RF

Resolution Foundation

BRIEFING

The deficit the election forgot?

Pre-election briefing on the main parties' fiscal positions

Adam Corlett & Matt Whittaker

May 2017

RF

resolutionfoundation.org info@resolutionfoundation.org +44 (0)203 372 2960 @resfoundation

For anyone aged under-30, next month's general election is likely to be the first one they've voted in where issues of government borrowing and debt haven't been top of the agenda.

Back in 2010, the Conservative manifesto opened by declaring that "our economy is overwhelmed by debt", while the Labour Party made halving the deficit by 2014 the first of its "50 steps to a fairer future for all". By 2015 the [Conservative manifesto] offered a choice between David Cameron's "economic competence" and "economic chaos under Labour, with higher taxes, more debt and no plan to fix our public finances". Meanwhile the [Labour document] set out a "Budget Responsibility Lock" even before it got to the contents page. The shared view of the battleground was very clear and the presence of up to a £30 billion gap between the two parties was also well-established.

Just two years later things are much altered. With most of the key personalities changed and the debate understandably dominated by Brexit, we are faced now with the deficit the election forgot. The Prime Minister made no mention of the deficit when calling the [General Election]. Likewise, when reflecting on her [visit to the Queen] she limited herself to referring to locking-in "strong" (she didn't say stable) finances.

While the deficit remains in place, it is heading back to the sort of level relative to the size of the economy that past generations have been comfortable with. With the process of fiscal consolidation dominating so much of the political discourse in recent years it's unlikely that many voters will be lamenting a dialling down of the volume in the new campaign. Yet it's an issue that still matters greatly, for reasons of delivery, debt and demographics.

First, delivery: whatever plans and targets the parties set out for the future, there are a number of policies already in the pipeline – from cuts in departmental budgets to large reductions in welfare payments – that have very significant implications for public services and for living standards. The fiscal envelopes the parties set themselves determine the extent to which more or less discretionary consolidation will be required over the coming years. Second, debt: while the deficit may be heading back to something like normal territory, our stock of debt relative to GDP remains highly elevated relative to the pre-crisis period, placing a value on debates about the optimal pace of its reduction. Finally there is the growing demographic challenge: the medium-term public finance picture is likely to be clouded by increasing demand for spending in certain areas as a result of an ageing society, something we would do well to prepare for.

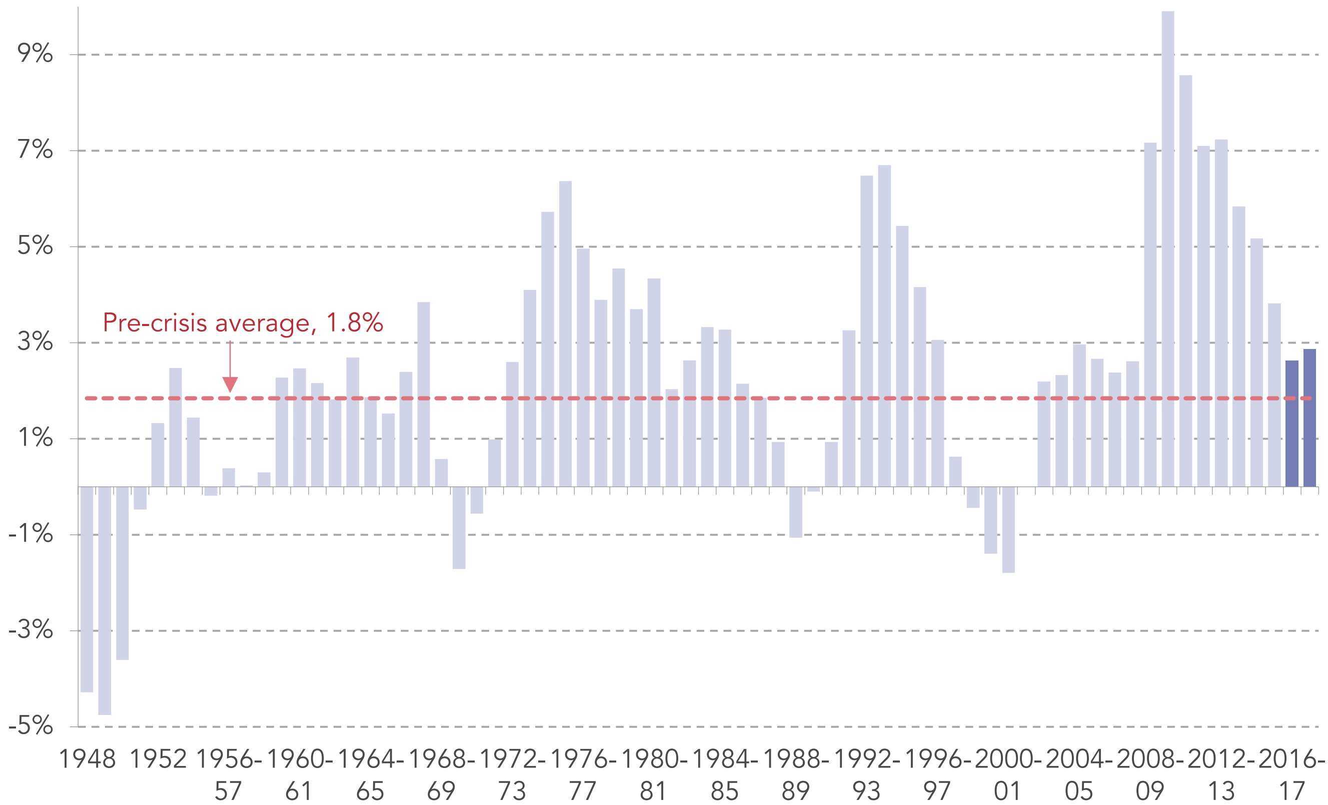
With all this in mind, this note – the first in a series of pre-election briefings – looks at what we might expect from the main parties ahead of the publication of their manifestos.

