2. The public finances under Labour

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Summary

- The evolution of the public finances since 1997 mirrors the first 12 years of Conservative governments after 1979: three years of impressive fiscal consolidation, eight years of drift (masked by economic overconfidence), and then a big jump in borrowing thanks to recession and newly-discovered structural weaknesses.
- Labour entered the current crisis with one of the largest structural budget deficits in the industrial world and a bigger debt than most OECD countries, having done less to reduce debt and – in particular – borrowing than most since 1997. Debt interest payments had fallen significantly since 1997, but less than in most OECD countries.
- Public sector borrowing is set to reach a post-war high next year, with public sector net debt in 2013–14 reaching its highest level since the early 1970s. Rising debt and cuts in investment will reduce the estimated net worth of the public sector – its assets minus liabilities – to less than half the level that Labour inherited from the Conservatives.
- The looming squeeze on public spending means that, even once the economy is back at trend in 2014–15, the Treasury plans imply that over the following two years only 21% of the 'proceeds of growth' will be consumed by the public sector. This is down from 44% under Labour to date and 29% under the previous Conservative governments.
- The Pre-Budget Report announced a net tax cut for 2008–09 and 2009–10 and a net tax rise for 2010–11 onwards. These help reduce tax revenues over the next two years, and increase them thereafter. This will smooth the path of after-tax incomes – national income less tax revenues will grow at a steady rate over these six years despite the forecast slowdown and subsequent recovery in the economy.
- From 1996–97 to 2007–08, the Treasury estimates that real national income rose by £12,700 per family – of which families are paying £5,600 more in tax, leaving them with £7,100 more income after tax. Between 2007–08 and 2013–14, the Treasury expects real national income to rise by £4,900 per family – of which £1,900 will be taken in tax, leaving an increase in after-tax income of £3,000.
- The revisions to the Treasury's public finances forecasts in the PBR were far larger than average, but not dissimilar from those seen at the outbreak of the last recession in the early 1990s. There is always considerable uncertainty around all public finance forecasts, but there is good reason to be particularly wary in the current situation.

2.1 Introduction

The past year has seen a spectacular deterioration in the outlook for the public finances and the abandonment (for the foreseeable future) of the fiscal rules that the current

Labour government imposed upon itself to persuade people that it would avoid the perceived sins of budgetary mismanagement committed by previous governments.

Ironically, the path of the public finances over the past 12 years and expected by the Treasury over the next five now looks uncannily similar to that trodden by the Conservatives from 1979 to 1997. Both parties inherited large structural budget deficits and turned them into sizeable surpluses within three years. Both then presided over eight years of fiscal drift masked by economic overconfidence, returning to unsustainably large structural deficits. Hubris then gave way to nemesis: in their 12th years in office, both governments faced a deep recession, combined with the discovery that the structural position of the public finances was much weaker than they had hitherto claimed. Borrowing ballooned, public sector debt climbed and retrenchment beckoned again.

The November 2008 Pre-Budget Report (PBR), far from being the largely consultative exercise that Labour had originally intended when inaugurating the event in November 1997, ended up with the appearance of two unusually large Budgets sandwiched together. The first was a giveaway Budget, cutting taxes and increasing spending in 2008–09 and 2009–10 in an attempt to make the recession shorter and shallower than it otherwise would be. The second was a takeaway Budget, cutting public spending and increasing tax revenues as shares of national income from 2010–11 onwards in an attempt to reduce the structural budget deficit and arrest the increase in public sector indebtedness. Both are reflected in the Treasury's latest set of public finance forecasts: the giveaway exacerbates the deterioration in the short term, while the takeaway begins a fiscal repair job expected to extend well beyond the next general election.

In this chapter we look at the evolution of the public finances under the current Labour government. We begin by looking at the state of the public finances when Labour took office in 1997 and at the objectives that the government set itself in light of that inheritance (Section 2.2). We then turn to the evolution of the public finances prior to the credit crunch and ask how well prepared this left the UK for the economic and fiscal shock we now confront (Section 2.3). After this, we look at the Treasury's assessment of the outlook over the next five years (Section 2.4) and at the uncertainty surrounding fiscal forecasts (Section 2.5). Section 2.6 concludes.

2.2 Labour's inheritance and objectives

In an analysis published by the Treasury in 1999, Labour characterised its inheritance from the Conservatives as follows:

> On arrival in office in 1997 the Government was faced with a large structural fiscal deficit, low net investment, rising public debt and falling public sector net worth. Urgent action was needed. This situation had come about in part as a result of a lack of clear and transparent fiscal objectives, together with fiscal reporting that did not permit full and effective public and Parliamentary scrutiny. The Government therefore took steps to implement a new framework for fiscal policy.[1]

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[1] Page 7 of HM Treasury, *Analysing UK Fiscal Policy*, November 1999 (http://www.hm-treasury.gov.uk/d/anfiscalp99.pdf).

When Labour took office, the Conservatives were still trying to eliminate the large budget deficit that had opened up in the early 1990s. Adjusting for the degree of overheating or spare capacity in the economy, the underlying 'structural' budget balance[2] had deteriorated from a surplus of 1.5% of national income in 1981–82 to a deficit of 5.5% in 1992–93. The impact of the recession on revenues and spending pushed the overall deficit even higher: to a peak of 7.7% of national income in 1993–94.

Britain's exit from the European Exchange Rate Mechanism in September 1992 prompted a significant rebalancing of macroeconomic policy. Looser monetary policy – lower interest rates and a weaker exchange rate – was accompanied by a big fiscal tightening. After the 1992 election, the then Chancellor Norman Lamont announced significant tax-raising measures. Kenneth Clarke, who became Chancellor in May 1993, continued this process and also cut public spending as a share of national income. This almost halved the structural budget deficit between 1992–93 and 1996–97. Together with strong economic growth, this helped stabilise public sector net debt, which peaked at 42.5% of national income in 1996–97. Mr Clarke forecast in his November 1996 Budget that revenues would continue to rise and spending would continue to fall as shares of national income. The Treasury expected this to get the budget back into surplus by 2000–01 and to pull public sector net debt back down towards 40% of national income.

This set the scene for Labour's inheritance. In 1996–97, the Conservatives' last year in office, total spending by the public sector (known as total managed expenditure, TME) stood at 39.9% of national income, while government revenues totalled 36.4% of national income. This left 3.4% of national income (after rounding) to be covered by borrowing. If sustained, this would have left net debt climbing significantly for the foreseeable future.

A fifth of this borrowing financed the low level of investment that Labour complained of – 0.7% of national income – leaving a current budget deficit of 2.7% of national income. The Treasury estimates that part was explained by the impact of weak economic activity on tax revenues and welfare spending, but that there was still a 'structural' current budget deficit of 2.2% of national income. In other words, the Conservatives were borrowing not just to pay for investment, but also for the day-to-day running costs of government – and not just because spending was inflated and revenues depressed by a weak economy.

By international standards, Labour inherited a relatively large budget deficit but a debt level in the middle of the industrial country league table. Using internationally comparable figures, in 1996 the UK's structural general government deficit was the seventh highest of the 25 major industrial countries for which we have data. General government net financial liabilities (the broadest OECD net debt measure) was the tenth highest of the 27 countries for which data are available.[3]

Faced with this inheritance, Labour set out four main goals for its own management of the public finances:[4]

- to avoid an unsustainable and potentially damaging rise in public sector debt;
- to ensure future taxpayers are not left to pay for spending that does not benefit them;

[2] The budget balance that would be recorded if economic activity were at its sustainable 'trend' level, consistent with stable inflation.

[3] See Table 2.1 later for more details.

[4] Page 7 of HM Treasury, *Analysing UK Fiscal Policy*, November 1999 (http://www.hm-treasury.gov.uk/d/anfiscalp99.pdf).

- to avoid a bias against investment when public spending has to be squeezed;
- to 'support' monetary policy in keeping inflation on target.

With no track record of his own, the then Chancellor Gordon Brown saw a new policy framework as the best way to convince people that he would avoid what he saw as the fiscal laxity and bias against investment of previous Chancellors. The key elements were:

- the **Code for Fiscal Stability**, which set out the broad principles of fiscal policy as well as requiring the Treasury to be transparent about its goals and record; and
- publicly-stated **fiscal rules**, which turned broad principles of 'sound' fiscal policy into specific operational targets against which success or failure could be judged.

The fiscal rules made Labour's four broad objectives for fiscal policy more concrete:

- The **golden rule** required the public sector to borrow only to pay for capital investment, and to finance its remaining 'current' spending from tax and other revenues. In other words, the government had to keep the current budget (revenues minus current spending) in balance or in surplus. To avoid exacerbating swings in the economy, the rule had to be met on average over the cycle rather than every year.
- The **sustainable investment rule** required the government to keep the public sector's debt (net of its short-term financial assets) at a 'stable and prudent' level. The Treasury defined this as less than 40% of national income (GDP) at the end of each financial year of the economic cycle.

