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Autumn Statement 2012: More fiscal pain to come?

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Summary

- The outlook for the public finances has worsened since the Office for Budget Responsibility's March 2012 forecasts, for two reasons. First, economic growth has been weaker than forecast. Second, growth in tax revenues has disappointed, and by more than would normally be explained purely by weak economic growth.
- Predominantly what matters for the fundamental strength of the UK public finances is whether these developments reflect a permanent or temporary worsening of the UK's economic position. We present two alternative scenarios for the public finances over the next five years: one that assumes that these problems reflect additional permanent, structural weakness in the UK economy and public finances, and one that assumes that they are purely temporary, cyclical problems.
- Under a scenario in which these are purely temporary problems, the additional borrowing required over the next few years would be largely cyclical. Therefore, no further action above that already planned would be required to meet the Chancellor's fiscal mandate, which states that the structural current budget should be forecast to be in balance or surplus by the end of the five-year forecast horizon.
- Under a scenario in which these problems reflect additional permanent weakness, most of the additional short-term borrowing would reflect a structural problem. An additional £23 billion of tax increases or spending cuts would need to be announced, to come in no later than 2017–18, to comply with the Chancellor's fiscal mandate.
- Under both scenarios, higher forecast borrowing in the short term would be sufficient to suggest that the Chancellor would be on course to miss his supplementary target for debt to fall as a share of national income between 2014–15 and 2015–16.
- Since a squeeze on spending has already been pencilled into the forecasts for 2015–16 and 2016–17, even under our 'optimistic' scenario there would still be difficult decisions about how to cut overall spending in these years.
- Under our 'pessimistic' scenario, the outlook would be even more difficult. Continuing to meet the fiscal mandate would require the Chancellor to, for example, extend to 2017–18 the same average squeeze on public service spending that is currently planned for the Spending Review 2010 period, implement the £8 billion of welfare cuts mooted in his March Budget Speech and implement a further £11 billion of tax increases or welfare cuts.

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1. Introduction

The latest official forecasts for the UK economy and public finances were published by the Office for Budget Responsibility (OBR) in March. At the time, the figures suggested the Chancellor was meeting one of his self-imposed fiscal targets and was on course, albeit only just, to meet the other. The first of these – the fiscal mandate – requires that the structural current budget be forecast to be in balance or surplus by the end of the rolling five-year forecast horizon.[2] Since, at the time of the March 2012 Budget, the OBR forecast was for a surplus of 0.5% of national income in 2016–17, this rule was being met. The second – known as the supplementary target – requires that debt as a share of national income must fall between the fixed dates of 2014–15 and 2015–16. Since the OBR forecast was for debt to fall by 0.3% of national income between these years, this rule was on course to be met although, given the considerable uncertainties about the future path of both debt and the economy, the margin for error was extremely small.

Since the March Budget, two factors have changed that adversely affect the outlook for the UK's public finances. First, economic growth in 2012 has turned out to be weaker than the OBR previously forecast. It had forecast that, over the first nine months of 2012, GDP would, on average, be 0.7% higher than the same months in 2011, whereas the latest estimates from the Office for National Statistics (ONS) suggest that it was actually 0.2% lower. Second, tax receipts have been weaker over the first seven months of this financial year than the OBR's forecasts suggest for the year as a whole. Furthermore, they appear to be even weaker than would be expected from taking into account the lower-than-forecast growth in the economy. Potentially better news, at least in terms of the government's plan to reduce the deficit, is that central government spending on the delivery and administration of public services has grown less quickly over the first seven months of 2012–13 than implied by the OBR's forecast for the year as a whole.

In this briefing note, we present two scenarios for the outlook for the public finances. These are not new bottom-up forecasts of receipts and spending – which we typically produce in the run-up to each year's Budget as part of the IFS Green Budget. Rather, the scenarios take the OBR's March 2012 forecast as a baseline and incorporate the newly-available information on economic growth, central government receipts and central government spending. These scenarios help to provide a considered view of how the OBR's forecasts might, under certain stated assumptions, look in next week's Autumn Statement and the resulting trade-offs these would imply for the Chancellor.

On 9 November 2012, the Treasury announced a change in the way that it finances the interest payments on outstanding government debt, which will affect the way that financial transactions relating to the Bank of England's purchase of gilts (as part of the quantitative easing (QE) programme) score on the public sector balance sheet.[3] The crucial thing to note is that, as the OBR has stated, this 'should not in itself have a significant impact on the eventual aggregate net profit or loss to the Exchequer from QE'.[4] In other words, this change will not have had a direct material impact, either for better or for worse, on the underlying long-term strength of the UK public finances. Given this, any

[2] The structural current budget is defined as the difference between public sector revenues and spending on non-investment items, adjusted for the temporary ups and downs of the economic cycle.

[3] For further details on this, see http://www.hm-treasury.gov.uk/ukecon_mon_index.htm.

[4] Office for Budget Responsibility, 'Press Notice: Asset Purchase Facility', 9 November 2012 (http://budgetresponsibility.independent.gov.uk/press-notice-asset-purchase-facility/).

assessment of whether the Chancellor is complying with his fiscal targets should be based on measures of the fiscal aggregates that do not take into account the impact of this change. Therefore, in order to focus on changes in the underlying fiscal position since the OBR's latest forecasts were published, we only present figures that exclude any estimated impact of this recently-announced change. When assessing compliance with the fiscal targets, the Chancellor should instruct the OBR to act in the same way. Further information about the change that is taking place and its impact on the public finances is summarised in Box 1.1.

Section 2 of this briefing note describes the assumptions underpinning our two scenarios and sets out the outlook for the public finances under each one. Section 3 considers the implications for compliance with the Chancellor's two fiscal targets and sets out the implications for the size of the required fiscal tightening. Section 4 concludes.

Box 1.1. Changes to the way Bank of England asset purchases will be scored in the public accounts

What is happening?

On 9 November 2012, the Treasury announced a change to the way that it finances the interest payments on outstanding government debt, which will affect the way that financial transactions relating to the Bank of England's purchase of gilts (as part of the quantitative easing (QE) programme) score on the public balance sheet. Prior to this change, the Bank of England was holding the interest (coupons) it received from the Treasury in its Asset Purchase Facility (APF); by the end of 2012–13, these are expected to amount to £34.8 billion.[a]

The change will mean that these funds, and future interest payments, will be transferred in tranches back to the Treasury. As a result, the Treasury will no longer need to issue gilts in order to finance the interest payments it was making to the APF, which the Treasury argues is more efficient cash management. However, it is now more likely that the Treasury will have to issue gilts over the longer term to cover any direct losses made by the Bank of England as interest rates rise and/or gilts held by the APF are redeemed or sold at a loss.

What does this mean for National Accounts measures of public borrowing and debt?

The £34.8 billion is to be transferred to the Treasury in tranches in 2012–13 and 2013–14 such that by the end of 2013–14 public sector net debt will be £34.8 billion lower than it would otherwise have been.

The impact of the change on borrowing will depend on how the transfer is classified by the ONS, which has said that it expects to announce its decision on classification by early January 2013.[b] The OBR expects ONS to classify the change in such a way that the transfer of £34.8 billion does not affect public sector net borrowing (as it would be treated as a financial transaction), but that the future transfers would affect public sector net borrowing as well as public sector net debt. As a result, public sector net borrowing would be reduced in the near term and, most likely, increased in the longer term.[c]

However, as the OBR has stated, this 'should not in itself have a significant impact on the eventual aggregate net profit or loss to the Exchequer from QE'. In other words, this change will not have had a direct material impact, either for better or for worse, on the underlying long-term strength of the UK public finances. However, it will affect the headline levels of borrowing and debt in the short and medium terms.

What does this mean for compliance with the fiscal rules?