The deficit is declining in scale and in perceived importance

Provisional ONS figures from last month showed that public sector net borrowing (PSNB) – the gap between the revenue raised by the government and its total spending – amounted to £52 billion in 2016-17. That's precisely £100 billion lower than its post-financial crisis peak in 2009-10. As Figure 1 shows, the deficit was equivalent to roughly 2.6 per cent of GDP last year.

Figure 1: Borrowing as a share of GDP is heading back towards pre-crisis levels

Public sector net borrowing as a share of GDP



Notes: Data for 2016-17 is an estimate and 2017-18 is a projection.

Source: OBR, *Public finances databank*

A combination of accounting shifts and economic changes mean that the deficit is projected to rise to 2.9 per cent in 2017-18, but even this level of borrowing marks a substantial reduction from the post-crisis peak of 9.9 per cent of GDP. Indeed, it is broadly in line with the level prevailing immediately before the financial crisis hit (2.6 per cent of GDP in 2007-08 and 2.4 per cent the year before). Looking over a longer horizon, the deficit remains above the 1.8 per cent average recorded between the years from 1948 to 2007-08, but not unusually so. In fact, the 2016-17 deficit of 2.6 per cent ranks 29th out of 69 years for the scale of borrowing relative to GDP.

But it continues to matter, for reasons of delivery, debt and demographics

Viewed from this perspective, it's impossible to argue that the annual deficit poses a serious risk to the UK's financial stability as some have done in recent elections. Against this backdrop, and with Brexit dominating the new election campaign, it is perhaps unsurprising to see a much reduced focus on fiscal matters relative to the experience of both the 2010 and 2015 debates. Yet there are good reasons why the deficit – and therefore the positions adopted by the main parties heading into the election – continues to matter. Three factors stand out.

Delivery – setting the backdrop to government decisions

Most immediately there is the question of delivery – of what policies more broadly we will see implemented by the next government. This is relevant both to how a future government deals with policies already in train but also to the delivery of new policies.

OBR projections for the deficit trajectory over the coming years incorporate a number of tax and spending plans that have been set out by the government but which are yet to be delivered. For example, of the £12 billion of welfare cuts pledged by the Conservatives ahead of the last election and subsequently set out by George Osborne, the vast majority are yet to bite – with around £8 billion of savings expected to accrue after 2017-18. Likewise, in addition to the specific departmental budget cuts set out in Spending Review 2015, there remains £3.5 billion of unallocated reductions to apply in 2019-20. Coming on top of the already sizeable cuts that some departments have endured since 2010-11, such spending reductions have clear implications for public service provision.

When it comes to new policies, it is worth noting that, while there appears to be more candour in discussing tax rises ahead of this election than in 2010 or 2015, the scale of any such increases will again depend upon the deficit level the next government wishes to target. Similarly on future decisions on investment spending, at a time of very low funding costs, the options available to a government will be shaped by decisions about how such spending is incorporated into the fiscal aggregates being targeted.

Of course, it should be noted that recent governments have failed to deliver on their initial fiscal promises. For example, in 2010 the coalition government targeted cyclically-adjusted current budget balance by the end of the parliament, but ended up delivering a deficit on this measure of £36 billion. Likewise, the 2015 Conservative government aimed for overall surplus by 2019-20, but subsequently accepted that a fiscal 'reset' was needed following the EU referendum. Yet even if we accept that any specified target might subsequently be missed, the shape of the initial target still matters for policy direction. Consider for example how the 2015 approach informed the government's setting out of large departmental and welfare cuts.

