

Government tax, spending and debt – a decade on from the financial crisis

Carl Emmerson

Presentation to A level students, London, 26 November 2018

<http://www.ifs.org.uk/>

<http://twitter.com/TheIFS>

What happened?

Financial crisis hits in 2008

- *UK enters a large recession*
- *Economy more than 6% smaller in 2009 Q2 than 2008 Q1*

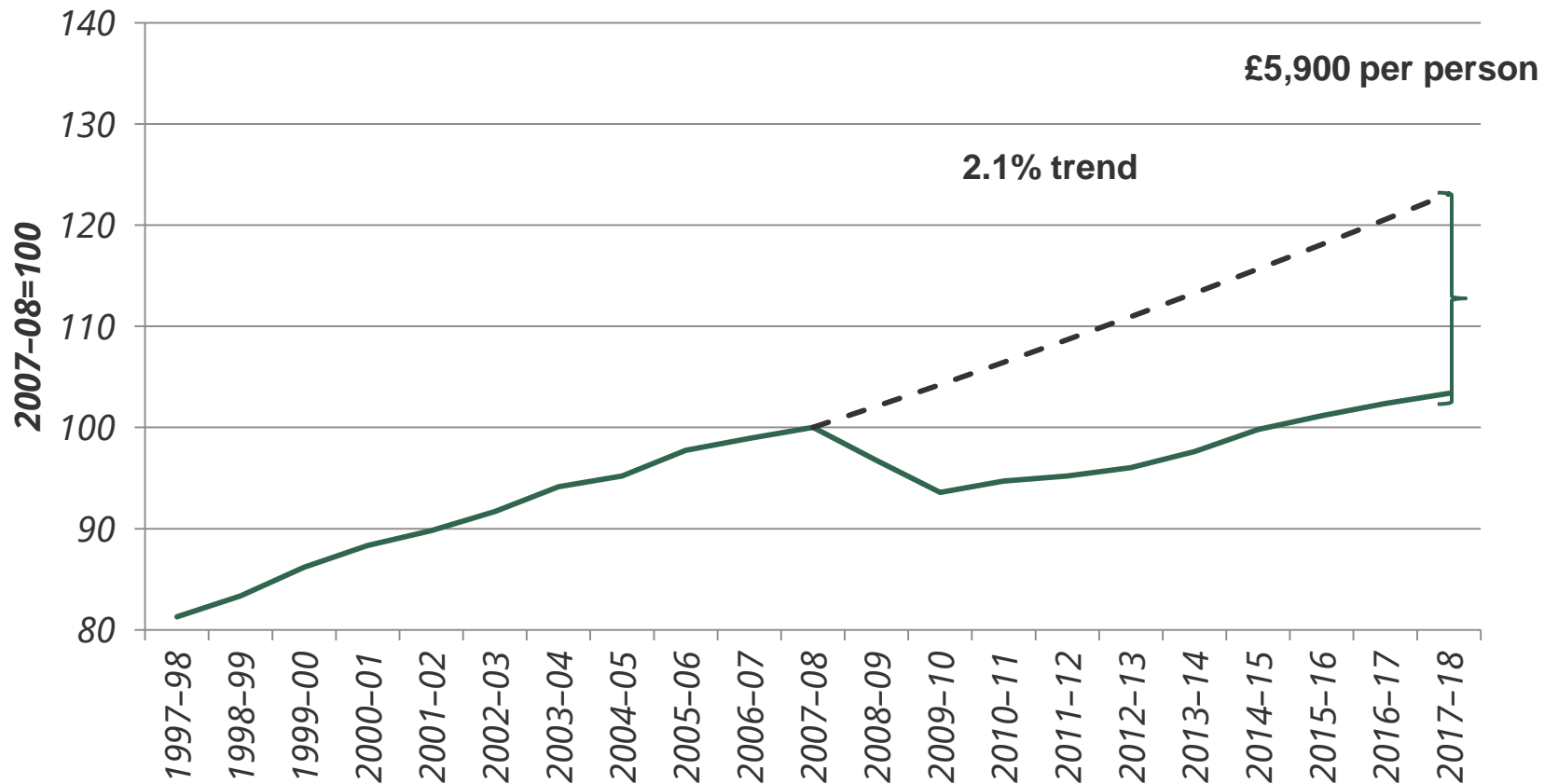
Leads to much higher borrowing

Why?

- *In cash terms, receipts lower but spending hardly affected*
- *As a share of national income – not much change to tax but spending much higher*
- *Government set out spending plans when it expected the economy to be bigger than it was*
- *So we ended up with a larger state than we could afford given our tax burden*

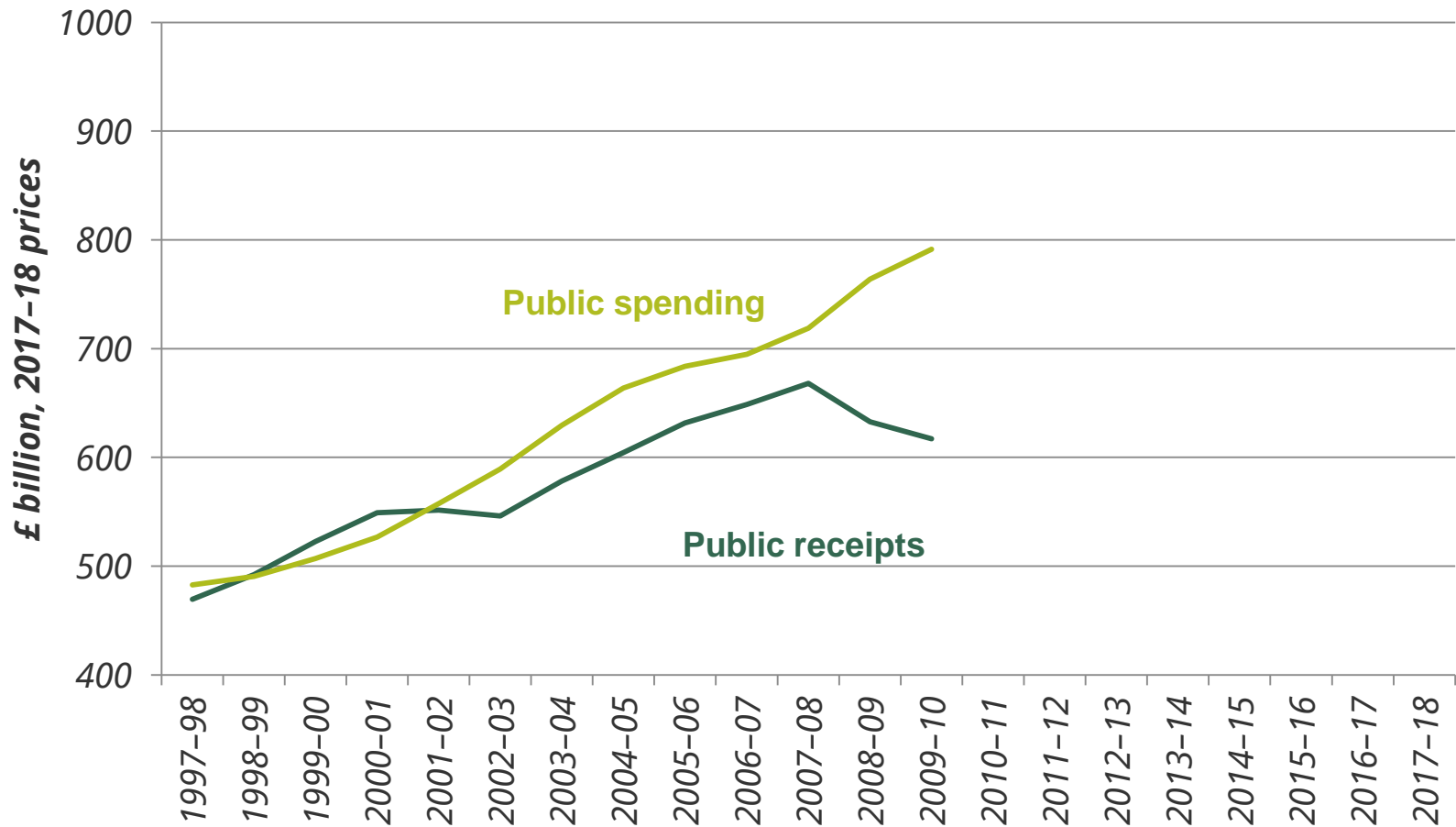
GDP per capita hardly above where it was a decade ago