Given that the change does not directly improve the health of the public finances in a significant way, even if this change did appear to make it easier for the Chancellor to meet his fiscal targets, it would be inappropriate for him to use these adjusted numbers as the sole basis for judging compliance against his fiscal rules. In particular, were the change to make the difference between one or both of the fiscal targets being met rather than missed, this might lead to accusations that the Chancellor had made the change purely to ensure that he complied with his self-imposed fiscal rules rather than based on sound economic principles. This would risk undermining the credibility with which he is managing the UK public finances. Similar arguments were made when, soon after the general election of 2005, the then Chancellor Gordon Brown revised his assessment about when the then current economic cycle began (from 1999–2000 to 1997–98), which happened to make his 'golden rule' easier to meet just at the moment when data from the ONS first suggested that the rule was on course to be breached.

Sensibly, the OBR has said that it will quantify the possible impact of this change on the public finances in its next *Economic and Fiscal Outlook* in December. The fiscal targets should also be assessed on measures of the fiscal aggregates that do not take into account the impact of this change. In this briefing note, therefore, we exclude the impact of this change from all the figures. When assessing compliance with the fiscal targets, the Chancellor should instruct the OBR to act similarly.

[a] For further details on this, see http://www.hm-treasury.gov.uk/ukecon_mon_index.htm.
[b] See http://www.ons.gov.uk/ons/guide-method/classifications/na-classifications/classification-announcements-and-statements/na-notice/index.html.
[c] See Office for Budget Responsibility, 'Press Notice: Asset Purchase Facility', 9 November 2012 (http://budgetresponsibility.independent.gov.uk/press-notice-asset-purchase-facility/).

2. Outlook for the public finances

In this section, we present two different scenarios for the outlook for the public finances. Both scenarios use the forecast produced by the OBR in March as their baseline and take into account information on the outlook for growth and the evolution of the public finances since then. The two scenarios presented contain different assumptions about the extent to which the disappointing data since the Budget reflect a purely temporary or a permanent deterioration in the outlook for the public finances. Our 'optimistic' scenario assumes that the deterioration is largely temporary, while our 'pessimistic' scenario assumes it is largely permanent.

A summary of the assumptions underlying our two scenarios is provided in Table 2.1. Sections 2.1 and 2.2 set out in detail the assumptions for economic growth and for spending and revenues, in 2012–13 and over the medium term. Section 2.3 then discusses the resulting forecasts for borrowing and debt in the medium term. However, readers interested solely in the bottom-line implications of our scenario analysis can skip straight to Section 3, which discusses the implications of each scenario for the Chancellor's two fiscal targets, without significant loss of understanding.

Table 2.1. Assumptions underlying alternative scenarios

Assumption	'Pessimistic' scenario	'Optimistic' scenario
GDP	Growth forecasts for 2012 to 2016 revised in line with the change in average of independent forecasts.	
Trend GDP	All change in GDP from OBR's March 2012 forecast reflects a change in trend GDP (so output gap unchanged).	All change in GDP from OBR's March 2012 forecast reflects a change in the output gap (so trend GDP unchanged).
Receipts in 2012–13	Undershoot by £17 billion based on data from first seven months of 2012–13.	
Receipts beyond 2012–13	Weakness in receipts in 2012–13 that is not explained by weaker growth is assumed to be entirely permanent.	Weakness in receipts in 2012–13 that is not explained by weaker growth is assumed to be entirely temporary.
Current spending in 2012–13	Undershoot by £4 billion based on data from first seven months of 2012–13.	
Current spending beyond 2012–13	No continued undershoot in discretionary spending.	
Public sector net investment	Follows OBR's March 2012 forecast.	

2.1 Economic growth

In its March forecast, the OBR projected that the UK economy would grow by 0.8% in 2012 and by 2.0% in 2013. At the time, this outlook for growth was similar to the average of independent forecasts for the UK economy: these suggested growth of 0.5% in 2012 and 1.7% in 2013 (as shown in Table 2.2).[5]

However, since then, growth has underperformed – in particular, the OBR forecast that the UK economy would grow by 0.3% in 2012Q1 and then remain flat in 2012Q2 before growing by 0.6% in 2012Q3, whereas the latest estimates from the ONS suggest the economy shrank by 0.3% and 0.4% in the first two quarters before growing by 1.0% in the third quarter.[6] Despite the stronger-than-forecast growth in the third quarter, over the first nine months of 2012 the ONS data suggest that, on average, GDP was 0.2% below the level in the same nine months of 2011, whereas the OBR March forecast was for GDP to be, on average, 0.7% higher.

No doubt partly as a direct result of the disappointing data from the ONS, independent forecasters have, on average, revised down their forecast for the prospects for the UK economy in 2012 (as shown in Table 2.2): in November 2012, the average independent forecast for growth in 2012 had fallen to –0.2%. The outlook for 2013 has also, on average, been revised down, to growth of just 1.1%.

[5] Source: HM Treasury, *Forecasts for the UK Economy*, March 2012 (http://www.hm-treasury.gov.uk/data_forecasts_index.htm).

[6] http://www.ons.gov.uk/ons/rel/gva/gross-domestic-product--preliminary-estimate/q3-2012/index.html.

Table 2.2. Summary of alternative forecasts for the UK economy

% (unless otherwise stated)	2012	2013	2014	2015	2016
OBR, March 2012	0.8	2.0	2.7	3.0	3.0
Average of independent forecasts:					
February 2012	–	–	2.2	2.4	2.3
March 2012	0.5	1.7	–	–	–
November 2012	–0.2	1.1	1.7	2.0	2.1
Change in average independent forecasts (percentage point):					
February to November	–	–	–0.5	–0.4	–0.2
March to November	–0.7	–0.6	–	–	–

Sources: Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2012 (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-march-2012/). HM Treasury, *Forecasts for the UK Economy*, February 2012, March 2012 and November 2012 (http://www.hm-treasury.gov.uk/data_forecasts_index.htm).

In both the scenarios we present in this paper, we assume that the OBR revises down its growth forecasts for 2012 and 2013 in line with the change in the average of independent forecasts that has occurred between March 2012 and November 2012 (the most recent now available). This would lead to the OBR's forecast for growth in 2012 being revised down by 0.7 percentage points (from 0.8% to 0.1%) and in 2013 by 0.6 percentage points (from 2.0% to 1.4%). We make a similar adjustment to the projections for growth in the years from 2014 to 2016.[7] As a result, over the whole period from 2011 to 2016, the OBR would be forecasting growth of an average of 1.8% a year compared with the 2.3% a year it projected back in March 2012. The levels of GDP under the OBR's March 2012 Budget forecast and under this alternative growth projection are shown by the dashed lines in Figure 2.1. Note that under our pessimistic scenario, we are still assuming that growth this year and next will be higher than the average prediction of independent forecasters. That is to keep the relativity between the OBR and others constant.

Weaker economic growth tends to worsen the public finances. This is because lower levels of income and spending depress tax receipts while lower levels of employment and income increase spending on welfare benefits. The key issue for the underlying health of the public finances is whether this weaker economic performance reflects weaker trend output – that is, the productive capacity of the UK is also lower than was previously thought – or whether it is felt to be only temporary. In the latter case, weaker growth now would lead to the economy growing more strongly in future (without leading to inflationary pressure) as it makes up the lost ground.