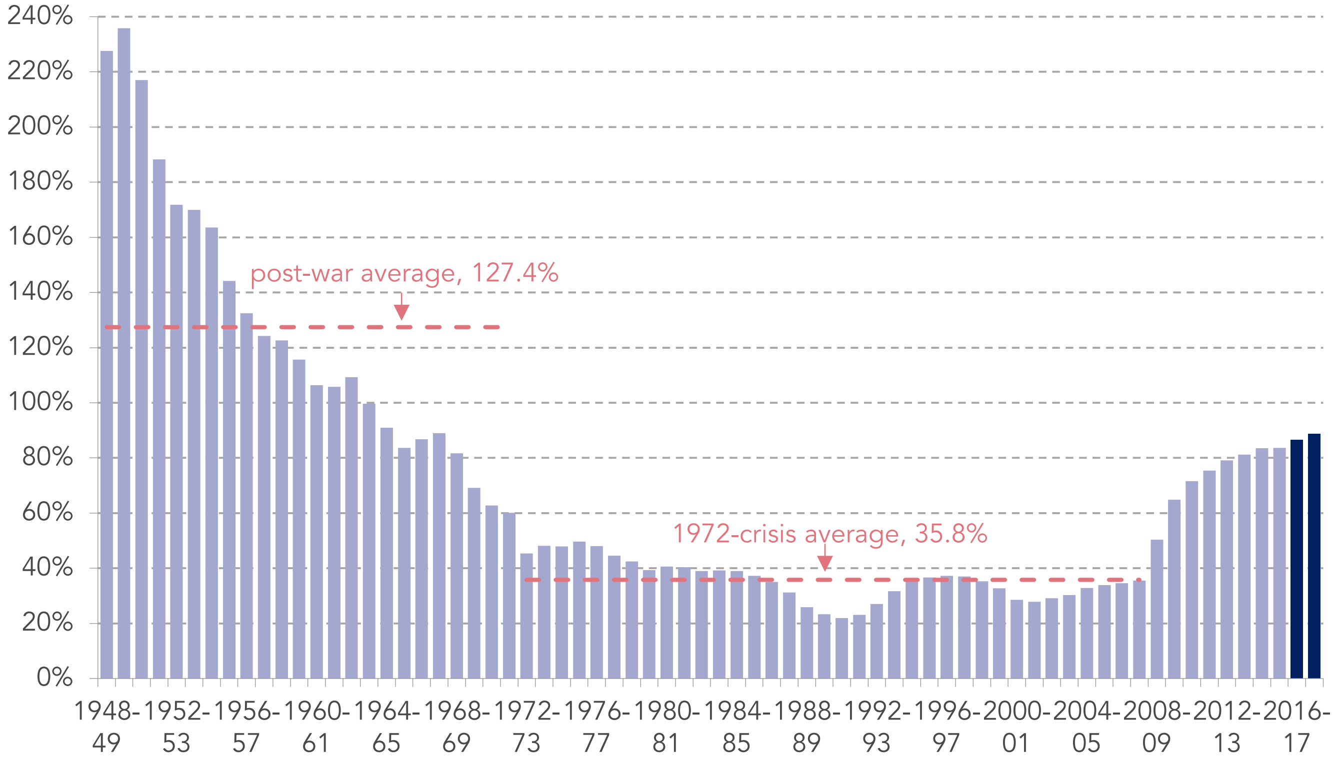
We'll look in more detail at some of the options for tax and spending in future notes in this pre-election series, but it's evident that the fiscal approach of the next government provides the background context to decisions about going ahead with or adding to policies already in train that will have a significant effects, for example on public services and living standards.

Debt – determining the UK's longer term fiscal position

From a medium-term macroeconomic perspective, it is the scale of UK debt that matters most – with a clear read-through from the parties' approaches to the annual deficit. The recent sustained period of historically large deficits, alongside a big fall and slow recovery in the size of our economy, has produced a sizeable increase in public sector net debt (PSND), which has not yet started to fall. Figure 2 shows that this is estimated to amount to 86.6 per cent of GDP in 2016-17 (or £1.7 trillion), with the level rising further to 88.8 per cent in 2017-18. That's roughly two and a half times the debt-to-GDP ratio of 35.5 per cent recorded immediately before the financial crisis hit – a level which almost precisely coincided with the longer-term pre-crisis average (35.8 per cent) – but remains well below the levels seen in the aftermath of the Second World War.

Figure 2: The stock of government debt as a share of GDP remains elevated

Public sector net debt as a share of GDP



Notes: Data for 2016-17 is an estimate and 2017-18 is a projection.

Source: OBR, *Public finances databank*

Sensible people disagree both about just what level of debt-to-GDP the UK should feel comfortable with and about the pace with which any reduction should be pursued, but most would agree that a debate about the desirable level and route to it would be welcome.

Given that attempts to lower debt involve trade-offs in relation to taxes that people would rather not pay and spending they would rather not see cut, alongside short term effects on growth, a case can be made for taking a very gradual approach to debt reduction. Certainly the idea that the UK has already breached some optimal level of debt-to-GDP with negative consequences for growth – which formed part of the debate around the 2010 election – has been discredited over recent years.

Equally though, there are arguments for taking a less sanguine view. Most obviously, higher debt levels mean higher debt interest payments which reduce the scope for other forms of spending. An elevated debt-to GDP ratio also raises question marks over the fiscal resilience of a country to another shock on the scale of that experienced in 2008. It's also worth noting that the government's financing requirements are affected not just by the annual deficit, but also by the need to replace maturing gilts. For example, the Treasury estimates that it needs to raise £80 billion in 2017-18 to cover gilt redemptions. This argument can readily accept that the cost of borrowing remains very low by historical standards today, while noting that exposure to future risks on the UK's funding costs are real.