GDP per capita: Latest forecasts and pre-2008 trend



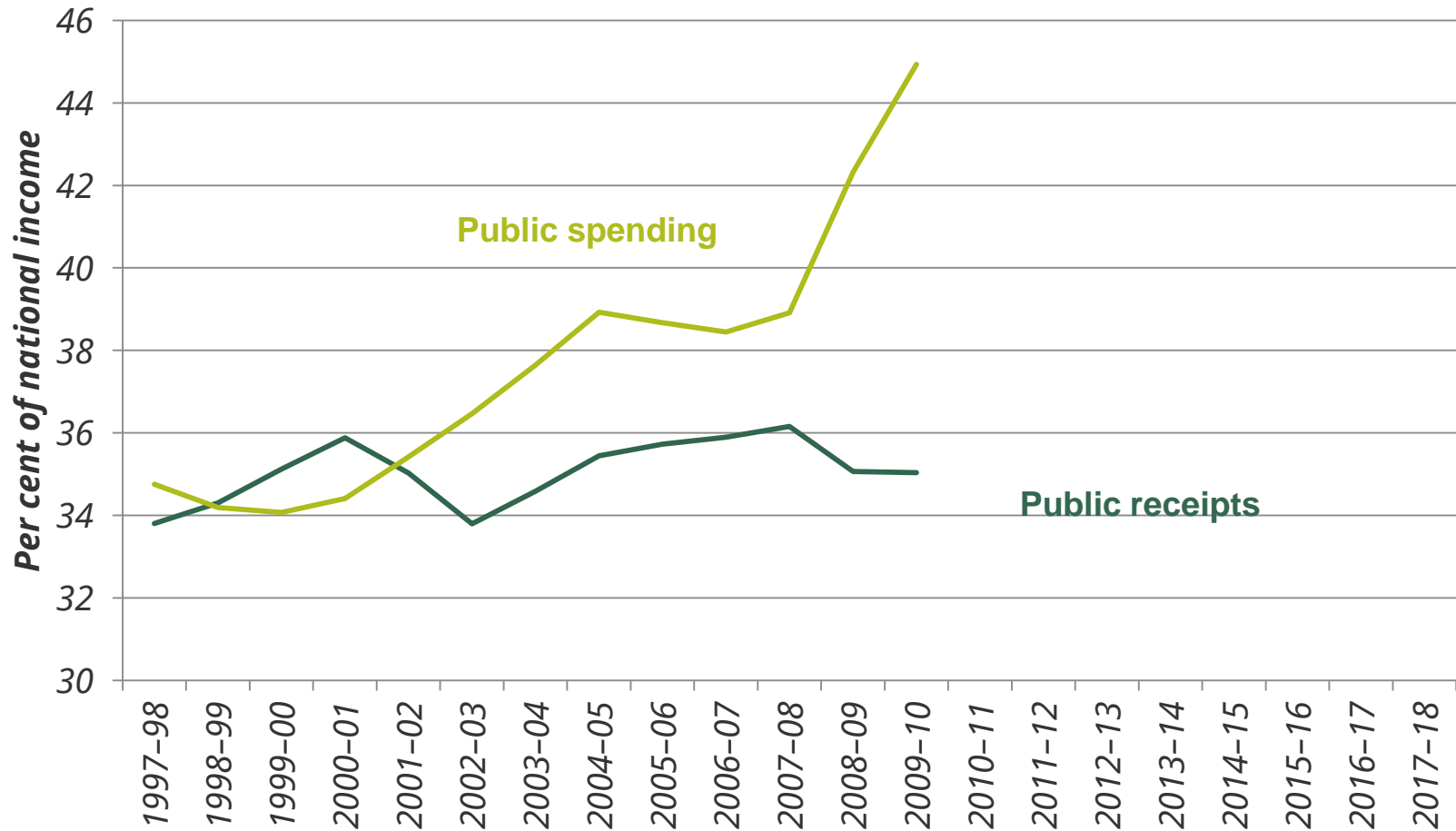
Source: Office for Budget Responsibility *Economic and Fiscal Outlook* and *Public finances databank*

Lower GDP means lower tax receipts



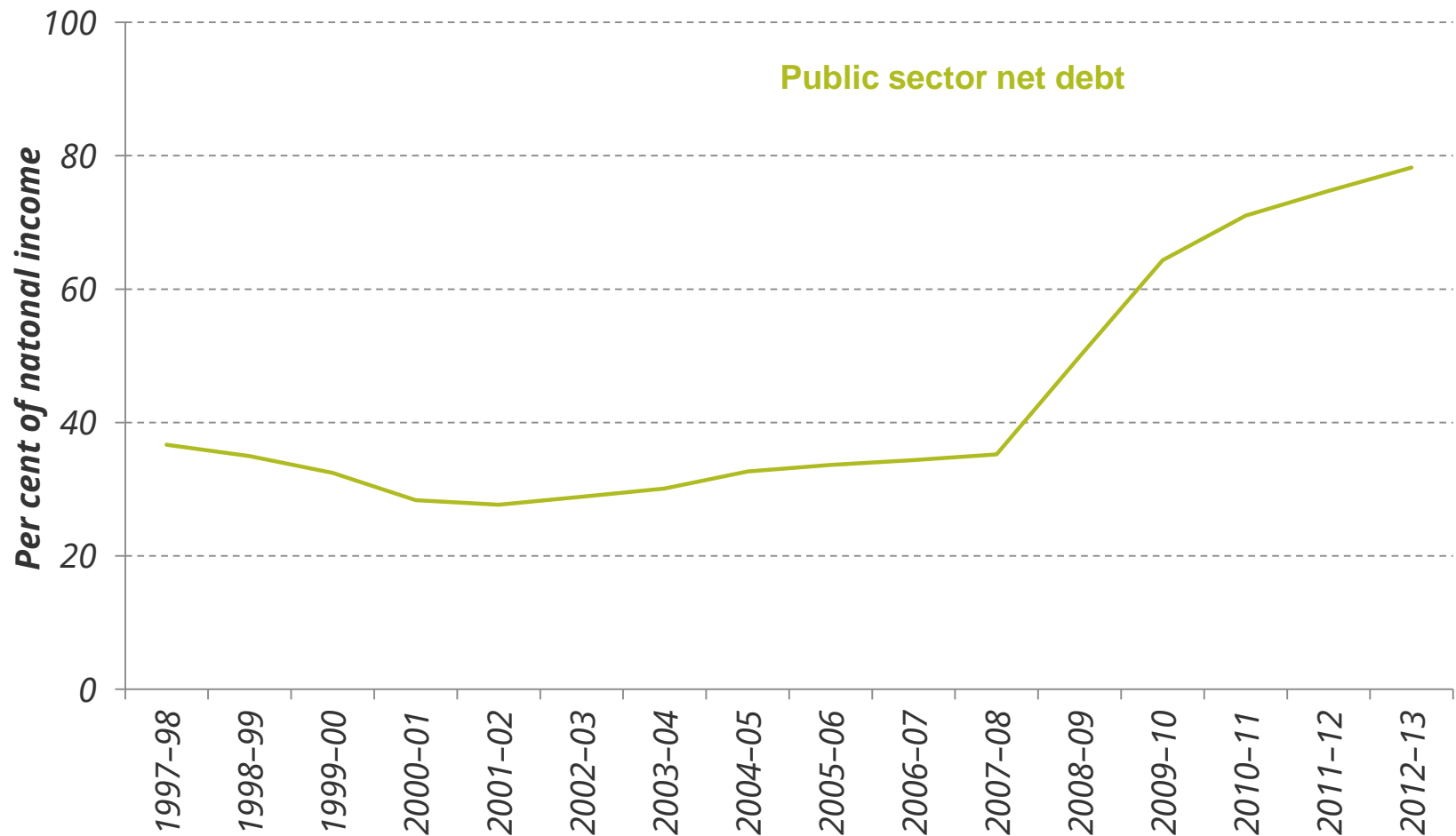
Source: Office for Budget Responsibility *Public finances databank*

Spending exploded as a share of national income



Source: Office for Budget Responsibility *Public finances databank*

High deficits led to debt increasing as a share of national income



Notes and Sources: See Figure 3.6 of the IFS Green Budget

Why might this be a problem?

