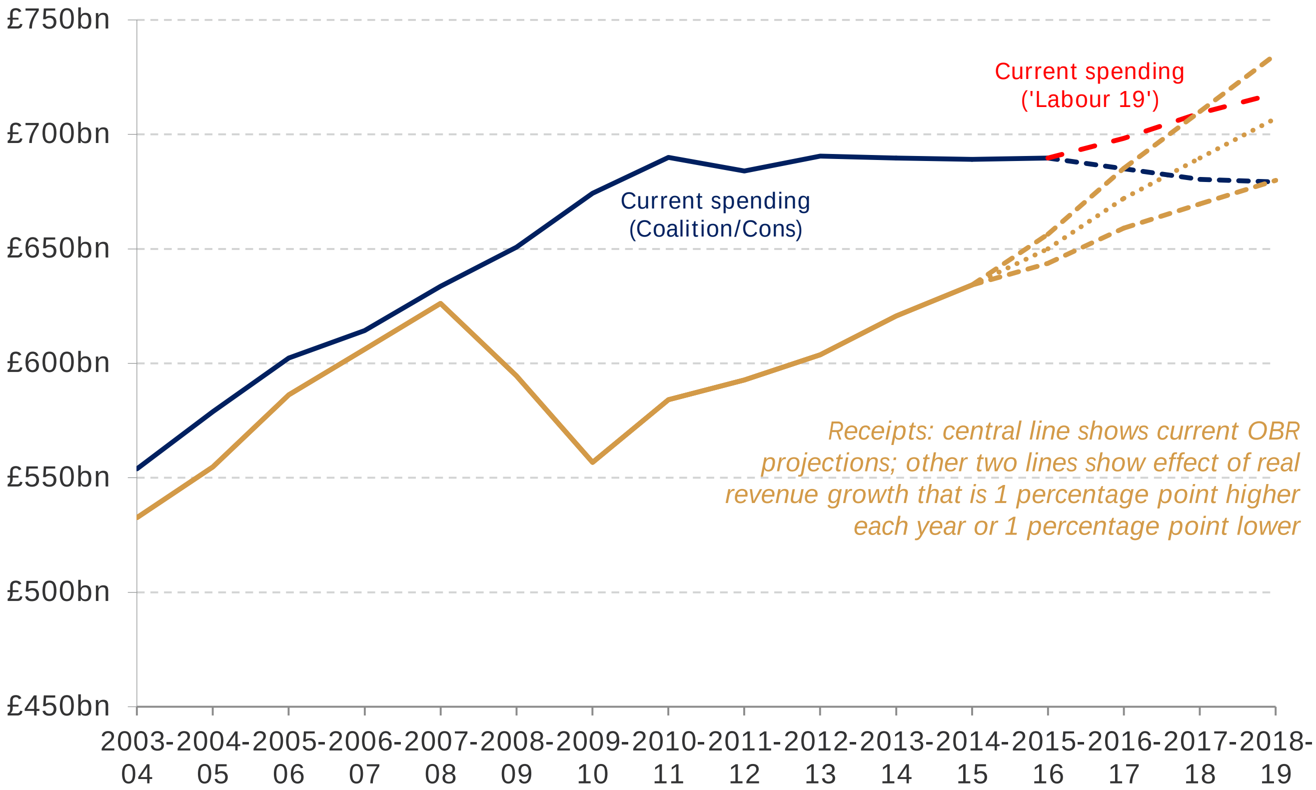
To demonstrate the upside and downside risks of revenue growth, Figure 15 repeats the projected convergence of tax receipts and current spending shown in Figure 3 (under the Conservative scenario and the 'Labour 19' one), together with the result if revenue growth were just 1 percentage point higher or lower than currently projected by the OBR in each of the four years from 2015-16.