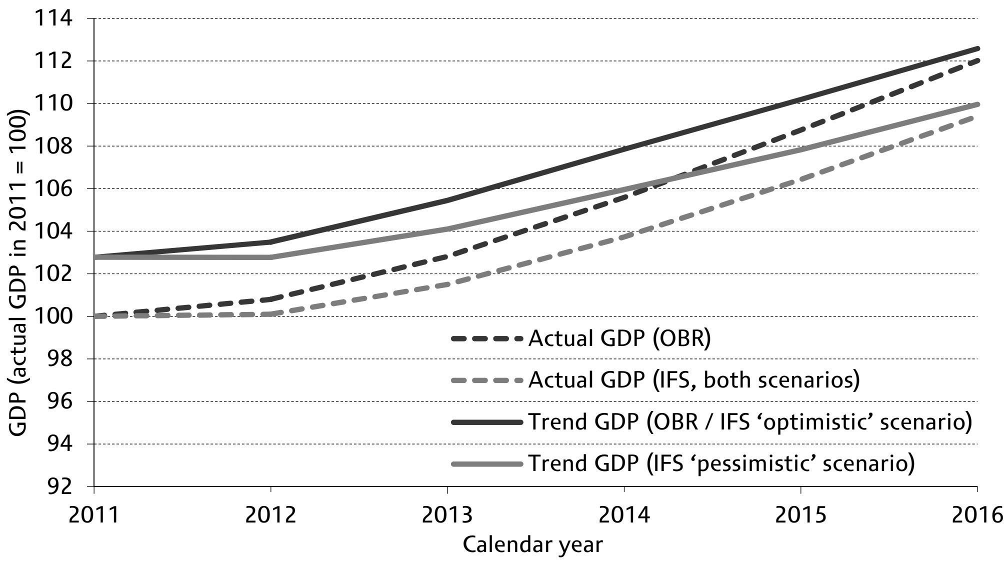
Under our first scenario, we assume that all of the downgrade in the outlook for the economy implied by the projection for the level of output (shown by the gap between the black and grey dashed lines in Figure 2.1) is permanent – that is, that it feeds one-for-one into lower trend output and the size of the output gap is unchanged. The level of trend GDP assumed under this scenario is shown by the grey solid line in Figure 2.1; the black solid line shows the level of trend output forecast by the OBR in March. In this scenario,

[7] To do this, we use the average of independent forecasts produced in February and November 2012. While the Treasury publishes information from its survey of independent forecasts for the current and subsequent year each month, the data for the medium-term outlook are only published each quarter. The February 2012 publication is therefore used as the closest one to the March 2012 Economic and Fiscal Outlook. The November 2012 publication is the most recent available at the time of writing.

weaker growth in 2012–13 will lead to higher borrowing in 2012–13, with all of this reflecting a structural increase.

Under our second scenario, we take essentially the opposite possibility – namely, that the level of trend output has remained the same as was projected by the OBR in March 2012 (the black solid line in Figure 2.1) and therefore the change in the outlook for growth this year feeds one-for-one into a change in the size of the output gap.[8] In this scenario, weaker growth in 2012–13 will lead to higher borrowing in 2012–13 but all of it will be cyclical and temporary.

Figure 2.1. Actual and trend national income alternative scenarios (actual GDP in 2011 = 100)



Sources: Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2012 (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-march-2012/). HM Treasury, *Forecasts for the UK Economy*, February 2012, March 2012 and November 2012 (http://www.hm-treasury.gov.uk/data_forecasts_index.htm).

These scenarios highlight that the OBR's assessment of the extent to which weaker growth feeds into a larger output gap or into a lower level of trend output will be crucial. To make this judgement, the OBR computes the historical and contemporaneous output gap using two different methodologies and, for projections of the evolution of the output gap, compares its projections for economic growth with its assessment of trend growth.[9]

Recent analysis published by the Social Market Foundation uses the latest available data to update the models used by the OBR to inform its judgement over the size of the output gap.[10] The results suggest that, despite weak headline growth, the output gap may have fallen during 2012, in which case lower growth this year would not imply greater scope for growth going forwards.

[8] In this scenario, the output gap would still be –1.8% in 2017–18, implying that there would be further scope for above-trend growth beyond that point.

[9] For more details, see chapter 3 of Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2012 (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-march-2012/).

[10] I. Mulheirn, N. Broughton, B. Lucas and H. Kippin, *Fiscal Fallout: The Challenge Ahead for Public Spending and Public Services*, November 2012, Social Market Foundation, London.

The average of independent forecasts for the output gap in 2012 has increased by just 0.1 percentage points from 2.6% in March to 2.7% in November.[11] This suggests that little of the 0.7 percentage point deterioration in growth prospects in 2012 is thought to reflect a temporary rather than a permanent phenomenon – although it should be noted that only a relatively small subset of the independent forecasters publish an estimate of the output gap.

For brevity, throughout the rest of this briefing note we will refer to the first scenario described above as our 'pessimistic' scenario and the second as our 'optimistic' scenario. However, there are clearly a number of other even more optimistic or pessimistic scenarios for the economy and public finances that could be envisaged.

2.2 Spending and revenues

Since the Budget in March, information has become available on what tax revenues have been collected over the first seven months of this financial year and how much central government has spent over the period. Central government receipts were 0.4% higher between April and October 2012 than the same seven months of 2011. However, the OBR's March 2012 forecast implied that, for the whole of 2012–13, they would be 3.7% above 2011–12 levels.[12] Should central government receipts continue to grow by only 0.4% over the remainder of this year, they would undershoot the OBR's forecast by £17.4 billion.

Central government current spending has also grown less quickly over the first seven months of 2012–13 compared with the same months in 2011–12 (2.3%) than was implied for the year as a whole in the OBR's latest forecast (3.0%).[13] Should this component of spending continue to grow by only 2.3% over the remainder of 2012–13, central government current spending would undershoot the OBR's March 2012 Budget forecast by £4.2 billion.

In both the scenarios we present in this briefing note, we assume that the trends in central government receipts and central government current spending seen over the first seven months of 2012–13 persist through to the end of 2012–13. We also assume that all other receipts, current spending by local government and public corporations, and public sector net investment come in in-line with the OBR's March forecast (and that there are no revisions to existing data). As a result, under both scenarios, receipts in 2012–13 come in £17.4 billion lower than the OBR's latest forecast, current spending is £4.2 billion lower, and the current budget deficit and public sector net borrowing both £13.1 billion higher. These assumptions about the levels of receipts and spending, coupled with our assumption about lower growth in the economy this year, mean that, under both our scenarios, receipts would amount to 36.6% of national income in 2012–13 (compared with 37.5% forecast by the OBR), while total spending would amount to 43.3% (compared with 43.4% forecast by the OBR).

[11] Source: HM Treasury, *Forecasts for the UK Economy*, March 2012 and November 2012 (http://www.hm-treasury.gov.uk/data_forecasts_index.htm).

[12] Source: R. Crawford, C. Emmerson and G. Tetlow, *Public Finance Bulletin: November 2012* (http://www.ifs.org.uk/publications/6450).

[13] While total spending is growing, this is not to say that there have not been cuts. For example, spending on public services is, in real terms, falling. While spending on social security benefits is higher in 2012–13 than in 2011–12, it would have been even higher had reforms not been implemented.

In both scenarios, we assume that the underspend of £4.2 billion is due to central government departments choosing not to, or unintentionally failing to, spend all of their budget allocations. This is what happened in 2011–12: data suggest that, in aggregate, Departmental Expenditure Limits were underspent last year by £6.7 billion.[14] However, beyond 2012–13, we assume in both scenarios that existing departmental spending plans set out by the Treasury are kept to and that the only deviations in spending from those forecast by the OBR in March 2012 are due to economic growth underperforming relative to the OBR's expectations, as set out in Section 2.1.

In particular, this means that in 2013–14 and 2014–15, we assume that discretionary public spending (including investment) will be at the same level in cash terms as has been set out by the Treasury for the spending review period. However, as the size of the economy is forecast to be smaller over the medium term under both our scenarios than was forecast by the OBR, these cash levels of spending imply higher spending as a share of national income. On top of this, we also assume that there will be some additional spending on welfare benefits and debt interest as a result of economic growth being lower than was forecast by the OBR.

After the current spending review period, in 2015–16 and 2016–17, we assume in both scenarios that total spending will be cut by 0.8% a year in real terms, with public sector gross investment being frozen in real terms within this budget. This is in line with the government's stated policy assumption and was also used by the OBR in its latest official forecast.[15] In 2017–18, we assume that total structural spending will remain constant as a share of national income; therefore total spending falls due to a decline in cyclical spending in 2016–17 and 2017–18 as the output gap is reduced through above-trend growth over this period in both scenarios.