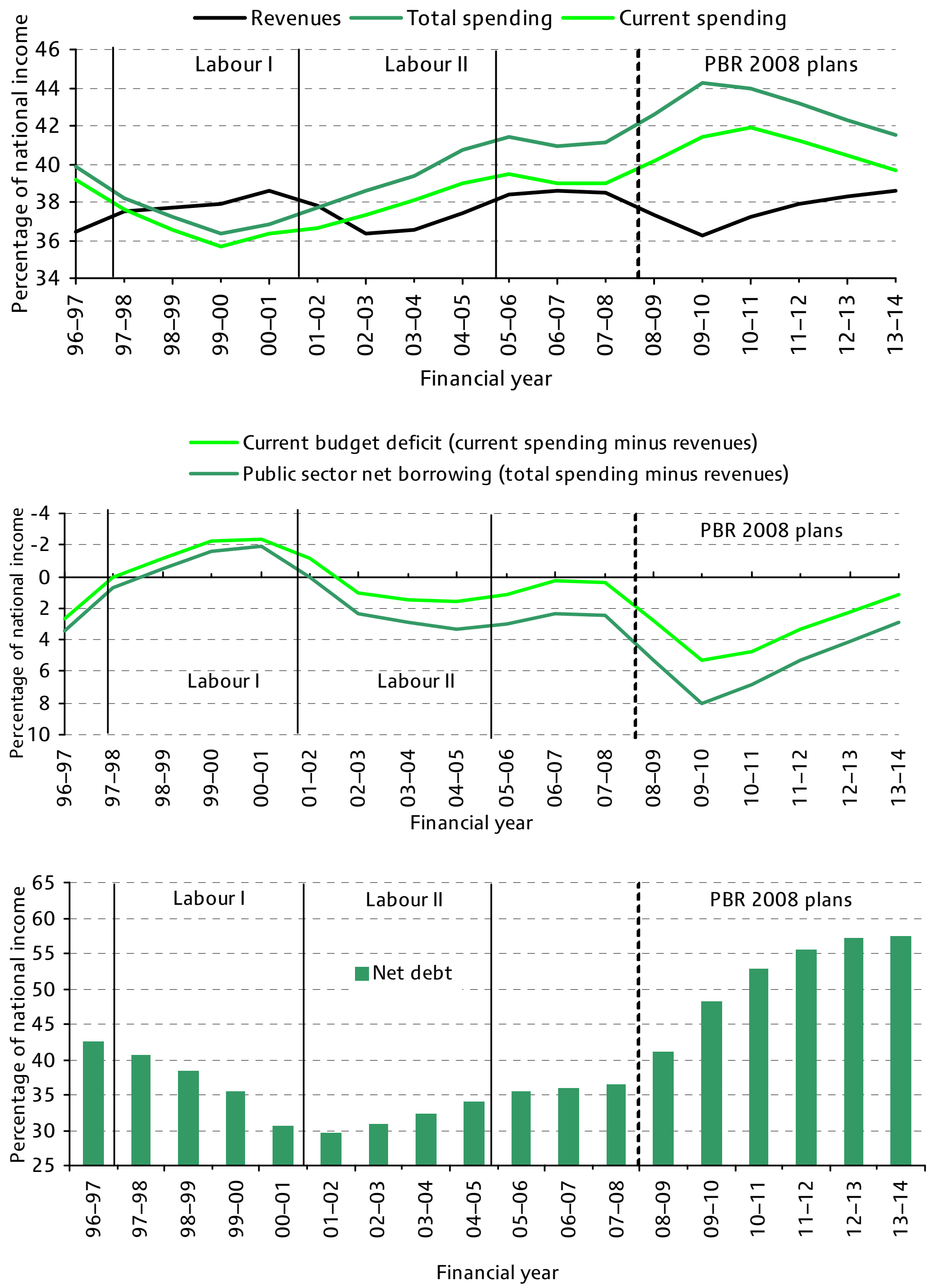
As we shall discuss in Chapter 5, the government claims to have complied with these rules over the economic cycle that it has chosen to define as running from 1997–98 to 2006–07. But in the November 2008 PBR, it conceded that it would not meet them over the next cycle: 'the Government will depart temporarily from the fiscal rules until the global shocks have worked their way through the economy in full'.[5]

2.3 Labour's record prior to the credit crunch

In its 1997 manifesto, the Labour Party promised to keep to the tight public spending plans laid down by Mr Clarke for two years. Mr Brown broadly kept that promise and reduced spending further in his third year at the Treasury, thanks partly to unintended departmental underspending. Despite beginning to spend more in the run-up to the 2001 election, public spending (TME) ended Labour's first term 3.1% of national income lower than it started (Figure 2.1). Most of the decline was in current spending, but public sector net investment also dropped, from 0.7% of national income to just 0.5% of national income. Notwithstanding Mr Brown's complaints about Conservative underinvestment, public sector net investment was lower on average in Labour's first term – at 0.6% of national income – than in any other four-year period since the Second World War.

[5] Page 15 of HM Treasury, *Pre-Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_repindex.htm).

Figure 2.1. Revenues, spending, budget balances and debt



Note: Net debt measure excludes the impact of financial market interventions.
Sources: HM Treasury, *Pre-Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm); HM Treasury, *Public Sector Finances Databank*, December 2008 (http://www.hm-treasury.gov.uk/d/public_finances_databank.xls).

Over the same four years of Labour's first term, government revenues rose by 2.2% of national income. This was thanks to: (i) real increases in fuel and tobacco duties (initiated by the Conservatives and then accelerated and maintained by Mr Brown until the November 1999 PBR); (ii) Budget measures, such as the abolition of repayable dividend tax credits; and (iii) above-average economic growth. Mr Brown also decided not to raise income tax thresholds as quickly as incomes, which meant that a growing proportion of people's incomes was taxed at higher rates ('fiscal drag').

With revenues rising and spending falling as shares of national income, by the time of the 2001 election the total budget balance and the current budget balance had both moved into surplus. The total budget surplus reached 1.9% of national income in 2000–01, comprising a structural surplus of 1.1% of national income and a cyclical surplus of 0.8% of national income. Meanwhile, public sector net debt fell from 42.5% of national income in 1996–97 to 30.7% of national income in 2000–01, aided in part by using £22½ billion raised from auctioning 3G mobile phone licences (2.3% of national income) to pay off debt.

Mr Brown had described his determination to reduce borrowing in Labour's early years in office as 'prudence for a purpose'.[6] The purpose became clear after 1999. The government reversed its earlier cuts in public spending, with health, education, and lower-income pensioners and families with children the main beneficiaries. However, as spending rose by 3.9% of national income over Labour's second term, tax revenues weakened unexpectedly when the stock market fell in 2000 and 2001, reducing tax payments by financial sector firms and their employees. The tax-raising Budget of April 2002 helped begin to reverse the decline, but government revenues still ended Labour's second term 1.2% of national income lower than they began it (even though the net effect of new policy measures during the second term had been to raise revenue).

The combination of higher spending and weaker tax revenues unwound the improvement in the public finances seen during Labour's first term. The current budget balance moved from a surplus of 2.4% of national income at the end of the first term to a deficit of 1.6% of national income at the end of the second. The swing in the overall budget balance was even larger, reflecting the fact that public sector net investment had at last begun to increase. The return to sizeable overall budget deficits began to push public sector net debt up again, reaching 34.1% of national income in 2004–05.

The 2004 Spending Review began to slow the increase in spending, with the Treasury's original plans showing real increases declining from 4.2% in 2005–06 to 2.6% in 2006–07 and 2.8% in 2007–08. In fact, spending growth came in at a higher-than-intended 4.3% in 2005–06 and then slowed more sharply than intended to 2.1% in 2006–07, before rebounding to 3.1% in 2007–08. But the average growth rate of 3.2% over the three years of the review was as predicted in the original plans. This left total spending at 41.1% of national income in 2007–08, up from 40.7% of national income in 2004–05.

Even with the slower spending growth planned for Spending Review 2004, IFS and other commentators argued in the run-up to the 2005 election that the government would have to announce further tax-raising measures or cut spending as a share of national income if it wished to meet its fiscal rules with the degree of comfort it had sought in the past.

Mr Brown rejected any such suggestion, claiming during the campaign that: 'People say we won't meet our fiscal rules. Once again, with the public finances strong, we will prove them wrong'.[7] But, with the election out of the way, it became clear that the government

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[6] Mr Brown's 1998 Budget Speech: 'I said that this would be a Budget based on prudence for a purpose and that guides us also in our approach to public spending' (http://www.hm-treasury.gov.uk/bud_budget98_speech.htm).

[7] 'Row over £11bn tax black hole', *Guardian*, 22 April 2005 (http://www.guardian.co.uk/money/2005/apr/22/publicfinances.politics).

was indeed on course to breach its rules and Mr Brown duly announced net tax increases in the 2005 PBR, the 2006 Budget and the 2006 PBR. This was followed by a relatively neutral 2007 Budget (at least in the medium term) and a relatively neutral 2007 PBR. Taken together, these post-election tax increases were sufficient to raise an extra £7.4 billion last year (£200 per family). Adding in the impact of a rebound in corporation tax receipts and a gradual increase in the income tax burden as people drifted into higher tax brackets, revenues in total rose from 37.4% of national income in 2004–05 to 38.5% of national income in 2007–08.

With revenues growing more quickly than spending, the current budget deficit narrowed from 1.6% of national income in 2004–05 to 0.4% of national income last year, while net borrowing dropped from 3.3% to 2.5% of national income over the same three years. But with borrowing remaining high relative to the growth rate of the economy, public sector net debt continued to rise – from 34.1% of national income in 2004–05 to 36.4% of national income in 2007–08. This formed the fiscal backdrop to the credit crunch.

Was the roof in good repair?

As it became clear that the mild economic slowdown predicted by the Treasury in the 2008 Budget would turn into something much worse, the political parties debated whether Labour's stewardship of the public finances had left the UK well or poorly placed to cope with the huge increase in public sector borrowing that would follow:

- In his PBR statement, the Chancellor Alistair Darling said: 'Mr Speaker, the economic crisis, and the action by governments across the world, will inevitably mean sharp increases in national debt relative to GDP. Again the UK will be no exception. But because we started from a stronger position, our debt will remain below that of most other major countries.'
- George Osborne, the Conservative Shadow Chancellor, responded: 'He ran a huge budget deficit on the unstable premise that he could milk the City every year, and never considered what would happen to public finances when the money ran dry. He did not fix the roof when the sun was shining.'

So was the roof in good repair? And which party has the stronger claim to have been an effective manager of the public finances? To answer those questions, we now compare the evolution of the public finances under Labour from 1997 to their evolution under the Conservatives from 1979. We then focus on two snapshot comparisons:

- Did Labour enter recession with the public finances in better shape than they inherited from the Conservatives? (2007–08 vs 1996–97)
- Did Labour enter recession with the public finances in better shape than when the Conservatives entered recession in the early 1990s? (2007–08 vs 1989–90)

The Labour and Conservative eras compared

As Figure 2.2 illustrates, there are some notable parallels and differences in the way in which the public finances have evolved under the current and previous governments.

The structural budget deficit has evolved in a remarkably similar way. Both parties inherited large structural deficits from their predecessors: 4.8% of national income in 1978–79 and 2.8% of national income in 1996–97. If left unchecked, these would have seen debt continuing to rise considerably. So both governments began their terms with a significant tightening of fiscal policy, achieving structural budget surpluses that peaked in their third years in office, at 1.5% of national income in 1981–82 and 1.1% of national income in 1999–2000. Thereafter, both presided over a steady drift back into the red. By year 11 of their terms in office, both governments were recording very similar structural deficits: 2.6% of national income in 1989–90 and 2.9% of national income in 2007–08.