We offer no firm conclusion on the exact optimal level of debt to target. What should be clear however, is that the continued elevation of the UK's debt-to-income ratio relative to its pre-crisis level is enough to warrant serious discussion during the election campaign, not least because different short term fiscal plans can imply very different medium term debt trajectories

Demographics – taking a longer view of fiscal sustainability

The need for such discussion is made more urgent still by a recognition of the coming demographic challenge facing the country. For example, the OBR has estimated that an ageing population will force up health spending by 0.6 per cent of GDP, care spending by 0.1 per cent of GDP, and state pension spending by 0.3 per cent of GDP between 2021-22 and 2025-26 on current policy. The trend towards self-employment and incorporation is expected to lower tax receipts over the same period, while cleaner cars and reduced smoking will reduce sin tax revenues too. Any reduction in migration will also have a fiscal impact, with a smaller economy lowering nominal GDP and therefore slowing the pace at which the debt-to-GDP ratio might be lowered.

While such pressures are likely to bear over the medium- rather than the near-term, they are real and will eventually need to be grappled with. With this in mind, such considerations should form part of any structural approach to fiscal reform that the next government wants to set out.

The deficit gap between the parties could be modest… or huge

Ahead of the publication of the latest set of manifestos we take a look below at what positions the parties might take, based on what has been said to date. Our analysis provides a sense of the fiscal gap that may – or may not – exist between the main parties, aiming to look beyond the big picture of a Conservative party intending to continue fiscal consolidation during the next parliament and a Labour party that would adopt a looser approach.

Conservatives – a 'loose' rule versus a 'tight' objective

It is perhaps easiest to guess at the fiscal stance of the Conservative Party given that we might expect it to bear a strong resemblance to the existing fiscal rules set out by the government – especially as they were tweaked as recently as November 2016 by the newly-arrived Chancellor. The government's *Charter for Budget Responsibility* has three[1] elements:

- *The fiscal 'mandate'*: sets a target to reduce cyclically-adjusted PSNB to below 2 per cent of GDP by 2020-21;
- *A 'supplementary goal'*: involves a target for PSND as a percentage of GDP to be falling in 2020-21.
- *The ultimate 'objective' for fiscal policy*: relates to returning the public finances to balance at the earliest possible date in the next parliament.

These fiscal targets could in fact cover a very broad range of actual fiscal policies, for two main reasons. First, the main 'rule' (the 'mandate') has very little bite. Current OBR projections for the deficit fall well within it, with the rule acting more as a ceiling to, rather than a target for, fiscal policy. As such, the Conservative Party could significantly loosen fiscal policy without breaching its 'mandate'. Second, and in stark contrast, literally taken, the 'objective' implies a significant further tightening of fiscal policy. Its real implications remain unclear however, because the bringing forward of the election casts some doubt on what "the earliest possible date in the next parliament" might now mean.

When the fiscal 'objective' was set, the next parliament was expected to run from 2020-21 to 2024-25; now it is set to cover 2017-18 to 2021-22. At this stage it is unclear whether this might mean that the Conservative Party intends to stick with the existing 'objective' and aim for balance within this tighter timeframe, or whether the it would instead change and 'rollover' the 'objective' to match the new "next" parliament of 2022-23 to 2026-27 – thereby extending the potential

[1] Beyond these fiscal aggregate objectives, the Charter also includes the government's overall cap on welfare spending.

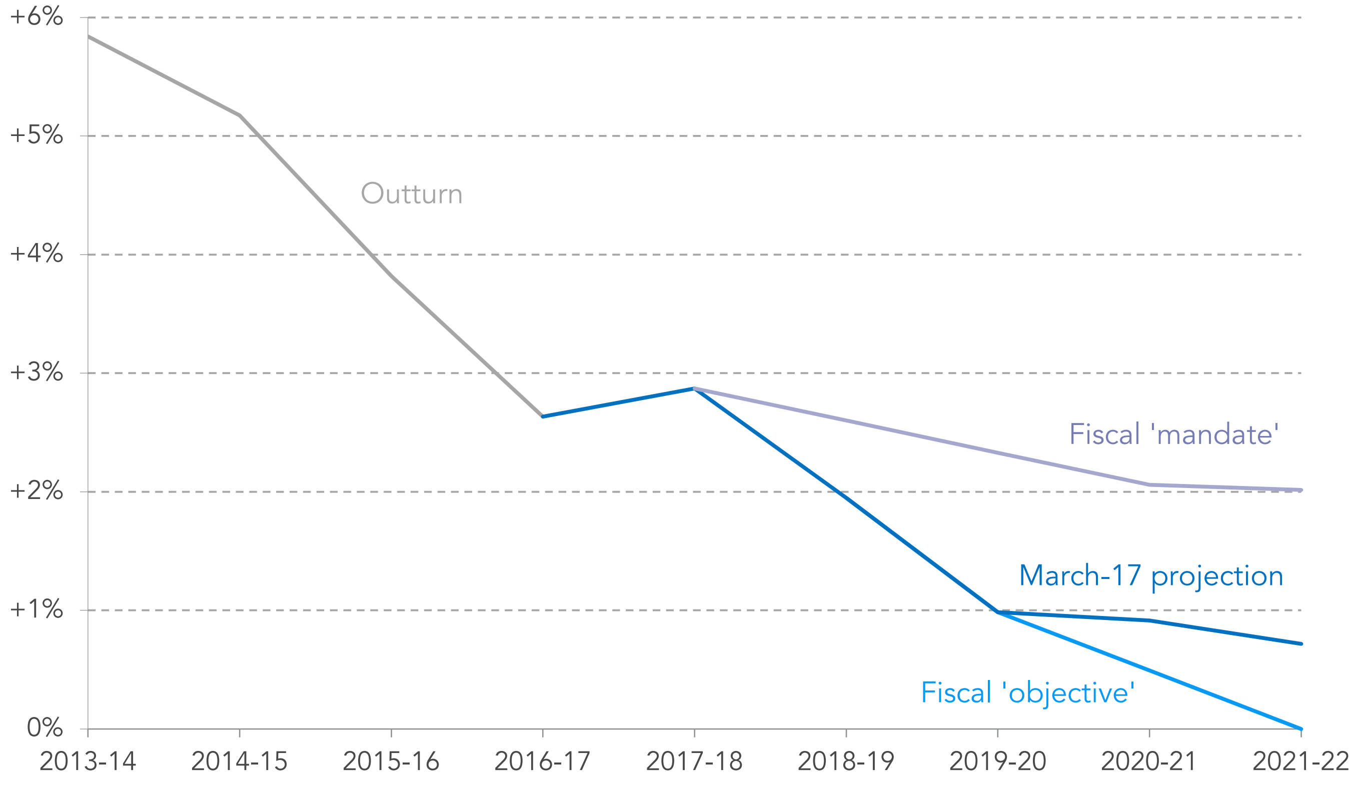
horizon for balance. The former approach represents the most literal interpretation, but the party is likely to set out more details in next week's manifesto. Speaking last month, the Philip Hammond acknowledged the need for a 'restatement' of the existing rules, but offered no details on what this might mean:

> *"We have set out our ambitions and we have done this relatively recently in the Autumn Statement in terms of parliaments. Clearly as we're going to have an election and the terms of parliament will fall on different date, we will need to restate our commitment in different terms and we will do that in the manifesto."*

By way of setting out the range of fiscal outcomes different interpretations of these positions would produce, Figure 3 compares existing projections for the deficit with both the stated 'mandate' and the literal interpretation of the current 'objective'.

Figure 3: The Conservative Party's fiscal rules allow for a range of outcomes

Public sector net borrowing as a share of GDP



Source: RF analysis of OBR data

The OBR's March 2017 projection shows the deficit falling to 1 per cent by 2019-20, with a much slower pace of reduction thereafter – leaving it at 0.7 per cent of GDP (£17 billion in nominal terms, £15 billion in 2015-16 terms) in 2021-22. If the Conservative Party retains its current fiscal objective and aims for overall balance by 2021-22 – that is, if it took its fiscal objective to apply to the "next" parliament after the *Charter* was voted on last Autumn – it would need to set out additional fiscal tightening equivalent to this £17 billion (and more if it wanted a surplus of course). By way of context, recall that the net effect of all tax rises and welfare cuts announced in the first Budget that followed the 2015 election was estimated to add up to just £3.5 billion more than this by 2021-22.

Indeed, the Conservative Party might well need to go further: the OBR projection includes £0.5 billion relating to the increase in Class 4 NICs which was scrapped after the Spring Budget and excludes as yet uncosted pledges in relation to raising the income tax personal allowance and higher rate threshold. The forecast also assumes that fuel duty rises with RPI inflation each year, but this default has been consistently overridden by a freeze since 2010-11 – maintaining that approach would prove expensive.

But the Conservative approach might alternatively be interpreted as providing room for significant fiscal *loosening* instead. Following a straight line path to the fiscal 'mandate' target date of 2020-21 (assuming the 2017-18 outcome is relatively fixed) and thereafter remaining at this limit results in a deficit of £47 billion by 2021-22. This provides £30 billion headroom relative to the OBR projection. That would be enough in theory to reverse all of those elements of the government's planned welfare cuts, tax rises and departmental spending cuts that are yet to be implemented – with some headroom still available after this.

The use of the fiscal 'mandate' as a ceiling to Conservative plans rather than a target for fiscal policy clearly has attractions. Given the economic uncertainty associated with beginning the Brexit process, it is sensible to maintain some flexibility. But this approach means the Conservative Party goes into the election with its fiscal rules offering very little by way of a guide to the approach it actually intends to take, as the range of potential outcomes that Figure 3 outlines illustrates. In the interests of candour and for the reasons set out above regarding the ongoing importance of fiscal policy, it will be important that the party provides some clarity on its preferred trajectory within this broad spectrum.

Labour – a focus on the current budget, with scope to borrow to invest

Ahead of the arrival of the manifestos it is harder to know just where the various opposition parties stand, though we can take some clues from statements made in the period since the last election.

The Labour Party last year set out a "fiscal credibility rule", which would commit it to "always eliminating the deficit on current spending in five years, as part of a strategy to target balance on current spending over a target five-year period." By focusing on *current* spending rather than overall (that is, by excluding public sector net investment (PSNI)), the target is broadly in line with the one adopted by the Coalition government of 2010-15, albeit in an absolute rather than cyclically adjusted form.

One interpretation of this approach is that, relative to any measure focused on overall balance (such as the one implied by the Conservative 'objective'), it provides additional headroom for current spending equivalent to the total size of PSNI. This figure is estimated to be roughly £40 billion in 2017-18, rising to £54 billion by 2021-22.