[41] European System of Accounts (ESA) 2010

Figure 15:

The speed of revenue growth beyond 2014-15 has big implications for the deficit: 2003-04 to 2018-19

Tax receipts and government spending (2013-14 prices)



Notes: 'Labour 19' scenario: based on assumption that it sticks to the 2015-16 plans of the Coalition and then targets a £1 billion current budget surplus in 2019-20, with steady reductions in spending in each year between 2015-16 and 2019-20. Does not include £2.5bn extra NHS spending and taxation or other announced changes. Conservative scenario: based on assumption that Coalition trajectory is followed, producing an overall surplus in 2018-19, but with an additional £12bn of welfare (AME) cuts in 2016-17 and 2017-18.

Source: RF analysis of ONS & OBR

The difference in the pace of deficit reduction in the case where annual real revenue growth is 1 point above expectations (still fractionally slower than the 2003-2007 trend) compared to the case in which is it 1 point below (similar to the 2010-2014 trend), is significant.

Taking the assumed Conservative level of spending, we find that the current budget would be in surplus in 2016-17 – rather than their target of 2017-18 – if growth in government revenues grew at the stronger rate shown here, but that surplus wouldn't occur until 2018-19 if revenues grew at the weaker rate.

Even under the 'Labour 19' policy – requiring the least consolidation of the scenarios we consider in this report – revenue growth 1 point above expectations would produce a current budget surplus in 2017-18. In contrast, the weaker rate of revenue growth would appear to offer very little sign of convergence between current spending and receipts in the period shown here.

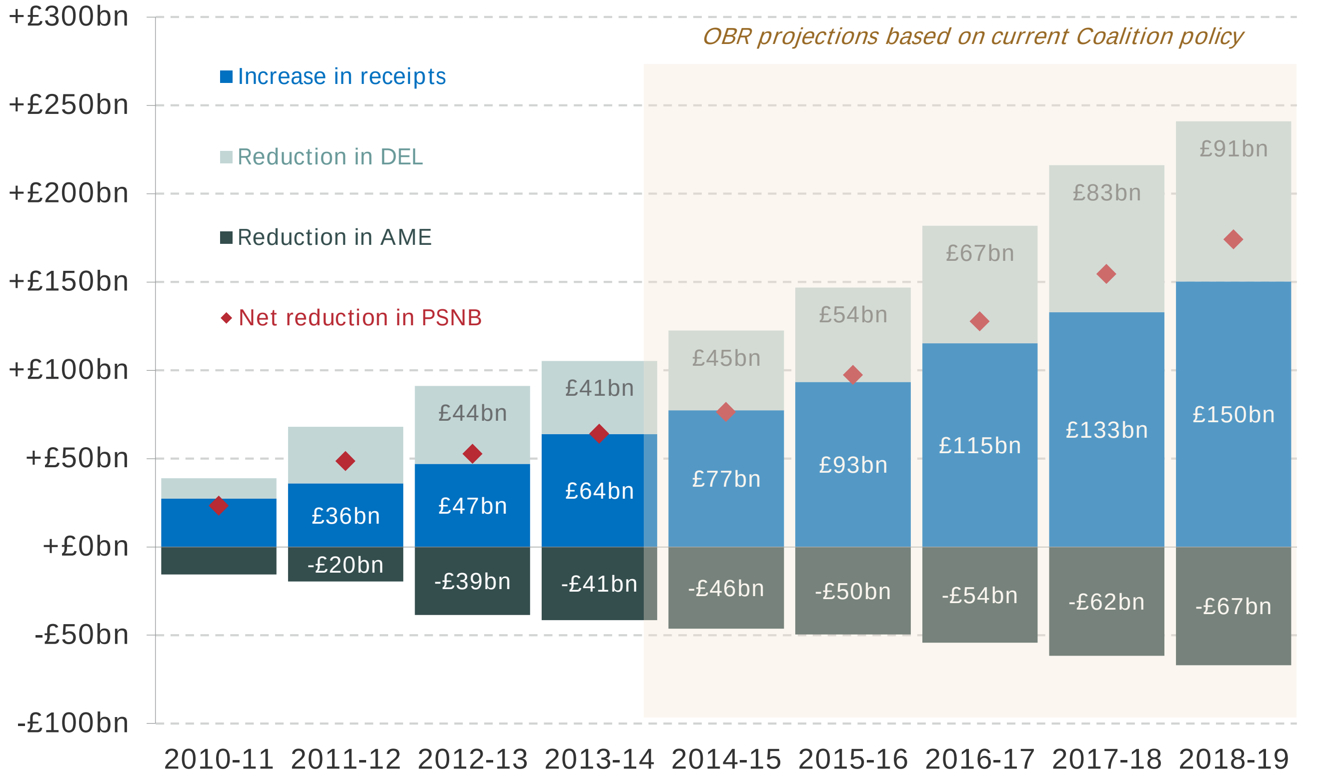
In terms of real annual GDP growth, we estimate that a 0.1 percentage point increase would do as much over the four years from 2015-16 for the deficit as roughly £3 billion of spending cuts. Another way of looking at this, is that if the economy were to reach its expected size in 2018-19 a year early (and tax receipts along with it), the deficit might be £17 billion lower in 2017-18 than is currently projected. It is useful to bear in mind the great sensitivity of the deficit to small variations in revenue growth when considering the significance of the differences in the fiscal stances of the three parties.