Main cost of higher borrowing is higher debt

Nothing wrong with a positive level of debt per se

But if the debt level becomes too high, investors may lose confidence

- *Could mean higher interest rates*
- *Or a very bad (though unlikely) outcome would be that the government couldn't borrow at all*

Much debate about what 'too high' means

- *Though a 10% of GDP deficit is clearly unsustainable*

Intergenerational equity issues too

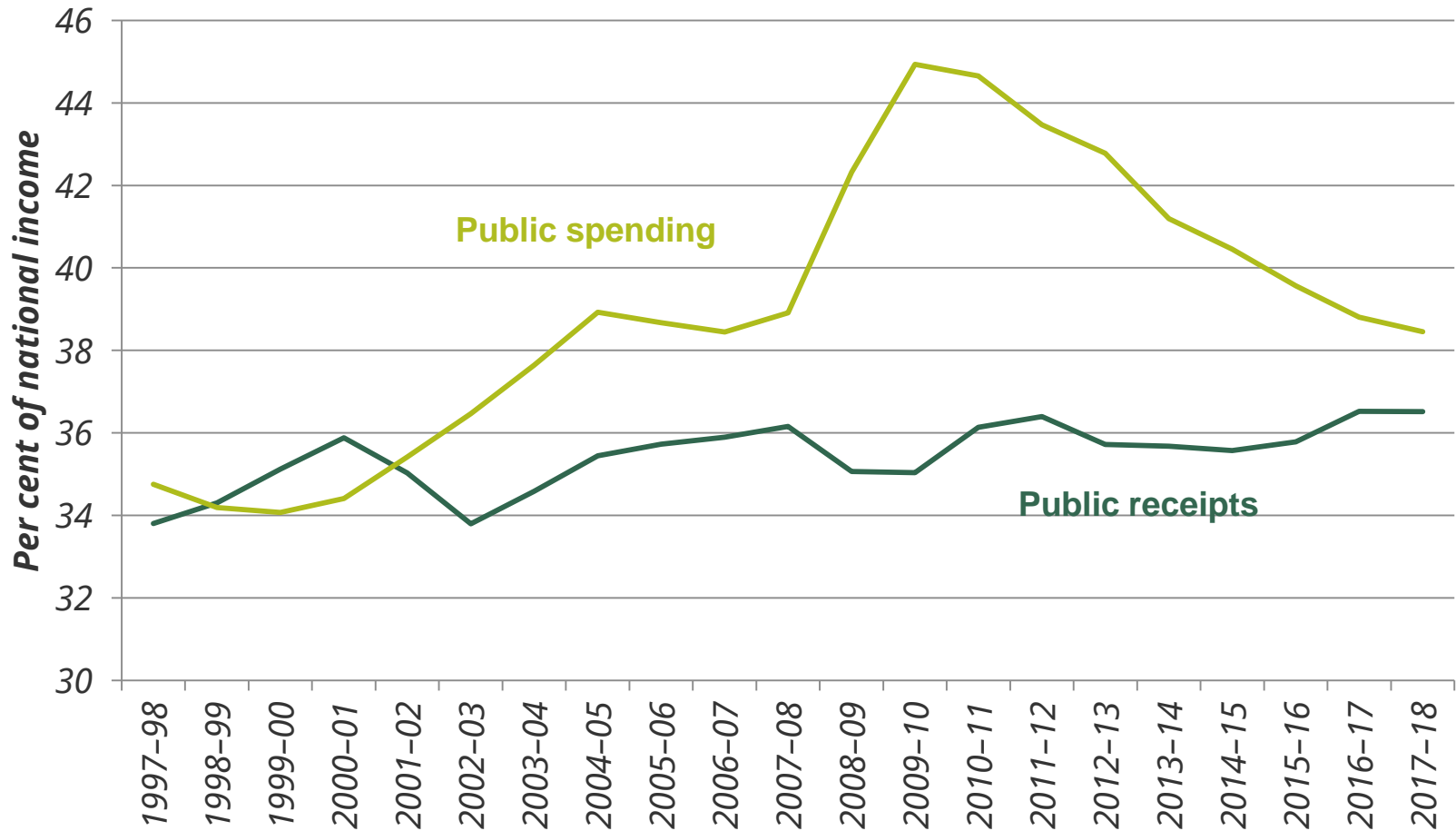
Fiscal consolidation since 2010

Substantial effort to reduce the deficit since 2010

Government always has choices and can choose priorities

- Between taxing more or spending less*
- Which taxes, and whose taxes, to increase*
- Whether to protect some areas of spending*

Achieved largely through a substantial spending squeeze



Source: Office for Budget Responsibility *Public finances databank*

A net tax rise since 2010

A combination of big tax cuts and bigger tax rises

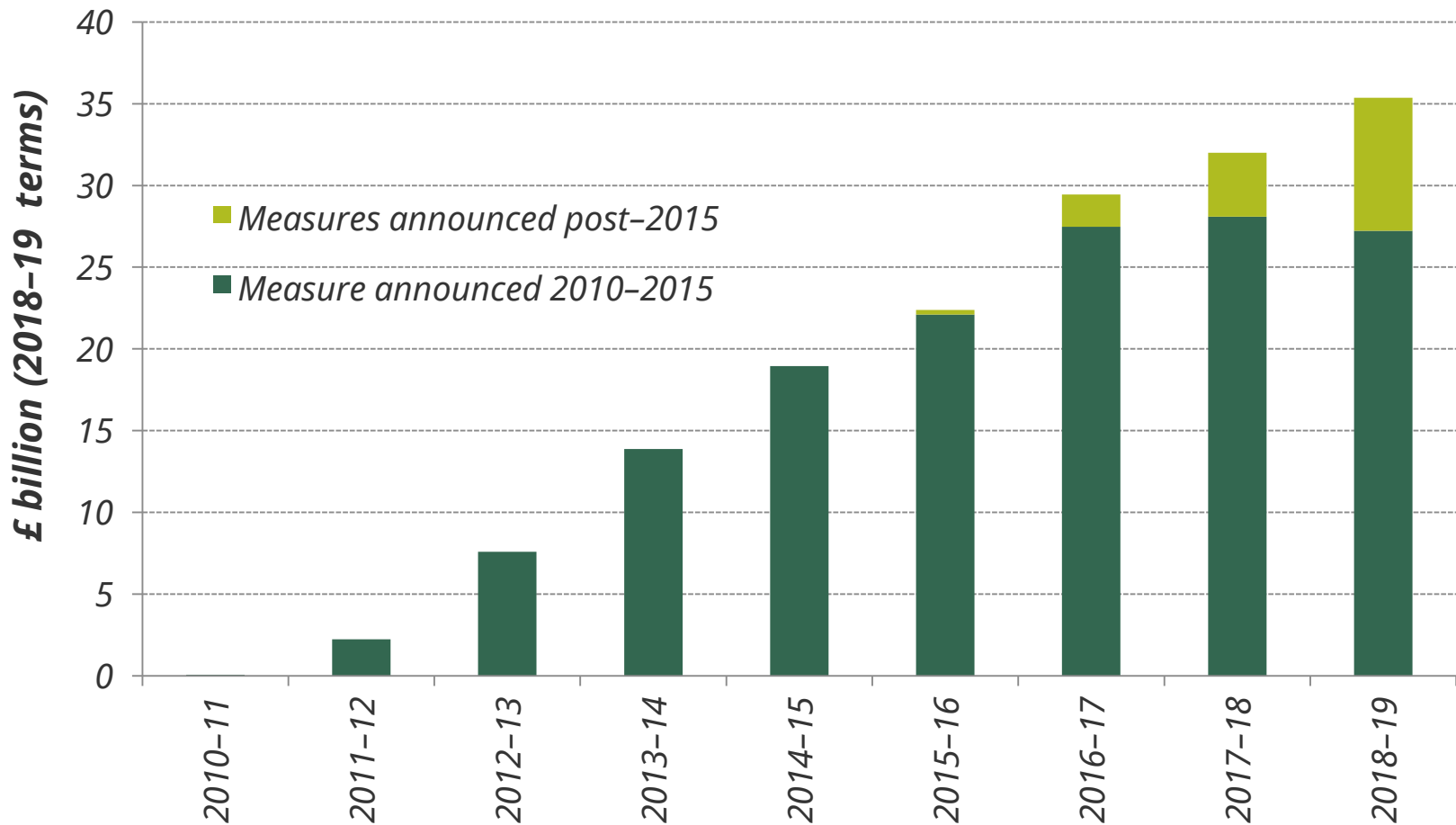
Biggest tax cuts:

- Above inflation increases in the personal allowance (~£25bn)*
- Fuel duties (since 2010, ~£9bn)*
- Main rate of corporation tax cut from 28% to 19% (~£17bn)*

Biggest tax rises

- Increase in VAT rate from 17½% to 20% (~£15bn)*
- Restrictions to pension tax relief (~£7bn)*
- End of contracting out (~£5½bn)*
- ‘Avoidance and evasion’ (~£10bn)*

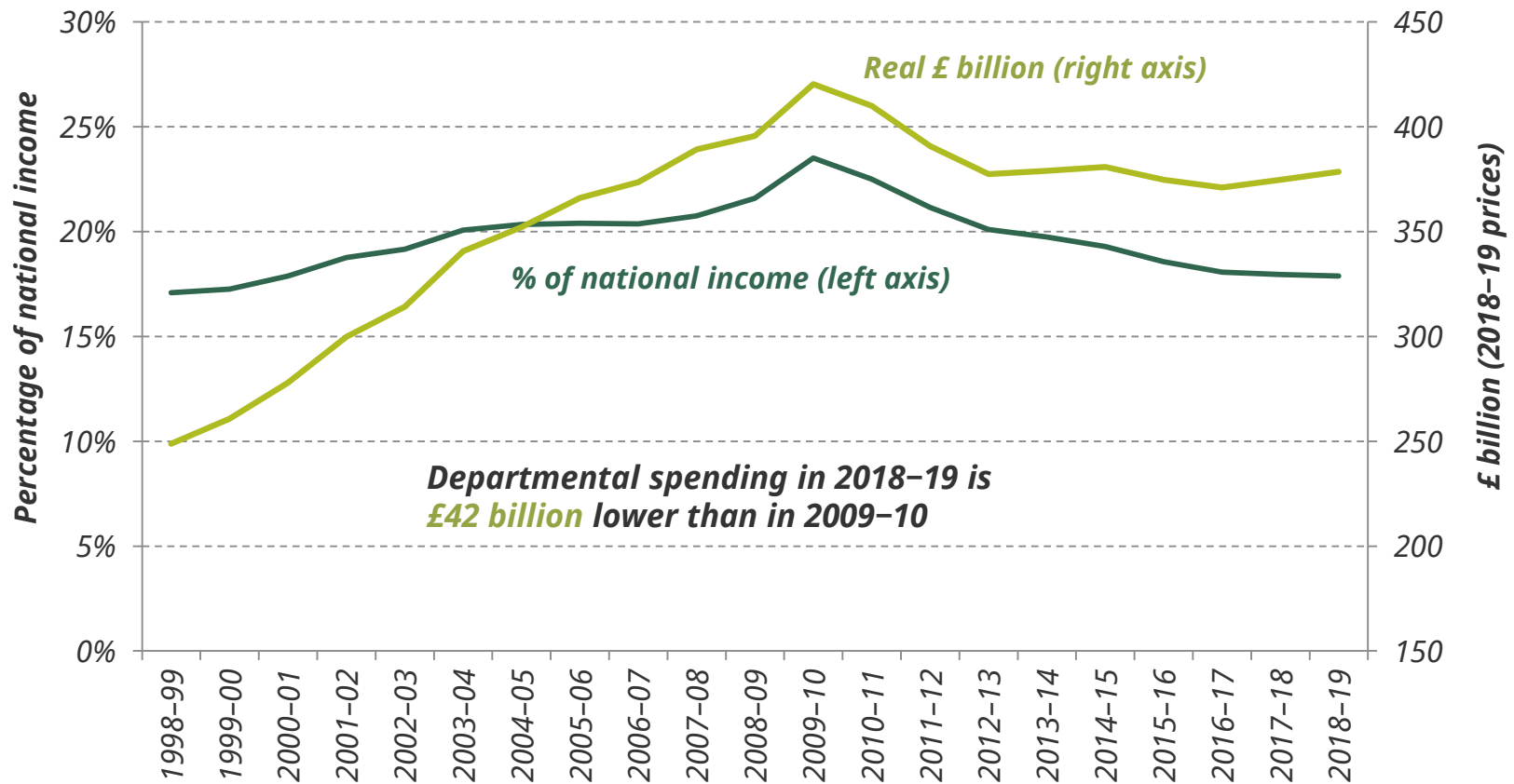
Substantial cuts to working age social security