These assumptions imply spending increasing to 44.0% of national income in 2013–14 before falling to 39.8% in 2016–17 and 39.6% by 2017–18 (as shown in Table 2.3). This compares with the OBR's latest forecast that total spending would fall from 43.6% of national income in 2013–14 to 39.0% in 2016–17.

On the receipts side, we apply a different assumption in each of our scenarios, over and above the impact of differences in economic growth set out in Section 2.1. Both scenarios have receipts being £17.4 billion lower in 2012–13 than was forecast by the OBR in the March 2012 Budget. Of this, only £4.0 billion can easily be explained by the weaker outlook for growth in 2012 causing a deterioration in receipts. The remaining £13.4 billion (0.9% of national income) is over-and-above what would normally be expected given the downgrade in growth and the typical impact of economic growth on government receipts.[16] Therefore, in our 'pessimistic' scenario, we assume that all of this £13.4 billion decline is permanent and persists into future years. In our 'optimistic' scenario, we make the opposite assumption – that is, we assume that all of this additional deterioration is temporary and disappears immediately after 2012–13. These assumptions imply that under our 'pessimistic' scenario receipts are at 36.7% of national income in 2013–14 and are still at that level in 2016–17, before rising to 36.9% of

[14] See R. Crawford and C. Emmerson, *Whitehall Departments Overachieve Budget Cuts in 2011–12*, July 2012 (http://www.ifs.org.uk/publications/6249).

[15] See page 123, paragraph 4.100 of Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2012 (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-march-2012/).

[16] See Office for Budget Responsibility, 'Cyclically adjusting the public finances', OBR Working Paper 3, June 2012 (http://budgetresponsibility.independent.gov.uk/pubs/Working-paper-No3.pdf).

national income in 2017–18 (compared with the OBR forecast of 37.9% in 2016–17). Meanwhile, under our 'optimistic' scenario, receipts would rise to 37.7% by 2017–18.[17]

All the key assumptions underlying our two scenarios and the difference between them are summarised in Table 2.1.

Table 2.3. Medium-term outlook for revenues and spending (% of GDP)

	11–12	12–13	13–14	14–15	15–16	16–17	17–18
OBR March 2012							
Current receipts	37.5	37.5	37.7	37.8	37.6	37.9	n/a
Current spending	44.0	43.6	42.2	40.8	39.3	37.9	n/a
Public sector net investment	1.8	–0.2	1.4	1.3	1.2	1.1	n/a
Total Managed Expenditure	45.8	43.4	43.6	42.2	40.5	39.0	n/a
'Pessimistic'							
Current receipts	37.3	36.6	36.7	36.7	36.5	36.7	36.9
Current spending	43.5	43.5	42.6	41.5	40.1	38.7	38.4
Public sector net investment	1.7	–0.2	1.4	1.3	1.2	1.2	1.2
Total Managed Expenditure	45.2	43.3	44.0	42.8	41.3	39.8	39.6
'Optimistic'							
Current receipts	37.3	36.6	37.5	37.6	37.3	37.5	37.7
Current spending	43.5	43.5	42.6	41.5	40.1	38.7	38.4
Public sector net investment	1.7	–0.2	1.4	1.3	1.2	1.2	1.2
Total Managed Expenditure	45.2	43.3	44.0	42.8	41.3	39.8	39.6

Note: Equivalent figures in £ billion are provided in Appendix Table A.1.
Sources: Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2012 (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-march-2012/). HM Treasury, *Forecasts for the UK Economy*, February 2012, March 2012 and November 2012 (http://www.hm-treasury.gov.uk/data_forecasts_index.htm). Office for National Statistics, *Public Sector Finances: October 2012* (http://ons.gov.uk/ons/rel/psa/public-sector-finances/october-2012/index.html). Authors' calculations.

2.3 Prospects for borrowing and debt

This section describes the outlook for borrowing and debt under our two alternative scenarios and compares these with the forecast produced by the OBR alongside the March 2012 Budget. Figures for key fiscal aggregates as a share of national income under both our scenarios and the OBR's March 2012 forecast are shown in Table 2.4. Equivalent figures in £ billion are provided in Appendix Table A.1. The next section discusses the implications of these alternative forecasts for the Chancellor's fiscal targets.

[17] In 2017–18, one year beyond the end of the OBR's latest forecast, we assume in both our scenarios that fiscal drag generates an additional 0.1% of national income structural improvement in revenues, with a small additional increase in revenues resulting from the output gap narrowing in that year. Fiscal drag is growth in tax receipts as a share of national income over time due to wages rising faster than tax thresholds within a progressive tax rate structure. The estimate of 0.1% of national income a year fiscal drag is from paragraph 2.19 of Office for Budget Responsibility, 'Cyclically adjusting the public finances', OBR Working Paper 3, June 2012 (http://budgetresponsibility.independent.gov.uk/pubs/Working-paper-No3.pdf).

Table 2.4. Medium-term outlook for borrowing and debt (% of GDP)

	11–12	12–13	13–14	14–15	15–16	16–17	17–18
OBR March 2012							
Current budget surplus	–6.5	–6.0	–4.5	–3.0	–1.6	0.1	n/a
Public sector net borrowing	8.3	5.8	5.9	4.3	2.8	1.1	n/a
Public sector net debt	67.3	71.9	75.0	76.3	76.0	74.3	n/a
Cyclically-adjusted current budget surplus	–4.6	–4.2	–2.7	–1.5	–0.7	0.5	n/a
Cyclically-adjusted PSNB	6.4	4.0	4.1	2.9	1.9	0.7	n/a
'Pessimistic'							
Current budget surplus	–6.2	–6.9	–5.9	–4.7	–3.7	–2.0	–1.5
Public sector net borrowing	8.0	6.7	7.3	6.1	4.9	3.1	2.7
Public sector net debt	66.2	73.1	77.9	81.1	82.8	82.8	81.2
Cyclically-adjusted current budget surplus	–4.6	–5.1	–4.2	–3.3	–2.7	–1.6	–1.5
Cyclically-adjusted PSNB	6.4	4.9	5.6	4.6	4.0	2.7	2.6
'Optimistic'							
Current budget surplus	–6.2	–6.9	–5.1	–3.9	–2.8	–1.1	–0.7
Public sector net borrowing	8.0	6.7	6.5	5.2	4.0	2.3	1.8
Public sector net debt	66.2	73.1	77.1	79.5	80.5	79.7	77.5
Cyclically-adjusted current budget surplus	–4.6	–4.9	–2.8	–1.5	–0.7	0.5	0.6
Cyclically-adjusted PSNB	6.4	4.7	4.2	2.9	1.9	0.6	0.5

Sources: As Table 2.3.

Given our assumptions (described above) that receipts and spending will be somewhat lower in 2012–13 than the OBR forecast in March, Table 2.4 shows that both our scenarios imply a current budget deficit for this year of 6.9% of national income and public sector net borrowing of 6.7%. These are 0.9% of national income (or £13.1 billion) higher than forecast by the OBR in March. Taking together our forecasts for revenues and spending under each scenario provides a forecast for how borrowing, and consequently debt, might evolve over the next five years.

Public sector net borrowing

Under our 'pessimistic' scenario, borrowing would fall from 8.0% of national income in 2011–12 to 6.7% of national income in 2012–13 before rising to 7.3% of national income next year. The 2012–13 figure is depressed by £28 billion (or 1.8% of national income) as a result of the one-off transfer of assets to the public sector from the Royal Mail Pension

Plan.[18] Underlying borrowing – that is, borrowing ignoring the impact of this change – increases under this scenario from 8.0% of national income in 2011–12 to 8.5% of national income in 2012–13 before falling to 7.3% of national income next year. Thereafter, borrowing would fall to 3.1% of national income in 2016–17 and 2.7% in 2017–18. This compares with the OBR's latest forecast that borrowing would amount to 5.9% of national income next year and 1.1% by 2016–17.