Figure 16 reinforces the importance of revenue growth with a breakdown of the cumulative (outturn and projected) reduction in PSNB from its peak of £170 billion in 2010-11. Despite the introduction of significant cuts in welfare spending, particularly for those of working age, the overall AME budget continues to grow, thereby reducing the pace at which the PSNB is being reduced. In contrast, cuts in DEL have played a large role in closing the gap between total government spending and receipts.

But the biggest contribution to the overall reduction in PSNB comes from tax receipt growth (overwhelmingly because of the link between revenues and growth rather than the introduction of discretionary tax increases). This element is expected to exceed that of reductions in departmental spending in every year from 2013-14 onwards: the upshot being that deficit reduction is, not surprisingly, extremely sensitive to revenue growth.

Figure 16:
Net components of cumulative reduction in PSNB since 2010-11 peak

Contributions to cumulative reduction in public sector net borrowing (2013-14 prices)



Source: RF analysis of ONS & OBR

Notes: As with other presentations of PSNB in this report, the total excludes the effects of the one-off transfer of Royal Mail pension assets in 2013-14 (treated as negative capital expenditure of £28 billion in the National Accounts). It also excludes flows associated with the Asset Purchase Facility (APF) which are projected to be positive (capital grants in the National Accounts) in the years to 2016-17 (thereby reducing PSNB) and offsettingly negative from 2017-18 to 2022-23 (thereby increasing PSNB).

Section 6

Conclusions

To reiterate: the analysis presented in this note is speculative. It is based on our interpretation of highly sketchy plans set out by each of the parties to date. It takes no account of the extent to which a future government will make things harder for itself by introducing new tax cuts or spending increases that will require funding,[42] or of growing pressures for new areas of ringfencing (such as defence spending). Nor does it deal with the fiscal pressures associated with an ageing society, or with the difficulties that might be posed if the recovery continues to be characterised by weak pay growth and therefore weak revenues. There are also likely to be some dynamic, macroeconomic effects associated with different paths of deficit reduction that we have made no attempt to reflect. And of course, all of the underlying numbers will change as economic conditions develop and official forecasts are revised.

The pre-election debate is likely to centre on questions of credibility and feasibility. Those advocating slower deficit reduction will question how realistic it is to assume that government departments have the capacity to withstand ever-deeper cuts, or that families will be able to cope with further reductions in benefits or indeed increases in tax. In contrast, those favouring a faster pace will argue that their opponents lack credibility and will burden the country with higher levels of debt (and therefore debt interest payments) for longer into the future and leave the economy less equipped to deal with new fiscal shocks and pressures.

And all parties will seek to suggest that they are prioritising future growth by at least ringfencing capital spending – whether that be in the form of excluding some (Liberal Democrats) or all (Labour) investment expenditure from their deficit targets, or via a formal target for investment as a share of GDP (Conservatives and Liberal Democrats).