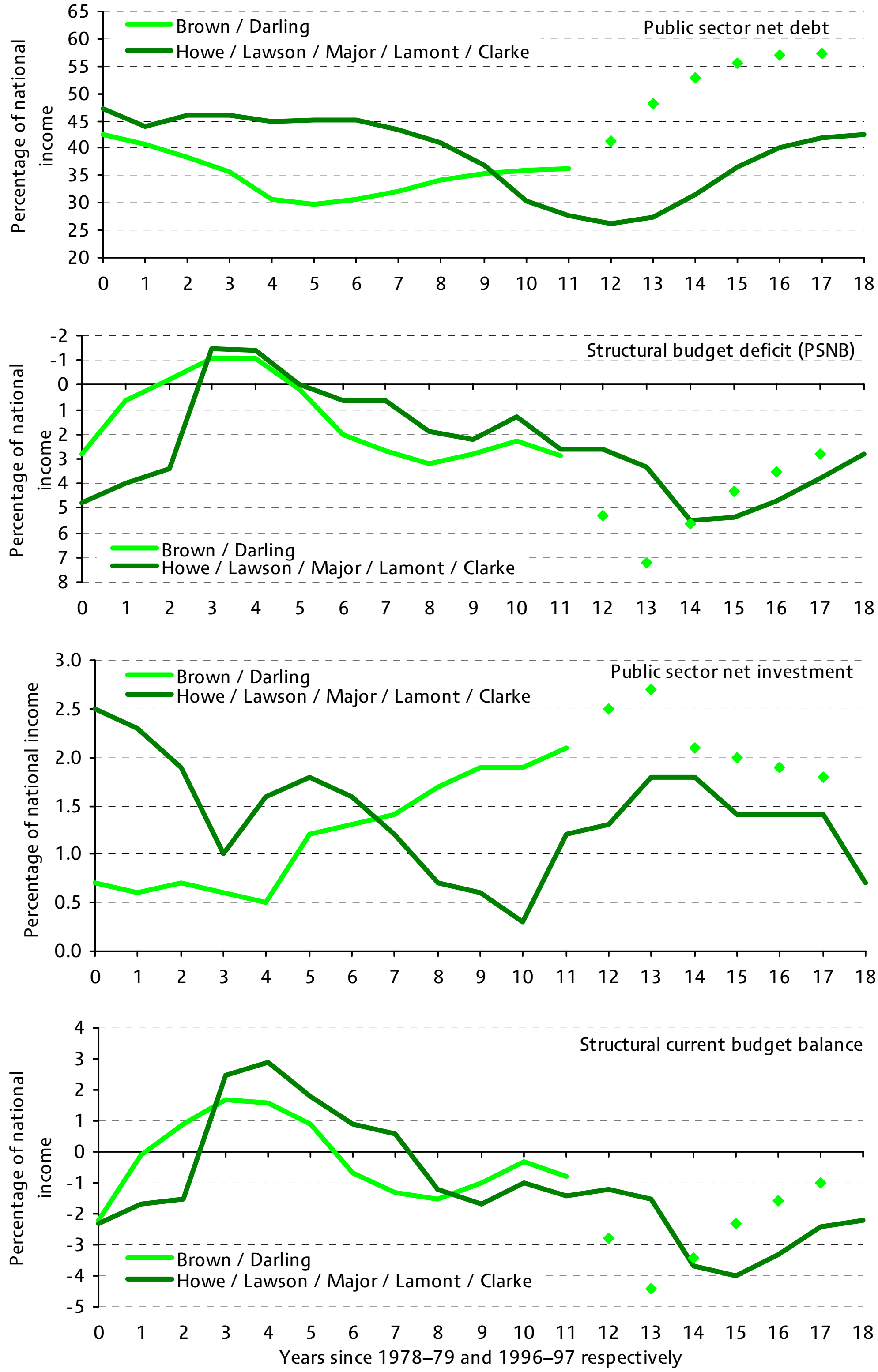
The evolution of public sector net debt differs rather more between the parties, because of movements in non-structural (i.e. cyclical) borrowing. Labour's move from structural budget deficit to surplus and back again was mirrored by a fall in public sector net debt – from the 42.5% of national income that it inherited in 1996–97 to a low of 29.7% in its fifth year (2001–02), since when debt has risen again to 36.4% of national income in year 11 (2007–08). By contrast, the Conservatives inherited a higher level of net debt than Labour in 1978–79 (47.1% of national income), but this did not fall as fiscal policy tightened in the early 1980s because the strengthening of the structural balance was offset by higher cyclical borrowing during the first Conservative recession. Net debt remained around 45% of national income until 1984–85, then fell sharply to a low of 26.2% of national income over the following six years (despite higher structural borrowing) as the boom of the mid-1980s generated an unsustainable cyclical surplus and a unsustainably high level of national income (both of which temporarily depressed the ratio of debt to national income).

The similarity in the paths of the structural budget deficit in part reflects Labour's willingness to borrow more to increase net investment. As Figure 2.2 shows, net investment actually fell over Labour's first term, but thereafter it increased strongly, and by last year net investment was three times higher than the level inherited from the Conservatives. In contrast, investment fell sharply during the Conservatives' first decade (although this in part reflected privatisation of capital-intensive industries). In their eleventh years in office, Labour was investing 75% more than the Conservatives.

If we exclude borrowing to finance investment, both parties inherited very similar structural current budget deficits in 1978–79 and 1996–97. Labour then achieved a smaller swing into surplus than the Conservatives during their first three years, followed by a smaller swing back into deficit over the next eight. But the patterns remain similar.

Looking forward, as we shall discuss further in Section 2.4, the Treasury predicts a sharp deterioration in the structural budget balance and current budget balance over the next two years – much sharper than in the equivalent period under the Conservatives. It hopes thereafter for a bigger improvement than under the Conservatives, but this will not be sufficient to prevent public sector net debt rising to levels significantly higher than it ever reached under the Conservatives. This would in part reflect the fact that, while Labour intends to squeeze public sector net investment as a share of national income, it does not plan to do so as severely as the Conservatives did following the last recession.

Figure 2.2. Debt, deficits and investment: Labour versus Conservatives



Sources: HM Treasury, Public Sector Finances Databank, December 2008 (http://www.hm-treasury.gov.uk/d/public_finances_databank.xls); HM Treasury, Pre-Budget Report 2008, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm).

Were the public finances stronger than when Labour came to power?

As Table 2.1 shows, Labour spent 1.2% of national income more last year than the Conservatives did in their final year in office (£18 billion more in 2008–09 terms), with the extra money more than accounted for by higher investment rather than current spending. But Labour increased tax and other revenues by an even larger 2.1% of national income (£30 billion). This paid for the extra spending and allowed Labour to borrow 0.9% of national income (£13 billion) less. The government was still borrowing last year to pay for some of its non-investment spending, but to a much lesser degree than the Conservatives did: at 0.4% of national income, the current budget deficit was much smaller in 2007–08 than the 2.7% of national income recorded in 1996–97.

Table 2.1. Key fiscal indicators: 1996–97 versus 2007–08

% of national income unless otherwise stated *Rankings: OECD member countries*	**Labour's inheritance (1996–97)**	**Pre-crisis position (2007–08)**	**Change, 1996–97 to 2007–08 (% points)**
Spending			
Total public spending	39.9%	41.1%	+1.2
Place in OECD league table	*20th/28 highest spending*	*11th/28 highest spending*	*2nd/28 largest increase*
Public sector net investment	0.7%	2.1%	+1.4
Revenues			
Tax and other revenues	36.4%	38.5%	+2.1
Place in OECD league table	*22nd/28 highest revenues*	*15th/28 highest revenues*	*3rd/28 largest increase*
Borrowing			
Public sector net borrowing: total	3.4%	2.5%	–0.9
Public sector net borrowing: structural	2.8%	2.9%	+0.1
Place in OECD league table	*7th/25 highest borrowing*	*3rd/26 highest borrowing*	*20th/25 largest reduction*
Current budget balance: total	–2.7%	–0.4%	+2.3
Current budget balance: structural	–2.2%	–0.8%	+1.4
Net worth, debt and debt interest			
Public sector net worth	17.7%	28.8%	+11.1
Public sector net debt	42.5%	36.4%	–6.1
Place in OECD league table	*10th/25 highest debt*	*11th/28 highest debt*	*10th/25 largest increase*
Public sector net debt interest	3.0%	1.7%	–1.4
Place in OECD league table	*16th/28 highest debt interest*	*10th/28 highest debt interest*	*20th/28 largest reduction*

Note: OECD figures relate to general government rather than public sector.
Sources: OECD, *Economic Outlook No. 84*, November 2008 (http://www.oecd.org/oecdEconomicOutlook); HM Treasury, *Public Sector Finances Databank*, December 2008 (http://www.hm-treasury.gov.uk/d/public_finances_databank.xls); Office for National Statistics.

Turning to the government's balance sheet, public sector net debt was 6.1% of national income (£89 billion) lower last year than in 1996–97, with the annual cost of public sector net debt interest 1.4% of national income (£20 billion) lower. Hence the government's claim that it has reduced the level of public sector debt and left the UK better placed to cope with the increase now in prospect. But this figure for debt excludes the impact of the nationalisation of Northern Rock, which increased the overall level of public sector net debt to 43% of national income at the end of 2007–08. On this measure, the level of public sector net debt was slightly higher at the end of 2007–08 than at the end of 1996–97. As we explain in Section 5.2, most of this increase should be temporary and it is unclear how big a profit or loss the government will have made once Northern Rock returns to the private sector. So to exclude it from comparisons at this stage seems sensible. Public sector net worth – a broader measure of the government's position than public sector net debt as it includes the value of the public sector's non-financial assets and its long-term financial assets – is estimated to have increased by 11.1% of national income (£162 billion) between 1996–97 and 2007–08. This is as a result of the reduction in public sector net debt and the increase in public sector net investment over this period.

The comparisons of overall borrowing flatter Labour because economic activity was weaker relative to its sustainable 'potential' level in 1996–97 than it was in 2007–08. This automatically depressed tax revenues and pushed up welfare bills for the Conservatives. Adjusting for the state of the economy, the structural budget deficit was actually 0.1% of national income larger in 2007–08 than in 1996–97. But public sector net debt was still significantly lower in 2007–08 than in 1996–97, even on a structural basis.