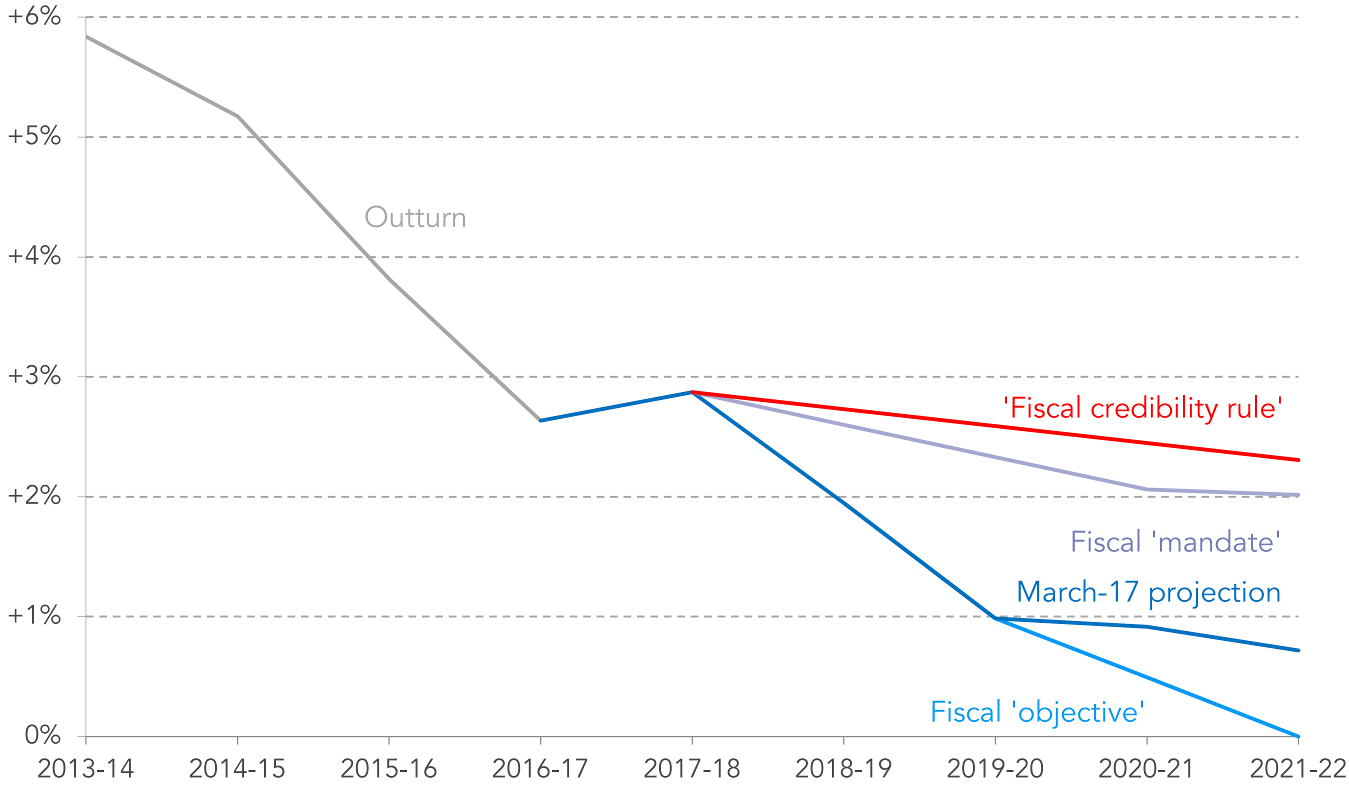
Such a rule also implies more flexibility to borrow for investment spending relative to current plans, with John McDonnell telling Andrew Marr that Labour would borrow an additional £25 billion a year for infrastructure over ten years, as part of its aim of creating a £500 billion investment fund.

Under this approach the only binding feature on the level of investment would relate to any supplementary debt rule. That is, while investment spending would sit outside of the deficit target, any debt associated with borrowing for this purpose would remain in scope. On this, Labour has said that it "will commit to ensuring that, at the end of every parliament, government debt as a proportion of trend GDP is lower than it was at the start." The inclusion of the word "trend" is interesting – giving extra leeway in the event of a downturn.

For simplicity, Figure 4 sets out what Labour's 'fiscal credibility rule' would mean for the deficit on the assumption that PSNI remains in line with current projections. We draw a simple straight line trajectory towards achieving balance on this measure by the end of the five year horizon. As such (in the absence of any increase in PSNI) this line represents the outside edge of what Labour's position would imply – the party might choose to sit inside this boundary, plotting a trajectory that more closely matches the government's fiscal 'mandate' for example.

Figure 4: The Labour Party's fiscal credibility rule could produce a significantly looser position than the one currently projected

Public sector net borrowing as a share of GDP



Source: RF analysis of OBR data

Adopting this approach would require lowering the overall deficit from an (assumed) 2017-18 baseline of 2.9 per cent of GDP to 2.3 per cent of GDP by 2021-22. This would provide the party with potential headroom of £37 billion by 2021-22 relative to current projections.