Under our 'optimistic' scenario, borrowing would fall from 8.0% of national income in 2011–12 to 6.7% of national income in 2012–13 and to 6.5% of national income in 2013–14. Ignoring the impact of the Royal Mail Pension Plan, it would rise from 8.0% of national income in 2011–12 to 8.5% of national income this year before falling to 6.5% of national income next year. Thereafter, borrowing would fall to 2.3% of national income in 2016–17 and 1.8% in 2017–18.

Current budget

The current budget balance – that is the gap between total receipts and non-investment spending – would be in deficit throughout the forecast horizon under both our 'pessimistic' and our 'optimistic' scenarios. In 2016–17, under the 'pessimistic' scenario it would be in deficit by 2.0% of national income, whereas under the 'optimistic' scenario it would be in deficit by 1.1% of national income. This compares with a surplus of 0.1% of national income in 2016–17 forecast by the OBR at the time of the March Budget.

Cyclically-adjusted measures

Our 'pessimistic' and our 'optimistic' scenarios differ in terms of the extent to which the projected deficit is explained by temporary weakness in the economy. Under our 'optimistic' scenario, the cyclically-adjusted projections of both public sector net borrowing and the current budget surplus for 2016–17 are, at 0.5% and 0.6% of national income respectively, very close to the OBR's March forecast (of 0.7% and 0.5% of national income respectively). This is because, under this scenario, the entire weaker outlook for economic growth through to 2016–17 is assumed to be temporary rather than permanent (in other words, trend GDP is as projected by the OBR in March and the weaker growth feeds through into a larger output gap) and receipts bounce back completely from the weak growth seen over the first seven months of 2012–13.

In contrast, under our 'pessimistic' scenario, cyclically-adjusted projections of both public sector net borrowing and the current budget surplus are 2.1% of national income and 2.0% of national income worse, respectively, than forecast by the OBR in March (at 2.7% and –1.6% of national income). This is because, under this scenario, all of the weaker outlook for economic growth through to 2016–17 is assumed to be permanent rather than temporary (in other words, the output gap is as projected by the OBR in March and the weaker growth feeds through into lower trend output) and the weak growth in receipts seen over the first seven months of 2012–13 that cannot be explained by weaker-than-expected economic growth is assumed entirely to persist.

Public sector net debt

The OBR's March 2012 forecast was for public sector net debt to rise from 71.9% of national income in 2012–13 to peak at 76.3% of national income in 2014–15 before beginning to fall. Our 'optimistic' scenario suggests instead that debt would peak at

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[18] Source: Paragraph 1.5, page 5, Office for Budget Responsibility, *Economic and Fiscal Outlook*, March 2012 (http://budgetresponsibility.independent.gov.uk/economic-and-fiscal-outlook-march-2012/).

80.5% of national income in 2015–16; our 'pessimistic' scenario also suggests it would peak in 2015–16 but at the higher level of 82.8% of national income.

3. Meeting the Chancellor's fiscal targets?

The Chancellor is endeavouring to abide by two self-imposed fiscal targets. These are:

- **fiscal mandate**: the structural current budget must be forecast to be in balance or surplus by the end of the rolling five-year forecast horizon;
- **supplementary target**: debt as a share of national income must fall between the fixed dates of 2014–15 and 2015–16.

At the time of the March Budget, the OBR forecast (reproduced in Table 2.4) was for a cyclically-adjusted current budget surplus of 0.5% of national income in 2016–17; this implied that the fiscal mandate was being met. At the same time, the OBR's forecast was for debt to fall by 0.3% of national income between 2014–15 and 2015–16, implying that the supplementary target was also on course to be met, although the margin for error was extremely small.

The two scenarios we have set out in Section 2 both imply a weaker outlook for the public finances over the next few years and thus could have implications for the Chancellor's ability to meet his fiscal rules without further policy action. We consider these implications in this section. Section 3.1 sets out the possible implications for the size of the required fiscal tightening, while Section 3.2 discusses what this might mean for tax and spending decisions.

3.1 Prospects for meeting the Chancellor's targets

Meeting the fiscal mandate?

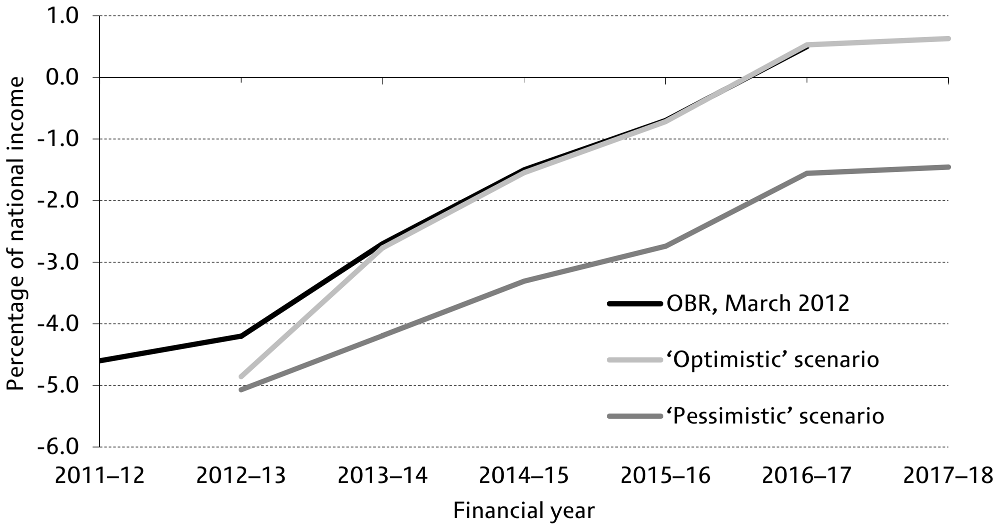
Under our 'optimistic' scenario the Chancellor would continue to meet his fiscal mandate under current policies, while under our 'pessimistic' scenario he would miss it without announcing any further fiscal tightening.

The fiscal mandate is judged in terms of the projected structural position of the public finances – that is, abstracting from any temporary effects of the economy performing below (or above) its trend level. Since our two scenarios contain very different assumptions about the size of the gap between actual and trend output over the next five years (as shown in Figure 2.1), the prospects for the fiscal mandate being met under each are very different.

Figure 3.1 shows forecasts for the cyclically-adjusted current budget surplus. The OBR's forecast in March was that this would strengthen from a deficit of 4.2% of national income in 2012–13 to a surplus of 0.5% of national income in 2016–17 (which was, at that point, the end of the forecasting horizon). In the OBR's next Economic and Fiscal Outlook, which will be published alongside the Government's Autumn Statement on 5 December, it is likely that (in line with recent practice) the forecast horizon will be extended by one year to 2017–18. Therefore, we focus here on the Chancellor's prospects for meeting his fiscal mandate over the period to 2017–18.

Under our 'optimistic' scenario, although overall borrowing is forecast to be higher in each of the next five years than the OBR forecast in March, most of this reflects an increase in temporary, cyclical borrowing rather than an increase in the structural deficit. Therefore, our forecast under this scenario is that the Chancellor would still be on course to have a surplus on the structural current budget of 0.5% of national income in 2016–17, strengthening further to a surplus of 0.6% of national income in 2017–18 as we assume (as mentioned in Section 2.2) that fiscal drag delivers a further increase in revenues as a share of national income, while (by assumption) structural spending remains constant as a share of national income. In other words, under this scenario, the Chancellor would meet his fiscal mandate.

Figure 3.1. Meeting the fiscal mandate? (Cyclically-adjusted current budget as a share of national income)



Sources: As Table 2.3.