The falls in public sector borrowing and indebtedness – and the small deterioration in the structural budget balance – between 1996–97 and 2007–08 occurred while most other industrialised countries were doing more to strengthen their public finances than the UK.

On the OECD measure, the UK had a structural budget deficit of 3.3% of national income in 2007. This was the largest structural budget deficit among the G7 economies and the third highest of the 26 industrial countries for which the OECD has data (behind only Hungary and Greece). Indeed, as the Conservative leader David Cameron has pointed out, half these OECD countries are facing the current slowdown with structural budget surpluses.

Although the structural budget deficit on this measure is slightly smaller than the one Labour inherited on taking office, the UK has slipped down the international league table, as 19 of the other 24 industrial countries for which we have comparable data have done more to reduce their structural deficits than the UK since 1996. In 1996, the UK had the third biggest structural deficit in the G7 (behind Japan and Italy) and the seventh biggest of the 25 OECD countries.

Turning to debt, as Mr Brown is fond of pointing out, in 2007 the UK had the second lowest ratio of general government debt to national income in the G7 after Canada. But our position in the broader industrial country league table looks less favourable – we had the eleventh highest debt ratio of the 28 countries for which the OECD has data for that year. Although the indebtedness of the larger economies matters more than that of the smaller ones in determining the total volume of government debt globally, it is not clear why we should compare ourselves to the G7 economies rather than to the broader range of OECD countries in judging how prudently we manage our public finances. One-third of OECD countries had net financial assets rather than net debts in 2007.

In 1996, we had the third lowest debt in the G7 and the tenth highest of 27 OECD countries. So we have moved slightly higher up the G7 league (with our debt now below that of Japan and Germany) but not really changed our position in the broader OECD league under Labour.

The sharp fall in annual debt interest payments in the UK between 1996 and 2007 is not that large relative to that which occurred elsewhere. In 2007 the UK had the tenth highest debt interest payments out of 28 OECD countries, whereas in 1996 it had the sixteenth highest. This move up the debt interest league table is due to the UK having the twentieth largest reduction out of the 28 OECD countries.

To summarise, the UK entered this recession with a similar structural budget deficit to that which it inherited from the Conservatives, but a smaller public sector net debt (if the impact of the nationalisation of Northern Rock is excluded). By international standards, we entered the recession with one of the biggest structural budget deficits in both the OECD and the G7 and a bigger public sector net debt than most OECD countries, although smaller than most G7 countries. Most OECD governments have done more to reduce their indebtedness and – in particular – their structural deficits than the UK while Labour has been in power.

Were the public finances stronger than at the time of the last recession?

If we compare the structural budget deficits in the years immediately before the latest two recessions, then Labour faced the downturn in a slightly weaker position than the Conservatives, with an underlying deficit of 2.9% of national income in 2007–08 compared with 2.6% of national income in 1989–90. However, the structural deficit also appears to be deteriorating more sharply early in this downturn than it did under the Conservatives and, as a result, is set to be much higher in the first year of recession than it was under the Conservatives. The Treasury expects the deficit to be 5.3% of national income this year compared with 2.6% of national income under the Conservatives in 1990–91. This largely reflects the impact of the credit crunch and the falls in the stock and housing markets, rather than policy decisions. (The fiscal stimulus announced in the 2008 PBR is expected to increase the deficit by only 0.6% of national income this year.)

The borrowing picture on the eve of recession looks even weaker in international perspective. On the comparable OECD measure, the UK has moved from having the second lowest structural deficit in the G7 in 1990 to the second highest in 2007, and from the thirteenth highest (of 23) in the OECD in 1990 to the fourth highest (of 26) in 2007.[8]

Labour is also beginning the current recession with a considerably higher level of public sector net debt than that with which the Conservatives entered the 1990 to 1991 recession. But the Conservative figures are clearly flattered by the Lawson boom.

In 1990 our debt was lower than that of most other OECD countries as well as most other G7 countries. We have moved down the broader international league table since the last recession, although it should be borne in mind that – unlike the structural budget deficit figures – comparing debt levels internationally is hampered by the fact that different countries will be at different points in their economic cycles.

In summary, we appear to be entering this recession with a bigger underlying budget deficit and a larger public sector net debt than the Conservatives entered the last recession with. As we shall see in the next section, the Treasury now expects the budget deficit and net debt to reach levels higher than seen in any year under the Conservatives.

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[8] Source: R. Chote, C. Emmerson and G. Tetlow, *The UK Public Finances: Ready for Recession?*, IFS Briefing Note 79, October 2008 (http://www.ifs.org.uk/bns/bn79.pdf), using data from annex table 28 of OECD, *Economic Outlook No. 83*, June 2008.

2.4 Labour's forecasts for the next five years

The November 2008 PBR included dramatic revisions to the Treasury's forecasts for the public finances for this year and for the following five years. These reflected new forecasts or assumptions for economic growth, movements in asset markets (notably the housing market and stock market) and other forecasting changes, plus the impact of tax and spending policy decisions announced in the PBR.

The main factor was the deterioration in the outlook for economic growth, which reduced expected tax revenues and increased expected social security spending. The Treasury estimates that every 1% cut in national income increases government borrowing by 0.5% of national income after one year and by a further 0.2% of national income a year later.[9]

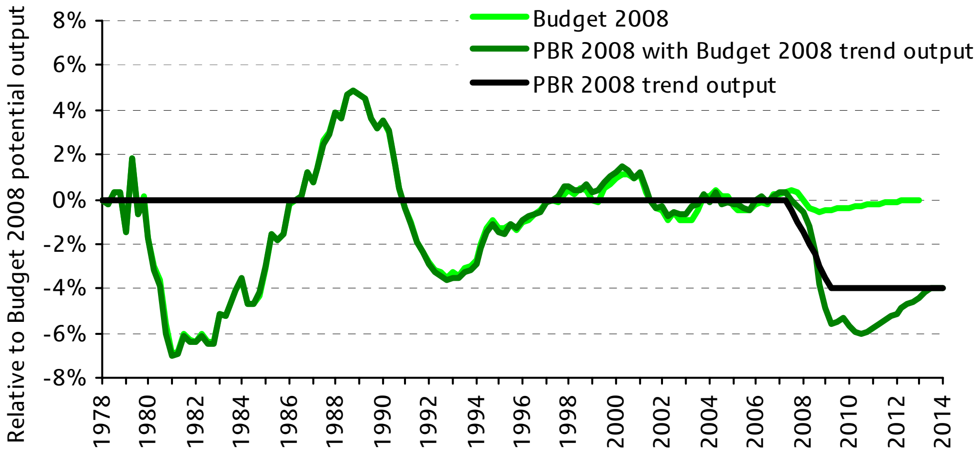
At the time of the Budget, the Treasury assumed for the purposes of its public finance forecasts that economic growth would slow modestly, from 3% in 2007–08 to 1¾% this year, before returning to its assumed trend rate of 2½% a year thereafter. In the PBR, it took a much gloomier view: that the economy would shrink by ¼% this year and ½% in 2009–10, before growing by 2% in 2010–11 and 3% in each of the next three years. Importantly, this growth profile implies not just that national output will be temporarily weaker than expected at the time of the Budget, but that there will be a permanent loss of national income as a result of the credit crunch.

Figure 2.3 shows the Treasury's recent estimates of the 'output gap' – the difference between the actual level of national income and the 'potential' level thought consistent with stable inflation. At the time of the Budget, the Treasury estimated that the economy was running at its full potential level in late 2006. It assumed that the economy's potential would grow by 2¾% thereafter (the 2½% used for its public finance projections, cited in the paragraph above, deliberately being ¼ percentage point below this to increase caution in the public finance forecasts) and that the actual level of economic activity would be slightly above potential in 2007 and slightly below it in 2008.

If the Treasury had maintained this assumption about the path of potential output, the much more pessimistic growth forecasts published in the PBR would have shown national income moving 6% below its sustainable potential, creating more spare capacity even than in the recession of the early 1990s. But the Treasury has instead assumed that the economy's potential will shrink by a total of 4% compared with the path assumed at Budget time, between mid-2007 and mid-2009. As Figure 2.3 illustrates, this means that the recession will create much less spare capacity and that there will be much less scope for the economy to rebound without running into inflationary bottlenecks.

[9] Source: Page 18, table 2.K of S. Farrington, J. McDonagh, C. Colebrook and A. Gurney, 'Public finances and the cycle, Treasury Economic Working Paper 5, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_publicfinances.htm).

Figure 2.3. Changing Treasury estimates of trend output and the output gap



Sources: HM Treasury, *Budget* 2008, March 2008 (http://www.hm-treasury.gov.uk/bud_bud08_index.htm); HM Treasury, *Pre-Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm).

The significance of this assumption for the public finances is that much of the increase in borrowing as a result of the recession is expected to be persistent rather than to disappear as the economy recovers. In effect, the credit crunch has punched a 4% or £60 billion hole in the potential of the economy, creating an additional structural budget deficit of roughly 2.8% of potential output in 2009–10 or around £40 billion in today's terms. (See Section 4.3 for a discussion of the Treasury's view of the path of potential output.)

Table 2.2 shows the impact of the loss of potential output and changes in the output gap on the Treasury's borrowing forecasts through to 2012–13. The addition to borrowing from the loss of potential adds significantly to borrowing throughout the period, while the impact of cyclical weakness in the economy peaks in 2010–11 as growth heads above its trend rate and the output gap begins to close (as shown in Figure 2.3). The other main forecasting changes arise from movements in the housing market and equity market. The Treasury assumes that house prices and share prices will remain permanently below the levels assumed in the 2008 Budget, so some of the resulting addition to borrowing persists.

The forecasting changes alone would have pushed public sector net borrowing this year from the 2.9% of national income forecast in the Budget to 4.7% of national income. The deficit would then have been predicted to rise to 7.1% of national income in 2010–11 before declining modestly as the output gap closes and the cyclical addition to borrowing disappears. However, given the permanent additions to the structural deficit, borrowing would have not have been projected to fall below 4.5% of national income until 2014–15.