Stepping back, the big picture appears to be that the Conservative Party is approaching the election with the intention of delivering further fiscal consolidation over the coming years while the Labour Party looks set to adopt a looser position. However, the precise gap between Labour and the Conservatives depends on the precise interpretation of the Conservative stance: at one end, the gap would be just £7 billion (assuming the Conservative Party delivers no more than its 'mandate); at the other it would be £54 billion (assuming the Conservative Party instead adopts the literal interpretation of its fiscal 'objective'). Adding in increases in investment spending by Labour could then widen this gap further still. In short, the difference between the two main parties could be modest, or it could be huge.

The other opposition parties have said less to date on their public finance positions, though the Liberal Democrats seem likely to adopt a substantively similar deficit position to Labour given Tim Farron's rhetorical emphasis on using cheap borrowing costs to invest more in infrastructure rather than focusing on the deficit. The SNP has also focused attention on current budget balance.

Differing deficit possibilities create uncertainty over the trajectory of debt

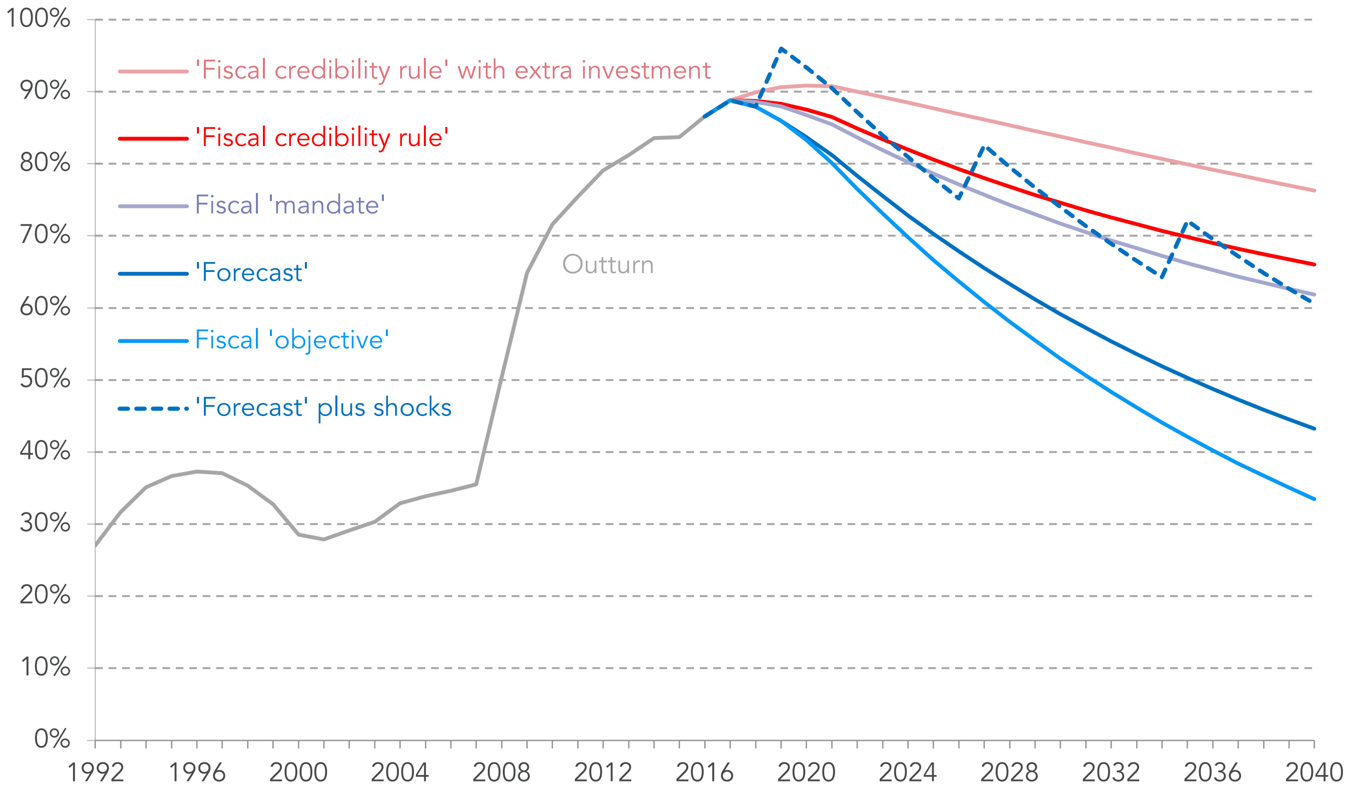
Given an expanding economy – with nominal GDP growth assumed to rise to a trend rate of 4.7 per cent – debt will fall relative to GDP under a wide range of deficit goals. It is not contingent on overall surplus, but simply on sustaining a level of deficit that adds less to the stock of debt each year than the economy grows by.

The presence of debt rules in both the Conservative and Labour plans reflects an acceptance across much of the political spectrum that the stock of debt relative to GDP should be lowered over time. Yet uncertainty over the size of any difference in approach to deficit reduction between the parties follows through into a, much larger, lack of clarity on their preferred positions on debt.