Under our 'pessimistic' scenario, not only is headline borrowing higher in each year than under our 'optimistic' scenario, but also – more importantly – most of this higher borrowing reflects a permanent increase in the projected structural deficit. The cyclically-adjusted current budget under this scenario is projected to be in deficit by 1.6% of national income in 2016–17 and by 1.5% of national income in 2017–18. Therefore, our forecast under this scenario is that the Chancellor would miss his fiscal mandate without further policy action. Were the Chancellor to want to comply with his fiscal mandate, he would need to announce a package of tax increases or further spending cuts amounting to 1.5% of national income (or £23 billion in today's terms), to be implemented no later than 2017–18. Such changes would need to be announced now (so that their impact could be incorporated into the official forecast) but their implementation could be postponed until after the planned date of the next general election. This would be similar to the Chancellor's response to a weaker outlook for the underlying public finances in last year's Autumn Statement: Mr Osborne chose to borrow more over this parliament, but offset the deterioration in underlying borrowing with spending cuts in 2015–16 and 2016–17.[19] In Section 3.2, we turn to considering how such a fiscal tightening could be achieved and what it might mean for taxes, welfare spending and public service spending.

[19] See G. Tetlow, 'Public finances: Osborne sails close to the wind', presentation given at post Autumn Statement IFS event, 30 November 2011 (http://www.ifs.org.uk/publications/5929).

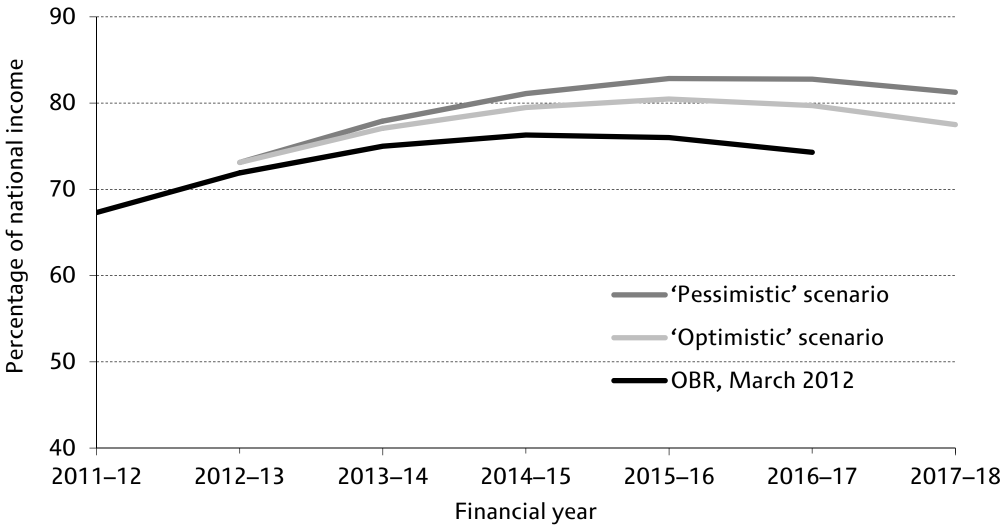
Meeting the supplementary target?

Both our scenarios suggest that debt would rise as a share of national income until 2015–16, implying the Chancellor would be on course to miss his supplementary target.

Unlike the fiscal mandate, the supplementary target is not a moving target. It requires simply that debt as a share of national income should be lower in 2015–16 than in 2014–15.[20] In March, the OBR's forecast suggested the Chancellor was still on course to meet this target but with only an extremely small margin for error – debt was forecast to fall from 76.3% of national income in 2014–15 to 76.0% in 2015–16. Even relatively small errors in projecting either borrowing or the level of national income could easily lead to the rule being breached.

With so little headroom in meeting this rule, the deterioration in the public finances implied by either of the two scenarios we have set out here would be sufficient to suggest that the Chancellor would no longer be on course to meet it. Our 'optimistic' scenario implies debt increasing from 79.5% of national income in 2014–15 to 80.5% in 2015–16, while our 'pessimistic' scenario implies a larger increase, from 81.1% to 82.8%, over the same period. This is shown in Figure 3.2.

Figure 3.2. Meeting the supplementary target? (Public sector net debt as a share of national income)



Sources: As Table 2.3.

As mentioned in the introduction, all the figures presented here ignore the recently-announced change in the way that the Treasury finances the interest payments on outstanding government debt, which will affect the way that financial transactions relating to the Bank of England's purchase of gilts (as part of the QE programme) score on the overall public sector balance sheet. The ONS is yet to announce exactly what impact this change will have on the National Accounts measures of the fiscal aggregates. While it is possible that the change could be sufficient to suggest that public sector net debt would be falling between 2014–15 and 2015–16, it would be disingenuous for the Chancellor to claim that he was still on course to meet his supplementary target purely as a result of

[20] Or, more precisely, that the level of debt at the end of March 2016 as a share of national income over the year centred around March 2016 is lower than the equivalent figure for March 2015. Therefore whether this rule has actually been met will not be confirmed for some time after March 2016.

such a change. Any assessment of whether the Chancellor remains on course to meet his supplementary target should use the same measure of debt as was in place at the time he committed himself to this rule; not doing so – and thus being seen to move the goalposts – could risk undermining the credibility of any commitments he makes to fiscal discipline.

Were the Chancellor to want to aim to meet his supplementary target exactly, then under both our scenarios he would need to announce and implement further tax rises and/or deeper spending cuts to come into effect before March 2016. Under our 'optimistic' scenario, announcing measures worth 1.0% of national income in 2015–16, or £16 billion in today's terms, would be sufficient to leave debt forecast to fall slightly in that year. Under our 'pessimistic' scenario, this figure rises to 1.7% of national income, or £27 billion in today's terms.

Having said that, and as we have argued elsewhere,[21] in terms of the economics of managing the public finances the supplementary target does not actually have much to commend it. Ensuring debt falls between two fixed dates does not ensure long-run sustainability, since it does not prevent the government from pursuing unsustainable fiscal policies before or after those dates. Furthermore, seeking to remain on course to meet this target could require the government to announce inappropriately contractionary fiscal policies. There will be periods when it would be better to allow debt to rise than to ensure (or try to ensure) that it falls. For example, announcing further fiscal consolidation to be implemented in 2015–16 (or earlier) purely on the basis that it was necessary in order to remain on course to meet the supplementary target would be entirely inappropriate if other indicators clearly showed that it would be better for debt to continue rising.

Whether the OBR's forecasts in December suggest that the supplementary target is on course to be met or missed on one definition or another, the Chancellor would likely be best advised to abandon the rule and consult on replacing it with something that better ensures long-run sustainability.

3.2 Increased pain ahead?

As Section 3.1 suggested, if our 'pessimistic' scenario were to emerge, the Chancellor would need to announce further tax increases or spending cuts (amounting to £23 billion in today's terms) in order to meet his fiscal mandate. A tightening of this size would increase the overall estimated size of the fiscal consolidation announced since the financial crisis began by 18%, from £127 billion in today's terms to £150 billion (or from £4,800 to £5,600 per household).[22] To give a sense of the magnitude of this, achieving an additional £23 billion (1.5% of national income) reduction in borrowing solely through increases in taxation would be roughly equivalent to increasing the main rate of VAT from 20% to 25%.[23] Alternatively, achieving it solely through cuts to benefit spending would require measures that were larger than the package of welfare cuts announced in

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[21] C. Emmerson and G. Tetlow, 'Biting the bullet on fiscal targets', *Public Finance*, 26 September 2012 (http://opinion.publicfinance.co.uk/2012/09/biting-the-bullet-on-fiscal-targets/).

[22] Based on there being 26.7 million households in the UK.