Source: Authors' calculations using OBR *Historical Measures Database*

Large cuts to departmental spending

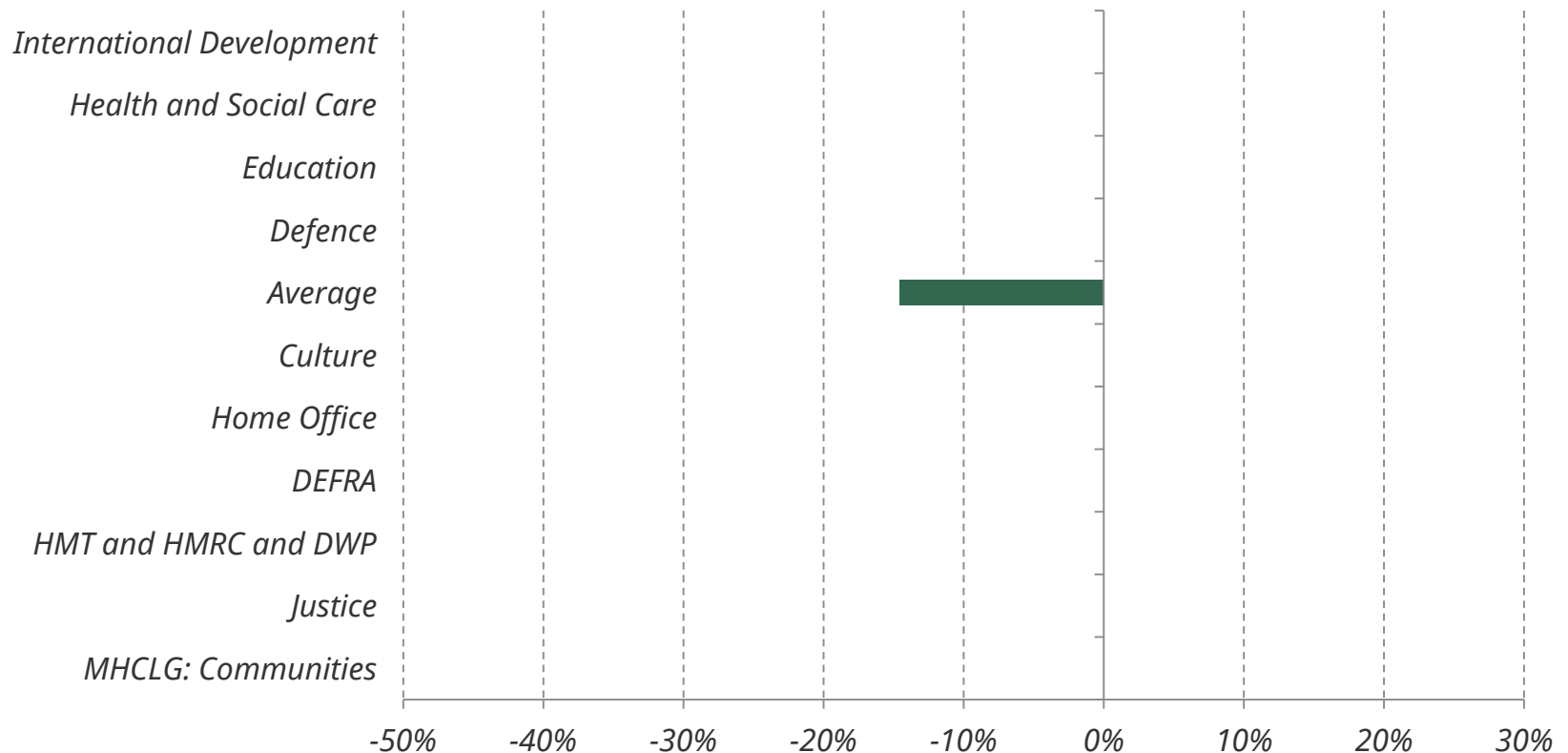
Total departmental expenditure limits



Notes and sources: See Figure 4.5 of the Green Budget

Cuts to day-to-day spending since 2010

Real terms departmental resource budget changes, 2010–11 to 2019–20

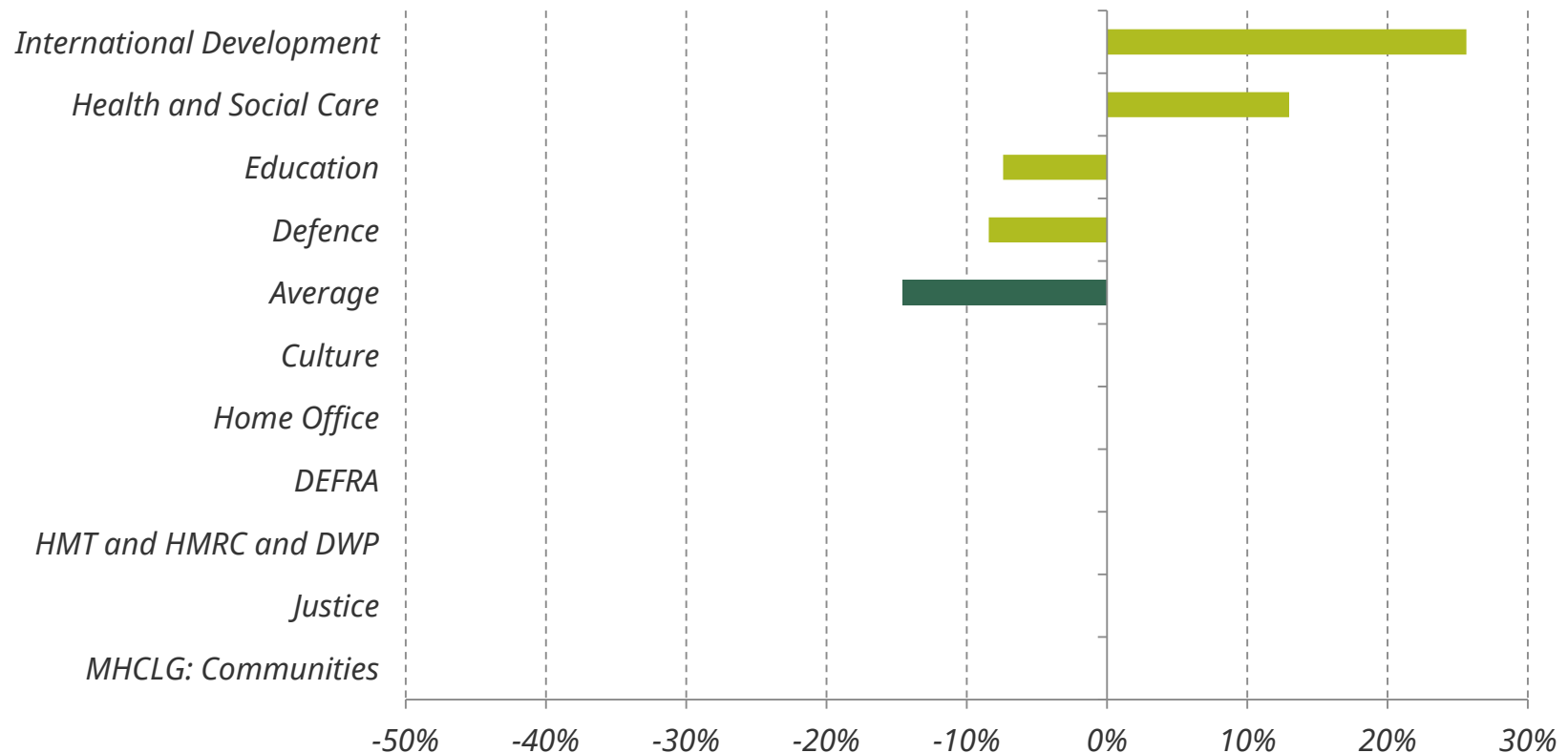


- Overall spending by English councils fell by 19% between 2009–10 and 2017–18

Notes and sources: See Figure 4.10 of the Green Budget