Figure 5 presents a very simplified and illustrative projection of the debt-to-GDP ratio under a range of scenarios (with no second-order effects in relation to growth or debt interest costs assumed for instance). While these trajectories should not be considered in any way definitive, the cumulative difference associated with different potential deficit stances is clearly evident.

Figure 5: A wide range of annual deficit positions are consistent with falling debt as a share of GDP

Public sector net debt as a share of GDP



Notes: In all scenarios, GDP is assumed to grow in line with existing forecasts through to 2021 and then at a steady 4.7 per cent thereafter. "'Fiscal credibility rule' with extra investment" scenario assumes a current balance by 2021-22 and in every year thereafter, but adds an extra £25 billion of investment spending on top of this each year; "'Fiscal credibility rule'" relates to movement towards a current balance by 2021-22 which is then fixed in all subsequent years; "Fiscal 'mandate'" shows path associated with moving towards a 2% cyclically-adjusted deficit by 2020-21 and remaining there thereafter; "'Forecast'" represents the debt trajectory associated with following the OBR projection for the deficit through to 2021-22 and then maintaining a 0.7% deficit indefinitely; "Fiscal 'objective'" shows the impact of moving towards an overall balance by 2021-22 and then returning a balance in every subsequent year; "'Forecast' plus shocks" uses the 'forecast' line as a base, adding in an illustrative shock that increased PSND by 10% of GDP every eight years.

Source: RF analysis of OBR data

For example, sticking to no more than the existing fiscal 'mandate' – running an overall deficit of 2 per cent a year – would lower the stock of debt-to-GDP to 62 per cent by 2040. Choosing instead to deliver an overall balance each year in line with the Conservative 'objective' lowers the ratio to 33 per cent instead – roughly half the level and returning to the kind of levels of debt targeted by the last Labour government before the financial crisis.

Again the potential 'Labour' line implied by sticking rigidly to the 'fiscal credibility rule' and delivering a current budget balance each year looks broadly similar to the Conservative 'mandate' approach, if no changes are made to investment spending. However, in this instance choices of spending levels on investment make a more noticeable difference. For the purpose of illustration, we include a line showing how PSND might evolve under conditions where a government delivered a current budget balance each year but additionally borrowed an extra £25 billion a year to fund extra investment spending. Such an approach would result in a much slower pace of reduction in the debt-to-GDP ratio over time, and an increase in the short term.[2]

As ever, a lot will depend on the state of the economy

Of course, the economy cannot be expected to grow smoothly and without shocks forever. Reusing the assumptions made by HM Treasury in Autumn Statement 2014, Figure 5 also shows a debt trajectory based on a regular deficit of 0.7 per cent of GDP (the current forecast for 2021-22) compounded by an "illustrative shock that increases public sector net debt by 10 per cent of GDP every eight years, starting in 2019-20". In this instance, the future debt path looks very different indeed.

Adding in the shocks in this way provides a useful reminder that all of the economic assumptions underpinning projections for public borrowing and debt are subject to a high degree of uncertainty and that plans for given reductions in debt are very likely to face headwinds from wider events. The OBR forecasts for the economy sit in the middle of a wide range of independent forecasters (if anything, recent forecasts have typically been slightly more pessimistic than the OBR on a number of metrics).

The world is of course very different from the confusion of the immediate post-crisis period of 2010 – at which time the OBR projected that the deficit would be some £50 billion smaller in 2015-16 than we now know to have been the case. But the process of Brexit has once again heightened the level of uncertainty in the economy.

Perhaps above all else, the future path of productivity growth – which has consistently underperformed since the financial crisis – is key to determining just how hard the next government will have to work to meet any given fiscal target. Indeed, the medium-term fiscal consequences of even relatively modest differences in future productivity growth trajectories could quickly outweigh any difference in stance between the political parties.

The deficit isn't the beast it was, but clarity still matters

In this way, the election focus on Brexit will of course diminish the focus on the fiscal debate that has dominated much of politics in Britain for the past decade. But far from providing an excuse for taking the public finances any less seriously than in 2010 and 2015, the Brexit backdrop if anything increases the need for a sharpening of the parties' positions. The public may understandably be suffering from 'deficit fatigue' after so many years of debate but, from perspectives of both principle and practicality, the fiscal framework remains a key election battleground.

At the moment, pinning down the difference between the options on offer from the main parties is a bit like trying to nail jelly to a wall. Given the importance of overall fiscal approaches to delivery, debt and demographics, we must hope that the parties overcome their uncharacteristic reticence to discuss the deficit in more detail by the time the manifestos are published.

[2] In this instance it should be noted however that broader measures of debt – such as Whole of Government Sector Net Liabilities – which include illiquid assets, would produce quite different looking outcomes.

Resolution Foundation

Resolution Foundation is an independent research and policy organisation. Our goal is to improve the lives of people with low to middle incomes by delivering change in areas where they are currently disadvantaged. We do this by:

- *undertaking research and economic analysis to understand the challenges facing people on a low to middle income;*
- *developing practical and effective policy proposals; and*
- *engaging with policy makers and stakeholders to influence decision-making and bring about change.*

For more information on this report, contact:

Adam Corlett
Economic Analyst
adam.corlett@resolutionfoundation.org
020 3372 2983