[23] See table 1.6 of HM Revenue and Customs, *Tax Expenditures and Ready Reckoners*, (http://www.hmrc.gov.uk/statistics/expenditures.htm).

the June 2010 Budget and the October 2010 Spending Review (which we estimate amounted to £20 billion by 2017–18).[24]

If our 'optimistic' scenario were to emerge, the Chancellor would not need to announce any further tax rise or spending squeeze to comply with the fiscal mandate on top of what is already planned. However, the government will still, at some stage, have to clarify how it intends to achieve the squeeze on total public spending that has already been pencilled in for 2015–16 and 2016–17.[25]

In this section, we document the trade-offs facing the Chancellor between further tax rises, welfare cuts and public service spending cuts over the period from 2015–16 to 2017–18 under our two scenarios, assuming he wishes to comply with his fiscal mandate.[26] In the case of our 'pessimistic' scenario, we assume that the additional fiscal tightening, while announced in the Autumn Statement of 2012, will not be implemented until 2017–18. As discussed in Section 3.1, this would be permissible under the fiscal mandate, and with some justification since it seems natural to take longer to adjust to a larger shock.

There are clearly a number of ways in which the Chancellor could implement the fiscal tightening that would be required to comply with his fiscal mandate under either our 'pessimistic' scenario or our 'optimistic' scenario. Figure 3.3 sets out the trade-off between further tax rises, further welfare cuts and deeper public service spending cuts under each scenario to illustrate the constraints within which the Chancellor would be operating.

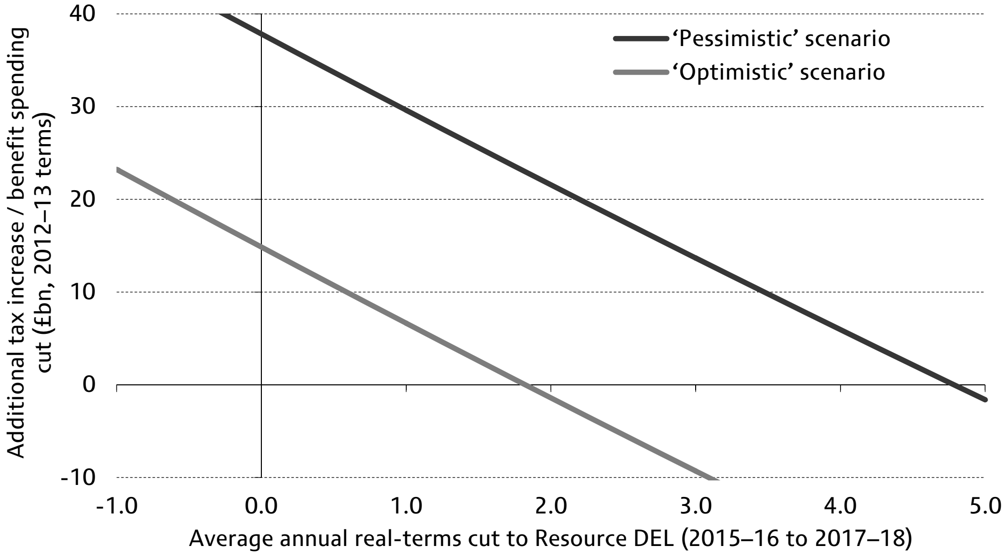
The vertical axis shows in £ billion (in today's terms) the size of welfare cut, or tax rise, that could be chosen. The horizontal axis shows the annual real cut to day-to-day spending by Whitehall departments on the delivery and administration of public services (Resource Departmental Expenditure Limits, DELs). For a given reduction in the deficit, a larger tax rise or cut to welfare spending would lead to a smaller cut to public service spending: hence the two budget constraints shown in Figure 3.3 are downwards sloping.

[24] The June 2010 Budget announced a range of cuts to the welfare budget, including that most benefit levels would in future by default be indexed to the consumer price index (rather than the retail price index or the Rossi index), and reforms to Housing Benefit and tax credits. See chapter 2 of HM Treasury, *Budget 2010*, HC 61, June 2010 (http://www.hm-treasury.gov.uk/2010_june_budget.htm). Further welfare cuts, including the time-limiting of receipt of contributory Employment and Support Allowance for some recipients and the withdrawal of Child Benefit from families containing a higher-rate income taxpayer, were announced in the October 2010 Spending Review. See HM Treasury, *Spending Review 2010*, Cm. 7942, October 2010 (http://cdn.hm-treasury.gov.uk/sr2010_completereport.pdf).

[25] In his Budget Speech in March 2012, the Chancellor highlighted one possible way in which the spending plans could be achieved – by cutting current spending on public services by 2.3% a year in real terms for a further two years beyond the current spending review period and also cutting £8 billion (in today's terms, equivalent to the £10 billion in 2016–17 terms stated in the speech) from welfare spending. However, there are clearly a number of alternative trade-offs between the two. See annex A of HM Treasury, *Budget 2012*, HC 1853, March 2012 (http://www.hm-treasury.gov.uk/budget2012_documents.htm).

[26] Under our 'pessimistic' scenario, we assume that the Chancellor aims to do the minimum required to comply with the mandate – that is, he implements sufficient additional tax rises or spending cuts to achieve a forecast cyclically-adjusted current budget balance in 2017–18. Under our 'optimistic' scenario, we assume that the Chancellor aims for the same cyclically-adjusted current budget surplus as was implied by the March 2012 Budget plans – that is, a surplus on the cyclically-adjusted current budget of 0.5% in 2016–17 (rising to 0.6% in 2017–18 as fiscal drag delivers a small further strengthening). These assumptions imply that the resulting health of the public finances would be stronger under our 'optimistic' scenario than under our 'pessimistic' scenario with £23 billion of additional fiscal tightening. If our 'pessimistic' scenario emerged but the Chancellor continued to wish to maintain the same headroom against the mandate in future as he previously had, £31 billion, rather than £23 billion (in today's terms), of additional tax rises or spending cuts would be required.

Figure 3.3. Trade-offs between tax increases, and welfare or public service spending cuts to meet the fiscal mandate (2015–16 to 2017–18): alternative scenarios



Sources: As Table 2.3.

Trade-offs under the ‘optimistic’ scenario

The trade-off implied under the ‘optimistic’ scenario – under which no additional fiscal tightening is required for the Chancellor to comply with his fiscal mandate – is shown by the lower (grey) line in Figure 3.3.

The trade-off under this scenario would be the same as the Chancellor would face if the OBR’s forecasts in the Autumn Statement were unchanged from those produced in March. The Budget pencilled in cuts to public spending in 2015–16 and 2016–17 (i.e. the last two years of the forecast horizon at that point, and the first two years beyond the period covered by the current spending review) in order to comply with the fiscal mandate. With the forecast horizon likely to be extended to 2017–18 in the Autumn Statement, the fiscal mandate would, formally, allow this pain now to be spread across three years rather than two. This is what is effectively implied by the horizontal axis of Figure 3.3, which shows the *average* annual cut to DEL required over the three years (2015–16 to 2017–18) to meet the fiscal mandate. But if the size of the expected fiscal challenge were unchanged since March, and the Chancellor thought at that point that it was reasonable to complete the repair job by 2016–17, it would seem natural to continue to do so now. Delaying the previously-planned fiscal tightening without good reason might risk reducing confidence among investors in UK government debt that the government was serious about the need to repair the public finances over the longer term. Therefore, under this scenario, the Chancellor might be best advised to continue to plan to deliver all of the fiscal tightening in 2015–16 and 2016–17 and have no need for additional planned fiscal tightening in 2017–18. But, for comparability with our ‘pessimistic’ scenario, it seems natural to compare the size of possible cuts to public services over the three years to 2017–18. However, achieving the same reduction in the structural deficit by 2016–17 as was forecast by the OBR in March would require doing all of the cuts over two years rather than three (which would then allow some scope for spending growth in 2017–18).

Under this scenario, the possible options would include the following:

- *No further DEL cut* – an increase in taxation or a cut to welfare spending of £15 billion would be required if further planned real cuts to resource DELs were to be avoided.
- *No further welfare cuts or tax increases* – not doing any further tax rises or welfare cuts would require a planned cut to resource DELs averaging 1.8% a year over the three-year period from 2015–16 to 2017–18.
- *£10 billion extra welfare cuts* – carrying out additional welfare cuts of the magnitude suggested by Mr Osborne in his March 2012 Budget Speech of £8 billion (in today's terms, equivalent to the £10 billion in 2016–17 terms stated in the speech) would require an average real-terms cut to resource DELs of 0.8% a year over the three years.