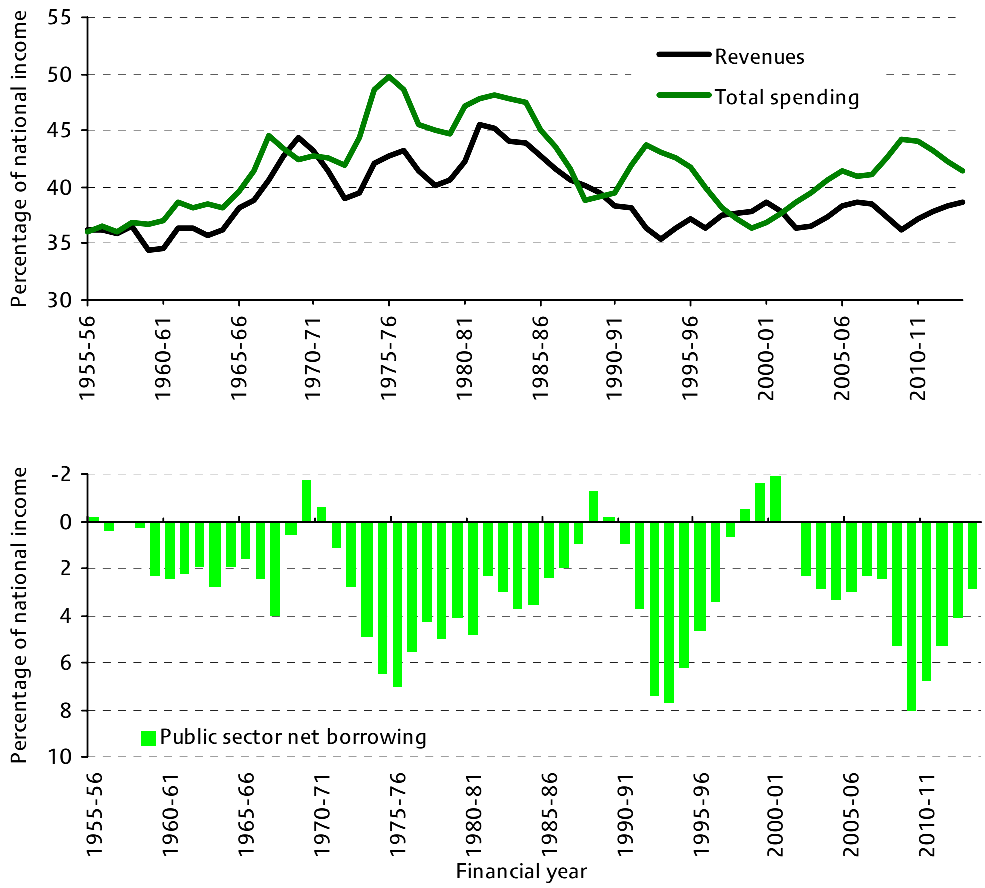
The changes in the borrowing forecasts between the Budget and the PBR reflect not just forecasting changes but also policy measures. The fiscal stimulus package – dominated by the temporary cut in VAT and the bringing-forward of proposed capital spending – is expected to add £9.3 billion to borrowing this year and £16.3 billion next year. Thereafter, policy measures – primarily cuts in prospective spending plans – reduce borrowing by £4.8 billion in 2010–11, £14 billion in 2011–12 and £22.5 billion in 2012–13.

Table 2.2. Change in Treasury forecast for public sector net borrowing

£ billion (% GDP)	2008–09	2009–10	2010–11	2011–12	2012–13
Budget 2008	**42.5 (2.9%)**	**38 (2.5%)**	**32 (2.0%)**	**27 (1.6%)**	**23 (1.3%)**
Lost potential output	+22.3	+38	+43	+46	+49
Cyclical movements	–2.3	+8	+16	+15	+10
Other (including asset prices)	+6	+18.5	+17.5	+11.5	+12.5
Budget 2008 + forecast changes	**68.3 (4.7%)**	**101.5 (6.9%)**	**109.5 (7.1%)**	**100 (6.1%)**	**93.5 (5.4%)**
Net tax cut	6.6	12.4	3.3	–2.9	–4.0
Net spending increase	2.7	3.9	–8.1	–11.2	–18.6
PBR 2008	**77.6 (5.3%)**	**118 (8%)**	**105 (6.8%)**	**87 (5.3%)**	**70 (4.1%)**

Note: Figures may not sum due to rounding.
Sources: Authors' calculations using HM Treasury, *Budget* 2008, March 2008 (http://www.hm-treasury.gov.uk/bud_bud08_index.htm) and HM Treasury, *Pre-Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm).

Figure 2.4. Revenues, spending and borrowing



Note: Borrowing is equal to total spending less revenues.
Sources: HM Treasury, *Pre-Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm); HM Treasury, *Public Sector Finances Databank*, December 2008 (http://www.hm-treasury.gov.uk/d/public_finances_databank.xls); Office for National Statistics.

The net result of the forecasting changes and policy measures is that Labour expects to spend 42.6% of national income this year (40.1% on current spending plus 2.5% on public sector net investment). With revenues forecast at 37.3% of national income, this leaves a current budget deficit of 2.8% of national income (£41.2 billion) and public sector net borrowing of 5.3% of national income (£77.6 billion).

Public sector net borrowing is forecast to peak at 8.0% of national income next year, narrowly exceeding the previous post-Second-World-War high of 7.7% of national income recorded in 1993–94 (as shown in Figure 2.4). At 44.2% of national income, total public spending is expected to be at its highest level since 1985–86, while at 36.2% current receipts (the broadest measure of the tax burden) is expected to be at its lowest level since 1993–94.

Beyond next year's peak, the Treasury expects public sector net borrowing to decline by 5.1% of national income over the following four years to 2013–14 (Table 2.3). Of this improvement, only 0.7% of national income reflects cyclical recovery in the economy. The remainder includes a cut in public sector net investment worth 0.9% of national income and a cut in the structural current budget deficit of 3.4% of national income. This in turn comprises a cut in structural current spending of 1.2% of national income and an increase in structural revenues of 2.3% of national income, both primarily due to policy measures.

Table 2.3. PBR forecasts for components of public sector net borrowing

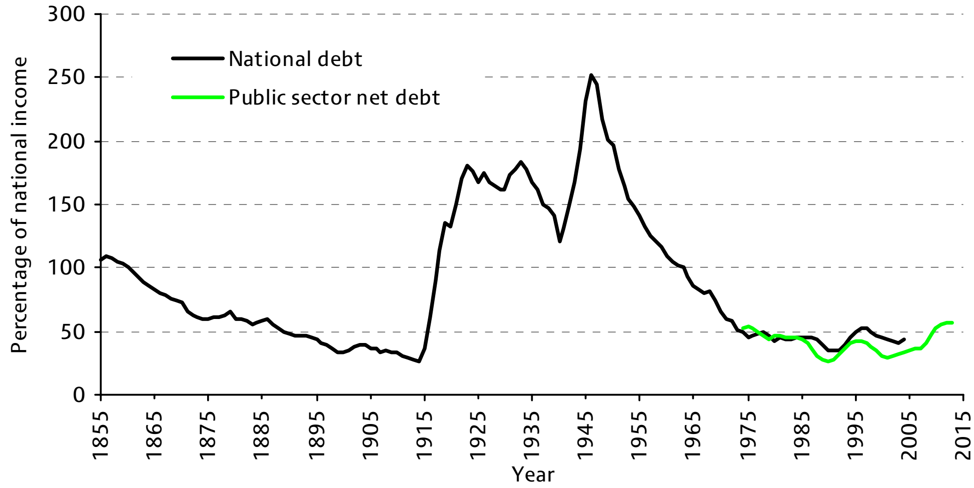
	Economic growth	*Output gap (% of potential output)*	*Current budget balance (% of GDP)* Cyclical	Structural	Total	Net investment (% of GDP)	Net borrowing (% of GDP)
2008–09	*–¼*	*–0.3*	0.0	–2.8	–2.8	2.5	5.3
2009–10	*–½*	*–1.5*	–0.9	–4.4	–5.3	2.7	8.0
2010–11	*2*	*–1.9*	–1.3	–3.4	–4.7	2.1	6.8
2011–12	*3*	*–1.3*	–1.0	–2.3	–3.3	2.0	5.3
2012–13	*3*	*–0.7*	–0.6	–1.6	–2.2	1.9	4.1
2013–14	*3*	*–0.1*	–0.1	–1.0	–1.1	1.8	2.9
2014–15	*2½*	*0*	0	–0.5	–0.5	1.8	2.3
2015–16	*2½*	*0*	0	0	0	1.8	1.8

Source: Tables B1 and B3 of HM Treasury, *Pre-Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm). Figures for 2014–15 and 2015–16 are Treasury illustrative projections, plus assumption that the economy will be back to sustainable levels of activity.

With the overall deficit remaining high relative to the growth rate of the economy, the Treasury expects public sector net debt to stabilise at 57.4% of national income in 2013–14. As Figure 2.5 illustrates, this would be higher than in any year for which we have consistent data and probably the highest since the early 1970s.

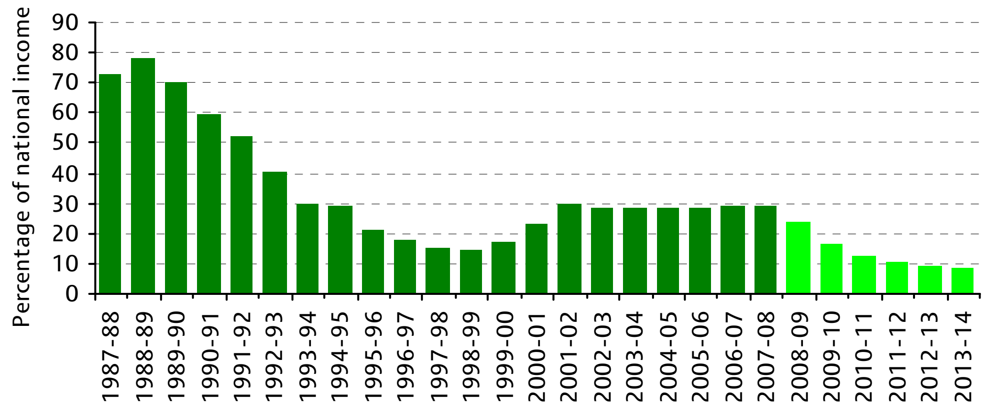
The Treasury also set out 'illustrative projections' in the PBR showing further reductions in the structural current budget deficit worth 0.5% of national income in 2014–15 and 2015–16 – presumably reflecting continued cuts in current public spending as a share of national income and the impact of fiscal drag – with public sector net investment held constant at its 2013–14 level of 1.8% of national income. This would eliminate the structural and overall current budget deficits, bring public sector net borrowing below 2% of national income and start to reduce public sector net debt as a share of national income.