Less than six months out from the general election no party has provided anything more than highly sketchy fiscal plans, which makes any overall judgements difficult. What is clear, however, is that all of the parties face an incredibly difficult dual challenge: establishing a clear and credible trajectory towards deficit reduction on the one hand; while detailing a path of spending cuts or tax-rises that is likely to be politically achievable on the other. The next government is going to have to walk an unusually precarious fiscal tightrope.

[42] Beyond incorporating increased NHS spending, funded through higher taxes, in Labour spending totals.

Annex: How government finances work

Budget deficits and net debt

Broadly speaking, the **budget deficit** measures the annual gap between government spending and revenue. In contrast, the **net debt** captures the stock of total debt held by the public sector. The annual budget deficit therefore flows into the cumulative stock of net debt.

There are, however, a number of different ways of measuring the deficit:

- The simplest is **Public Sector Net Borrowing** (PSNB), which is total spending minus total receipts.
- In contrast, the **current budget** deficit **excludes net investment** from the spending total. It therefore (usually) results in a lower deficit than PSNB. The excluded net investment covers capital spending that adds to the value of fixed assets (such as on railways, new schools, roads or aircraft carriers).
- The **primary balance** instead excludes debt interest from the spending total. This again gives a lower deficit value than PSNB. By excluding the repayment burden of historic debt accumulation, it may better reflect the gap between what current taxpayers pay and consume, and be less sensitive to bond yields.

Each of these three deficit measures can additionally be **cyclically-adjusted**, with the **cyclically-adjusted current budget (CACB)** sitting at the heart of the Coalition government's fiscal mandate.

This technique aims to account for the state of the economy in order to give a better idea of the underlying, structural deficit. For example, downturn-related changes in tax receipts and unemployment benefits that are expected to automatically disappear as the economy recovers can be ignored, thereby giving a better understanding of the magnitude of the deficit during more normal times. The cyclical adjustment is not measured directly, but is instead based on estimates by the Office for Budget Responsibility about the potential of the economy.

Public Sector Net Debt (PSND) is in some ways more straightforward, representing the sum of historical borrowing (minus surpluses) – largely the stock of outstanding government bonds – and other liquid assets such as cash reserves (illiquid assets such as council housing or the public road network are not included).

One further complication is that the deficit can be affected by one-off transfers which are sizeable but which have little bearing on the structural position of public finances. Throughout this note, we have corrected for the sale of the Royal Mail pension scheme and transfers between the Bank of England and the Treasury related to Quantitative Easing. Separately, almost all figures exclude the bank rescue package(s) of the financial crisis.

Divisions of public sector spending

Figure 17 shows how different elements of spending and receipts interact and how these relate to the Coalition government's fiscal rules.

The total amount that government (including local government and public corporations) spends is known as **Total Managed Expenditure (TME)**. It is the difference between this and receipts that gives PSNB. The government divides TME into two classes of spending, with each currently comprising around half of the total:

» **Departmental Expenditure Limits (DEL)** are the tightly-controlled allocations to different government departments, as set at Spending Reviews; and