Trade-offs under the 'pessimistic' scenario

Under the 'pessimistic' scenario, an additional £23 billion of fiscal tightening would need to be announced for implementation no later than 2017–18. The trade-off between tax rises, welfare cuts and public service cuts is shown by the top (black) line in Figure 3.3. The line is shifted out because, for any given tax rise or welfare cut, a larger cut to public service spending is required in order to bring the deficit down in this scenario than in the 'optimistic' scenario.

Under this scenario, the possible options would include the following:

- *No further DEL cut* – an increase in taxation or a cut to welfare benefit spending of £38 billion (the £15 billion in the first bullet under "Trade-offs under the 'optimistic' scenario" plus the additional £23 billion from the previous paragraph) would be required if further planned real cuts to resource DELs were to be avoided.
- *No further welfare cuts or tax increases* – not doing any further tax rises or welfare cuts would require a planned cut to resource DELs averaging 4.8% a year over the three-year period from 2015–16 to 2017–18.
- *£10 billion extra welfare cuts* – carrying out additional welfare cuts of the magnitude suggested by Mr Osborne in his March 2012 Budget Speech would require an average real-terms cut to resource DELs of 3.7% a year over the three years. A cut of this rate would be somewhat greater than that planned on average for the four years covered by the Spending Review 2010 period (2011–12 to 2014–15), which was also mooted by the Chancellor for the following two years (2015–16 and 2016–17) in his March 2012 Budget Statement: resource DELs are set to be cut over the Spending Review 2010 period on average by 2.3% a year in real terms.

Essentially, under our 'pessimistic' scenario, extending the period of planned real cuts to DELs (which average 2.3% a year) to 2017–18 and announcing a further £11 billion of tax increases or additional welfare cuts (on top of the £8 billion suggested by the Chancellor in March) would be sufficient to fill the extra hole that has opened up in the public finances since the Budget.

4. Conclusions

Developments since March suggest that the outlook for the UK's public finances is weaker now than the OBR forecast at the time of the March 2012 Budget. With the Chancellor's Autumn Statement due to be published on 5 December, this briefing note has examined what the implications of recent developments in economic growth and the performance of tax revenues might imply for the outlook for the UK's public finances and the Chancellor's chances of complying with his self-imposed fiscal targets.

Since March, when the OBR published its latest set of official forecasts, economic growth has turned out to be weaker than it (and many others) expected. The OBR forecast that, over the first nine months of 2012, the UK economy would, on average, be 0.7% higher than the same months of 2011, whereas the latest estimates from the ONS now suggest that it was 0.2% lower.

At the same time, tax receipts have been weaker than the OBR's forecasts suggest for the year as a whole. Over the first seven months of this financial year, they have been just 0.4% higher than over the same period in 2011, compared with the OBR's forecast that they would grow by 3.7% over the year as a whole. If this low growth rate continued for the rest of the year, revenues would undershoot the OBR's forecast by £17 billion. While some relative weakness in tax revenues is to be expected as the economy has grown less strongly than forecast, what we have seen is considerably greater weakness in revenues than would typically be expected from that factor alone. Potentially better news, at least in terms of the government's plan to reduce the deficit, is that central government spending on the delivery and administration of public services has grown less quickly over the first seven months of 2012–13 than implied by the OBR's forecast for the year as a whole.

While weaker economic growth undoubtedly tends to worsen the public finances in the short term, the key issue for the underlying health of the public finances is whether this weaker economic performance reflects weaker trend output or whether it is felt to be temporary. In this briefing note, we have presented two alternative scenarios – one in which all the additional weakness in economic growth and tax revenues is a temporary, cyclical phenomenon (our 'optimistic' scenario) and one in which all of it is assumed to reflect a permanent, structural problem (our 'pessimistic' scenario).

Under both these scenarios, headline borrowing would be higher for each of the next five years than forecast by the OBR in March. This would be sufficient to imply debt rising as a share of national income until 2015–16. In other words, both these scenarios would suggest the Chancellor would be on course to miss his supplementary target (that debt should fall as a share of national income between 2014–15 and 2015–16). However, in terms of the economics of managing the public finances, the supplementary target has little to commend it. Therefore, whether the OBR's forecasts in December suggest he is on course to meet or miss this rule, the Chancellor would likely be best advised to abandon it and consult on replacing it with something that better ensures long-run sustainability.

Under our 'optimistic' scenario, although headline borrowing is forecast to be higher in each of the next five years than the OBR forecast in March, most of this is cyclical rather than an increase in the structural deficit. Therefore, the Chancellor would still be on course to have a surplus on the structural current budget of 0.5% of national income by 2016–17 (rising to 0.6% of national income in 2017–18) and so would still meet his fiscal mandate, which requires that the structural current budget be forecast to be in balance or surplus by the end of the rolling five-year forecast horizon.

But under this 'optimistic' scenario, the squeeze on spending already pencilled in by the Chancellor would still require difficult decisions to be made about how to cut overall spending beyond 2014–15, which is the end of the current spending review period. For example, were the Chancellor to implement additional welfare cuts of the magnitude he suggested in his March 2012 Budget Speech (£8 billion in today's terms, or £10 billion in 2016–17 terms, which is the figure he used in the speech), he would still need an average real-terms cut to resource DELs of 0.8% a year over the three years 2015–16, 2016–17 and 2017–18 to keep to his spending plans and comply with his fiscal mandate.

Under our 'pessimistic' scenario, most of the additional short-term borrowing would be structural. As a result, an additional £23 billion of tax increases or spending cuts would need to be announced on top of those planned in the March 2012 Budget, to come in no later than 2017–18, if the Chancellor wished to continue to meet his fiscal mandate. Under this outlook, even if the Chancellor extended to 2017–18 the same average squeeze on public service spending that is currently planned for the Spending Review 2010 period, and implemented the £8 billion of welfare cuts mooted in his March Budget Speech, he would still need to plan for a further £11 billion of tax increases or welfare cuts in order to comply with his fiscal mandate.

Appendix

Table A.1. Medium-term outlook for the public finances (£ billion)

	11–12	**12–13**	**13–14**	**14–15**	**15–16**	**16–17**	**17–18**
OBR March 2012							
Current receipts	570.4	591.5	622.5	658.4	692.0	735.3	n/a
Current spending	668.5	687	697	710	722	735	n/a
Public sector net investment	27.8	–3	23	23	22	22	n/a
Current budget surplus	–98	–95	–74	–52	–30	1	n/a
Public sector net borrowing	126	92	98	75	52	21	n/a
Public sector net debt	1,039	1,159	1,272	1,365	1,437	1,479	n/a
'Pessimistic'							
Current receipts	569.3	574.1	599.5	629.7	658.0	699.0	740.2
Current spending	664.2	682.2	696.4	710.9	724.2	736.7	771.0
Public sector net investment	26.7	–3.0	23.0	23.0	22.0	22.0	23.1
Current budget surplus	–94.9	–108.0	–96.9	–81.2	–66.3	–37.7	–30.8
Public sector net borrowing	121.6	105.0	119.9	104.2	88.2	59.7	54.0
Public sector net debt	1,025	1,172	1,307	1,429	1,537	1,618	1,672
'Optimistic'							
Current receipts	569.3	574.1	613.4	644.3	673.3	715.3	757.3
Current spending	664.2	682.2	696.4	710.9	724.2	736.7	771.1
Public sector net investment	26.7	–3.0	23.0	23.0	22.0	22.0	23.1
Current budget surplus	–94.9	–108.0	–83.0	–66.6	–50.9	–21.5	–13.8
Public sector net borrowing	121.6	105.0	106.0	89.6	72.9	43.5	36.9
Public sector net debt	1,025	1,172	1,293	1,401	1,493	1,558	1,595

Sources: As Table 2.3.