Figure 2.5. National debt and public sector net debt



Note: Years on the x-axis refer to calendar years for national debt and financial years for public sector net debt.
Sources: HM Treasury, *Pre-Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm); HM Treasury, *Public Sector Finances Databank*, December 2008 (http://www.hm-treasury.gov.uk/d/public_finances_databank.xls); Debt Management Office (http://www.dmo.gov.uk/reportView.aspx?rptCode=D4A&rptName=37790042&reportpage=national_debt); Office for National Statistics.

Figure 2.6. Public sector net worth



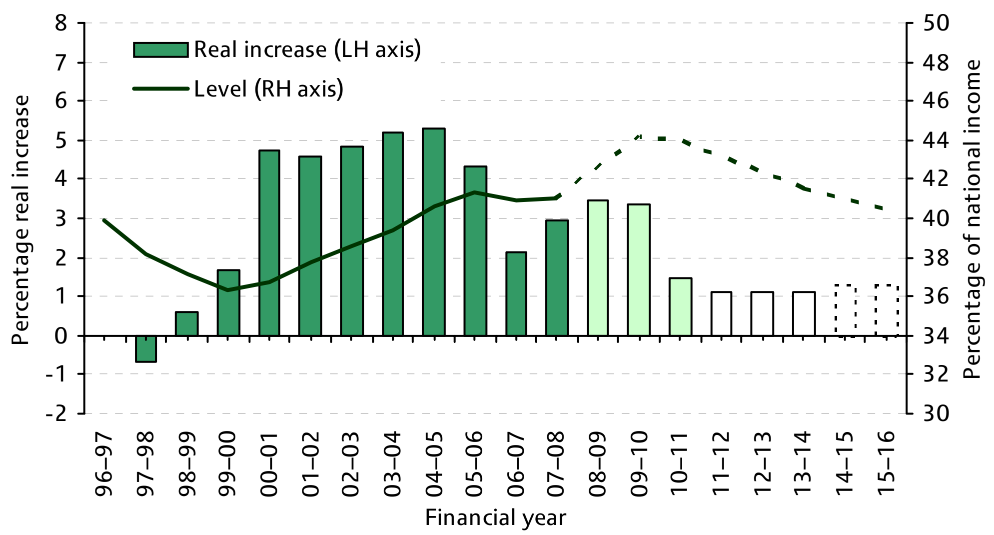
Source: HM Treasury, *Public Sector Finances Databank*, December 2008 (http://www.hm-treasury.gov.uk/d/public_finances_databank.xls).

Labour's critique of the state of the public finances that they inherited included a reference to 'falling public sector net worth' – the estimated net value of the public sector's physical and financial assets minus its financial liabilities. Increased investment spending and falling public sector net debt led to public sector net worth increasing between 1998–99 and 2001–02. As shown in Figure 2.6, since 2001–02 public sector net worth has been stable at around 30% of national income. This is due to the positive impact of further increases in investment being cancelled out by the negative impact of rising public sector net debt. Looking forwards, the Treasury's projections suggest that the scaling-back of investment spending as a share of national income and the sharp projected rise in public sector net debt will lead to a decline in public sector net worth. In 2013–14, the Treasury forecasts imply public sector net worth of just 8.7% of national income, which would be half the level that Labour inherited from Conservatives (17.7% of national income).

Spending

The 2007 Comprehensive Spending Review (CSR) proposed to increase total spending by an average of 2.0% a year in real terms in 2008–09, 2009–10 and 2010–11, which was expected at the time to cut spending by 0.4% of national income. However, with the November 2008 PBR predicting that the economy will grow by an average of only 0.4% a year over these three years, real spending growth of 2.0% a year would actually increase spending as a share of national income. What is more, the Treasury has been forced to increase its estimate of average real spending growth to 2.7% a year to reflect the costs of the slowdown and policy measures. As a result, spending is expected to rise by 3.0% of national income over the CSR 2007 period. Ironically, the spending review that Labour intended to be the toughest of its time in office is now expected to see a bigger rise in spending as a share of national income than any of its predecessors.

Figure 2.7. Total managed expenditure



Notes: Light green bars represent the years covered by the 2007 CSR and white bars are illustrative Treasury plans for government spending for years not yet covered by a Spending Review, while the dotted white bars are not explicit government projections but are based on authors' calculations.
Sources: Table B1 of HM Treasury, *Public Sector Finances Databank*, December 2008 (http://www.hm-treasury.gov.uk/d/public_finances_databank.xls) and table B10 and paragraphs 2.60 and 6.33 of HM Treasury, *Pre-Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_repindex.htm). GDP and GDP deflators up-to-date as of 23 December 2008 from HM Treasury website (http://www.hm-treasury.gov.uk/d/gdp_deflators.xls).

Looking further ahead, the PBR has also pencilled in real spending growth averaging 1.1% a year in real terms over the subsequent three years of what we presume will be Spending Review 2010, with current spending growing by 1.2% a year and capital spending being cut by 2.4% a year. With the economy expected to grow at an average rate of 3% a year over this period, this is expected to cut total public spending by 2.5% of national income – this would be the toughest spending review under Labour to date. The Treasury's illustrative projections for 2014–15 and 2015–16 assume that capital spending grows in line with the economy in these two years, presumably at its trend rate of 2.5% a year. If current spending continues to grow at the rate pencilled in for Spending

Review 2010, then this would give an average real growth rate in total spending of 1.3% over the two years, reducing it by a further 1.0% of national income.

Another way to characterise the changes in spending as shares of national income is to ask what proportion of the 'proceeds of growth' are spent publicly. In other words, what proportion of every extra pound of national output does the Treasury expect the public sector to spend? When considering this split, which is shown for various periods in Table 2.4, it is important to bear in mind that a large part of public spending is distributed within the population in the form of social security benefits and tax credits.

Table 2.4. Sharing the proceeds of growth: spending

	Average annual real growth in:			*% of GDP growth spent:*	
	GDP	**TME**	**GDP minus TME**	**Publicly**	**Not publicly**
Conservatives (1979–80 to 1996–97)	2.2	1.5	2.7	28.7	71.3
Margaret Thatcher's premiership (1979–80 to 1990–91)	2.2	1.1	3.1	20.6	79.4
John Major's premiership (1991–92 to 1996–97)	2.1	2.2	1.9	43.1	56.9
Labour to date (1997–98 to 2007–08)	2.9	3.2	2.8	44.2	55.8
Labour plans: all (2008–09 to 2013–14)	1.7	1.9	1.6	45.9	54.1
Labour plans: CSR 2007 years (2008–09 to 2010–11)	0.4	2.8	–1.3	285.3	–185.3
Labour plans: SR 2010 years (2011–12 to 2013–14)	3.0	1.1	4.5	14.4	85.6
Labour: illustrative projections (2014–15 & 2015–16)	2.5	1.3	3.3	21.5	78.5

Sources: As Figure 2.7.

Under the Conservatives from 1979 to 1997, the economy grew by an average of 2.2% a year, and TME grew by an average of 1.5% a year, in real terms. This meant that national income not spent publicly grew by 2.7% a year on average. So the public sector spent nearly 30% of additional national output, leaving 70% not being spent publicly. Under Labour to date, the public sector has spent just under 45% of the additional national output, leaving a little over 55% not being spent publicly. This is quite similar to what happened over John Major's years as Prime Minister, although higher average annual growth in national income under Labour has meant that both public spending and national income less public spending have been able to grow faster than they did under Mr Major's premiership.

The PBR 2008 forecasts suggest a rather different pattern going forwards. Over the three years from 2008–09 to 2010–11 – the CSR 2007 years – national income is expected to grow by just 0.4% a year on average while TME is forecast to grow by an average of 2.8% a year. The cash increase in TME over this period is forecast to be nearly three times larger than the cash increase in the economy (so public spending is set to absorb 285% of the proceeds of growth over this period). From 2011–12 onwards, the economy is forecast to grow more quickly as it returns to trend, and TME is forecast to grow more slowly, such that only 14% of the proceeds of growth are projected to be spent publicly. From 2014–15, the economy is projected to remain at trend. If the government were to increase total spending at 1.3% a year until 2015–16, the Treasury would expect to spend just 21.5% of the proceeds of economic growth, leaving almost 80% not to be spent publicly.

We discuss the consequences for different departments of the projected squeeze during the Spending Review 2010 years in Chapter 9.

Revenues

The Treasury is expecting revenues to fall by 2.3% of national income (£34 billion) between 2007–08 and 2009–10, and then to rise by 2.4% (£35 billion) over the subsequent four years. As Table 2.5 illustrates, income tax and National Insurance contributions (NICs) together are the only tax from which the Treasury gains more during the tightening phase than it loses in the downturn. This reflects a combination of fiscal drag and the increases in income tax and NICs rates announced in the PBR to take effect from 2010–11. VAT revenues are sharply lower next year than in 2008–09, reflecting the temporary cut in the standard rate (see Chapter 10 for a discussion), but they remain lower than their 2007–08 level in 2013–14 thanks to relatively weak consumer spending and a rise in the 'VAT gap' between what HMRC thinks should be paid and expects to collect.

As with spending, we can compare the average annual real growth in the economy with average annual increases in tax revenues and, therefore, the average annual increase in the size of the economy less the overall tax take. This allows us to characterise changes in the tax burden as changes in how much of the 'proceeds of growth' are taken in revenues by the public sector. (See Table 2.6.)