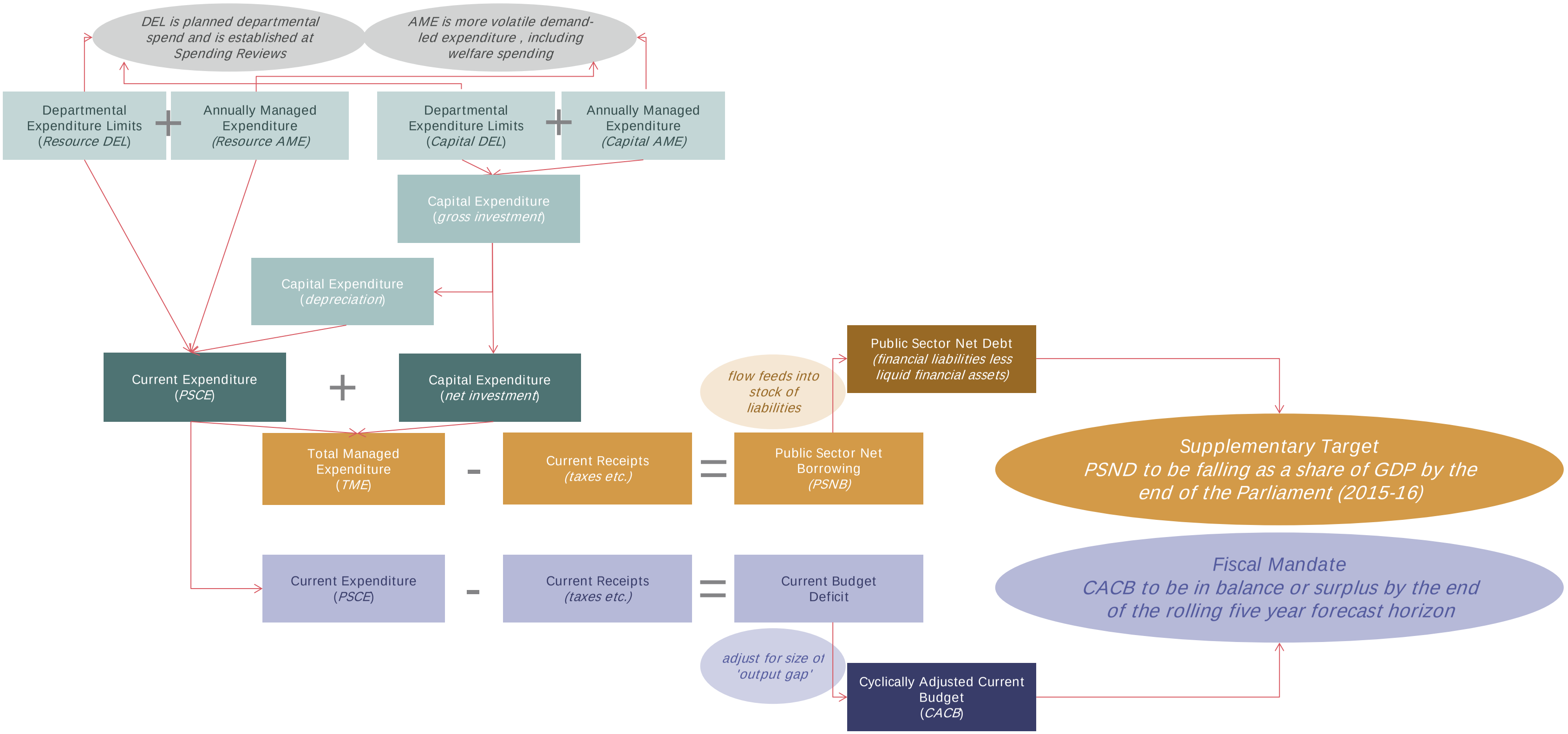
» **Annually Managed Expenditure (AME)** is less predictable, demand-led spending, such as welfare expenditure, debt interest and public sector pensions.

Changes in policies and definitions can lead to spending moving from DEL to AME or vice versa, complicating comparisons across time (an example is the replacement of Council Tax Benefit, which was AME, with localised Council Tax Support funded through DEL). Throughout this note we correct for major movements in recent years in order to provide consistent time series.

DEL and AME can be further split between **resource spending** and **capital spending**. Resource spending is money that is spent on day to day resources and administration costs, while capital spending is that which adds to fixed assets. It is therefore possible to talk, for example, of capital DEL (or **CDEL**), which might be the building of schools; as opposed to the resource DEL (or **RDEL**) costs of running those schools. Similarly, Capital AME (or **CAME**) includes spending on student loans, while resource AME (or **RAME**) covers social security payments and debt interest among other things.

Finally, **net investment** is capital spending minus **depreciation** – the reduction in value of assets over time (which counts as negative resource spending). It is this net investment rather than gross capital spending which is used in fiscal targets.

Figure 17: How public finances and the Coalition government's fiscal rules interact



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- *engaging with policy makers and stakeholders to influence decision-making and bring about change.*

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