Cuts to day-to-day spending since 2010

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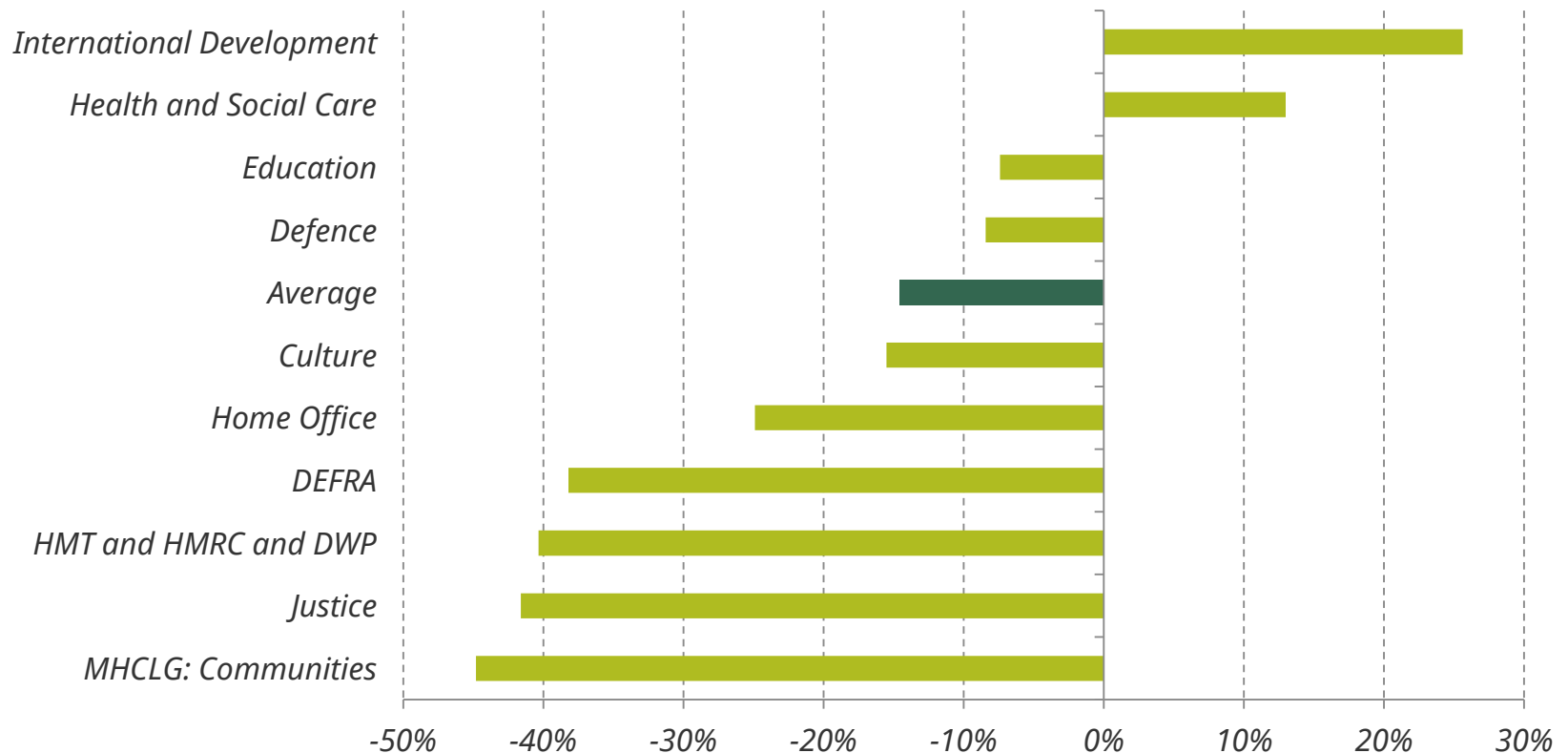


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Cuts to day-to-day spending since 2010

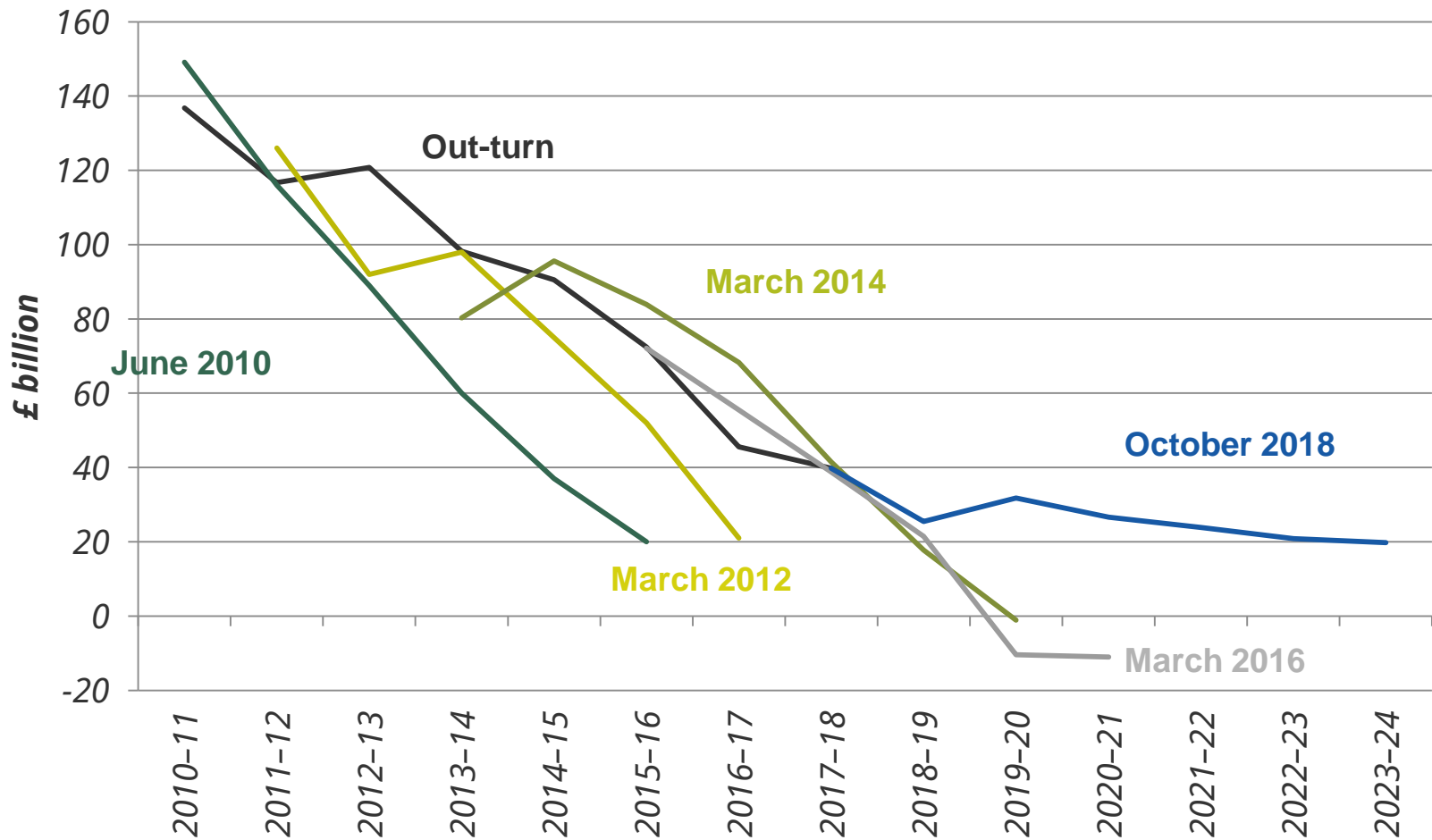
Real terms departmental resource budget changes, 2010–11 to 2019–20



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Notes and sources: See Figure 4.10 of the Green Budget

Successive forecasts for the deficit



What should the government do now?