Table 2.5. Revenue changes projected in PBR 2008 (% of national income)

	2007–08	2009–10	2013–14	Change 2007–08 to 2009–10	Change 2009–10 to 2013–14
Income tax & NICs net of tax credits	17.4	16.5	18.1	–0.9	+1.6
Corporation tax	2.9	2.4	2.7	–0.5	+0.3
North Sea revenues	0.5	0.6	0.4	+0.1	–0.2
VAT	5.7	4.9	5.4	–0.8	+0.5
Excise duties	2.9	2.9	2.7	0	–0.2
Other taxes & royalties	6.9	6.4	6.7	–0.5	+0.3
Net taxes & NICs	**36.3**	**33.8**	**36.0**	**–2.5**	**+2.2**
Other receipts etc.	2.2	2.5	2.6	+0.3	+0.1
Current receipts	**38.5**	**36.2**	**38.6**	**–2.3**	**+2.4**

Note: Components may not add to totals due to rounding.
Source: Table B14 of HM Treasury, *Pre-Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm).

Table 2.6. Sharing the proceeds of growth: tax

	Average annual real growth			*% of GDP growth:*	
	GDP	**Current receipts**	**GDP minus current receipts**	**Taken in current receipts**	**Not taken in current receipts**
Conservatives (1979–80 to 1996–97)	2.2	1.6	2.5	28.6	71.4
Margaret Thatcher's premiership (1979–80 to 1990–91)	2.2	1.9	2.5	32.8	67.2
John Major's premiership (1991–92 to 1996–97)	2.1	1.2	2.6	21.1	78.9
Labour to date (1997–98 to 2007–08)	2.9	3.5	2.6	44.1	55.9
Labour plans: all (2008–09 to 2013–14)	1.7	1.7	1.7	38.8	61.2
Labour plans: PBR 2008 giveaway (2008–09 to 2009–10)	–0.3	–3.4	1.6	n/a	n/a
Labour plans: PBR 2008 takeaway (2010–11 to 2013–14)	2.7	4.4	1.7	59.9	40.1

Sources: As Figure 2.7.

Over the period of Labour governments to date, tax revenues have grown by an average 3.5% a year. This is higher than that seen under Margaret Thatcher (1.9%) or John Major (1.2%). Higher growth in national income under Labour has meant that national income less that taken in tax has still grown at a comparable rate under Labour to what it did under either Mrs Thatcher or Mr Major (2.6% compared to 2.5% and 2.6% respectively). Overall under Labour, 44% of every extra pound in national income has been taken in tax compared with 29% over the 18 years of Conservative governments from 1979.

Again, a very different picture for the period going forwards is implied by the Treasury's PBR forecasts. Over 2008–09 and 2009–10 – the PBR 2008 giveaway period – tax revenues are projected to decrease by 3.4% a year. This means that, despite the economy being forecast to shrink by an average of 0.3% a year over this period, national income that is not taken in tax could grow at 1.6% a year. Over the following four years, from 2010–11 to 2013–14 – the PBR 2008 takeaway years – tax revenues are forecast to grow by 4.4% a year on average, leading to national income not taken in tax being projected to continue growing at a similar rate to that seen over the two previous giveaway years (1.7% compared to 1.6%). Over the four takeaway years, this would lead to 60p of every pound generated in the economy being taken in tax revenue.

Converting the increases in national income, tax revenues and national income less tax revenues into pounds per family shows how large the proceeds of growth have been. Under Labour to date, between 1996–97 and 2007–08, the Treasury estimates that real national income has risen by £400 billion, or £12,700 for each of the 31.6 million families in the UK. Of this total, families are paying £5,600 more in tax (and seeing £5,600 more being spent publicly), leaving them with £7,100 more income after tax. Between 2007–08 and 2013–14, the Treasury expects real national income to rise by £156 billion, or £4,900 per family. Of this, £1,900 will be taken in tax (but with £2,300 being spent publicly), leaving an increase in after-tax income of £3,000. (These figures take into account all government revenue and not just taxes that are formally paid by specific households. The Treasury apparently believes that some taxes are actually ultimately paid by businesses.[10] However, this is incorrect; all taxes – even those formally levied on businesses – are ultimately paid by individuals.)

2.5 Uncertainty and the Treasury's fiscal forecasts

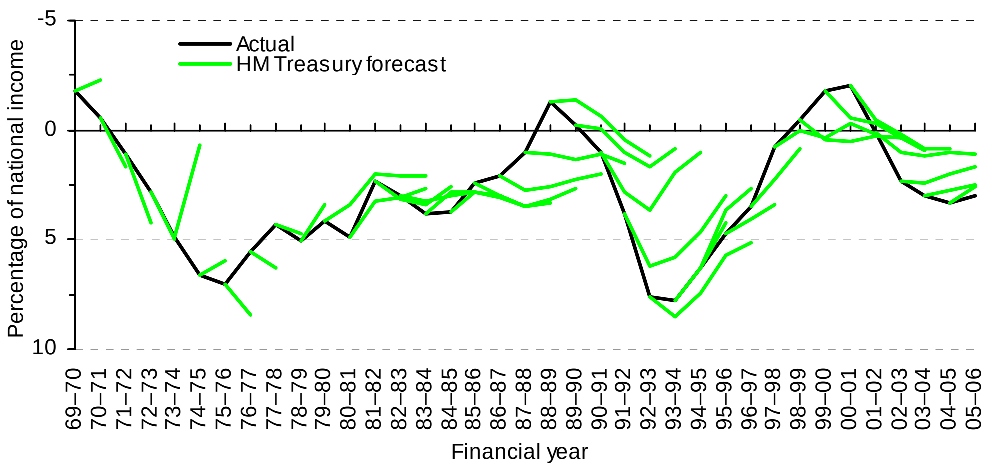
Forecasting the public finances is a difficult business at the best of times and these are certainly not the best of times. Even small errors in forecasts for spending or revenues can imply proportionately much bigger errors in forecasts of budget balances – the difference between the two. Given the uncertainty surrounding all fiscal forecasts – and the unusual degree of uncertainty surrounding the current ones – how confident can we be that the Treasury's predictions of the deterioration in the public finances in the short term and the subsequent improvement in the longer term will be accurate?

Lessons from past experience

The Treasury's past forecasting errors are a good place to start in assessing the confidence we should have in its latest predictions. If we assume that its forecasting performance in the future will be the same as that in the past, we can calculate the probability that the outcome will differ by a given amount in one direction or the other from the central forecast.

Figure 2.8 shows how Treasury forecasts of changes in public sector net borrowing since the early 1970s compare with what actually happened. We can see that the errors are relatively large and serially correlated: in other words, an optimistic forecast tends to be followed by another optimistic one and a pessimistic forecast by another pessimistic one.

Figure 2.8. Treasury public sector net borrowing forecasts



Source: Authors' calculations, from data contained in HM Treasury, *End of Year Fiscal Report*, October 2007 (http://www.hm-treasury.gov.uk/end_of_year_fiscal_report.htm).

If the November 2008 PBR projections are correct, then recent forecast errors made by the Treasury will be large – but not unprecedented. For example, the March 2007 Budget

[10] In 2007, a Treasury spokesman said, of similar analysis: 'This analysis is based on flawed assumptions, as it incorporates taxes paid by companies rather than by individuals into the calculation'. Source: *Daily Express*, 29 May 2007 (http://www.express.co.uk/posts/view/8225/How+you+pay+%C2%A36.60+an+hour+in+tax).

forecast that the current budget balance in three years' time (2009–10) would be 0.4% of national income (as did the January 2007 IFS Green Budget). If the November 2008 PBR is correct, 2009–10 will actually see a current budget deficit of 5.3% of national income. An error of 5.7% of national income on the current budget three years out has only been made in two out of the Treasury's 26 Budget forecasts for public sector net borrowing since the March 1980 Budget. The two exceptions both came prior to the sharp recession of the early 1990s: the projection made in the March 1990 Budget for 1992–93 and the projection made in the March 1991 Budget for 1993–94, both of which underestimated public sector net borrowing by 5.9% of national income.

The apparent forecast errors shown in Figure 2.8 are likely to understate the true error that would have occurred had policies been unchanged. This is because previous Chancellors might well have responded to forecast errors by taking action to bring borrowing back on track. For example, in the late 1980s, when previous forecasts for borrowing were proving to have been too pessimistic, Nigel Lawson announced significant tax-cutting Budgets. Conversely, in the early 1990s, when previous forecasts for borrowing were proving too optimistic, Norman Lamont and Kenneth Clarke announced significant tax-increasing Budgets. A similar response also occurred under Mr Brown: Budget 2000 announced increases in public spending as a share of national income at a time when borrowing was better than previously forecast; conversely, Budget 2004 and Budget 2007 announced future cuts in public spending as a share of national income at a time when the outlook for borrowing appeared worse than previously forecast.

The Treasury's average absolute error in forecasting public sector net borrowing one, two, three and four years ahead for the period from 1977–78 to 2006–07 is shown in Table 2.7. This shows that even one year ahead, the average absolute error is 1.0% of national income, or £14.6 billion in today's prices.[11]

Table 2.7. Treasury errors in forecasting public sector net borrowing

Time period	Average absolute error (% of national income)	Average absolute error (£ billion)
One year ahead	1.0	15
Two years ahead	1.5	22
Three years ahead	1.9	28
Four years ahead	2.4	35

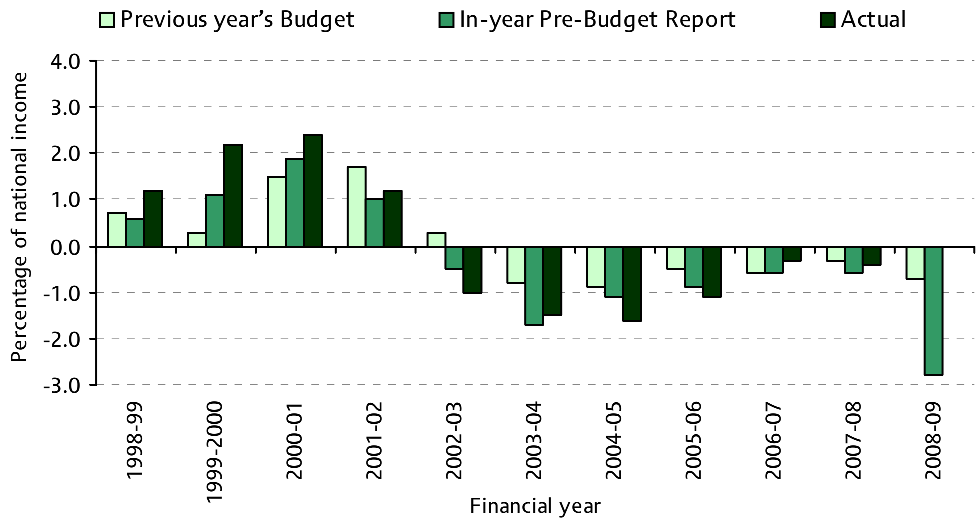
Notes: Figures in £ billion are calculated assuming HM Treasury forecast for national income in 2008–09 of £1,463 billion. Average absolute error is given over the period 1977–78 to 2006–07 for one year ahead, 1981–82 to 2006–07 for two years ahead, 1982–83 to 2006–07 (excluding 1996–97 to 1999–2000) for three years ahead, and 1983–84 to 2006–07 (excluding 1984–85 to 1986–87 and 1997–98 to 2000–01) for four years ahead.