Deficit back to pre-crisis levels

But debt is still much higher

- As a result of the very large deficits run since 2008*

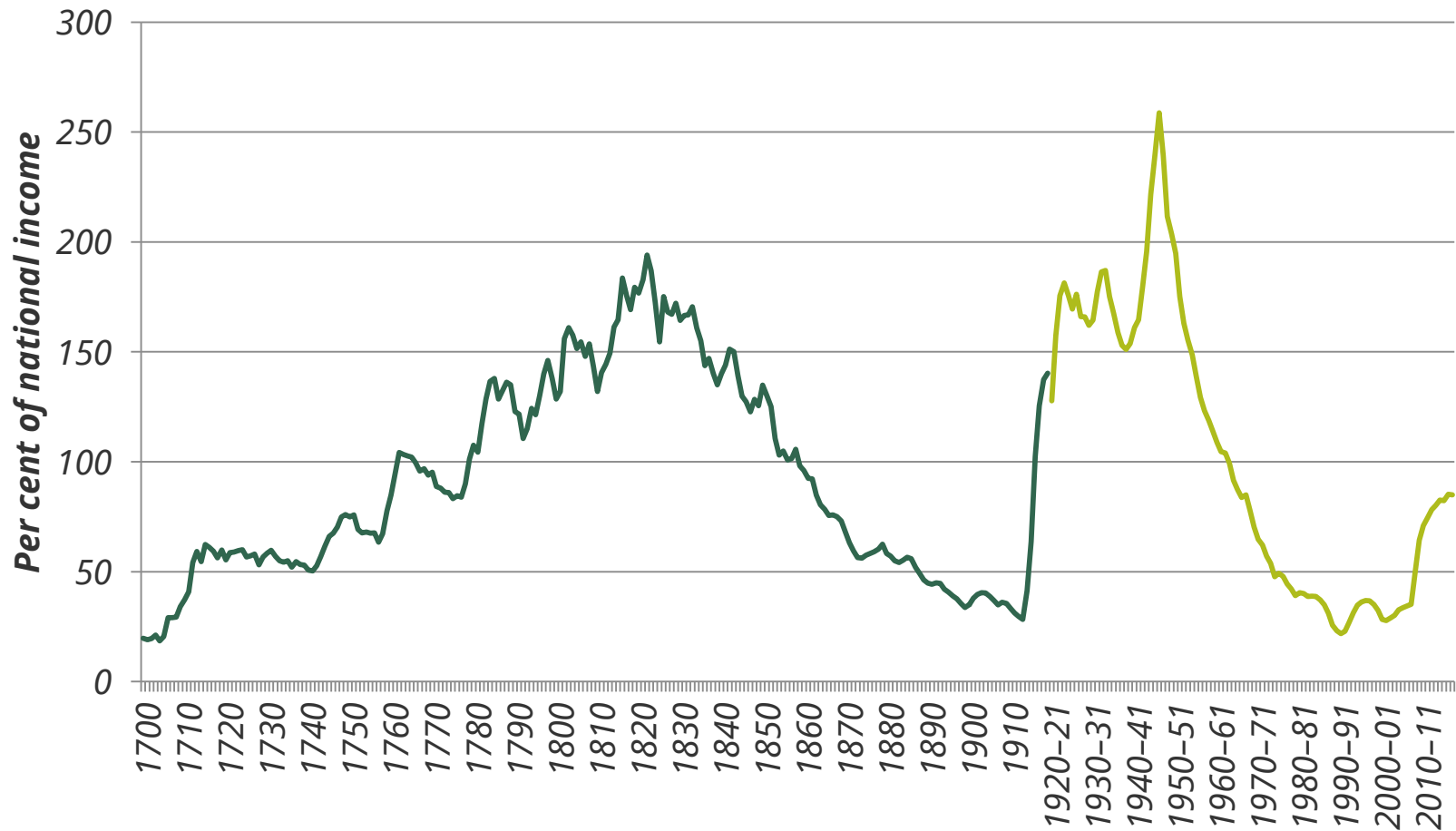
Government has a target to ‘eliminate the deficit entirely by the mid-2020s’

- Is this necessary?*

Debt would hardly fall as %GDP with deficit at current level

But we have had debt at higher levels before...

Is debt too high?



Source: Bank of England *Millenium of Macroeconomic Data* and OBR *Public finances databank*

An ageing population – the longer-run challenge

People are living longer

- *This is good news!*

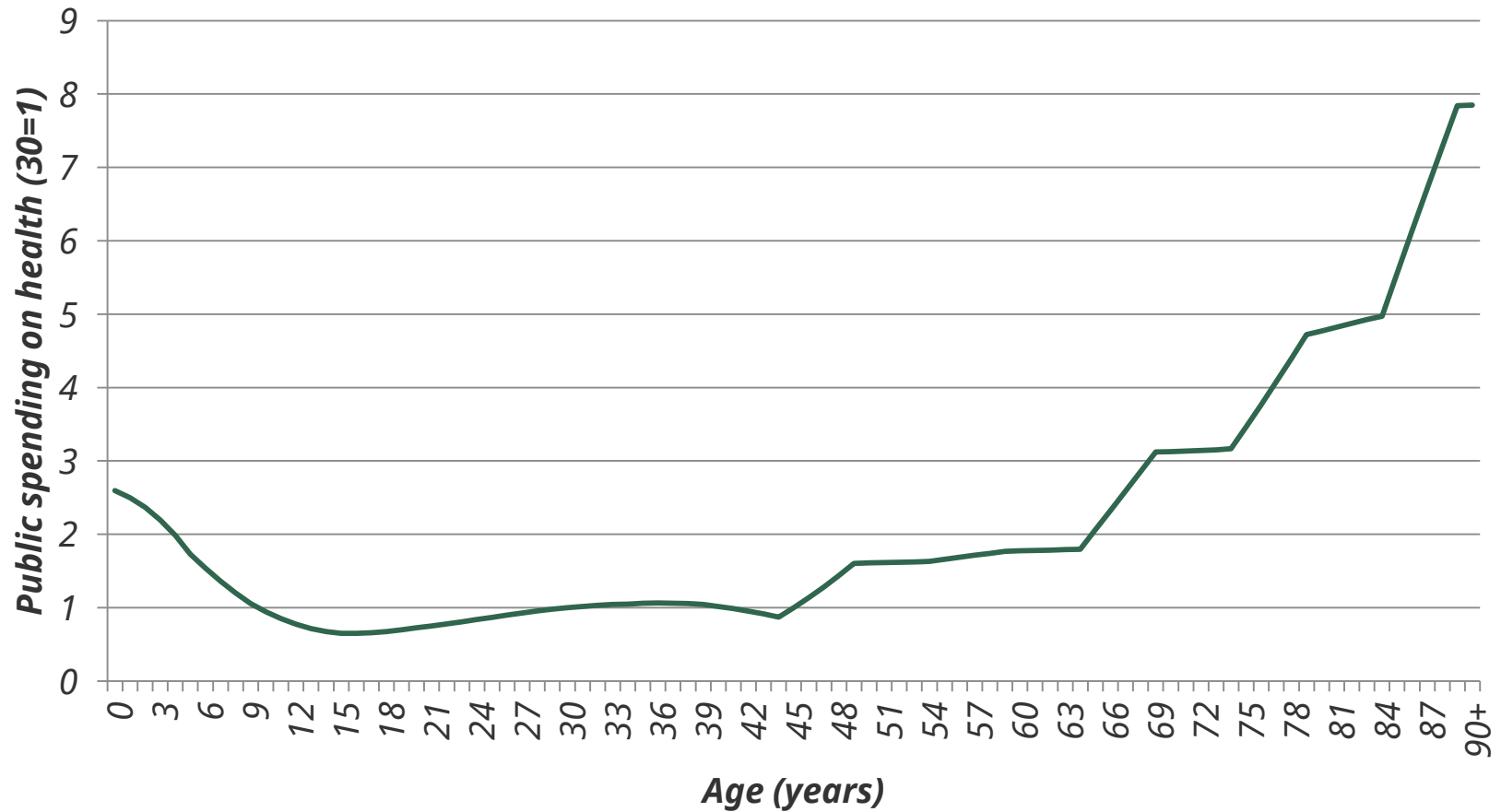
But it poses challenges for the public finances