Sources: HM Treasury, *End of Year Fiscal Report*, October 2007 (http://www.hm-treasury.gov.uk/end_of_year_fiscal_report.htm); authors' calculations.

[11] IFS forecasts show errors of similar magnitude. See C. Giles and J. Hall, 'Forecasting the PSBR outside government: the IFS perspective', *Fiscal Studies*, 1998, 19(1): 83–100 (http://www.ifs.org.uk/publications/2250).

Errors in forecasting public sector net borrowing can arise either from errors in forecasting the strength and composition of economic growth or from errors in predicting tax revenues and spending for any given level and composition of national income. (Labour claims that its forecasts are deliberately cautious, by assuming that economic growth will be a quarter of a percentage point lower each year than its true expectation; for a discussion, see Chapter 5.) In 1998, the Treasury concluded that only a minority of its previous errors in forecasting budget balances can be explained by errors in forecasting economic growth; the more significant factor in explaining previous forecast errors was found to have been errors in predicting tax revenues and spending for any given level and composition of national income.[12]

Figure 2.9. Treasury current budget balance forecasts



Sources: HM Treasury, various Budgets and Pre-Budget Reports.

As mentioned above, forecasting errors tend to be correlated from one year to the next. We can see this for the current government's short-term forecasts of the current budget balance in Figure 2.9. The Treasury was serially overpessimistic in its first three years of forecasts under Labour and serially overoptimistic in the following five. Budget 2006 saw the Treasury return to undue pessimism in its current budget forecast for 2006–07. But this has not persisted. The forecast made in Budget 2007 (although not PBR 2007) proved to be too optimistic. If PBR 2008 is correct, then the current budget deficit this year will be 2.8% of national income, which would be 2.1% of national income larger than the forecast of 0.7% made in Budget 2007. This would be the worst one-year forecast error since Labour came to power.

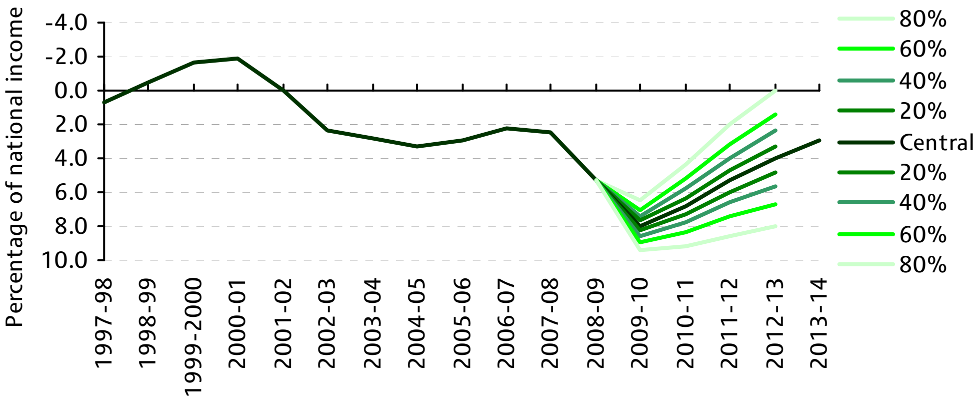
If we assume that the Treasury's latest forecasts will be as accurate as its past ones and that errors are normally distributed, we can put confidence intervals around the projections. Figure 2.10 shows confidence intervals around the central projections for net borrowing over the next four years. By assumption, it is just as likely that things will turn out better than the Treasury expects as that they will turn out worse than expected. This seems reasonable: looking at the Treasury's one-year- and two-year-ahead forecasts back

[12] See table B13 of HM Treasury, *Pre-Budget Report 1998*, November 1998 (http://archive.treasury.gov.uk/pub/html/prebudgetNov98/index.html).

to 1970 and 1980 respectively, the positive and negative errors roughly offset each other.[13]

We assume that the Treasury's projection for 2008–09 is correct but that there is uncertainty thereafter. The presentation is analogous to the Bank of England's inflation and growth forecasts in its quarterly *Inflation Report*.[14] The 'central' estimate is the PBR forecast shown in Figure 2.1. Figure 2.10 shows that there is a 20% probability that the outcome will lie within the darkest bands either side of the central forecast, a 40% probability that it will lie between the next darkest bands, and so on. It shows that in 2012–13 there is slightly above a 1-in-10 chance on past performance that the deficit will have been eliminated. But equivalently there is a slightly above 1-in-10 chance that it will be in excess of 8% of national income. This assumes that the Chancellor does not announce any new policy measures – of course, were net borrowing to turn out to be worse than the current forecasts suggest, the Chancellor may, as his predecessors typically did, choose to implement new measures to bring borrowing back towards previous forecasts.

Figure 2.10. Probabilities for net borrowing outcomes



Sources: Historic figures come from HM Treasury, *Public Sector Finances Databank*, December 2008 (http://www.hm-treasury.gov.uk/d/public_finances_databank.xls). Central projections are taken from HM Treasury, *Pre-Budget Report 2008*, November 2008 (http://www.hm-treasury.gov.uk/prebud_pbr08_index.htm) and assume that the forecast for 2008–09 is correct; methodology for computing fan charts taken from C. Emmerson, C. Frayne and S. Love, 'Updating the UK's Code for Fiscal Stability', IFS Working Paper W04/29, 2004 (http://www.ifs.org.uk/publications/3163).

The fan chart presented in Figure 2.10 is likely to understate the true level of uncertainty that is present in the Treasury's – or indeed anyone else's – fiscal projections at the present time. The shocks to the economy, and their knock-on impact on tax revenues, have been very large, which will make the future path of tax revenues more uncertain. For example, projecting the medium-term outlook for corporation tax revenues from financial sector firms, or stamp duty revenues from house purchases, will be even more difficult than it is in more normal circumstances.

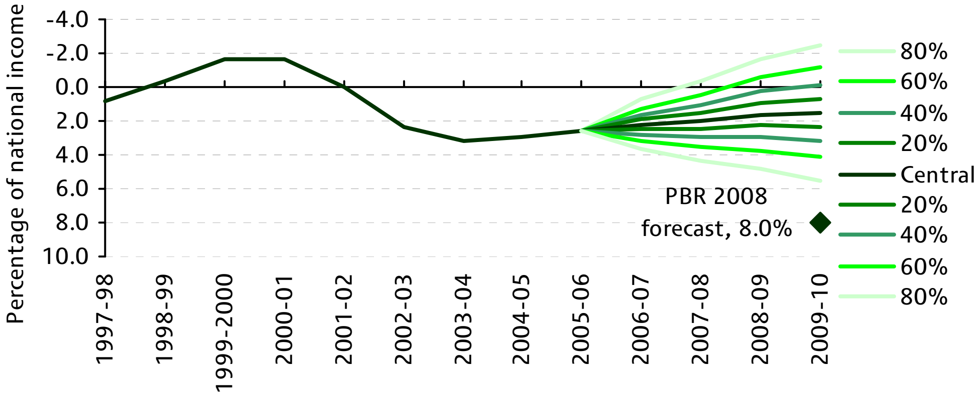
This point is highlighted in Figure 2.11, which shows the forecasts for public sector net borrowing set out in the March 2005 Budget in our fan chart format. The March 2005

[13] Table 2.2 of HM Treasury, *End of Year Fiscal Report*, October 2007 (http://www.hm-treasury.gov.uk/end_of_year_fiscal_report.htm).

[14] http://www.bankofengland.co.uk/publications/inflationreport/index.htm.

Budget forecast that borrowing would fall from 2.9% of national income in 2004–05 to 1.5% of national income in 2009–10. As can be seen from the fan chart, the likelihood that borrowing would actually turn out to be 8.0% of national income was extremely small on the basis of previous Treasury forecast errors. Indeed, the estimated likelihood of borrowing in 2009–10 turning out to be 8.0% of national income or worse on the basis of the Budget 2005 forecasts was – at least on the assumptions on which our fan charts are based – just 1 in 50. The January 2005 IFS Green Budget was less optimistic than the March 2005 Budget: it projected that public sector net borrowing in 2009–10 would be 2.5% of national income rather than 1.5% of national income. But even on the basis of this less optimistic projection, the chances that borrowing would turn out to be 8.0% of national income or worse were still only 1 in 25.

Figure 2.11. Probabilities for net borrowing outcomes, Budget 2005 forecast



2.6 Conclusions

The past year has seen a dramatic deterioration in the outlook for the public finances, reflecting both permanent and temporary consequences of the credit crunch. The current government did not do as much as most comparable countries to strengthen the public finances during the period leading up to the current crisis. We therefore entered the crisis already burdened by one of the largest structural budget deficits in the industrial world and a bigger public sector debt than most OECD countries.

The deterioration revealed in the PBR reinforces the eerie similarity between the path of the structural budget deficit under this government and its Conservative predecessor: three years of consolidation, eight years of drift and then a sudden downward lurch as the onset of recession coincided with the discovery of a sudden weakening in the underlying structural position. But fortunately for this government – as for other countries – borrowing costs have been declining, so the burden of interest payments is considerably lower now than it was in 1997.

Looking forward, the government will add to its borrowing through the fiscal stimulus package, before tightening policy to get borrowing down again. This will involve a tight squeeze on public spending and measures to recoup some of the tax revenue lost as a result of the crunch. Such is the size of the hole into which we have fallen that the

Treasury thinks it will be seven more years before the current budget returns to balance and before public sector debt begins to fall again.

The uncertainty around any set of public finance forecasts is considerable. Given the question marks surrounding the eventual depth and duration of the current recession – and the size of any underlying structural deterioration – the Treasury's latest projections (and those of anyone else) must be more prone to revision than normal.