- *Older people are expensive – they use more health care and receive pensions*

These trends have been going on for a while

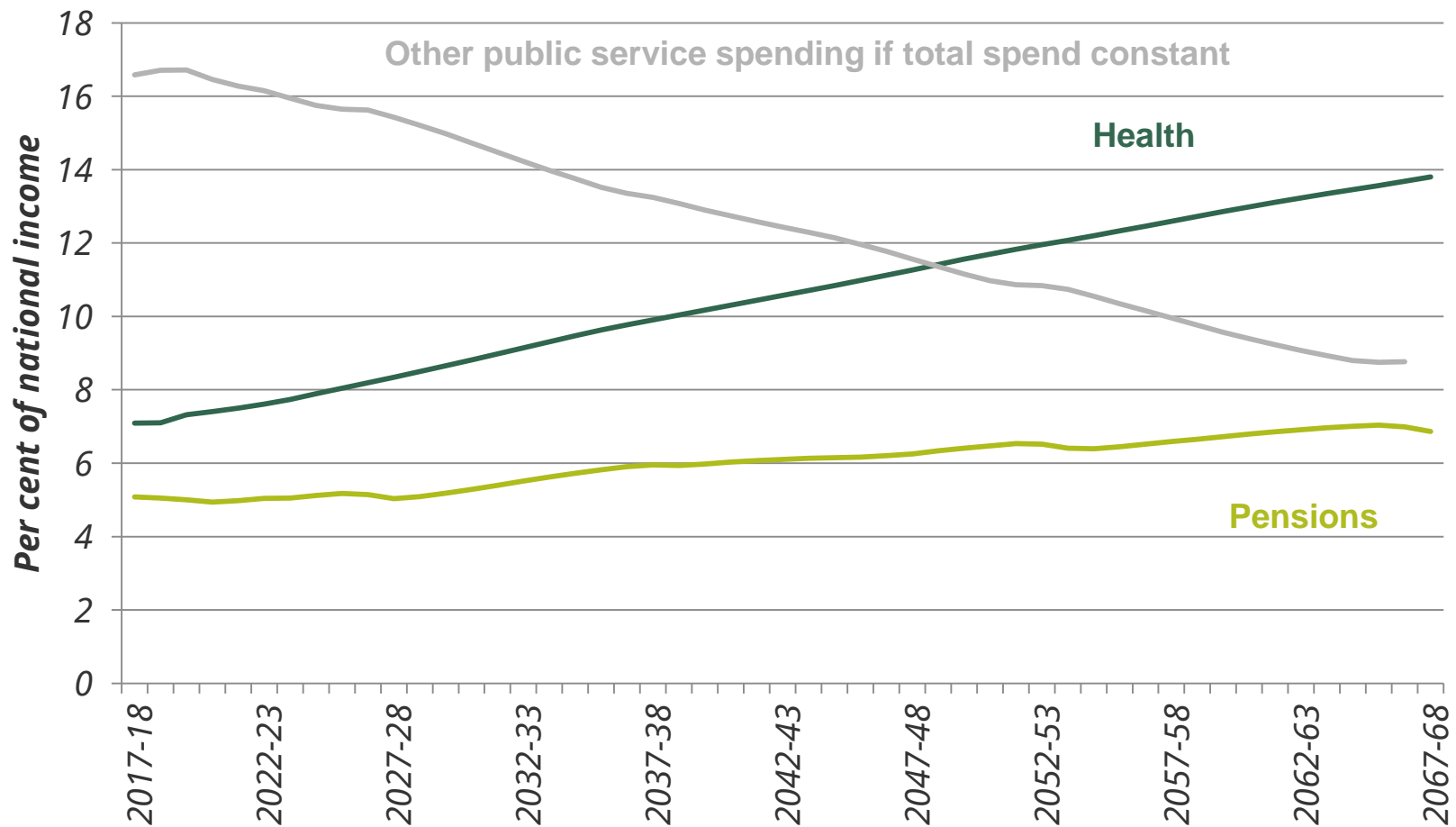
- *But options for cutting other spending more limited now*

Older people use more healthcare



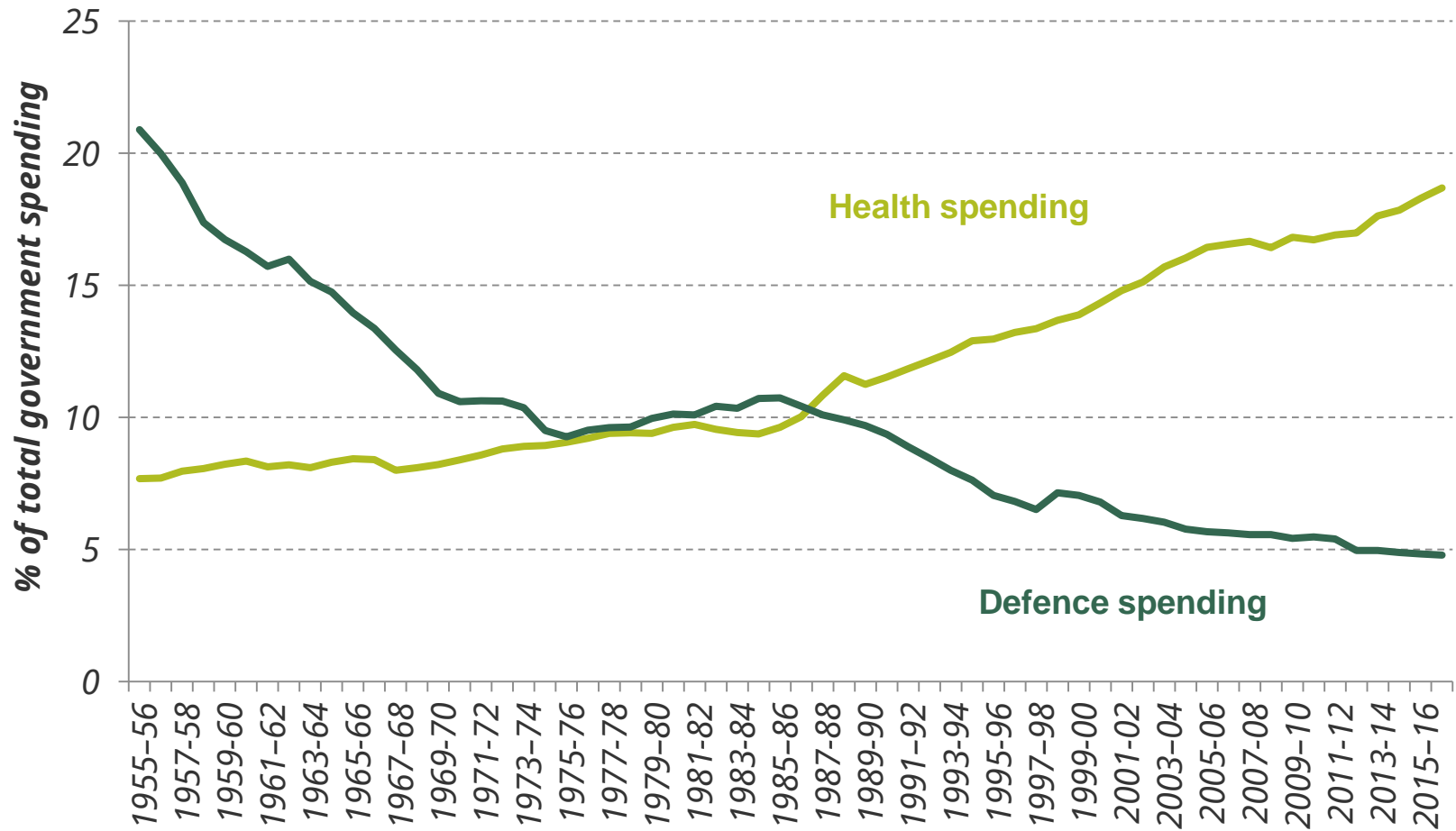
Source: UK Health and Social Care Spending, *IFS Publication 2018*

Projected cost of meeting demand for Health and Pensions over next 50 years



Source: Office for Budget Responsibility *Fiscal Sustainability Report*, July 2018 and author's calculations

Defence and health moving in opposite directions Institute for Fiscal Studies



Source: 'Securing the future: future health and social care to the 2030s'

No easy choices

Big demands for higher spending

Could choose not to meet these demands, or cut spending elsewhere

In long-run, higher borrowing not an option

So maybe higher taxes

- Need an honest conversation about which taxes and who should pay*
- Likely means most people paying at least a bit more*

Conclusions

Government budgeting involves trading off higher spending, lower taxes and higher debt

- *Spending more than government receives is the norm*
- *Main cost of higher deficits is higher debt*
- *Possible cost of higher debt is future adverse event*

The financial crisis caused a big hole in the public finances

- *Increase in spending as %GDP, mostly reduced through spending restraint*
- *More painful than expected due to weak growth*

Big public finance challenge on the horizon

- *Pressures from an ageing population call for a serious public debate about possible tax rises*

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